THE STOCK TRADING HANDBOOK
Fundamental and Technical Analysis Combined

- How The Market Works
- The Importance of Market Psychology
- Money & Risk Management
- Fundamental Analysis Explained
- The Roles of Technical Analysis
- Profitable Trading Strategies that Really Work
- Putting it all Together

From the co-author of the Investing & Online Trading stock market newsletter
**Acknowledgements:** The author would like to thank Paritech and Justdata for their permission to reproduce selected screenshots. Also a special thanks to Louise Bedford, Zdenko Simonic, Dr Brett Steenbarger, John Atkinson and Tim Wilcox for their contributions.

First Published 2002 by Wrightbooks as ‘The Share Trader’s Handbook’.


This is an updated version of the first publication.

**Disclaimer**

Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or ‘buy’ or sell recommendations are not provided.

This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action.

The decision to trade and the method of trading is for the reader alone to decide. Any losses that are incurred are the sole responsibility of each trader and investor. The authors of this ebook, Avestra Capital Pty Ltd (“Avestra”) AFSL 309743, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra, disclaim all liability of the authors, Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of the authors, Avestra, STE or its Associates or otherwise.

All reasonable steps and due diligence have been taken in preparing this ebook. However, it may contain ideas and reference to trading instruments that are not appropriate to you or your style of investing or trading. So it is up to you to do your own research and draw your own conclusions. By itself, this document will not enhance your investing or trading performance, nor will it prevent you from incurring losses.

Please also refer to the disclaimer at the back of this ebook and our [Terms of Use](#).

**Copyright**

The information contained in this publication is copyright © and for the sole use of readers who have purchased it or who have received it as part of their seminar registration. All rights reserved. No part of this publication may be reproduced, copied or circulated to other readers.

*Each issue incorporates fingerprint protection that enables us to track the original source of pirate copies. Offenders may be prosecuted.*
CONTENTS

Foreword by Louise Bedford 4

Introduction 5

Chapter 1 How the Market Works 8

Chapter 2 Taxation, Financial Planning & Choosing a Broker 23

Chapter 3 Market Psychology 43

Chapter 4 Fundamental Analysis 68

Chapter 5 Technical Analysis – Charting 75

Chapter 6 Technical Analysis – Indicators 97

Chapter 7 Money Management, Exits and Position Sizing 114

Chapter 8 Profitable Trading Strategies that Really Work 134

Epilogue 166

Bibliography 168

Glossary 168

Jim Berg’s Trading Tools 169

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Foreword

When I initially started speaking on the share market lecture circuit, I kept hearing about a man called Jim Berg. In this surprisingly small industry, when a true professional cements his presence, it doesn't take long for the word to travel. All that I ever heard in relation to Jim was positive.

I decided to investigate. As I found out, Jim Berg is a former broker, private trader and lecturer with over 20 years experience in the investment industry. Jim has appeared on CNBC Asia and Market Wrap and has been a guest speaker at the Australian Stock Exchange, the Sydney Futures Exchange and the Australian Technical Analysts Association. After hearing all of these rave reports, I finally met the man and we immediately developed a good friendship.

Jim’s obvious credentials complement his passion for training. Not only does he have the knowledge about how to trade effectively, but Jim also has the rare gift of being able to impart trading concepts in ways that have helped both novice and experienced traders alike. Jim was a schoolteacher for eight years before embarking on his career in the stock market, and it is clear that his teaching qualification and former experience have stood him in good stead.

Jim combines the fields of fundamental and technical analysis. This method is growing in popularity as a result of several market events, including the tech wreck and high-profile liquidations such as that of HIH. Using tools and trading strategies demonstrated in his investment workshops and seminars, Jim recently returned an annualized 27.5% in five months of trading in the Personal Investor Sharetrader’s Showdown for 2001. This was in the uncertain market conditions that eventuated in the All Ords only gaining 6% in the same year. This is just one piece of evidence that Jim’s methods are effective.

The Stock Trading Handbook is a comprehensive, practical guide inspired by Jim’s years of experience. If you are after a no-nonsense easy-to-follow, direct book that will help you get started trading the markets by combining fundamental and technical analysis, then this is the book for you.

Louise Bedford
www.tradingscrets.com.au

Louise Bedford is the author of the bestselling books Trading Secrets, The Secret of Candlestick Charting, The Secret of Writing Options and Charting Secrets
Introduction

The Penguin English Dictionary describes a handbook as a guide-book. The Stock Trading Handbook will guide the beginning trader through the difficult process of applying indicators in a trading system that combines fundamental and technical analysis. This is a manual disguised as a book. It contains information on trading and important related issues that could affect investment decisions.

The aim of this handbook is to help those inexperienced at trading shares to understand the share market and take the first steps to investing successfully. There is a vast amount of information available on markets and investing.

To put all this information in one book would intimidate by its volume. There are entire books written on many of the topics presented in these pages. The beginning trader can use this book as a starting point to learn the basic investment concepts and explore each in greater depth when it is more appropriate and convenient.

This ebook is not just for beginners. For experienced readers, more advanced topics, are covered, with the intention of helping traders improve their performance in the market.

An investor can buy and sell shares over a short-, medium or long-term timeframe. The process of buying and selling shares is called trading. Every investor is thus a trader, to an extent. A narrower definition of a trader would be someone who buys and sells shares on a frequent basis for capital gains rather than infrequently for income.

For the purposes of this book, the words ‘investor’ and ‘trader’ are used interchangeably. Equally, while we discuss ‘shares’ and share market’ , most of the principles in this ebook can be applied to ‘stocks’ and ‘stock markets’ around the world - so these words can also be interchanged.

In this ebook, and our weekly newsletter, we stress the importance of psychology, money and risk management, as well as providing profitable trading strategies which use both technical and fundamental analysis combined. By mastering these, investors and traders increase their chances of long term survival and profitability in the market.

Some investors rely on a company’s fundamental performance to make their investment decisions. Other traders ignore fundamental analysis and rely completely on charting and technical indicators. Technical analysts reason that everything worth knowing about a company is reflected in the current price action.

My trading strategy combines fundamental and technical analysis as weight-of-evidence to improve the probability of success in the market.

Chapter 1 contains a brief explanation of why the share market exists and how it works. Market influences and several different styles of investing are also examined.

Chapter 2 provides information on taxation in relation to share trading, financial planning, DIY Super Funds and the difficult decision of whether to trade online or with a full service broker. We also discuss the benefits of using a broker assisted conditional ordering facility.

Chapter 3 focuses on investor psychology and will help beginning traders understand how an individual’s personality and beliefs can sabotage their trading.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise: Refer also to our Terms of Use.
Many professional traders believe psychology and risk management are the most important elements to successful trading.

Chapter 4 provides some of the key fundamental criteria which are important for fundamental analysis.

Chapters 5 and 6 examine many of the specific technical analysis tools for investing - these are later grouped together in an example of a trading system in Chapter 8.

Chapter 7 concentrates on the vitally important areas of money and risk management including:
- Stop loss and profit taking exits
- Position sizing
- Developing a trading plan
- Planning and managing your portfolio
- Accurate record keeping

A thorough understanding of these concepts is often the difference between success and failure.

Chapter 8 pulls it all together by demonstrating profitable trading strategies that really work. Many authors will describe the tools and provide readers with the knowledge to use those tools but will fail to show the process of combining indicators and developing a trading system.

In contrast, this chapter is a step by step guide to investing, using a common sense and proven trading system that combines fundamental and technical analysis.

One of the easiest ways to develop a trading strategy is to “borrow” a system from another trader. The borrowed system is used as a base to test and eventually build a trading strategy that suits the investor’s personality and trading philosophy. It is extremely important that the investor feels confident their trading system suits them and believe their investment strategies will make money.

The trading system outlined in Chapter 8 may be adapted for either long-term or shorter-term timeframes. It provides practical examples of the process of combining indicators to create a trading system that really works. Many of the investors attending my seminars over the past three years have borrowed this system as the basis for creating their own successful system.

An extensive Glossary of Terms has been produced to aid beginning traders in the challenging task of becoming familiar with new vocabulary and terminology. Such a comprehensive Glossary is a valuable reference tool that can be used when attending seminars, watching or listening to financial programs and reading financial market material.

This Glossary of over 20 pages may be downloaded with our compliments. Simply log in at our Free Downloads section at www.ShareTradingEducation.com or Click Here

For some investors, share trading can be a positive intellectual, financial and emotional experience. For many others it can be terrifying and financially devastating.

Without an experienced guide, learning to trade the share market can be a very expensive education.

It is much easier to learn from others’ experiences than having to repeat their mistakes yourself.
The purpose of this Handbook and our weekly ‘Investing & Online Trading’ stock market newsletter is to help our readers survive by avoiding the pitfalls of the market - and then thrive by developing profitable trading strategies.

For a few years now I have been presenting a series of workshops and seminars developed to teach beginning traders the concepts essential to successfully investing in the share market. “What books should I read?” and “Which book should I read first?” are often among the earliest questions asked.

By providing an extensive list of quality books on the financial markets in the Bibliography, the first question is answered. Answering the second question is considerably more difficult. Each book contains useful information, but an inexperienced trader does not know what is essential knowledge until after it has been acquired.

It often takes a considerable amount of time and effort for the beginning trader to discover what is relevant. This ebook will give the inexperienced investor an overall view of the market and the relevant knowledge to begin trading now. To help readers easily find other resources, hyperlinks are provided within this document.

The Stock Trading Handbook is the result of the feedback from the participants in my workshops and seminars. This is the book they wished they had read first.

For questions on topics covered in this ebook or our newsletter, please Contact Us.

Questions on the market in general can be directed to me in the dedicated ‘Ask Jim Berg’ section at www.sharescene.com.

Trade with 'Weight-of-Evidence’

Jim Berg

June 2009

www.ShareTradingEducation.com
and www.jimberg.com.au
Chapter 1

How the Market Works

- Primary and Secondary Markets
- Types of Shares
- Indices
- Market Influences
- Investing Styles
- Technological Influences
- How Shares are Traded
- Depth of Market

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
CHAPTER 1. HOW THE MARKET WORKS

Why Have a Market?

The rational behind the existence of share markets is fairly basic. Share markets facilitate the wealth creation process by providing companies with opportunities to raise funds by publicly listing on an exchange. After listing, a successful company will have further opportunities to raise funds with the issue of additional securities.

The public listing of companies means that private investors can purchase company shares with the goal of creating wealth through capital gains and dividends. In this situation a company is in search of capital and an investor is in search of the best rate of return on his or her money. With the purchase of shares, the investor gains part ownership of the company and will have a share in potential profits or losses. In this way, risks and rewards are spread over a large group of investors.

Primary Market

Companies wanting to take this route must comply with the Listing Rules of the relevant stock exchange. Investors can purchase shares when a company initially lists on the exchange through a float or Initial Public Offering (IPO). This is called the primary market.

The number of shares on offer and the price per share, which is the float price, is established among company owners, accountants and the sponsoring broker. The sponsoring broker (the underwriter) receives a fee for promoting and selling the shares to their clients and the general public. Its aim is to see that the float is over-subscribed, that investors have submitted documents requesting a total amount of shares greater than the amount available for sale. The broker then has the luxury of rewarding its staff and top clients with participation in a hot issue that is likely to list at a premium to the issue price.

This creates the opportunity for speculators to stag, which means to sell their shares for a quick profit on the listing. If the float is under-subscribed the underwriter is left holding the stock. They can attempt to sell the stock at a discount or hold the shares for selling into the market at some time in the future. Regardless, the company has its money and can proceed with its business.

Many investors believe that participating in floats is the way to easy money. This is a myth. Of the 169 companies floated in the year 2000, only 36% ended the year in positive territory. Even in positive years for the share market, a significant proportion of floats end the year trading below their issue price.

If you are interested in a float, check out the track record of the broker underwriting the issue, as many of them consistently back losers.

Secondary Market

The Exchange also provides the secondary market where investors and traders trade company shares at the current market price.
They place their orders through brokers and buyers and sellers are matched, which leads to an exchange of cash and shares. On the secondary market, price fluctuations constantly reflect the latest information available to market participants.

**Example**

A company intends to list and raise $10 million to expand its business activities. It issues a prospectus and offers 20 million shares at a par value of $.50 cents each. The sponsoring broker is responsible for selling the 20 million shares prior to the listing. When the company is floated on the stock exchange the shares will be given a market value based on expectations. The company’s share price will eventually reflect its success, or otherwise, in the marketplace.

**Types of Shares**

The above example refers to ordinary shares. Other types of shares are preference and contributing. The features of each are outlined below.

<table>
<thead>
<tr>
<th>TYPE</th>
<th>FEATURES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary Shares</td>
<td>Most common form of ownership</td>
</tr>
<tr>
<td></td>
<td>Receive dividends</td>
</tr>
<tr>
<td></td>
<td>Voting rights</td>
</tr>
<tr>
<td></td>
<td>Benefits from retained earnings</td>
</tr>
<tr>
<td></td>
<td>Rank last in priority (on company liquidation)</td>
</tr>
<tr>
<td>Preference Shares</td>
<td>Have fixed dividend rate (% of par value)</td>
</tr>
<tr>
<td></td>
<td>If company is liquidated, this dividend is paid before the ordinary dividend is declared</td>
</tr>
<tr>
<td></td>
<td>Rank before ordinary shares in any distribution of assets</td>
</tr>
<tr>
<td>Contributing Shares</td>
<td>Partly paid</td>
</tr>
<tr>
<td></td>
<td>Require certain future payments</td>
</tr>
<tr>
<td></td>
<td>Shareholders are required to pay calls when due, unless the company is a no liability company, in which case, shares can be forfeited</td>
</tr>
</tbody>
</table>

**Stock Codes**

Each share has a code. For example, the code for Woolworths is WOW and for Newcrest Mining is NCM. The codes are used when placing orders, for checking prices on a quote screen or internet watch screen and for monitoring shares with a software charting package. Company codes can be found on the ASX website at [www.asx.com.au](http://www.asx.com.au)

**Indices**

Every Stock Exchange has at least one index, a group of shares drawn from the broader market and used as a benchmark in an attempt to measure the financial health of the entire market. The index may be composed of companies in the exchange's Top 100, for instance. There are also indices representing the different company sectors (see the next section).
index level could be calculated by simply adding together the closing prices of the group of shares or by weighting them first, then adding them together.

The three largest exchanges and their major Indices are:

- **United States** - S&P 500, Nasdaq, Dow Jones Industrial Average
- **Japan** - Nikkei
- **United Kingdom** – FTSE

Historically, the U.S. Dow Jones has been the most widely watched of the market indices. Critics claim it is not representative of the market as a whole as it consists of only 30 of the thousands of companies traded on the New York Stock Exchange (NYSE). Professionals also closely monitor the broader Standard & Poor's (S&P) 500 Index that was first established and published in 1957.

The main Australian Indices are the All Ordinaries and the S&P/ASX 200. The minor indices are the S&P/ASX 300, S&P/ASX 100, S&P/ASX 50, S&P/ASX 20 and the S&P/ASX Small Ordinaries Index. The lists are constructed and calculated by Standard and Poor’s and can viewed at their website [www.standardandpoors.com](http://www.standardandpoors.com). Click on Indices and select S&P Australian Indices.

**Sectors**

Every listed company is a member of a sector, based on the nature of its business. At the time of writing the First Edition of this book in 2001 the sectors were:

- Alcohol and Tobacco
- Banks and Finance
- Building Materials
- Chemicals
- Developers & Contractors
- Diversified Industrials
- Diversified Resources
- Energy
- Engineering
- Food & Household Goods
- Gold
- Healthcare & Biotechnology
- Infrastructure and Utilities
- Insurance
- Investment & Financial Services
- Media
- Miscellaneous Industrials
- Other Metals
- Paper and Packaging
- Property Trusts
- Retail
- Telecommunications
- Tourism & Leisure
- Transport

In April, 2001 the sectors on the ASX were reorganized and reduced in number, to bring them in line with overseas markets. The new **Global Industry Classification Standard (GICs)** sectors are:

- S&P/ASX GICs Energy
- S&P/ASX GICs Materials
- S&P/ASX GICs Industrials
- S&P/ASX GICs Consumer Discretionary
- S&P/ASX GICs Consumer Staples
- S&P/ASX GICs Healthcare
- S&P/ASX GICs Financials
- S&P/ASX GICs Financials, excluding Property Trusts
- S&P/ASX GICs Property Trusts
- S&P/ASX GICs Information Technology
- S&P/ASX GICs Telecommunication Services
- S&P/ASX GICs Utilities

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or 'buy' or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our [Terms of Use](http://www术语条款).
Many investors and traders who analysed charts of the more specific 24 Sub Industry sectors find it difficult to use the new GICs. Reducing the sectors from 24 to 12 means several Sub Industry sectors are grouped together in the new GICs, making it difficult to analyse specific industries.

The GICs are actually broken down into Industry Groups but, unfortunately, the information is not readily available to the investing public. I know of only two Australian data service providers that provide Industry Group data for charting.

**Industry Groups and Codes for JB Premium Data are:**

- AUTO & COMPONENTS (XACJ)
- BANKS (XBAJ)
- CAPITAL GOODS (XCGJ)
- COMMERCIAL & PROFESSIONAL SERVICES (XCSJ)
- CONSUMER DURABLES & APPAREL (XCDJ)
- DIVERSIFIED FINANCIALS (XDFJ)
- ENERGY (XENJ)
- FOOD & STAPLES RETAILING (XFDJ)
- FOOD, BEVERAGE & TOBACCO (XFBJ)
- HEALTHCARE EQUIPMENT & SERVICES (XHCJ)
- INSURANCE (XINJ)
- MATERIALS (XMAJ)
- MEDIA (XMEJ)
- PHARMACEUTICAL & BIOTECHNOLOGY (XPBJ)
- REAL ESTATE (XREJ)
- RETAILING (XRTJ)
- SOFTWARE & SERVICES (XSSJ)
- TECH. HARDWARE & EQUIP. (XTHJ)
- TELECOMMUNICATION SERVICES (XTEJ)
- TRANSPORTATION (XTRJ)
- UTILITIES (XUTJ)

The importance of undertaking industry group analysis before purchasing specific shares cannot be overemphasised. Much more on this can be found Chapter 6 on Trading Strategies.

Figure 1.1 below shows how the Industry Groups can be simply set up in a Watch List folder ('Book') in my JB Premium Data, which is suitable for users of Metastock, Amibroker, Market Analyst and many more charting programs. It is also the basis of my own JB Premium Charts.

For those without such programs, a Free easy-to-use Charting program is also provided to all users of JB Premium Data. For your Free 3 week trial of this reliable, accurate Data and the Free charting program, simply register here.

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra, disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Market Influences

1. The Economy

Looking at the big picture is called the macro viewpoint. This consists of analysing the current state of the economy and its prospects for the future. The outlook for the Australian economy is linked to larger world economies and to those of our major trading partners. Brokers and investment firms hire economists to analyse Australian and world economic conditions and explain the impact these relationships will have on our changing economic conditions. This economic forecasting is a very difficult exercise, as it is attempting to predict the future with data that is often outdated. The poor success rate of forecasts has led to Economics becoming known as the dismal science.

While forecasting is of questionable value, knowing approximately where you are in the economic, or business, cycle can be a useful tool. The business cycle is the fluctuations between the boom times and bad times in economic activity.

Figure 1.2 below is an example of the economic clock, compiled by The Evening Standard in London, from a study of business cycles over a period of 150 years.

![The Economic Clock](image)

The clock is a long term indicator and represents a typical cycle that averages nine years, with a variation of a year or two either way.

Following are the typical characteristics of each of the different phases.

1 o’clock – Rising Interest Rates

- Government judges need to curb inflation with rate rises.
- Faltering of business optimism.
- Reduction of business investment.

2 o’clock – Falling Share prices

- Rate rises have negative affect on share market.
3 o'clock – Falling Commodity Prices
- Rising rates and lower demand affect commodity prices.
- Decreasing prices.
- Decreasing wages.
- Decrease in the level of spending.

4 o'clock – Tighter Money
- Banks are in danger of defaults on bad loans made during speculative boom.
- Rates rise, increasing cost of new and existing loans.
- Lower demand and rising costs impact on company profits.

5 o'clock – Falling Real Estate Values
- Rising interest rates impact on mortgage rates and real estate prices decline.

6 o'clock – Bottom Of Recession
- Consumer spending tightens.
- Rising unemployment.
- Low level of investment.
- High level of preference for liquidity.
- Lack of investment opportunities because of low profit expectations.

7 o'clock – Falling Interest Rates
- Government eases interest rates to spark demand.
- Share buying opportunities for economic recovery.

8 o'clock – Rising Share Prices
- Shares rise with easing rates and recovery.

9 o'clock – Rising Commodity Prices
- Share buying opportunities in resource sector.
- Rising Australian dollar.
- Increase in price levels.
- Rising employment.
- Rising wages.

10 o'clock – Easier Money
- Increased business opportunities with lower lending rates.
- Increase in consumer spending.

11 o'clock – Rising Real Estate Values
- Lower lending rates fuels real estate boom.
- High levels of employment.

12 o'clock – Top of Boom
- High levels of speculation.
- Rising share prices and real estate values create a wealth effect and rising inflation.

2. Interest Rates (Monetary Policy)

Interest rates represent the price paid for the use of money or credit. When domestic rates rise, the cost of money increases.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise: Refer also to our Terms of Use.
This reduces investment by companies and individuals and is regarded by economists as deflationary. Rising interest rates have a negative effect on share prices while falling interest rates are generally considered positive.

Fluctuations in interest rates alter the relationship between the investment return from bonds and shares. Quality fixed interest investments are more liquid and safer than shares but usually generate less income. Investors hold shares to gain a higher return from dividends and capital gains.

As interest rates rise, investors can get a higher return on short-term fixed interest securities such as bank bills and government bonds. In this environment, money tends to flow out the share market and into the bond and money market as investors determine the marginally higher rate of return in the share market in not worth the extra risk. A rising share price will usually cause falling dividends on a percentage basis as share price increases will rise faster than dividend gains. This falling yield narrows the difference in return from fixed interest. Falling share prices are needed to increase the yield from dividends and attract investors to the higher risk investment.

Higher interest rates also increase the cost of borrowing from brokers and banks to buy shares, called margin lending. This reduces the money available to buy shares and has a deflating effect on share prices.

International interest rates of the major economies have an influence on the level of international economic activity and Australian companies operate in this macro economic environment. The expected earnings of Australian companies is affected by the international determination of rates of economic growth through adjustments to interest rates.

The movement in interest rates in a country can alter the return to investors in these markets. Central banks can alter interest rates and have a major impact on capital inflows. High interest rates are often used as a means of attracting foreign capital. The changing international rates have a direct bearing on Australian domestic rates by making them more or less attractive to domestic or overseas investors. This will affect company performance through the cost of credit, value of the currency and the relative performance of competing forms of investment.

The Government sets monetary policy objectives and the Reserve Bank of Australia (RBA) determines changes in interest rates by controlling the cash rate through the buying and selling of Commonwealth government securities. Changing the interest rate is the RBA’s attempt to influence spending behaviour in the economy. The RBA’s management of monetary policy is important to maintaining confidence in the financial system.

3. Exchange Rates

Movements in the Australian currency can directly affect the value of shares as Australia is a major trading and importing country. The relative strength of the Australian currency directly affects the economic wellbeing of Australian companies. A country’s currency influences the level of income from export earnings, the expected profits in industries vulnerable to imports and the perceived and actual returns of foreign investors.

4. Inflation and Inflationary Expectations

Inflation occurs when the price of goods and services increases and the value of money falls. Consumers feel inflation as a loss of purchasing power and invest their savings to control the impact of inflation on their lives. Investors are concerned about the real rate of return on their investments - as opposed to the nominal rate - which is the actual dollar return expressed as a percentage of the principal.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or “sell” recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STEducation”), as Corporate Authorised Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
For example, a $10,000 profit on a $100,000 investment is a 10% nominal return. The real rate of return is the nominal rate minus the inflation rate. A popular indicator of inflation is the Consumer Price Index (CPI), which measures the price of a basket of goods and services over time to follow their rise or fall. An inflation rate of 3% subtracted from the nominal return of 10% results in a real rate of return of 7%.

5. Fiscal Policy

Government fiscal policy attempts to influence the economy through changes to taxation, welfare payments and expenditure. It is important for investors as it affects overall economic performance and influences the profitability of individual industries.

Recent fiscal policy decisions that impact on investments include:
- Taxing of superannuation fund profits.
- Corporate tax rate dropped to 34% for 2000-01 and to 30% from July 2001.
- Capital Gains Tax (CGT) cut by 50% on assets acquired after 1 October 1999 and held for at least one year. Super funds CGT on two thirds of gains.
- 10% Goods and Services Tax (GST) introduced on 1 July 2000 to shift the tax burden from income to consumption. This removed the wholesale sales tax, reduced marginal tax rates and resulted in a “once-off” (hopefully) rise in inflation.

6. Seasonal Effects

Market historians track the seasonal trends that influence share market behaviour. Seasonal trends are statistical probabilities that need to be used with caution as trends can shift or completely reverse. Observers of seasonal trends look for lows in June and November and highs in January and July. The January high is the peak of the Christmas rally that, market historians claim, occurs 84% of the time.

The most famous seasonal is the month of October, when many severe sharemarket falls have occurred. The most notable is the crash of 1929 that resulted in the Great Depression. Significant October falls also occurred in 1987, 1989 and 1997.

Investing/Trading Styles

1. Top Down Analysis

Top down analysis starts with a macro-economic outlook of the political and economic environment and gradually narrows down to a micro affect these conditions will have on specific securities. It is a logical process from analyzing the big picture down to their impact on shares, fixed income securities and property.

Top down analysis examines:
- The global economic situation and its’ affect on Australia’s economy
- Trends in Australia’s asset markets
- Trends in specific sectors
- Specific investments and how they will react to economic changes
2. Bottom Up Analysis

In the bottom up, micro approach, analysts do a detailed fundamental analysis of the investment by examining its performance, management, balance sheet, risk, etc. The analysis is concentrated primarily on the strength of the investment, using a wide range of tools, but also may include the economic environment and macro considerations.

3. Value and Growth Investing

Value and growth investing are the two most common styles of investing.

Value investors are looking for bargains. They believe inefficiencies in the market result in shares becoming under-priced to their book value, trading at a discount to their intrinsic worth. Book value is a company’s balance sheet assets minus its liabilities. The company might also have hidden value, such as property that hasn’t been revalued to its current worth. If a company has a book value of $8 per share and a share price of $7 per share, it may be perceived as a bargain as it is selling at a discount to its breakup value.

The value picker is hunting for companies that have fallen on difficult times and are out of favour with brokers and institutions. The bad news is out and is reflected in the share price. In time, the true value of the company will be realised and the share price will hopefully rise to reflect its worth.

Value investing has outperformed growth investing over the long-term but lagged significantly behind during the three years leading up to the tech wreck of 2000. Value stocks have regained the upper hand and substantially outperformed since the bursting of the tech bubble. Features typically associated with value shares are dividend yield, cashflow yield, price earnings ratio, discount to book value and earnings yield (see Chapter 3 for an explanation of some of these fundamental calculations). The legendary Warren Buffett has created fortunes for many investors using value investing.

Growth investors target companies that have the capability of increasing their earnings at a faster than average rate. Investors are looking for industries with strong sustained growth trends and companies in those industries with growth in sales and earnings.

A problem here is the high cost of buying these companies as they often sell at a high price/earnings ratio, reflecting their expectations. A disappointing earnings report often causes a significant decline in share price. Features typically associated with growth shares are positive industry fundamentals, earnings and sales growth and a high return on equity.

4. Momentum Investing

Momentum traders ride the bullish trend. They believe that what is in motion tends to stay in motion. They are buyers of strength rather than weakness. There are many variations, but basically, momentum investors are targeting companies with a strong rising share price.

5. Contrary Opinion

Contrarian traders target shares that are out of favour with the crowd. The crowd stampedes into shares when they are booming and panics out of all positions when the market falls. Mass psychology and the herd mentality are followed closely by contrarians to avoid joining the majority.
There is more to contrary investing than blindly selecting out of favour companies. One of the many variations of the Dogs of the Dow contrarian investment strategy is to target the lowest priced shares from the U.S. Dow Jones Industrial Average, or any other index, with a low price/earnings ratio and a high dividend yield.

6. Index Benchmarking

This is a buy and hold strategy where investors or fund managers attempt to mirror the results of a particular share market index. If the index has a rise of, say 10%, then the investors portfolio should experience a similar increase in value.

To trade this strategy, a selection of securities from the index are purchased in proportion to the weighting of the companies in the index. The large number of shares in many indices makes it difficult for the average investor to construct a benchmarking portfolio and leaves managed funds as the only alternative.

Sector benchmarking uses the same strategy, targeting the companies in a specific sector, and offers the more active investor the opportunity to switch among sector funds when the timing is appropriate. For example, an investor with capital in an All Ords index fund might determine that the index was likely to consolidate or fall for the next twelve months.

In this case money left in this fund would struggle to produce a capital gain and could result in a loss. If the outlook was favourable for a particular group of shares, such as resources, capital could be switched to a fund targeting shares from this sector. This could get expensive, depending on fee structures, but many funds are now offering a free switching facility among funds under their control.

7. Follow the Money

Many traders monitor the director’s share holdings in their own company. The theory is to follow the smart money, as represented by the individuals with inside knowledge of the company’s future prospects. A director buying or selling their own company’s shares could give an indication of the near-term direction of the company’s share price. Director’s interests are listed weekly in major newspapers.

Another follow the money strategy is to monitor the investments of powerful and successful public figures and purchase shares in the same companies. An Australian broker that promotes this strategy says “If it’s good enough for them, it’s good enough for me”.

Monitoring successful fund managers is another strategy for following the money. Hundreds of small cap, mid cap and large capitalised funds, along with the specialised funds, offer investors plenty of choice. Agencies rate the funds for safety and publish their short-term and long-term performance figures.

Investors would be unlikely to have the available resources to match a managed fund’s diversification but could use other filters, such as technical analysis, to narrow the number of companies to a manageable level and fine tune their entry levels.

8. Fundamental and Technical Analysis

These investing/trading styles are covered in depth in Chapters 4, 5 and 6 respectively.
Technological Influences

Over the years, advances in technology have had a tremendous impact on investing. Trading in the 1950’s and most of the 1960’s was done with prices delivered via a ticker tape and orders were placed with a telex machine. The ticker tape recorded transactions on a large roll of paper. Veteran traders claim the tape talked to them, as the changing sound of the ticker tape alerted them to a market on the move.

The ticker made a different sound when the tape sped up on an increasing number of transactions, signaling a potential turn in the market. Breaking market information was delivered via a Dow Jones Machine, again on rolls of paper. The machine rang once, twice or three times, depending on the significance of the information.

Telephone direct dialing in 1967 changed the method of investing but analysing the market was still sensory. Trading decisions were often based on feel, sounds, atmosphere and intangibles. With very little market information, investors relied on their street smarts and intuition.

Computers made their first impact in the back offices of brokerage firms. The stock market boom of the 1960’s increased trading activity and resulted in backlogs of unprocessed orders. Brokerage firms without a computer facility to handle large increases in transactions went out of business.

In 1971 the Nasdaq Exchange began trading in the U.S., and for the first time, traders could buy and sell shares from the information on a computer terminal. Broker back offices began to be wired and automated to satisfy the business generating traders’ visions. The computer literate traders used the new technology to develop new products and to trade them faster.

Apple computers, much in use by 1979, allowed traders faster number crunching in increasingly complex ways. IBM released its PC in the early 1980’s and by the second half of the decade the power of the computer could run increasingly complex programs.

Stock Market Crashes

This rise in the technology curve pushed the markets forward, but computers also played a part in one of the biggest events of the decade, the Crash of ’87’. The stock market drop on Monday, October 19th, was unlike anything seen since the 1929 crash that preceded the Great Depression. The enormous losses shook the confidence of people inside and outside of the market, with many individuals and groups looking to place blame. Some focused on program traders and their use of computer trading, as the cause of the crash.

Institutions and fund managers use program trading to quickly buy or sell large amounts of shares. Their order size is often as large as $10 million to $30 million worth of different securities. It would be time consuming and inefficient to place individual orders with a dealer. Program trader’s computers, linked to the order-taking systems at the New York Stock Exchange (NYSE), can buy or sell shares in hundreds of different companies in a matter of minutes. Technological advances have made this method of trading possible. Several different program traders, acting at the same time, are capable of producing significant moves in the market.

The 1987 crash shook the financial markets’ foundations and resulted in investigations, reports, books, new regulations, safeguards and circuit breakers to prevent a recurrence. Each crash produces important lessons that result in a greater understanding of market dynamics.
This knowledge, combined with the new regulations, safeguards and circuit breakers, leads to the belief "next time will be different". We are assured there will never be another crash. We’ll see.

Computers continue to speed up the process of gathering and collating information. This has allowed institutional traders to manage an increasingly larger number of transactions, multiplying the volume of business and the speed at which it is done. Computer technology also helps in simplifying and eliminating wasteful and time-consuming tasks, doing things more efficiently than humans and reducing errors and paperwork.

Software packages are being developed with artificial intelligence and mathematical models to duplicate a successful trader’s methodology. Trading rules, appropriate responses to news events and changes in market characteristics can be factored into a program that actually “learns” from analyzing each transaction and recognizes patterns of human thought.

**Electronic Trading**

The internet and electronic trading have brought trading to the masses. Anyone can do it from anywhere. It has become a form of entertainment for some, akin to a hobby. Online, investors can access a summary of developments on world exchanges, scan broker research, check company announcements, visit trading forums for ideas and rumours, monitor share prices, create watchlists and portfolios and place buy or sell orders.

Investing has captured the public’s imagination. Magazines, books, seminars and financial news programs are flourishing. It’s fun and the investor is in control. Do-it-yourself investing eliminates the need to listen on the phone to a broker’s scripted sales pitch. On-line trading and discount commissions have shifted the balance of power away from the traditional market professionals.

Brokers can no longer simply collect fees for marginal advice and inefficient paper processing. Automation will cut costs to the brokers and these savings will be passed on to the customers. As the trading process goes through fewer human beings, using computers much more, fewer mistakes are made and this saves money.

Investors are getting closer to connecting directly with other investors, reducing the role of brokers, the traditional middle-men. The pace of change is likely to increase as new technology is developed and traditional brokers rise to the challenge of this new competition. Their function and their thinking will need to change to anticipate the demands of the new technology driven markets.

One of the steps being taken by the established markets is to move away from being mutually owned by its members, into a shareholder-owned company, as the Australian Stock Exchange did in 2000. This move will help eliminate the painfully slow and conservative decision making process that is caused by so many members interest in preserving the status quo.

The world’s exchanges have been slow to merge and move away from floor based trading to screen trading. This has allowed electronic communications networks (ECNs) to flourish and steal trading volume from the traditional market makers. New rules, in the United States, now allow ECNs to apply for exchange status and regulation, clouding the description of an exchange as a place where shares are traded.

It must now be decided what the requirements really are for becoming an exchange. The biggest financial institutions already operate globally and electronically and some question whether it is worth having national exchanges.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The traditional exchanges are in a battle for their existence. Their established reputations and higher trading volume might keep loyal clients away from electronic trading if they offer competitive trade execution costs. Once they lose the advantage of superior liquidity it will be difficult to regain.

Experienced investors are no longer interested in talking to brokers: while beginning investors want advisors who can educate and empower them, not to make trading decisions for them. People want to have more control of their future by making their own trading decisions. Investors are convinced that taking educated risks will produce greater returns and will also prove to be an enjoyable experience.

Many investors feel uneasy about the growing presence of computerized or electronic trading. How can the average investor compete against individuals with highly sophisticated and expensive software packages?

I’m referring to computers and programs that are out of reach to the average investor. The answer is that computers have logic but they can’t think. The market is littered with the debris of computerized trading programs gone bust.

One such perfect asset management package, run by a U.S. specialized fund, was programmed to purchase the shares of the cheapest companies in several different sectors. The fund ended up as the largest shareholder in a number of companies that eventually went bankrupt as the program continued to accumulate stock as the share price deteriorated.

Computer technology combined with human common sense creates a tool greater than each alone.

**How Shares are Traded**

You’ve done the research and analysis and are ready to pull the trigger, buy some shares. You can call a broker or place your order with an online broker at a significant discount.

The discount broker has an obvious advantage but many beginning traders could learn valuable insights from the expertise of an experienced technical analyst at a full-service broker.

The problem is in finding one as the majority of brokers are fundamental analysts with no interest in the technicals. However your order is placed, it should quickly appear in the Stock Exchange Automated Trading System (SEATS) computer, ready for execution.

SEATS is a screen based computer trading system that matches buyers and sellers. It replaced the old floor trading, open outcry, system in 1990.

You can now watch the market and often, literally, see your order executed. If you use an online broker, there will be a facility on its site for monitoring shares individually and in groups.

You can check the range on the day, the years highest and lowest price, every price at which the share traded today and much more. Of immediate interest will be the last price at which the share traded, the bid and offer prices and how many shares are on offer at each price. This depth of the market can be a valuable tool.
Figure 1.3 below, is an example of a typical depth-of-market screen.

**Figure 1.3  Depth of Market**

The screen print shows the Coles Myer code (CML), last price ($7.21), change in price, percentage change in price, open, high, low, number of trades, etc. There are two buyers at a price of $7.20, totaling 16,252 shares. There is one seller at $7.21 with 4892 shares. No transactions will take place until a trader changes their order or another trader enters a new order. If you are interested in purchasing 4000 shares in Coles Myer and are happy to pay the $7.21 asking price, your order can be immediately filled, since 4892 shares are on offer.

This ability to determine the likely price at which you will trade, if you place an order, is the main value of live depth-of-market screens. Some traders will sum the total number of buyers from the first five bids and compare it to the total sellers from the first five offers. In this case, the numbers are 48,166 shares to buy and 51,674 shares to sell, relatively equal numbers.

A large difference in numbers could signal the next short term direction of the share price. A word of caution is warranted here, as large brokers and institutions will place fake orders to discourage traders from buying or selling, if it interferes with their trading strategy. Knowing their influence, they will place large orders a safe distance from the last price, with no intention of trading at that price.

When an order is filled, the investor will receive a contract note with information concerning the trade. The date of the trade and the settlement date are included. The settlement date is T+3 (transaction date plus three days), which means, to avoid penalties, ownership and payment must be completed within three days. Most investors maintain funds with their broker, often in a cash management account, and the broker is authorized to settle trades by debiting or crediting the account.

The Clearing House Electronic Subregister System (CHESS) has done away with the need to deliver scrip, share certificates representing ownership. The computerized CHESS system records the transaction instantly and can follow any subsequent transactions, regardless of frequency.
CHAPTER 2

TAXATION, FINANCIAL PLANNING, DIY SUPER & CHOOSING A BROKER

- Capital Gains Tax
- Tax Scales
- Franking Credits
- Financial Planning
- DIY Superannuation
- Brokers
CHAPTER 2. TAXATION, FINANCIAL PLANNING, DIY SUPER & CHOOSING A BROKER

Knowing what kind of share market participant you are, how to look for suitable trading candidates and how to manage both trades and trading funds, puts you well on the way to being successful in your endeavours. There are still some other issues to cover, though, which will have an impact on the individual’s overall trading strategy.

Taxation plays an important part in investing and decision-making. Investors are never happy about paying tax on their hard-earned profits, but if you are paying Capital Gains Tax, it means you are a successful investor. Investment strategies will be affected by the individual’s marginal tax rate.

Tax evasion involves arrangements outside the law where the liability to pay tax is concealed or ignored. It is a criminal offence. Tax minimization, on the other hand, involves arrangements within the law to legally reduce the amount of tax paid to the level required by law. The government requires taxpayers to meet their tax obligations but it is the responsibility of the individual to organize his or her tax affairs so that the fair share, and no more, is paid.

The tax office will not advise you that by changing the way you invest you can legally reduce your tax liability, increase your return on capital and put money in your pocket. This is an area where you really need to consult with the professionals. Each individual should see an accountant and a financial planner before he or she commences trading. The entity under which you trade under can have significant implications for your return on capital. Paying tax on profits is one of the costs of the business of trading, but paying more than you are required is unfair to yourself and your family.

For example, below are the nominal tax scales for residents of Australia for the year 2008-09.

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Tax*</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $6,000</td>
<td>Nil</td>
</tr>
<tr>
<td>$6,001 - $34,000</td>
<td>Nil plus 15 cents for each $1 over $6,000</td>
</tr>
<tr>
<td>$34,001 - $80,000</td>
<td>$4,200 plus 30 cents for each $1 over $34,000</td>
</tr>
<tr>
<td>$80,000 - $180,000</td>
<td>$18,000 plus 40 cents for each $1 over $80,000</td>
</tr>
<tr>
<td>$180,001 and over</td>
<td>$58,000 plus 45 cents for each $1 over $180,000</td>
</tr>
</tbody>
</table>

*Not including the 1.5% Medicare levy

At the Australian Taxation Office Website, a simple tax calculator is available to help you calculate the tax on your taxable income. The comprehensive tax calculator also takes into account Medicare levy, HECS/ SFSS repayments, tax offsets and tax credits to give you an estimate of the amount of your tax refund or debt.

Capital Gains Tax

Capital gains tax (CGT) became law on 24 June 1986. The taxation of capital gains means that profits from share trading are included in assessable income. The legislation also allows for capital losses to be carried forward indefinitely against current or future capital gains. A capital gain may be offset against trading losses and against losses from negatively-geared property investments. The capital gain on shares is the difference between the cost and the disposal.

The amount of taxable gain is dependant upon the acquisition date and the date of disposal.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Shares acquired before 10 September 1985 attract no CGT. Shares acquired before 21 September 1999 include an allowance for the effect of inflation i.e. only real capital gains are taxed (indexed to 30 September 1999). Shares acquired on or after 21 September 1999 are taxed based on the length of ownership, with no allowance for the effect of inflation during the time of ownership.

**Shares Sold Within 12 Months**

Shares disposed of within 12 months of the date of acquisition are taxed at the nominal capital gain. This means you will pay tax on the full profit at your nominal tax rate.

If your income is greater than $80,000 per year, your nominal tax rate is 40 cents per dollar. This figure does not include the medicare levy. If you are on this rate and declare a $5,000 profit for the financial year, 40%, ($2,000) of your profit goes to the tax office. If your spouse earns $40,000 per year, he or she has a nominal tax rate of 30 cents per dollar. If the trading account were in the spouse’s name, $1,500 of the profit goes to the tax office, a saving of $500 for the investor. If your spouse has no income, the first $6,000 of capital gain is tax free. This is why it is important to see a Financial Planner before trading commences.

The calculations for this example are listed below.

**Investor**

Income = $80,001 Per Year (Tax Of $18,000 Plus 40 Cents Per Dollar Over $80,000)

<table>
<thead>
<tr>
<th>Taxable Gain</th>
<th>Nominal Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5,000</td>
<td>$5,000 X 0.40 (Tax Rate Per Dollar)</td>
</tr>
<tr>
<td></td>
<td>$2,000 Taxable Gain</td>
</tr>
</tbody>
</table>

**Spouse**

Income = $40,000 Per Year (Tax Of $4,200 Plus 30 Cents Per Dollar Over $34,000)

<table>
<thead>
<tr>
<th>Taxable Gain</th>
<th>Nominal Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5,000</td>
<td>$5,000 X 0.30 (Tax Rate Per Dollar)</td>
</tr>
<tr>
<td></td>
<td>$1,500 Taxable Gain</td>
</tr>
</tbody>
</table>

**Shares Sold After 12 Months**

When shares are held for more than 12 months the taxable gain can be calculated as half the nominal capital gain. This means that the investor from the previous example, with a profit of $5,000 and a 47% tax rate, will pay tax on $2,500 of that gain if the shares are not sold within 12 months. This amounts to a final tax liability of $1,000, when holding the asset for 12 months, as opposed to $2,000 when disposing of the shares within 12 months.

**Investor**

Income = $80,001 Per Year (Tax Of $18,000 Plus 40 Cents Per Dollar Over $80,000)

<table>
<thead>
<tr>
<th>Taxable Gain</th>
<th>½ X Nominal Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2,500 X 0.40</td>
<td>$1,000 Taxable Gain</td>
</tr>
</tbody>
</table>
The effective top tax rate for individuals is 22.5% (i.e. half of 45%) for gains on shares held for more than one year. The 1.5% Medicare levy also needs to be considered when calculating this figure.

\[
\text{Taxable Gain} = \frac{1}{2} \times \text{Nominal Capital Gain} \\
= \frac{1}{2} \times 5000 \\
= \$2,500 \times 0.465 \text{ (45 Tax Rate Per Dollar Plus .015 Medicare Levy)} \\
= 1,162.5 \text{ Taxable Gain} \\
= \frac{1,162.5}{5000} \\
= 23.25\% \text{ Tax Rate}
\]

This tax concession can have a significant impact on an investor’s style of trading. It is unlikely to affect the short-term trader as he or she would seldom be in a trading position long enough to consider the option of holding shares a few months longer to gain a tax concession. The higher tax rate would simply be the cost of doing business in the chosen style.

The long-term investor and the medium-term trader could have some difficulty with calendar watching. The long-term investor would have taken this tax concession into consideration and developed a trading system to suit the favourable conditions of holding shares for 12 months or longer.

The medium-term trader might exit the majority of trades in less than 12 months but have a few trading positions that last longer. Each investor could have a problem with an exit signal 11 months into a profitable trade. Exit now and pay the higher tax? Ignore your trading system’s exit signal? Ignore the signal and you are trading on hope. Hope is a four letter word that will cost you money.

It is a difficult decision, initially, for a trader to ignore a signal. If the decision to ignore a signal results in a successful trade, the investor receives positive feedback. It becomes easier to ignore subsequent signals and eventually the investor is trading what he or she feels. If you trade what you feel you will lose your money! Experienced traders follow their proven trading system and set up a tax-effective vehicle to manage capital gains.

Complying Superannuation Funds

For complying superannuation funds the taxable gain is two-thirds of the nominal capital gain and a nominal tax rate of 15 cents per dollar.

For many traders, this is a tax-effective way to manage capital gains and provide for their retirement. Investors should talk to a financial planner about the suitability of a self managed superannuation fund, particularly after the 2008 release of the Superannuation amendments for Australian residents.

Below are the calculations showing the effective tax rate for a superannuation fund is 10%.

Superannuation Fund

\[
\text{Taxable Gain} = \frac{2}{3} \times \text{Nominal Capital Gain} \\
= \frac{2}{3} \times 5000 \\
= 3333.33 \times 0.15 \text{ (Super Tax Rate)} \\
= 500 \text{ Taxable Gain} \\
\text{Tax Rate} = \frac{500}{5000} \\
= 10\% \text{ Tax Rate}
\]
Share Trader Classification

Most investors are subject to Capital Gains Tax on the disposal of their shares. Some share market participants, however, are classified as "share traders" for tax purposes.

A "share trader" is entitled to tax relief from a fall in the value of his or her shares, as the shares are considered trading stock, part of the trader’s business. At the end of the year, the stock may be valued at "market value", "replacement value" or "cost price". If the market value is less than the original cost price, a share trader may claim a tax loss and offset the loss against other income or capital gains.

The status of "share trader" is determined by previous sharemarket trading activity, frequency of share purchases and sales and the trader’s intentions when purchasing the shares. An investor with a long-term time frame would probably not qualify but short and medium-term investors that trade frequently could benefit from status as a "share trader".

The table below presents a clear picture of the CGT rules for all types of shareholders.

<table>
<thead>
<tr>
<th>Asset Acquired</th>
<th>Asset Disposed of</th>
<th>Taxable Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before 19-9-85</td>
<td>At any time</td>
<td>Generally exempt from CGT</td>
</tr>
<tr>
<td>From 20-9-85</td>
<td>Within 12 mths of acquisition</td>
<td>Cap Gain = amount received less cost base (non-indexed)</td>
</tr>
<tr>
<td>To 20-9-99</td>
<td>12 mths or more from date of</td>
<td>Cap Gain = amount received less cost base indexed to CPI from date of acquisition to date of disposal</td>
</tr>
<tr>
<td></td>
<td>acquisition and before 21-9-99</td>
<td>Two methods:</td>
</tr>
<tr>
<td></td>
<td>12 mths or more from date of</td>
<td>1. Cap Gain = amount received less cost base indexed to CPI from date of acquisition to 30-9-99</td>
</tr>
<tr>
<td></td>
<td>acquisition and after 21-9-99</td>
<td>2. (a) Individuals</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cap Gain = ½ (amount received less non-indexed cost base less any capital losses on other assets)</td>
</tr>
<tr>
<td></td>
<td>On or after 21-9-99</td>
<td>(b) Super Funds</td>
</tr>
<tr>
<td></td>
<td>Within 12 mths of acquisition</td>
<td>Cap Gain = 2/3 (amount received less non-indexed cost base less any capital losses on other assets)</td>
</tr>
<tr>
<td></td>
<td>12 mths or more from date of</td>
<td></td>
</tr>
<tr>
<td></td>
<td>acquisition</td>
<td></td>
</tr>
</tbody>
</table>

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise: Refer also to our Terms of Use.
Franking Credits

Many companies pay an income distribution, called a dividend, to their shareholders. Investors often target dividend income as part of their trading strategy. Dividend imputation is a way of preventing double taxation i.e. taxation of income at the company level and in the hands of the shareholder when the dividend is received. The shareholder may receive the dividend payment and a credit for the tax already paid by the company. This is called a “franked” dividend. An “unfranked” dividend is paid out of profits on which the company has not paid tax and the paying of tax is the responsibility of the shareholder. Tax on an unfranked dividend is paid at the shareholder’s marginal tax rate.

A franked dividend is not exempt from tax but carries with it an imputation credit equivalent to the company tax paid. This means an investor on a higher Marginal Tax Rate (MTR) will benefit less from imputation credits than those with a lower MTR. The dividend and the imputation credit are added to the taxable income of the individual. This is called the “grossed up” value of the imputation credit.

The tax owing is then calculated, using the shareholders MTR and the imputation credit is subtracted to arrive at the tax payable. The following examples show how the system works.

From the 1st. July, 2001 the company tax rate is 30%.

An investor with income of $15,000 would pay tax of 15 cents per dollar (see tax scales). The investor received a fully franked dividend of $1,000. Excess imputation credits can be offset against any tax payable.

The formula for determining the amount of tax paid, by the company, on a franked dividend is:

Company

Dividend x 30/70 = Imputation credit

$1000 x 30/70 = $428 (rounded to the dollar) Tax paid by Company, i.e. "Imputation Credit"

Investor on Tax Rate of 15%

$1000 + $428 = $1,428 Grossed up value

$1428 x .15(tax rate) = $214.20 Tax owing

$428 credit subtracted from taxable income

$428 - $214.20 = $213.80 Excess credits

Say, Gross income = $15,000

$1,000 Fully franked dividend

$428 Imputation credit

Taxable income = $16,428 (if no exempt income and no allowable deductions, minus $6000 tax free threshold)

Tax owing = ($16,428 - $6000 tax free threshold) x 0.15
The Stock Trading Handbook                                                                                                               Copyright© Jim Berg                                                                                                                 29

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No
representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell
recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your
Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This
information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any
action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and
ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for
any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether
arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.

\[
\text{Tax payable} = \text{\$1564.20 - \$428} \\
\text{\$1136.20}
\]

The investor on a 15% marginal tax rate is allowed to use excess credits to offset any tax payable. If there were no tax payable, as of 1 July 2001 the excess franking credits would be refunded to the shareholder.

The calculation for an investor on a 30 cents per dollar tax rate would look like this:

**Investor on Tax Rate of 30%**

\[
\text{\$1000 x 30/70 = \$428 Tax paid by company, i.e. “Imputation Credit”}
\]

\[
\text{\$1428 x .30 = \$428 Tax owing}
\]

Taxable income subtracted from $428 credit.

\[
\text{\$428 - \$428 = \$0 (Investor and company on same tax rate)}
\]

Say, Gross income = $40,000

\[
\text{+\$1000 Fully franked dividend} \\
\text{+ \$428 Imputation credit}
\]

Taxable income = $41,428 (If no exempt income or allowable deductions)

Tax owing = \$4,200 + 30% for each $1 over $34,000

\[
= \$4,200 + (0.30 \times \$7,428)
\]

= \$6,428

Tax Payable = \$6,428 - \$428

= \$6,000

The investor on the same 30% tax rate as a company would receive the full benefit of a $1000 distribution.

The calculation for an investor on a 47 cents per dollar tax rate would look like this:

**Investor on Tax Rate of 45%**

\[
\text{\$1000 x 30/70 = \$428 Tax paid by company, i.e. “Imputation Credit”}
\]

\[
\text{\$1428 x .45 = \$643 Tax owing}
\]

Taxable income subtracted from $428 credit.

\[
\text{\$428 - \$643 = - \$215 (Investor on higher tax rate than company)}
\]
$1000 - $215 = $785 Dividend income

Say, Gross income = $180,001
+ $1,000 Fully franked dividend
+ $428 Imputation credit

Taxable income = $181,429 (If no exempt income or allowable deductions)

Tax owing = $58,000 + 45% for each $1 over $180,000
= $58,000 + (0.45 x $1,429)
= $58,643

Tax Payable = $58,643 - $428
= $58,215

The investor on the highest marginal tax rate of 45% would receive $785 dividend income, after tax, from a distribution of $1,000.

**Financial Planning**

Investors have several important decisions to make before they commence trading and most would benefit from a meeting with a knowledgeable financial planner. The selection of the trading entity is only one of the many services the financial planner can provide.

Financial planning draws from a number of other disciplines, including accounting, risk management, taxation, legal services, investment, economics and small business management.

Additional areas of concern to financial planners and the investor include:

- Budgeting and financing
- Social security planning
- Retirement and superannuation
- Disability and income insurance
- Estate planning

Financial planners bring their skills, knowledge and experience together to work with the client in developing a financial strategy and putting it into action.

A knowledgeable financial planner will help you determine where you are today financially, where you want to be in the future and what resources to use along the way.
DIY Superannuation

Zdenko Simonic, the CEO of SuperEasy® is a regular contributor to our Investing & Online Trading mentoring style Newsletter, providing valuable information on Self Managed Superannuation Funds for Australian investors.

The following collated extracts from his newsletter articles are reproduced with his permission.

“The European Union, once a model of economic vigor and financial probity, faces a time bomb in its generous pension system. Put bluntly, even the most affluent economies in the world cannot afford them. As birth rates decline and the numbers of aged people increase, Germany, France, Italy and Spain are struggling to introduce reforms – but against the well organised opposition of a significant proportion of their population.” starts John McIlwrath’s article in the November 2003 issue of ASFA’s “Superfunds” magazine.

The article raises the alarming question of how the European Union countries will be able to support, at the current pension levels, the growing number of retired people with rising life expectancy and declining birth rates.

“There are currently 35 people of pensionable age for every 100 people of working age in Europe, but by 2050, on present demographic trends, there will be 75 pensioners for every 100 workers”.

In Australia, in November 2005, the Federal Government announced superannuation fund changes that take into account Australians' longer life expectancies and demand for more flexible allocated pension payments.

The latest study shows that by the year 2025 there will be less Australians in the under 20 age bracket than there are Australians aged between 60 and 80 years.

This means that in 2025, there will be about 3.5 workers for every person aged over 65, instead of currently 5.3. One of the contributing reasons is the fact that we live longer. Retirement income therefore, needs to last longer as well.

What is Super Choice?

Since 1st of July 2005, Western Australia is no longer the only State where future retirees have unlimited choice of superannuation funds. Almost 5 million Australians now have the same basic consumer right as the Western Australians (except for public servants and people not covered by the state industrial award), to consolidate their superannuation monies and choose where and how their money is going to be invested.

Employers' contributions are now paid into a fund nominated by the employees. Previously, the super contributions were paid into the fund chosen by the employer. The Choice of fund can also include a complying Self Managed Superannuation Fund.

According to the experts, the choice of funds is expected to increase the competition, culminating in lower fees and increased savings for members. It should also improve the overall standards of the industry and increase the range of investment options.

Ultimately, the choice will encourage and motivate Australians to start thinking and educating themselves about their retirement, saving and investing before it is too late, i.e. once they retire, or even worse, after they are retrenched close to the retirement age and left with only a lump sum payment in their hands.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The government has been organising educational campaigns to ensure that Australians have enough information to make an informed decision about the available options. One of the initiatives is a special web site fully dedicated to the choice of superannuation funds.

The Choice of Fund website is accessible via www.superchoice.gov.au and is the main website through which the ATO and other Government bodies, such as ASIC and The Treasury, communicate to individuals, employers and the industry about the choice of superannuation funds.

The website is designed to guide all employees, employers, and professional advisers through the introduction and ongoing issues of Choice of superannuation funds. Topics covered include not only issues concerning Choice of funds, but also financial product advice and general superannuation related matters. The initiative also provides a new Super Choice Info Line: 13 28 64.

Since the introduction of new Superannuation Legislation relating to the Choice of Superannuation Funds, started 1st of July 2005, government agencies have released a series of free brochures and fact sheets, aimed at helping Australians better understand their superannuation options.

The educational materials supplement the advice consumers should obtain from a licensed adviser and should also engage consumers to start thinking about investing and retirement in general. The fact sheets explaining different retirement options are available from the Australian Securities and Investments Commission’s (ASIC) consumer website, at www.fido.asic.gov.au/retire

The web site offers a wealth of information on retirement, including:

- Plan your financial goals for your retirement years
- Plan your budget using FIDO’s budget planner
- Estimate your super account balance using ASIC’s calculator. Get to know your current superannuation balance by learning to read your annual super statements. Ask your super fund managers to send you information about your retirement benefits
- Look after your eligible rollover funds
- Find out more about your superannuation with ASIC’s Super decisions brochure
- Getting your superannuation earlier? Actions undertaken against the theft by unscrupulous advisers
- Find out how much money you will need to retire
- Know your retirement income options
- Key features of retirement income stream products
- Understanding the language of retirement incomes. For example, do you know what a RBL or a complying income stream is?
- Reverse mortgages' (sometimes called 'home equity loans' or 'housing equity withdrawal')

The recent industry push for the full disclosure of fund managers' fees and charges aims to educate investors, by enabling them to see the fund’s investment performance. The newly imposed transparency of fees and charges facilitates the making of the right decision when it comes to investing the retirement nest egg under the new regime.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
What is a Self Managed Superannuation Fund (SMSF)?

Self-Managed Superannuation Fund (SMSF), also called Do It Yourself (DIY) Super Fund, is a superannuation fund that is regulated by the Australian Taxation Office (ATO) and all members of the fund (maximum of 4) are the trustees of the fund. The exceptions to this rule are, if a member is a minor, or a person is under legal disability.

In such cases regulatory provisions state, that a member of a SMSF cannot be the trustee of the fund, and needs to be represented by some other trustee of the fund.

The principle that all members of the fund are also the trustees, ensures that each trustee takes part in the decision making process of the fund. Trustees also ensure that the fund complies with the Superannuation Industry (Supervision) Act 1993 (SISA), the rules governing the operation of Self Managed Super Funds, as well as with other legislative and administrative requirements. Breach of any legislative requirements could result in the fund losing its complying status and trustees facing civil and criminal penalties.

If a SMSF complies with the SISA standards, the fund is complying superannuation fund and is taxed concessionally at a maximum rate of 15%. To stay complying, the fund needs to meet the sole purpose test, i.e. providing benefits to fund's members on or after retirement, paying benefits to members on the member's death, or benefits being passed on to a member's dependants or legal representatives.

The main difference between a SMSF and any other type of superannuation fund, such as government, industry, retail, or corporate fund, is the fact, that SMSF trustees also being the members of the fund cannot pay themselves any fee for performing trustees' duties. This works in the SMSF's advantage if trustees properly manage the fund's activity, therefore saving on the professional trustee's fees. This can also be a disadvantage, and can waste the fund's assets, if the trustees are not proficient and diligent in performing his/her duties.

So when deciding which type of fund you want to invest your retirement nest egg in, make sure that you understand all the available options, this being one of the most important investment decisions you will ever make.

SMSF is an option for investors, looking to have control over their superannuation assets, who are prepared to work at managing their investments and enjoy the benefits. Apart from managing the investments, some other responsibilities of the trustees are:

- Paying members' benefits
- Record keeping of membership details (and retention of all records for a minimum of 10 years),
- Annual tax returns to the ATO (and retention of all tax information for a minimum of 10 years),
- Change of membership in the fund, or trustee details changes, need to be reflected in the trust deed and the ATO notified,
- Payment of the annual (currently $150) Superannuation Supervisory Levy.

There are two types of regulated Self Managed Super Funds. The most common type is usually called a non-corporate trustee SMSF, and the other one a corporate trustee SMSF. Non-corporate trustee SMSF can be a single or multiple member fund. Corporate trustee Self Managed Super Fund can also be single or multiple member fund.
Non-corporate trustee single member fund has only one member. The member is also the trustee of the fund, and the fund must have another individual as a trustee only. The second trustee cannot be a member of the fund. He or she can be a relative of the member, or alternatively, can be any other person providing the member is not an employee of that person.

Non-corporate trustee multiple member fund has more than one, and up to four members. Each trustee of the fund is also the member of the fund. Members of the fund cannot be employees of another member, unless they are related.

Corporate trustee single member fund has only one member and a company as a trustee. The member:

- Must be the sole director of that company, or
- Must be related to the other director of the trustee company and they have to be the only two directors of that company.

Corporate trustee multiple member fund has more than one, and up to four members, and a company as the trustee of the fund. Each director of the company is a member of the fund.

For more information about any superannuation issue phone the Australian Taxation Office (ATO) Superannuation Infoline on 13 10 20, or visit their web site: www.ato.gov.au/super

**Self Managed Superannuation Fund's Restrictions**

Before embarking on a self managed superannuation fund (SMSF) journey, potential trustees need to make sure that they not only understand all pros and cons of managing a DIY super fund, but also, they need to read on the subject continuously, and be well informed with the ongoing legislative and compliance issues.

The recommended and prudent approach is always to seek the professional advice from an AFSL holder before making any financial decision! *(AFSL -Australian Financial Services Licence - is a license issued by ASIC under the FSRA that permits the issuing of a financial product or giving of financial product advice.)*

If considering a Self Managed Superannuation Fund (SMSF), please note the following restrictions relevant to SMSFs:

- Lending to members and their relatives,
- Acquiring assets from 'related parties' of the fund,
- Borrowing,
- Investing in in-house assets,
- All investments need to follow the two main rules: "sole purpose test" and "arms' length".

It is the duty of the SMSF trustees to separate the SMSF assets from their own personal assets, or assets belonging to their business.
SMSF assets cannot be used for personal or business purpose, this representing the "sole purpose test" i.e. the funds in the SMSF are for retirement purposes only, and cannot be accessed generally until retirement.

Money from the fund must not, under any circumstance, be used for personal or business purposes, as mentioned above. The fund's assets must not be viewed as a form of credit or emergency reserve, should the need arise! The main purpose of the superannuation investment is to generate and grow retirement benefits for the members.

The ATO, being the regulator of the self managed superannuation funds, offers trustees booklets emphasising the importance of fulfilling SMSFs obligations when it comes to compliance issues.

One of these booklets "Role and responsibilities of trustees" is a must reading for everyone running or thinking about starting their own self managed superannuation fund, and it covers SMSF issues from "A to Z" including:

- What is superannuation?
- What is a self managed superannuation fund?
- Superannuation Industry (Supervision) Act (SIS Act) requirements
- Compliance with the sole purpose test
- Accepting the contributions in accordance with the rules
- Managing the fund's investments
- Paying benefits in accordance with the rules
- Meeting administrative obligations
- Appointing an approved auditor
- Winding up the self managed superannuation fund
- Penalties and compliance
- Compliance checklist for trustees.

Copies of the booklet are available by contacting the ATO Super Helpline: 13 10 20, or you can download a copy from www.ato.gov.au/super

**Self Managed Superannuation Fund's Risks, Costs & Charges**

Choosing the right superannuation fund as part of your overall individual investment strategy can be an effective way of achieving your personal financial goals. However no two superannuation funds are the same.

You should speak to a licensed financial advisor before proceeding with any investment including superannuation, and in particular self managed superannuation.

You need to understand the main features of all types of superannuation funds and request assistance regarding investing in a particular fund from a licensed financial advisor before making any decision.
There are risks, costs and charges in choosing to invest in superannuation and self managed superannuation.

There are also risks associated with choosing particular investments – all investments are subject to varying risks and generally all change in value. Different asset classes perform differently at different times.

Every class of asset and each individual asset within a class have different risks associated with them. Whilst the following summary is not exhaustive, the ones mentioned below are the most significant:

- **Inflation**: may exceed the return on any investment in a given period
- **Individual investment risk**: Individual assets can fall in value for many reasons, such as changes in the internal operations or management of a fund or company we invest in, or in its business environment
- **Market risk**: Economic, technological, political or legal conditions, and even market sentiment, can change, and changes in such market conditions can affect the value of investments in the fund
- **Interest rate risk**: Changes in interest rates can have a positive or negative impact directly or indirectly on investment values and returns – for example the income return on a fixed interest security or the underlying cost of a company’s borrowing
- **Changes to superannuation law**: Changes are frequently made to superannuation law, which may affect your ability to access your investment. Recent changes to Family law mean that your superannuation entitlement may now be split with your spouse, by agreement or court order, if you should permanently separate
- **Changes to taxation law**: Changes can also occur to the taxation treatment of superannuation moneys, which may affect the value of your investment and ultimate benefits receivable.

There are also costs and charges associated with investing in superannuation. Here is a list of some of them:

- Entry fees and or exit fees
- Investment charges
- Management fees
- Administration/Accounting fees
- Audit charges
- ATO levy
- Legal costs
- Other costs

Finally, there is a taxation aspect of superannuation. The superannuation fund is, in general, subject to tax at the rate of 15% on the taxable contributions it receives and its net fund earnings.
**Simpler Super**

New Superannuation legislation has been effective from July 1, 2007. The new legislation simplifies and streamlines significantly the Superannuation process, removing complex tax arrangements and providing instruments for increasing retirement funds.

This article outlines the main changes and summarizes the new legislation, but we recommend that you contact your service provider or the Australian Taxation Office if you need further clarification and assistance. Please note that while there are general guidelines applying to the Superannuation and its application in the future, each case needs to be fully investigated in order to assess how the take the advantage of the latest legislation in the proper manner.

The main points of the new legislation are:

- Payment of benefits from a taxed source, as lumps sum or income stream is **tax free, for most people aged 60 and over**.
- Reasonable benefit limits (RBLs) are abolished.
- Concessional contributions made to super will have an annual cap of $50,000. Contributions over the cap are taxed at the rate of 31.5%.
- Non-concessional contributions made to super operate under the annual cap of $150,000. Contributions over the cap will be taxed at the rate of 46.5%.
- Self-employed may be able to claim full tax deduction of super contributions and be eligible for Super Co- Contribution.
- Personal contributions and employer contributions without a tax file number are taxed an additional 31.5%.
- The tax treatment of employment termination payments has changed.
- Deductible superannuation contributions extended up to age 75.
- From 20 September 2007 the pension assets test taper rate is halved to $1.50 per fortnight for every $1,000 of assets above the assets test free area.
- The superannuation preservation age has not changed.
- The ATO Supervisory Levy for self managed superannuation funds (SMSF) increased from $45 to $150 per annum.
- For SMSFs the ATO has streamlined reporting requirements with new administrative penalties for late returns and false statements.
- The ATO is also working on improving the operation and effectiveness of reuniting people with their lost superannuation entitlements and it will take more active role in consolidation of lost accounts.

From the above you can see that, in Australia, people over 60 year of age and in pension do not pay any tax on the income stream from the super fund - no CGT, no tax on dividends, distributions, interest and so on.

---

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or ‘buy’ or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
“To SMSF or not”? 

This brings us to another important issue relating to the Choice: the role of a Self Managed Superannuation Fund (SMSF) under the Choice regime, and the question of whether “to SMSF or not”. There are contrasting schools of thought when it comes to SMSFs, with criticism mainly pointing to the risk/compliance factors and lack of expertise of the trustees. Self Managed Superannuation Funds are not suited for every investor. Potential trustees will need to consider investment risks, on-going costs and the time and skill required of running a SMSF.

Before seeing a professional advisor, it is a good idea to get educated through reading and by browsing the government web sites www.superchoice.gov.au and www.ato.gov.au (select the superannuation pages).

Both websites are excellent sources of information, providing definitions, specific rules and regulations, aimed at a wide audience from financial professionals, accountants, lawyers, tax agents and trustees of funds.

For the more generic approach to the subject, more information about SMSFs is also available on the SuperEasy web site, under Frequently Asked Questions (FAQ). The following table is designed to help potential trustees understand some of the aspects of superannuation and SMSFs and prepare them for a discussion with his or her AFSL adviser:

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Do you understand the following terms and definitions, and their</td>
<td>Y/N</td>
</tr>
<tr>
<td>implications: SMSF, Trustee, Member, Trust Deed, Corporate Trustee?</td>
<td></td>
</tr>
<tr>
<td>Do you understand what the &quot;sole purpose&quot; and &quot;arm length&quot; tests are?</td>
<td>Y/N</td>
</tr>
<tr>
<td>Do you know about benefits and tax rates applicable to superannuation</td>
<td>Y/N</td>
</tr>
<tr>
<td>and SMSFs in particular?</td>
<td></td>
</tr>
<tr>
<td>Did you know that a trustee of a SMSF can't receive any compensation</td>
<td>Y/N</td>
</tr>
<tr>
<td>for the management of the fund?</td>
<td></td>
</tr>
<tr>
<td>Do you know how much money you currently have in your superannuation</td>
<td>Y/N</td>
</tr>
<tr>
<td>portfolio, and who is currently managing it?</td>
<td></td>
</tr>
<tr>
<td>Do you know the current performance of your superannuation fund, and</td>
<td>Y/N</td>
</tr>
<tr>
<td>the charges relating to the running of the fund?</td>
<td></td>
</tr>
<tr>
<td>Do you know how much your current superannuation provider is charging</td>
<td>Y/N</td>
</tr>
<tr>
<td>you: admin fees and management/investment fees? Do you understand all</td>
<td></td>
</tr>
<tr>
<td>of the charges?</td>
<td></td>
</tr>
<tr>
<td>Do you know that some super funds have an entry or exit fee, and also</td>
<td>Y/N</td>
</tr>
<tr>
<td>for investing your money in the fund “Buy Unit Price” and for taking</td>
<td></td>
</tr>
<tr>
<td>the money from the fund “Sell Unit Price”?</td>
<td></td>
</tr>
<tr>
<td>Do you know what an adviser’s commission is and how it works?</td>
<td>Y/N</td>
</tr>
</tbody>
</table>
Superannuation and relating topics have always been one of the most important social and economic issues of almost every country in the world.

It is important for every Australian to understand and appreciate the impact the new legislation could have on their lives.

Our government is attempting to educate the public and put in place mechanisms that enable a smooth transition to the new superannuation system.

Choice of super funds will shift control and decision making towards the end user and with this comes newly acquired responsibility and accountability. Now is the time for Australians to start thinking and planning in advance, by educating themselves and understanding the relating issues.

Gaining the knowledge and understanding of the relevant superannuation issues will help the legislative changes to have a positive and meaningful long term beneficial effect on our society.
Choosing A Broker

Brokers are an essential part of the workings of the share market. Their services can range from simply executing buy and sell orders to offering advice and research.

Full Service Broker

Advantages:

- Knowledge of market participants - who the consistent buyers and sellers are and whether a large line of stock is waiting on the sideline and how it will impact on prices.
- Knowledge of the client - understanding the clients trading equity, shareholdings, risk profile and how often he or she trade.
- Knowledge of market information that might affect the clients decision to buy or sell a particular share.
- Ability to “work” an order to the client’s advantage. A large order in a share with low liquidity could cause a price move that would disadvantage the client. The broker could slowly feed the order into the market in smaller parcels to the benefit of the client.
- Company research.
- Advice.

Disadvantages:

- All of the above, if the client is not making money.
- Cost.

I encourage inexperienced technical analysts to find a full service broker that uses technical analysis and has a similar trading style to them. There are a number of reasons why this can be an advantage:

- Training. Inexperienced traders often ask “where do I start?” They might have developed their trading system but finding shares and pulling the trigger is a big step. A good broker / technical analyst will be sending their clients charts on a daily basis, with recommendations on where to buy, sell and place stops.

Also, many will advise on whether the shares belong in a trading or investment account and if the trade is suitable for a DIY super fund. This gives the inexperienced trader valuable insights as they observe the step by step process of trading by a professional. A lot will be learned, even if the broker’s trading style is different from the clients.

- Time-saving by working together to find trading opportunities. A broker / technical analyst's working life is centered around finding potential successful trading opportunities and managing existing positions.

An example is a successful Melbourne broker with a large number of clients using technical analysis. He is the centre of the network, with potential trading opportunities flowing to him and, when appropriate, on to other clients in the network.
Accountability. Many traders like the anonymity of internet trading. No one knows what they are doing. What company shares they own or the size of their positions. This is all right for the experienced investor but internet trading can be an easy place to hide for the beginner. There is no one to see their mistakes and failures, no one looking over their shoulder to question the wisdom of their trading decisions, when this is exactly what the inexperienced trader needs.

The broker / technical analyst will want information on the analysis behind the trading decision, the stop, money management, position sizing and position management. Beginning traders will be accountable for their investment decisions and they will be better traders for it.

Beginning traders will have a trading system with rules to handle every contingency. They will have a well thought out strategy, before they pick up the phone to call their broker, as there will be no place to hide. The extra cost of trading with a full service broker is worth the opportunity to form a partnership with a professional.

Internet Discount Brokers

Internet discount broking has allowed investors to choose what services they pay for. It has separated the actual transaction cost from the cost of advice and other services. The low-cost benefit of online trading is the primary attraction, though many internet discount brokers are attracting traders with some or all of the following services:

- Improved investor education and customer service
- A larger and more diverse range of products
- Better research
- Transaction speed
- Additional discounts for volume trading
- Portfolio management tools
- Trading platform tools
- Charting service

Every trader will be faced with the decision of whether to use a full service or discount broker.

A beginning trader’s partnership with a broker who uses technical analysis could provide the knowledge and confidence necessary for successful trading. With the right professional, beginning traders can analyse every aspect of every trade recommendation, following the broker’s strategy while perfecting their own.

For the experienced investor with no need or interest in talking to a broker, the internet discount broker delivers cost benefits and total control over buy and sell decisions.
Conditional Orders

Conditional orders give traders increased flexibility to manage their trades by placing an IF order that's held off market and out of view. They are only activated:

✓ **IF** the price is rising and trades with an upward volume of (A) at price (B) or above, then **BUY** (C) shares up to a limit price of (D)

And/or

**IF** the price is falling and trades with a downward volume of (P) at price (Q) or less, then **SELL** (R) shares AT MARKET (or some people limit the sell price).

An extra condition may be that the broker does not place your order until say 1/2 to 1 hour after the market opens (or in the final match out at the close), to avoid excess volatility.

A potential downside is that automated stop loss selling can create false intraday 'avalanche selling' and trades may be exited prematurely. An operated assisted stop loss broker helps eliminate this weakness. They provide a hybrid service, combining computers with a team of brokers to monitor the conditional orders.
CHAPTER 3
MARKET PSYCHOLOGY

- Emotions
- Herd Mentality
- The Holy Grail
- False Prophets
- Gambling
- Myths
- Investment Style & Personality
- Freezing & Panic
- Invoking the Internal Observer
- Coping With Risk
- Remapping The Mind
- Characteristics of a Successful Investor

---

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise: Refer also to our Terms of Use.
CHAPTER 3. MARKET PSYCHOLOGY

Now we know how the market works, we need to look at the detail—the participants, why people trade shares, how damaging the wrong psychology can be—so we can figure out the characteristics of a successful investor.

Many professional traders believe psychology is the most important element to successful trading. Confronting fears, overcoming emotions such as panic, indecision, anger and greed, and building up patience, confidence and detachment are all necessary survival tactics.

The bad news is that the majority of beginning traders are psychologically ill-suited to trading. They are programmed for failure. Consciously, otherwise successful people attempt to transfer beliefs and methods to investing that won’t work. They reason that what worked well in other areas should be applied to investing. Unconsciously, everyone brings along with them baggage from past experiences that interfere with the way they view markets and investing.

The good news is that an understanding of the psychological pitfalls is the first step towards overcoming the problems they present. Reading this chapter is taking that first step. The second step is in knowing yourself well enough to identify your areas of weakness. Self awareness is a key to successful investing.

The following sections outline areas of concern of which every investor should be aware.

**Emotions**

Stress, fear, greed, denial and revenge are enemies of the investor.

Investors might enter trades with good intentions but often lose control of their emotions. This loss of control leads to poor buying and selling decisions, i.e. poor position management. It is difficult to make objective decisions and follow a disciplined trading strategy when under emotional stress.

Emotions interfere with trading when the investor is focused on the money. If a trader has to produce a certain level of income, or needs a few successful trades to stay liquid, trades are often taken for the wrong reasons.

The successful investor is focused on a trading system and money is a by-product of the success of the system.

Also, a dollar lost is twice as painful as a dollar gained. This can have serious implications on a beginning investor’s trading decisions. Recent studies have found that beginning traders are risk averse when initiating a trade but are loss averse once they are in the market. That is, they will do almost anything not to have to close a losing position, often resulting in even larger losses. In addition, profitable trades are often closed out too early to ensure they remain a profit.

Investors that trade on gut feelings and emotions often redo their analysis at emotional extremes and invent reasons to initiate a trade or hold onto a losing position.

Successful investors also have to keep an eye on their egos. When investors believe they are invincible, the market will quickly prove them wrong. With a few losses, fear appears and desperation trading can result in significant draining of money and self-belief.
Many inexperienced traders feel victimized when they have losing trades. They feel that the market is out to get them. This often results in revenge trading, where obstinate investors will repeatedly return to the same share or sector to get it right and get their money back.

Many investors adopt the BHP approach – they **Buy, Hope and Pray**. Lacking a clear trading strategy, they hope the shares they own will rise in price to give them an opportunity to exit the position at a higher price. After the shares are sold, their hope is that the share price will fall, confirming the sell as the right decision. If the share price continues to rise it often causes a considerable amount of anxiety as the hopeful count the money lost in opportunity.

Peace of mind is unlikely to be restored until the share price retreats below the trader’s exit price. Meanwhile, this emotional rollercoaster is exerting a negative influence on all trading decisions.

**The Herd Mentality**

Beginners want to be part of a group. They enjoy the comfort of numbers and running with the crowd. This is not an advantage, as the majority are generally wrong. Professional traders attempt to stay ahead of the crowd by analyzing its behavior. There are several advisory services that publish the results of polling advisors and experts on their recommendations. Contrarians use this information to trade against the crowd.

**The Holy Grail**

A tremendous amount of time is spent trying to find an entry signal with a very high rate of success. The beginning traders’ search for this Holy Grail entry has produced an industry of designer systems and seminar experts. They reinforce the myth that the proper entry technique gives the trader control over the markets.

The entry signal is an important part of the trading system but where do I get in? is not the most important question the investor should ask. Traders should be asking where do I get out?, for it is the exit signal that allows traders to control profits and losses.

Beginning traders who purchase complete systems are invariably disappointed with the trading results. The people selling the trading systems are the only ones making money. Holy Grail trading systems proliferate towards the end of bull markets and disappear altogether when a bear market prevails. They are optimized and curve- fitted to historical data and current market conditions. They are doomed to failure with any change in present market conditions.

Many traders will lose money trading the experts’ system and will then purchase others until they run out of money or develop a system of their own.

There is more to a trading system than the tools that generate buy and sell signals, such as:

- How many shares do I buy?
- How much should I risk?
- Does my trading system suit my philosophy and personality?
- Does my trading system suit the market and timeframe I’m trading?

**False Prophets**

The search for the holy grail often leads inexperienced traders to market gurus for leadership and direction. They believe the key to wealth is in finding the advisor with the secret to the universe.

---

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or ‘buy’ or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Some gurus offer specific trading advice and others promote their unique trading method. The media is happy to satisfy their public’s needs with extensive coverage of the predictions of gurus.

Accurate predictions are used for further publicity and failures are quickly forgotten. Several fortune tellers are still trumpeting successful predictions on the October 1987 market crash. How accurate can an adviser’s track record be when they need to recall successful predictions from more than a decade in the past?

Often overlooked is the advisor’s self interest in the securities being touted. Full disclosure would lend some credibility.

Advisers also fill the inexperienced trader’s need for complex theories about the reasons for market action. Advisors and economists are good at explaining why something happened but it is a different matter when discussing what will likely happen next. As I said earlier, sometimes economics is called the dismal science because it accurately describes the success of economist’ forecasts of events.

Predicting market direction is so difficult that information services regularly poll the advisors and newsletter writers for advice on specific investment strategies and distribute the results to their clients.

A contrary opinion investment strategy is suggested, as historical results have shown that when 80% of the experts agree, prices will move in the opposite direction.

**Gambling**

Gamblers Anonymous is a world wide organization directly modeled on Alcoholics Anonymous. The urge to trade is the same as the urge to drink. Gambling is a disease and there is a significant increase in the number of gamblers turning to the share market because of its respectability. Investing is considered more sophisticated and intellectual than the race track or casinos.

Trading attracts individuals with a self destructive streak who enjoy taking risks. They are often impulsive, trading short-term for the thrill. The adventure and excitement of trading is a major reason people are drawn to the markets. Successful investors learn to keep their emotions under control.

Gamblers believe that after several consecutive losing bets, the odds increase on the next bet being a winner. The trader-gambler is constantly looking for a change in market direction, creating tradable tops or bottoms.

**Market Myths**

There are certain myths about the share market of which beginning traders should be aware. The following points expose some of the more common myths:

- **Fund Managers will produce the best results.**

  Over the long term, fund managers will produce results coinciding with index performance. If you factor in management fees, their results often fall below the index.
• **Shares outperform other assets over the long term.**

There are three time periods in the last 100 years, lasting 20 years each, where investors holding shares for the entire 20 years made little or no profit, adjusted for inflation.

• **Bear Markets cause investment losses**

Bear markets can last for considerable periods of time and offer trading opportunities via a number of strategies, including short selling, buying put options and put warrants and the granting (writing) of call options.

At any time, regardless of the direction of the major indices, there are market sectors that are in a bear trend. A balanced, diversified portfolio would include not only buying shares in rising sectors but a strategy for taking advantage of opportunities in falling sectors.

• **Time in the market is more important than timing**

Fund managers encourage investors to remain in funds for the long term, stressing that it is time in the market that matters. An investor caught in a fund for one of the 20 year time periods mentioned earlier, would likely suffer dramatically, while the fund consistently collects its management fees. Timing is crucial, and is one of the main reasons so many investors are becoming interested in technical analysis.

• **Blue-chip shares always outperform the market**

Blue-chip shares can fall just as hard and just as far as any other share. Size is important when combined with quality. Healthy, blue-chip companies in a rising sector is a powerful combination.

**Investment Style & Personality**

Brett N. Steenbarger, Ph.D. is Director of Trader Development for Kingstree Trading, LLC in Chicago and Clinical Associate Professor of Psychiatry and Behavioral Sciences at SUNY Upstate Medical University in Syracuse, NY. A clinical psychologist and active trader for the past 20 years, Brett is the author of ‘The Psychology of Trading’ and numerous articles on trading psychology for financial publications.

In July, 2004, Dr. Steenbarger stepped down from his medical school faculty position and began intensive work with traders at Kingstree Trading.

Drawing upon an intensive research program that began in 1998, he has created a number of unique measures of market trend, momentum, and institutional activity designed to aid short-term traders. These measures, and the trading strategies derived from them, have been chronicled on his site at [www.brettsteenbarger.com](http://www.brettsteenbarger.com)

The following articles and responses to readers’ questions have appeared in our ‘What’s Up Doc?’ section in our Investing & Online Trading Newsletter. They are reproduced here with his permission.

The following topics apply to investors and traders with experience levels ranging from complete novice through to advanced.
Matching Your Investment Style to your Personality

Having worked with many professional and retail traders since the publication of my book (The Psychology of Trading; Wiley, 2003), I have found that success is not found in a single trading or investment strategy, but rather in the harmonious blending of an investor’s personality with his or her trading approach.

When traders lose money, it is often because they are trading in a manner that does not take advantage of their cognitive and personality strengths and, indeed, may unwittingly be playing to their weaknesses.

In this article, I'd like to toss out a few considerations relevant to the matching of your investment style and your personality.

- **The time frame of your holdings will determine your emotional experience.**

As an investor, your business plan should outline the time frame appropriate for your trades. Are you buying and holding undervalued companies for years, expecting a large, long-term return? Are you trading in and out of shares with positive news or favourable momentum patterns?

Positive returns can be achieved either way, but your experience as a longer-term investor will differ significantly from your experience as a shorter-term trader. Longer time frames allow for more movement: the variation in expected price changes increases as the holding time expands.

This means that, on average, longer-term investments will produce larger (hopefully temporary) drawdown (losses of capital or reductions in unrealized gains) than shorter-term ones. Shares that move from $20 to $30 in a year's time and then back down to $24 in the next few months before trading at $40 six months later require the investor to accept a temporary drawdown of 20% (the drop from $30 to $24) before doubling his or her money.

Such draw downs can be gut wrenching and are not easy to accept for individuals who are risk averse. Indeed, risk averse investors often find themselves cutting their gains short because they cannot stomach the temporary reversals that are expectable over longer time frames. Conversely, shorter holding periods require more active monitoring of the markets and more frequent decision making.

This is fine for individuals who enjoy following the markets, but may be burdensome to those who would like their investments to do the work for them while they go about the business of life. While draw downs will be smaller for the active trader, frequent decision making produces its own stresses and can be deadly for those with impulse control problems (gamblers, etc.) The line dividing active trading from overtrading is small indeed.

- **The time frame of your holdings will determine your business overhead.**

You want to think of your investments as a kind of business. Like any business, they are designed to produce a favourable economic return. You'll maximize your profits if you keep your business expenses down. In the trading world, expenses are associated with each transaction.

If you buy at the market (at the offer price) and sell at the market (at the bid price), you lose at least a tick on either side.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
For actively traded shares, this may not amount to much, but for less actively traded issues—or for some futures contracts—it can add up in a hurry, particularly if you are frequently changing your positions. Of course, there is a commission cost associated with each transaction and, even at discount rates, these can accumulate. A trader who trades once a day and pays even $5 for each side of the transaction will have spent roughly $2500 on commissions at the end of the year.

At that rate, a $100,000 account would have to earn a trading profit of 2.5% just to break even before taxes! While shorter holding periods can look attractive because they minimize draw downs, they can sink your investment business through increased transaction costs.

• **The time frame of your holdings will determine your trading strategy.**

A professional trader holding onto a futures contract for only a couple of minutes in order to buy at the bid price and sell at the offer cannot afford the luxury of exhaustive analysis. The time frame is so short that decisions are necessarily made at an intuitive level. As time frames widen out, they also open the door to explicit analyses, such as technical, fundamental, and statistical analysis.

The active short-term trader who holds on to positions only for a day or two will tend to be less concerned with company and economic fundamentals than the longer-term investor, because those fundamentals aren’t likely to change dramatically in a day’s time.

Such active traders are thus more likely to attend to technical variables, such as short-term trending behaviour, momentum, and volume. Longer-term investors will widen their research horizons and will likely look, not only at the growth potentials of the firms they are considering, but the growth potential for the national economy and the likely impacts of such global factors as currency rate movement, energy price behaviour, and shifts in interest rates.

Many investments are held for intermediate time frames (six months to several years), where a combination of analytic approaches can make the greatest sense.

• **The diversification of your holdings will determine your emotional experience.**

Perhaps the soundest investment strategy of all is diversification. A well diversified portfolio which invests in instruments that are not highly correlated with each other can enhance return and reduce risk.

Share prices, even from different market sectors (industries), still tend to be highly correlated, influenced by the movement in broad market averages. Diversification thus requires an allotment of assets to different investments, such as fixed income, real estate, stocks, and commodities. For example, in an inflationary environment, your fixed income may not perform so well, but your returns will be bolstered by the performance of commodities. A slowing economy could hurt commodities, but support fixed income, as investors seek safety.

When your financial eggs are mostly in a single basket, the emotional pain can be severe when that basket is threatened. Holding different stocks is better than putting all of one’s capital in a single issue, but it is still a single basket in terms of asset class. Hedging the bets is a great aid to sound sleep.

• **Your position sizing will determine your emotional experience.**

I have always kept my trading capital (the money that I use for active trading) separate from my investment capital, and I have always made sure that the trading capital is a very small percentage of my total capital.
Moreover, within my investment capital, I have always made sure that any single investment does not get more than a 5% allotment. What this means is that, if an investment or trade goes sour, I will not suffer a debilitating blow.

To a risk averse individual like me, that works perfectly. I may not make double digit returns year after year, but neither has my investment “business” ever lost money in a year. It is not unusual for traders to make money for a period of time and then lose it all when they make an unusually large bet on a particular trade.

When placing a large portion of one’s capital in a single investment, one not only increases the risk and potential reward, but the emotionality associated with those. Such strong emotions have a way of distorting perception, overriding well-laid plans, and sabotaging the investment business. The idea is to make reasonable, consistent profits that can compound over time—not seek a quick killing that can mortally wound your account.

- **Your risk management will determine the success or failure of your investment business.**

One key metric that separates successful traders from unsuccessful ones is the average length of time they hold onto winning trades versus losers. Because, as we’ve seen, lengthening holding times also increases the variability in the outcomes of a trade, holding onto losing trades inevitably results in devastating losses.

In fact, I have known traders who make many more winning trades than losing ones and yet lose money consistently. This is because the size of their losers far exceeds the size of their winners.

Similarly, with longer-term investments, a **loss of 50% of your capital means that you have to double your money subsequently just to return to your starting point!**

I encourage traders and investors alike to think of each of their trades as hypotheses: You are like a scientist hypothesizing that the investment will give you a favourable return. Like any good scientist, you will need to know what will disconfirm your hypotheses.

For example, if your analysis shows that a company’s shares are in an uptrend and you believe this trend will continue over the next year (due to favourable fundamentals), a break of the trendline may disconfirm your idea.

This disconfirmation acts as a “stop loss”, allowing you to minimize the financial pain of those occasions when you’re wrong. Setting stop losses so that only a small portion of capital can be lost on any given investment and honouring those stops is an essential part of success at any time frame.

Research in cognitive neuroscience suggests that the region of the brain that is primarily responsible for such executive functions as planning, judgment, and reasoning is the frontal cortex. This area is activated with enhanced blood flow when we are in a “thinking” mode.

The brain areas predominantly associated with strong emotional experience, such as the amygdala, divert this blood flow from the frontal cortex during periods of high excitement or stress, literally putting us “out of our mind” for that time.

Trading and investment should not be emotional roller-coasters, and, if they are, we will likely be making financial decisions when we are not in our right minds.

---

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise; Refer also to our Terms of Use.
By matching our investment style to our personalities and following basic rules of diversification, position sizing, and risk management, we will stand the best chance of success in the business of asset management.

Dr Brett Steenbarger

Freezing & Panic

Overcoming Market Panic

Dear Doc,

When I was younger and fitter I played soccer. My skills were okay, but I tended to panic when I possessed the ball and heard the opposition hurtling towards me. Unfortunately I’ve carried this kink in my think over into my share trading.

I love trading. I’ve been learning and applying in earnest for the past year and have managed to overcome several barriers. However, three times I have panicked during a broad market sell off and sold out as I watched my paper profits disappear.

The latest example was yesterday. I’d struck a purple patch recently and the paper profits were looking very healthy. However, my positions began retracing without hitting my stops and those paper profits disappeared like sand slipping through my fingers.

When the market dropped yesterday, I found this too much to handle and I sold out at just above break even! I know I won’t be a good trader until I learn a few strategies to conquer these panic attacks.

I have a few observations and suggestions for our earnest and motivated trader. But first, let me ask you—the reader—to review what he wrote and identify what you think is the most important thing he said. One way of doing that is to figure out what you would first ask him if you were counselling him directly. Would you inquire about:

• The soccer experience
• His emotional reaction to sell-offs
• Yesterday’s market incident
• His desire to be a good trader
• Or something else?

My first question to our trader would be “something else”. I would say to him, “That’s interesting; you say you’ve managed to overcome several barriers. Could you tell me about those barriers and how you overcame them?”

Why would I ask this? Simple: Whatever he did to overcome his earlier barriers may hold the kernel of a solution for his current dilemma. Those solutions reflect the genuine and unique strengths of each individual.

Instead of focusing on the problem and unwittingly reinforcing the notion that he is the problem—Note how easily he jumps from the issue of handling sell-offs to the larger, personalized problem of “I know I won’t be a good trader”—it makes sense to apply his known strengths to the challenge at hand.

This reinforces the important message that even very good traders face huge hurdles to success.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.

JBEbook090610Aa
This approach is known as solution-focused brief therapy, and it is particularly effective as a change strategy for those of us facing normal life dilemmas.

Let’s say you come to me with a trading issue and I find out that you recently worked out a marital problem. You and your spouse learned to be better listeners by not taking disagreements personally and, instead, using them to identify each other’s needs and desires.

Right away, we might then take a look at how you’ve been able to listen to your spouse and how you became able to not take differences personally. Perhaps this same strategy could work when it comes to listening to the market and not allowing your self-esteem to ride the market’s ups and downs!

*The working assumption of the solution-focused therapist is that somewhere, at some time, each of us has successfully dealt with situations that are similar to the present dilemma.*

Depressed people aren’t always depressed, so how about finding out what they’re doing when they’re feeling better about themselves? Couples with problems don’t always argue; what are they doing right when they’re getting along?

And our trader is not always panicking in the market, even when markets don’t always move his way. It would be worth identifying what he’s doing during those times: *the kernels of solutions are often hidden in exceptions to problem patterns.*

As it happens, I faced a dilemma much like our trader’s early in my trading career. I became panicky whenever I increased my size, as even normal movements against my position felt too risky. I overcame that problem when I examined how I handled risk in other areas of my life.

For example, whenever I tackled a new project as a psychologist, such as writing a journal article, I always made sure that there was a guaranteed home for the article before I had finished it. I did this by consulting with editors ahead of the writing. My logic was that, by securing my publication, I could free myself to focus on the process of writing.

Similarly with trading, I learned to take guaranteed profits when positions went my way. Once a trade moved in my favor by the amount I was willing to risk on the trade, I immediately created a trailing stop on the position that guaranteed a profit. *As a result, a winning trade could never become a loser.*

As the position moved in my favor, the stop moved with it, locking in an increasing profit. The security of knowing, “*This trade will be a winner, no matter what*” provided the reassurance I needed to counteract fears of risk.

In my work with high frequency traders, I’ve used the same rationale to create trailing stops on *daily* profit/loss, so that, once the trader is up by a certain amount of money during the day, the stop point for the trading session is moved to a level of assured profitability.

My solution may not be yours; the beauty of solution-focused counseling is that it allows each person to craft solutions based on *their* experience—not the abstract advice of a guru.

If you can identify the occasions when you’re already a good trader, the chances are good that an analysis of those occasions will start you on the road toward solving the next market challenge.

*Dr Brett Steenbarger*
**Hot Risk, Frozen Trader**

Dear Doc,

My son brought home an expression once - "To know and not to do is not to know"

Having studied this newsletter ([Investing & Online Trading](#)) and many books I fully understand the importance of cutting losses short and letting profits run

Yet when tested and the market suddenly drops below my stop loss I immediately calculate in my mind how much money that is and equate it to what I could have done with it e.g. something around the house, an air trip overseas, many air trips overseas and just freeze.

Then when the pain gets really huge, either I'm the last one selling at the very bottom or I think "I won't do that again & be the last one out" so do nothing at all, in which case the rest disappears to virtually nothing.

What’s up doc? Thank you

Frozen

Hi Frozen,

Your problem is more common than you might realise. Many traders spend considerable time figuring out when and how to enter the market, but put far less effort into determining exits and the amount of capital to risk on their trades. As you describe it, the hitting of your stop losses is triggering a sense of regret.

That, in turn, produces a stream of thoughts regarding all the wonderful things that could have been done with the money lost. Such a pattern raises the distinct possibility for me that your stops and/or your position sizes are too extreme for your personal risk tolerance.

Personality studies among traders have failed to unearth a single set of traits that is associated with trading success. We do know, however, that personality is an important determinant in one’s risk tolerance.

As a whole, people who are extroverted and who have a high need for variety and stimulation tend to be greater risk takers than those who are introverted and who desire greater routine and stability.

Many times traders don't know themselves well and set risk parameters for their trading that are not appropriate for their personalities.

As a result, normal trading events, such as being stopped out of a trade, produce abnormal emotional upheaval, interfering with subsequent decision making.

This is especially true when traders are undercapitalized relative to the position sizes they are trading and the amount they are risking on each trade.

The risk in a trade is a function of several factors:

- **Position sizing** – Placing large bets on trades leads to significant volatility in one’s profit/loss statement, and this can contribute to emotional volatility. In many markets, news events and the actions of large traders can move prices many ticks or even points in a short period of time, creating outsized losses when stops are missed (due to the market gapping and not trading at the stop price).

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our [Terms of Use](#).
One trader I worked with recently had sizable bids comfortably below the market prior to the release of an economic report. The market’s violent reaction to the news filled the trader’s position, and prices proceeded to move against the trader. That single loss wiped out months of previous profits.

• **Stops** – It is common for traders to enter large position sizes relative to their account sizes and then hope to balance the risk by entering tight stops. The problem with this strategy is that simple, random price action ensures that the stops will be hit on many occasions, leading to 'death by a thousand cuts'.

The opposite problem, placing overly wide stops or not utilizing stops at all, creates the situation you mention in which a small number of losing trades eat up your capital. One statistic I make sure my traders keep is the average size of their winning and losing trades. *It is very, very difficult for traders to make money over time if their losing trades tend to be larger than their winners.* Wide or non-existent stops ensure that large losers will eventually swamp a portfolio.

• **Holding Period** – The longer one holds a trade, the greater the expectable price variation. Prices move more in a day than an hour, and they move more in a week than a day. Extending your holding period is equivalent to increasing your position size, creating more exposure to adverse price movements.

When traders hold onto losing trades, they create a double risk exposure, *as they widen their time frames precisely at those times when they’re trading their worst.*

If one’s trading method calls for a longer holding period (measured in days rather than minutes or hours), stops will need to be wider, given the expectable degree of normal, random price fluctuation.

This means that position sizing becomes critical to risk management. The risk of a day trade of hundreds of shares and the risk of a long-term trade of only 100 shares may be equivalent.

*It is vitally important to think of the hitting of stops as normal market events.* Your stop is your way of knowing that the idea behind your trade was wrong. Because we are fallible and markets are uncertain, we will be wrong frequently.

Many great traders lose on more trades than they win. Because their wins are larger than their losses, however, they make good livings.

*Stops are their friends, keeping them out of those large losers that eat up many days of profit.*

As I’ve mentioned elsewhere, even a trader who is right 60% of the time and wrong on 40% of occasions will have runs of three losses 6% of the time—many times a year for active traders.

If stops are too wide (or are disregarded), these normal, expectable runs of losses create what is called *risk of ruin*.

Because all traders are subject to risk of ruin, keeping position sizes aligned with holding periods and stops is essential to success. If you’re trading large relative to your account size and you’re worrying about stops being hit, maybe you should worry.
My advice, Frozen, is to reduce your position size to the point where having your stops hit becomes no big deal. When your stop is hit, you want to think, “That’s OK; I can make this back.” You don’t want to feel like it’s a calamity. *If a string of five consecutive losing trades would knock you for a loop, financially or emotionally, you know you’re trading too large.*

All active traders eventually undergo such slumps, even the pros. It’s tough to win at the game if you’re knocked out of the game!

*Dr Brett Steenbarger*

### Invoking the Internal Observer

**Overcoming Psychological Triggers**

- **Become a Trader’s Coach**

*Extract from Dr Brett Steenbarger’s book – The Psychology of Trading*

“... I discovered that many of my trades lacked consistency in execution..... also I found that, when I performed my homework and remained focused on the market rather than on my profits and losses, I actually traded reasonably well.

If you have a valid, tested methodology (and this is a significant “if”) and if you are underperforming the method’s historical performance, there is a real possibility that you ... are encountering triggers for state shifts that are getting in your way....

Many traders – myself included – have at least two trading selves. At times these selves are in sync with the market, letting the hard work speak for itself. Other times, traders front run their trading signals, ignore their stops, double up on their losers and pull the rug from underneath their winners.

If you can examine occasions when you’ve traded in the zone and well out of it, you will find that ... you are carrying on very different internal dialogues at those times.

Activating your Internal Observer and noticing your self-talk as you are trading will tell you precisely who is doing the trading, which of the “I’s” is in control. Many times you do not identify the triggers as they occur, but you can recognise the negative self talk that immediately follows.

This self-talk has an automatic, scripted quality that is largely independent of the objective circumstances of the moment. It truly seems as though the trigger has pressed a “play” button in your head, activating a well-worn tape.

Identifying the contents of those tapes is a very helpful step in being able to interrupt them.

Many times, you can become sensitive to common phrases in your negative self talk, such as “loser” or the catastrophising “what if”, using these to trigger a new more constructive action pattern.

One way of accomplishing that is through what I call the “trading coach” exercise.... In your “trading coach” exercise, you are to go into trades as if you were a mentor to a developing trader.
Your job is to teach this student how to become the most successful trader possible. Imagine that any position you contemplate, enter, or exit is your student’s position.

How will you talk with your student with your student if the trade is going well? If the trade begins to falter? If the student is contemplating an exit or wants to hold on?

*Your job is to be the best coach you can be. Then compare that talk to the self-talk you may have been engaging in before, during and after you put on your positions.*

Most people...have a caring, constructive side that they can access in their relationships, personal and professional. Too often, people cannot access this engaging self once they experience triggers associated with past losses, failures and threats.

By using their negative self-talk to trigger a coaching exercise, people.....can interrupt damaging patterns and replace them with their most positive ones.

....The vast majority of traders I have encountered do not need therapy. Rather, they need to learn to become their own therapists, by observing their triggers and shifting to new modes of thought, feeling and behaviour once their problematic tapes begin playing.

Generally, the successful trades come from immersion in the process of trading. The unsuccessful trades come from immersion in the potential outcomes of trading. The winning trader is immersed in the market...

......The losing trader is not really focused on the market. He is thinking about himself, his account statement or his reputation.

A profitable exercise you can conduct is to ....Identify the contexts in which you are already enacting the role of the successful trader. Audit your trades and observe your patterns.

Focus your attention on what you are doing right during those trades that work out well. And then, in the best solution focused tradition, do more and more of what works – *and find the triggers that help you get into positive modes.*

*The goal is to create a model for yourself of “you, the successful trader”. What you will find, if you observe carefully is that this successful trader is a distinct self, complete with its own moods, internal dialogues, body postures and thinking patterns.*

The idea is to find that spot on your mind’s radio dial corresponding to that Successful Trader and then lock in a preset on that frequency. *You want to access that channel so many times that eventually you can summon it at will.*

All you need to reach your profitability goal is a replicable edge in the markets, a pattern to trade that tilts the odds in your favour. Once you've found that the rest is consistency – doing over and over what works.

Many traders with whom I have talked despair that they have not discovered more patterns to give them an edge. They buy books and attend seminars in the desperate hope of accumulating more sources of edge. That climb up the trading mountain face, however must be tackled one step at a time, beginning with a single toehold.

It is far better to internalise success from a single pattern than mixed results from many patterns.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise: Refer also to our Terms of Use.
As Linda Raschke has emphasised, if you can master even a single trading set-up, you will have set into motion a model – an identity – that can be accessed and expanded many times over. Vince Lombardi (famous grid-iron football coach) once remarked that every game boils down to doing things you do best and doing them repeatedly.

The key is finding what you can do best and making that a template for your future development. .....Traders change when they recruit those aspects of themselves that are focused, disciplined and flexible and import those into their trading – even when there is but one source of edge.

In the absence of consistency, any edge is valueless. Without the trading edge, however – the pattern as well as the consistency to follow it – the rock ledge of trading looks perilously steep and breathtakingly sheer.”

Dr Brett Steenbarger

Coping With Risk

How do you cope with the risk and uncertainty that are built into markets, and are you coping effectively?

The topic of coping actually begins with the notion of stress. Stress is a characteristic set of physiological, cognitive, and emotional responses to threat.

Generally, these responses speed up such bodily functions as heart rate, galvanic skin response, muscle tension, and rate of respiration.

For this reason, the stress response has sometimes been called the “flight or fight” reaction.

In the face of threat, our bodies prepare us for action: either to attack the source of danger or to run from it.

What constitutes a source of stress is highly dependent upon our perception. If we define something as a threat, we will experience it as threatening, and that will trigger a stress response.

For some people, public speaking is an everyday activity, not to be feared at all. It might even be something enjoyable. Others view public speaking as a potentially humiliating event. Their perception of threat triggers the stress response that we call performance anxiety. Cognitive psychologists, however, remind us that it is not the public speaking event itself that is generating the anxiety, but rather our processing of that event.

Take away the perception of threat and the anxiety diminishes.

Some of us view the world through lenses that emphasize the threat in life events.

Perhaps we grew up in an unstable home, perhaps we were overprotected and never experienced life's hard knocks, or perhaps we learned to anticipate negative events as a way of handling multiple setbacks during a difficult period of life.

All of these scenarios can lead to situations where stress becomes a way of life. Once we acquire habitual thinking patterns that emphasize life's dangers, we fall into a chronic mode of flight or fight.
Continually mobilized, we can experience ongoing high blood pressure, muscle tension, and jitteriness.

Psychologically, chronic stress is experienced as dis-stress. Anxiety, depression, and anger are common consequences of viewing the world through the lenses of threat.

These emotional reactions, in turn, produce typical behavioral consequences, such as indecision, lack of self confidence, impulsivity, and interpersonal conflict.

We know from cognitive neuroscience research that high levels of distress shift regional cerebral blood flow away from the frontal cortex--our executive center of judging, planning, and reasoning--and toward motor regions.

This is why it is so difficult for people under chronic stress to calmly work out their problems.

Their perceptions of threat create physical and emotional arousal, which in turn make it difficult to access the cognitive capacities most needed at those times.

Every trader knows how easy it can be to abandon a well thought out trading plan in the heat of adverse market activity!

The term coping refers to the actions we take to deal with sources of threat. Broadly speaking, there are three coping styles:

1. **Emotion-focused coping** - Dealing with dangerous and threatening events by processing one's emotions and engaging others for support

2. **Problem-focused coping** - Handling threats by focusing on the situation and ways of dealing with it to reduce danger

3. **Avoidant coping** - Avoiding sources of threat or choosing to not think about or deal with a problematic situation.

None of these coping styles are good or bad in and of themselves. Each can be used effectively, and each can be misused. We know that a coping style is effective when it reduces threat and produces positive outcomes.

There are times when it can be effective to sort out our feelings and deal with these, such as after the loss of a relationship.

There are occasions when it is very helpful to be problem focused and directly deal with an immediate emergency. Other times, we need to suppress feelings of upset and problematic situations in order to get by in a job or as a parent.

In many respects, the best coping style is one that flexibly incorporates all three ways of handling situations.

While all of us do cope at times by dealing with feelings, attacking problems, and removing ourselves from situations, most of us have characteristic ways of dealing with threat. Those are our typical coping patterns, and they are integral to our personalities.

For instance, if I have a significant problem, I very often will cease interaction with others and become extremely task focused. At such times, my attention narrows considerably and is concentrated on the problem at hand.

---

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or 'buy' or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
This is useful in that it generally accelerates the resolution of the problem. It is not useful in other respects, particularly if it leads to others feeling shut out in a team-based work situation.

If I become locked into particular ways of coping that worked for me in one setting—or during one period of life—and then bring these to new situations, there is a real risk that the coping will no longer ward off threat and may even create new conflicts.

My colleagues at work who feel shut out by my problem focus, for example, may stop collaborating with me at times when I want and need their assistance.

This situation is much more common than people realize, and it is a source of untold trading problems. Coping strategies that worked well at one time or in other situations are brought into the trading arena, where they wreak havoc.

Very often this occurs when the emotions evoked by our perception of trading situations (perceptions of failure, danger, invincibility, etc.) trigger coping actions from an earlier life period where those emotions were problematic.

Perhaps, for example, I felt like a failure in my growing up years because I could not make friends or develop relationships. This led me to cope by avoiding social situations and retreating into my own fantasy world where I didn't have to deal with others.

As a child, this may have helped me through a painful and awkward life period. Now as an adult, however, responding to market losses with feelings of failure—and then retreating into fantasy—is not constructive.

Very often, our most problematic coping occurs when we deal with threatening situations in ways that greatly differ from our normal coping styles. During normal trading, I might be highly problem focused. In a volatile stretch of trading where I take large losses, however, I find myself coping by exploding emotionally and then feeling guilty over my outburst.

Such out-of-the-ordinary coping generally is a sign that an earlier coping mode is being activated. Something about the day's trading is triggering old memories, feelings, or conflicts. As a result, we're no longer using our constructive, adult coping capacities. Instead, we're mindlessly repeating a pattern from the past.

If you find yourself overreacting to a situation, there's a good chance it's not really an overreaction.

You are reacting to the situation—and to something previous in your life that is being stimulated by the situation.

The first step of progress you can make in this circumstance is to remind yourself that you're not really reacting to the situation at hand. "This isn't about trading," you tell yourself. "Something else is going on."

Such a reminder does not, by itself, eliminate the threat response, but it starts the process of putting threat in perspective. That is important.

Remember: threat—and stress—are functions of perception. As you alter your perception, you alter your responses.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Changing How We Cope

Many traders are aware of behaviour patterns that consistently lose them money and can’t understand why they repeat these patterns despite their awareness.

This is the fundamental dilemma that brings people to psychologists: *knowing your problem patterns is necessary for change, but not sufficient.*

Addicts, for example, are typically quite aware of their problems. What waxes and wanes is their emotional connection to the consequences of these problems. To some degree, we are all addicts: we act on habit.

Knowing our bad habits and sustaining the awareness to avoid and change them are very different challenges.

Often, frustrated by their inability to change their patterns--and the perverse tendency to repeat costly mistakes--traders become armchair psychologists and conclude that they harbor, deep within themselves, a desire to fail.

Repetitive patterns are self-defeating, but this doesn't mean that traders have a hidden urge to do themselves in.

In fact, just the contrary: Problem patterns often began as healthy coping efforts during an earlier life period.

This is why they are so resistant to change: they have been over learned precisely because they *did* work so well for a considerable period of time.

Imagine the trader who grew up in an alcoholic household filled with conflict. Fearful of being drawn into the strife, he learned to bottle his emotions and withdraw from heated situations.

Now, as an adult, he no longer lives in such an environment, but bails out of trades at the first hint that they are moving against him. This consistently loses him money, and--feeling like a jerk--he wonders why he so often sells the lows.

He doesn't recognize that the feelings evoked by the losing trade are sufficiently similar to the emotions of the past that they trigger the old methods of coping.

So how can we change these over learned coping patterns? Although the particulars of each person's change process are different, the structure of change is remarkably consistent. Three stages appear to be essential to change:

1) **Pattern recognition** - In some ways this is the most difficult of the stages. It is not possible to change a pattern unless you can recognize its appearance in real time.

For this reason, many therapists have their clients keep journals in which they observe situations that trigger problem patterns and the correlates and consequences of those patterns.

By keeping detailed records, for example, you may find that your pattern of impulsive, revenge trading after a loss is preceded by a high degree of muscle tension and verbal expressions of frustration.

This allows you to use the tension and venting of emotion as cues for recognizing that your old pattern is about to repeat.
Adding a log of your emotions and behaviours to your trading journal is extremely helpful in helping you see the patterns that set you up for success and failure.

2) **Pattern interruption** - Once we become familiar with the triggers and cues associated with problem patterns, we may not know what to do instead, but we can actively choose to not repeat the pattern.

If my pattern is one of anger outburst and impulsive action, I can choose to walk away from the situation and gain a new perspective. This is often most effectively accomplished by interrupting the pattern with vivid reminders of the consequences of those patterns.

For instance, an alcoholic might rationalise that it's ok to go to the bar with friends, but will intercept the "stinkin' thinkin'" and remind himself that his last relapse began exactly that way.

By getting in touch with the consequences of that last relapse (or that last bad trade), a person turns the motivational tables and puts the brakes on automatic behavior patterns.

I often tell my clients that "You will begin to change when you consistently hate your old ways." Once you make the problem pattern an enemy and vividly remind yourself of all the ways it has cost you money and grief, it is much easier to interrupt its future appearance.

3) **Pattern substitution** - After interrupting a pattern, it's necessary to try something different. The alcoholic of our above example might choose to visit a friend or talk with an AA buddy rather than go to the bar.

A frustrated losing trader who is tempted to put on larger trades to make her money back might instead take a break from the screen and engage in biofeedback exercises until she is calm and focused.

*The goal is to take the triggers of the old coping pattern and turn them into triggers for new, more constructive coping.*

Imagery and mental rehearsal are excellent ways of building new patterns for substitution. Before the trading situation starts, for example, the trader might purposely visualize--in great detail--a market scenario that has recently caused emotional havoc.

In her mind's eye, she will watch herself feel tempted to make the same mistakes, but then visualize herself interrupting this urge and engaging in a better trading behavior.

By rehearsing the desired trading behavior before the market session and looking out for triggers during the session, the trader tilts the odds in her favor that she will be able to extricate herself from her old ways.

*The key to making this work is repetition.*

You want to turn your desired behavior patterns into habit patterns. Motivation is important when you first make changes, but eventually you don't want to have to muster your motivation every time you want to do the right thing.

You want the right behaviors to occur naturally. This means that good trading behaviors need to be repeated so many times that they become over learned. Mental rehearsal can accelerate this process, but ultimately we need to work the change process every day in real time circumstances.
Every trading day offers you an opportunity to repeat old mistakes or to make changes. If you focus on personal change, you can't guarantee that every market day will make you money, but you can ensure that every day will be profitable.

Dr Brett Steenbarger

Remapping The Mind – (Edited)

Remapping the Mind: Cognitive Therapy for Traders

Active traders of futures and options make frequent rapid decisions, requiring a high degree of mental clarity. Reviewing their losing trades, they often find that they have deviated from their established strategies and plans, talking themselves into decisions that they would never make in paper trading rehearsals.

It is acutely frustrating to replay the day's session and see the "obvious" signals missed and the impulsive decisions made.

"What was I thinking?" is the common refrain. At times, it seems as though we are not in our right minds.

According to cognitive therapists, that is exactly what happens. In the heat of trading, we shift our mind states, activating automatic thought patterns that can sabotage the best-laid trading plans. The goal of cognitive therapy is to identify these thinking patterns, intercept them, and replace them with more constructive alternatives.

In this article, I will review the basics of this approach and explain how traders can become their own cognitive therapists.

Schemas: The Mind’s Maps

Cognitive therapy begins with the notion that people have a basic need to make sense of their world. Our need to explain life events is so strong that sometimes we will prefer superstitious and mystical explanations to none at all.

A classic example comes from people who suffer from a problem known as panic disorder. In the midst of completely non-threatening situations, such individuals can suddenly experience overwhelming fear. Because the reaction seems to literally come out of nowhere, patients with panic disorder invent their own explanations for their attacks.

If their panic occurred in a mall or in a car, they will assume that malls and cars are the problem and avoid these settings. Eventually, the list of offending situations multiplies to the point where panicky patients refuse to leave their houses.

The webs of ideas that organize our perceptions are known as schemas. We can think of schemas as mental maps. In a sense, they are the filing cabinets in which our experiences are stored.

The Swiss developmental researcher Jean Piaget described intellectual growth as a function of the development of our schemas. When we first encounter new information and experiences, we try to assimilate these to existing schemas.
For example, if we are expecting a market to decline, we may interpret a short-term rise to a new high as a potential head in a head-and-shoulders formation.

If, however, it is no longer possible to fit the new information with our expectations, we eventually accommodate—or alter—our schemas to explain our experience. Thus if the market breaks sharply higher rather than turns down following the suspected “head”, we might abandon our bearish position and trade the upside in a breakout mode.

Ultimately, all of us are heirs to our experience. As we grow older, we develop increasingly rich and complex schemas, helping us understand more of life’s experiences. The categories in our mental filing cabinets reflect the life events we have encountered.

People who have grown up feeling secure and loved will internalize positive schemas about themselves. Someone who has experienced violence and rejection will tend to develop a more negative mental map.

Most of us have met individuals with low self-esteem who can barely accept a compliment. Their filing cabinets simply can’t accommodate positive feedback; it doesn’t fit their experience.

The challenge for traders of stocks, futures, and options is that we inevitably bring our schemas to our trading. How we interpret the world will colour how we interpret market action.

To see how this can disrupt trading, let us consider the example of a trader I will call Tony.

**Identifying Negative Schemas**

The first step in altering negative schemas is identifying them in the first place.

Cognitive therapy views the negative thinking that emerges from depressive, anxious, and perfectionist schemas as habit patterns. Catching ourselves in the act of misinterpreting events and then interrupting those habitual thinking errors is half of the change process.

How can we recognize a problematic schema when it first arises?

The pioneer of cognitive therapy, Dr. Aaron Beck, found that one hallmark of negative schemas is *automatic thinking*. Once these schemas are activated by life events, there is a cascade of automatic, negative thoughts that generate anxious, depressed, and angry feelings.

These thoughts have a scripted quality, almost as if a tape plays inside our heads.

Very often the same thoughts will emerge for very different situations, suggesting that this is not true independent reasoning, but a by product of schemas derived from previous life experience.

Very often people are not aware of their automatic, negative thoughts. By keeping a cognitive journal, traders can become better observers of their habitual thinking.

**The cognitive journal has two functions:**

1) *It can be used to review past problems and identify the automatic thoughts that have sabotaged trading in the past; and*

2) *It can be used in real time to interrupt negative thought and action patterns as they are occurring. Keeping a cognitive journal is useful in targeting specific schemas for change.*
One of the best ways for traders to begin a cognitive journal is to integrate it with a trading journal. Many traders keep a journal of their trades, noting the setups they are trading, the entries, trade sizes, parameters for stops, exits, and profits/losses.

Review of such a journal often yields helpful insights into one’s trading strengths and weaknesses and to monitor the relationship between their trading results and their state of mind.

A real-time trading journal that incorporates a description of the thoughts, feelings, and behaviours at the time trades are placed, managed, and exited allows traders to review their self-talk and identify its consequences.

*Equally important, the filling out of a journal during problem periods requires an interruption of the automatic thoughts.*

By adopting the role of self-observer and identifying the consequences of negative thoughts, the trader begins the process of divorcing the self from schemas.

It is a real step of progress when people can say, “This isn’t really me thinking; it’s that silly tape going through my head.”

Interrupting a pattern is the first step in divesting it of its strength.

### Changing Negative Schemas

The beginning work in cognitive therapy, maintaining the journal, allows traders to identify their negative thoughts as they occur and observe their destructive impact. Once traders become proficient at interrupting their automatic thinking, however, the next step is to turn their thinking around.

There are a number of techniques for altering disruptive thought patterns, as summarised in Figure 3.1 at the end of this article.

This can be accomplished in cognitive therapy where the individual Disputes the negative thoughts and beliefs that are generating anxiety, depression, and frustration.

This disputation is an active process in which people challenge and undermine their negative thoughts. In a sense, the trader plays devil’s advocate to his or her negative thoughts, questioning their validity and reminding themselves of their consequences.

In my own practice, one of my favourite techniques for disputation is to have people role-play conversations they would have with others in similar situations. Interestingly, people who become immersed in their own negative thoughts can be very positive, encouraging, and supportive of others who face the same dilemmas.

### Keys to Success in Cognitive Therapy

Cognitive therapy is not the answer to all problems involving negative thinking. Some people suffer from chronic depression or anxiety and require more intensive psychotherapy and/or medications.

For many people who face performance-based conflicts, however, cognitive work can be a rapid and powerful means for self-change. In these situations, several factors are responsible for the success of the cognitive approach:

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
**Self-monitoring** – Daily monitoring one’s thought processes with a cognitive journal is very helpful in targeting specific thought patterns for change and helping traders recognize the connection between their negative schemas and their trading problems.

Active traders of futures and options often feel as though they do not have the time for such self-work, but without clear targets for change, efforts at self-improvement are apt to be diluted.

**Homework** – Research suggests that there is a direct correlation between the completion of cognitive homework assignments and the eventual success of cognitive therapy.

The idea is to develop new, positive thought patterns, and this can only be accomplished through repetition. Indeed, I would venture to say that such therapy is unlikely to be successful unless traders make a daily commitment to self-work. It is difficult to imagine unlearning longstanding patterns without such consistency of effort.

**Emotional Arousal** – Research studies have also found that the challenging of negative thought patterns is most likely to be successful if it is conducted in an emotionally charged fashion.

Simply filling out a cognitive journal and not truly confronting one’s schemas is likely to prove a futile, intellectual exercise.

In over 20 years of conducting brief therapy and writing numerous academic journal articles and book chapters on the topic, I can state with relative certainty: *The quickest way to change a pattern of thought or behaviour is to make it your enemy.* Once we no longer identify with our problem patterns, it is easier to interrupt them, challenge them, and enact more promising alternatives.

One exercise I found helpful in my own trading was an annual trading audit where I added up the precise dollar amounts of my losing trades that I could attribute to destructive trading practices. I wrote that number down next to my trade station and, each time I was tempted to fall into the old traps, I asked myself if I really wanted to add to that figure. This put the brakes on many ill-considered trades.

In that spirit, I leave you with a homework exercise. Once you have targeted a few automatic thoughts for change, tape a set of cue cards to the wall beside your monitors. One automatic, negative thought will be written on each card, and beside each thought will be an estimate of the amount of money that thinking pattern has cost you.

Before each trade, simply scan the cue cards and nix any impulses to trade if those thoughts are dominant. If you can perform such an exercise with consistency, you will be well on the way toward becoming your own therapist.

**Techniques for Disrupting Negative Thought Patterns**

- **Shifting Gears** – Most negative thought patterns are accompanied by distinctive emotional and physical manifestations. As soon as you notice these manifestations, it is useful to shift emotional gears by discontinuing whatever you are doing and engaging in an alternate activity. For example, you might leave the trade station and perform some vigorous physical exercise. By interrupting the flow of negative thoughts and placing yourself in a different state, you can often return to the situation in a different mode.
Using the Cognitive Journal and Cue Cards – One purpose of the cognitive journal is to remind traders of the potential consequences of negative thought patterns. Often, a graphic emotional reminder is enough to halt traders in their tracks. Cue cards that can be kept handy during trading can serve as a mental “pre-flight checklist” to ensure that traders are in the right mindset for their work.

Performing Stress Inoculation – This is a technique where traders actually mentally rehearse and combat their negative tendencies prior to placing trades. Invoking and coping with these patterns in advance serves as a psychological inoculation, making it easier to deal with problematic schemas when they emerge in real time.

Making Patterns Your Enemy – I often encourage people to associate their most negative patterns with some hated person in their lives, imagining that their self-talk is actually coming from someone they can’t stand. Vividly imagining that negative thoughts are coming from an “enemy” makes it easier to “answer back” and stand up for oneself, beginning the process of building more positive schemas.

Note: These can be useful and powerful techniques, but no psychological methods can substitute for rational trading strategies grounded in research and trading experience. Many traders who experience doubt and fear experience these feelings rationally, reflecting the inner realization that they lack adequate preparation in the markets.

Trading psychology can help you make the most of a good trading system or method, but cannot substitute for one.

Dr Brett Steenbarger

Characteristics of Successful Traders

The previous sections in this chapter explored some of the negatives of market and individual psychology. When traders work on those aspects of their personality which could hinder their performance in the sharemarket and learn about some of the traps and pitfalls to avoid, they are well on their way to becoming successful in their sharemarket endeavours.

The following points are essential for success:

- Successful traders think independently. They do not follow the crowd.
- Investing is a business. The goal of the successful trader is to trade well. Money will be a by-product of conducting business successfully.
- Risk control is an important key to success. Successful traders learn that losses are a part of doing business. No one succeeds at trading without being wrong many times. It is how quickly losses are taken, and their magnitude, which is important. The first goal of money management is survival.
- Successful traders have realistic expectations. A 20% - 30% return per year is a reasonable expectation. Fund managers would be delighted with consistent returns at this level.
- Trade for steady gains and small draw-downs to establish a good track record.
- **No one knows where markets are going.** Successful investors **react** to price movements. They are not forecasting, but working with the probability of historical price action repeating itself in the next timeframe. They have a specialized trading strategy and the discipline to follow the plan.

- **The successful trader is patient.** Knowing when not to trade is often as important as when to trade.

- **The successful trader does not get attached to their trades** or a particular group of shares, but remains unbiased and diversified.

- **Successful traders do not fight the trend.** Good money is made well off the lows and before the highs. Predicting tops and bottoms is the road to ruin.

- **Choose a trading timeframe that suits your personality and philosophy of trading.** This will ensure that your trading fits comfortably with your daily activities, family and lifestyle.

---

Brett N. Steenbarger, Ph.D. is Associate Clinical Professor of Psychiatry and Behavioral Sciences at SUNY Upstate Medical University in Syracuse, NY and author of *The Psychology of Trading* (Wiley, 2003).

As Director of Trader Development for Kingstree Trading, LLC in Chicago, he has mentored numerous professional traders and coordinated a training program for traders. An active trader of the stock indexes, Brett utilizes statistically-based pattern recognition for intraday trading. Brett does not offer commercial services to traders, but maintains an archive of articles and a trading blog at www.brettsteenbarger.com and a blog of market analytics at www.traderfeed.blogspot.com.

Through his own trading experiences and those of individuals he has mentored, Dr. Brett Steenbarger is familiar with the challenges that traders face and the performance and psychological strategies that can meet those challenges.

In his latest book, *Enhancing Trader Performance - Proven Strategies From the Cutting Edge of Trading Psychology*, he shows you how to transform talent into trading skill through a structured process of expertise development and reveals how this approach can help you achieve market mastery.

---

For Audio + Workbook packages to help you build your focus, discipline & personal strengths, see Catherine Taylor's:

- **Your Antidote for Fear**
- **Maximize Your Trading Performance**
- **You and Your Goals**

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
CHAPTER 4

FUNDAMENTAL ANALYSIS

- Company Annual Reports, including Balance Sheets
- Fundamental Criteria and Ratios
CHAPTER 4. FUNDAMENTAL ANALYSIS

As the subtitle of this book suggests, my approach to share trading combines fundamental and technical analysis. First, we will look at the fundamentals.

Fundamental analysis involves analyzing the underlying forces that affect the well being of the economy, industry groups, and companies. Top-down analysis starts with an analysis of global and local economic conditions that could affect corporate performance.

Economic factors that might impact on a company’s success include interest rates, exchange rates, employment levels, inflation and the rate of economic growth.

Top down analysis then works down from industry sectors to specific companies. Depending on the expectations for the economy, certain sectors are likely to benefit more than others. An investor can narrow the field to those sectors that are best suited to benefit from the current or future economic environment. The individual company is important but its industry group often exerts just as much, or more, influence on the stock price. When stocks move, they usually move as groups.

This depth of analysis is most often carried out by professionals such as broker analysts and prominent newsletters. The average private investor would get this big picture (macro) view of global and local economic health from various media sources such as financial magazines, TV, newspapers and newsletters. The present state of economic health could then influence the level at which an investor adds securities to their portfolio.

At the company level, fundamental analysis may involve examination of financial data, management, business concept and competition. Most often, the aim of company analysis is to derive a stock’s current fair value and forecast future value.

If fair value is not equal to the current stock price, fundamental analysts believe that the stock is either over or under valued and the market price will ultimately gravitate towards fair value. By believing that prices do not accurately reflect all available information, fundamental analysts look to capitalize on perceived price discrepancies. Most private investors focus on a company’s financial data.

A company’s vital statistics and financial performance are used to determine the financial health of a company and to then compare it to other companies. Some of the more popular ratios are found by dividing the stock price by a key value driver.

Below is a list of potential inputs into the financial analysis of a company:

<table>
<thead>
<tr>
<th>Net Tangible Assets</th>
<th>Market Cap.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow</td>
<td>Sector</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>SubIndustry Sector</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>Net Profit Margin</td>
</tr>
<tr>
<td>Price Earnings Ratio</td>
<td>PEG Ratio</td>
</tr>
<tr>
<td>Debt:Equity Ratio</td>
<td>Earnings per Share</td>
</tr>
<tr>
<td>Debt to CashFlow</td>
<td>Earnings per Share Growth</td>
</tr>
<tr>
<td>Dividend</td>
<td>Interest Cover</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td></td>
</tr>
</tbody>
</table>
**Information**

The key sources of information on fundamental analysis are the Australian Stock Exchange (ASX), stockbrokers, media, the internet and computer software packages.

The growth of investment information on the internet has been phenomenal. Statements of financial position and ratio analysis can be obtained from websites of stockbrokers, financial services providers and some companies provide research on their own website.

Below is an example of a company’s vital statistics and financial performance that might be viewed on the internet.

<table>
<thead>
<tr>
<th>Ordinary shares on issue</th>
<th>100m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share price</td>
<td>$1.00</td>
</tr>
<tr>
<td>Market capitalisation</td>
<td>$100m</td>
</tr>
<tr>
<td>Earnings per share</td>
<td>10 cents</td>
</tr>
<tr>
<td>PE Ratio (share price/EPS)</td>
<td>10 times</td>
</tr>
<tr>
<td>Dividend per share</td>
<td>5 cents</td>
</tr>
<tr>
<td>Dividend yield (DPS/share price)</td>
<td>5%</td>
</tr>
</tbody>
</table>

**Abbreviated statement of financial performance**

| Sales revenue            | $125m |
| Earnings before interest & tax (EBIT) | $17m |
| Taxation expense         | $5m   |
| Net interest expense     | $2m   |
| Net operating profit     | $10m  |
| Depreciation expense     | $3m   |
| Cash flow                | $13m  |

This financial information could help an investor determine whether a company is healthy and low risk and how it compares to other companies. As part of the analysis process, it is important to remember that all information is relative. Usually, companies are compared with other companies in the same sector. For example, a media share (Fairfax) would be compared to another media share (Rural Press), not to a retailing company (Coles Myer).

Analysts, working for Share Brokers, are the acknowledged experts in this field and relieve us of the need to master this discipline. We do not need to compete with these experts, as their analysis is readily available, often at a cost.

Whenever companies release financial or other relevant information—which they do at least twice a year—the experts analyse the fundamentals and the ratios created from the raw data and recommend the purchase of shares in companies with favourable fundamentals. The investor who follows this advice would need only a working knowledge of the specifics of fundamental analysis.

In Chapter 8 several fundamental criteria are grouped together to show an example of a trading system.

**Annual Reports**

Listed companies are required to publish and distribute an annual report to shareholders. Annual reports are commonly thick, glossy publications containing a seemingly endless amount of figures, some more confusing than others. Knowing what to look for is the first step in the analysis, separating the wheat from the chaff.

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to ourTerms of Use.
Below is a list of the kind of information that can be obtained from a company’s annual report:

- Net Profit
- Dividend
- **Franking (TAX) Credits**
- Directors’ Report
- Profit and Loss Account:
- Sales
- Abnormal & Extraordinary Items
- Balance Sheet:
- Assets and Liabilities
- Intangibles: Goodwill, Brand Names, Intellectual Property
- Cashflow Statement
- Auditors’ Report
- Accounting Policies Report

A valuable source for those seeking fundamental information is the internet. Online brokers and specialized web sites offer their clients an increasing amount of fundamental analysis as raw data and recommendations.

In addition to brokers and the internet, fundamental software packages are a further source of raw data and analysis. They enable an investor to rank companies based on a single fundamental or group criteria and search for companies that meet a number of specific fundamental requirements. Investors would benefit from a basic understanding of fundamental data and ratios if they intend to use a software package.

The following sections explore some of the basic fundamentals and ratios investors will encounter in their research.

**EARNINGS PER SHARE (EPS)**

\[
\text{EPS} = \frac{\text{NET PROFIT}}{\text{# OF SHARES}}
\]

\[
\text{EPS} = \frac{\$10 \text{ M.}}{100 \text{ M. SHARES}} = \$0.10 \text{ CENTS PER SHARE}
\]

**EPS** is the net profit of the company divided by the number of shares on issue. It shows the profit earned for every share on issue. There is a high correlation between **EPS** and a company’s share price. If the **EPS** figure is down from the previous year, was it caused by declining profits or an increase in the number of shares? How much of the earnings are from operations and how much from once off events? How much of the earnings were paid in dividends?

**PRICE EARNINGS RATIO (P / E)**

\[
\frac{\text{P / E}}{\text{EPS}} = \frac{\text{SHARE PRICE}}{\text{EPS}} = \frac{\$2.00}{\$0.10 \text{ per share}} = \times 20 \text{ TIMES}
\]

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The **P / E** ratio looks at **EPS** in relation to the company’s share price. It is a measure of expectations. In this example, the **P / E** number of 20 times suggests that at the current rate of earnings, the company will take 20 years to pay the share buyer back for the price paid for the share.

Many analysts use this ratio to determine whether a company is under or overvalued but the financial health of the company must be taken into consideration. A low Price-to-Earnings ratio could mean the company is in extreme trouble and could be facing liquidation.

**DIVIDEND PER SHARE (DPS)**

The **DPS** is the amount the company pays to shareholders, out of net profits. It is expressed in cents per share. It is the return the shareholder receives for owning the company’s shares and is not related to share price moves.

It is important to know if the dividend is paid from current or previous earnings and what percent of earnings were paid in dividends.

**DIVIDEND YIELD**

\[
\text{YIELD} = \frac{\text{DPS}}{\text{SHARE PRICE}} \times 100
\]

Dividend yield is the return on owning the share, expressed as a percentage of current share price.

The percentage rate obtained from this calculation is useful for comparing against other investments. Many investors target dividend income in their trading strategy.

Investors should be cautious of companies with an unusually high yield as this could be a danger signal. The high yield could be a short term strategy to attract funds in an attempt to cover some long-term problems.

Investors targeting dividend income need to be aware of the franking credits associated with the dividend. A franked dividend entitles the shareholder to a tax credit because the company has already paid tax on the dividend before distributing it to shareholders.

**NET TANGIBLE ASSETS (NTA)**

\[
\text{NTA} = \frac{\text{NET ASSETS - INTANGIBLES}}{\# \text{ OF ORDINARY SHARES}}
\]

\[
\text{NTA} = \frac{\$85 \text{ M}}{50 \text{ M}} = \$1.70 \text{ PER SHARE}
\]

**NTA** shows the value of a company’s assets on a per share basis. It is the theoretical worth of a company, after paying off all debts. The valuation is the theoretical price the assets would likely receive in the market if the company were liquidated. A share price considerably below...
NTA could attract a corporate raider who would buy up all the shares, pay off the debt and sell the remaining assets for a profit.

The assets might be worth $1.70 per share (as in the example above), but what price would the assets receive in the marketplace, especially during a liquidation process?

Intangible assets, such as brand names, goodwill and intellectual property are excluded because they are difficult to value. The accounting rules that cover these assets have considerable flexibility about how the rules are applied. The problem is that many company’s main assets are these intangibles.

**PRICE-TO-NTA RATIO**

\[
\frac{\text{SHARE PRICE}}{\text{NTA}} = \frac{\$2.00}{\$1.70} = 1.17
\]

Divide the share price by NTA to calculate the price-to-net-tangible assets. This ratio values the company’s share price against its net tangible assets. A figure of 1.00 means the company is valued in line with its NTA. A figure less than 1.00 means the company could be a bargain, or could be in considerable trouble. In our example, this company is trading at 1.17 times NTA.

**RETURN ON EQUITY (ROE)**

\[
\frac{\text{NET PROFIT} \times 100}{\text{SHAREHOLDERS EQUITY}} = \frac{\$40,000 \times 100}{\$200,000} = 20\%
\]

ROE measures the after-tax profit as a percentage of shareholders’ equity and is a good test of a company’s profit performance. On a shareholder’s investment, it tells how much the company’s managers made for them. Many analysts believe the trend in ROE is one of the best indicators of likely share price performance.

A high ROE will place management in a favourable position and provide the profits to fuel further growth and attract future funding.

**MARKET CAPITALIZATION**

\[
\text{MARKET CAP} = \text{SHARE PRICE} \times \text{NUMBER OF SHARES ON ISSUE}
\]

\[\text{e.g. } \$1.70 \times 50 \text{ MILLION SHARES} = \$85 \text{ M. CAPITALIZATION}\]

This is the measure of the size of a company and is an important fundamental criteria I use in the trading strategy outlined in Chapter 8.

For conservative, long term investors there are sound reasons for concentrating on companies with a high market capitalization. Portfolios and funds with large cap shares show less volatility. The spread between buyers and sellers is usually narrow.
There is plenty of fundamental research available and a greater interest from institution investors. The “Blue-chips” are often high cap shares.

A “Blue-chip” share gets its name from a casino’s most expensive betting chip. It is considered a quality investment, based on size, reputation, balance sheet and management.

**SUMMARY**

It is important to remember that there are a number of limitations to investment decisions based only on fundamental analysis. This was shown in 2001 when a prominent broker sent a letter to its clients with an explanation of how its research team recommended a company that was subsequently placed in provisional liquidation.

The broker’s recommendation was based on information from company officers, an investment agency’s favourable rating of the company’s financial position, the lack of any indication of concern from regulators, company audits, the industry outlook and the company’s response to media reports.

All this fundamental information, coupled with the expertise to evaluate the criteria, produced favourable reports and resulted in disaster for shareholders.

The failures in 2000-2003 and again in 2008-2009 of several high-profile companies have thrown the spotlight on the accounting profession and the regulators. Auditors are reliant on the information provided by the company.

A trusted senior executive at one collapsed company explained to receivers how he deliberately manipulated the books to achieve profit targets demanded by more senior management. The fact that the accounts were audited provided no protection for investors. Traditional accounting methods are being put under the microscope, with many analysts claiming inadequate methods need to be upgraded to disclose the true health of public companies.

Another limitation of fundamental analysis relates to the company’s share price. In the short term, a healthy company could perform poorly in terms of its share price and a company with poor fundamentals could do very well.

Investors need to be aware of the strengths and weaknesses of fundamental analysis and to combine those strengths with the strengths of technical analysis (see the following two chapters) to develop a common sense approach to investing.
CHAPTER 5

TECHNICAL ANALYSIS –
The Basics of Charting

- Types of Charts
- Trendlines
- Support and Resistance
- Reversal Patterns
- Continuation Patterns
- Gaps
CHAPTER 5. TECHNICAL ANALYSIS – The Basics of Charting

Technical analysis is the study of price action in the attempt to gauge the probable future direction of market action. I have divided this analysis into two sections; charting (discussed in this chapter) and technical indicators (see Chapter 6).

Charting is old school technical analysis. Before computers, chartists collected price information from newspapers or brokers and would hand draw their charts on graph paper.

The chartists’ tools are patterns and trends. Chart analysis is subjective and is often called an art. The analysis involves reading the chart, which means inexperienced investors often see what they want to see.

New school technical analysis uses indicators as tools, relying on mechanical trading systems. Many new school analysts avoid chart reading as they would not want to make an investment decision based on subjective analysis.

Charts present historic facts showing previous market behavior. They can help an investor observe market trends, gauge the relative strength of buyers and sellers, identify potential trades and formulate a risk strategy.

The approach of individual chartists can vary considerably, as chart formations have different degrees of reliability and are subject to different interpretations. Each chartist must develop his or her own style in translating chart analysis into trading action. A consistent approach is vital.

The underlying philosophy of charting is based on three premises:

1. Prices move in trends. The flow of prices is not merely a series of random events. Once prices start to move in a certain direction, the existing trend should continue.

2. The market has a memory. This is based on the belief that in analyzing a chart a trader is, in part, analyzing the behaviour of those setting the prices. As a random group, participants in the marketplace have responded one specific way at a given price.

   Traders are often sensitive to those price levels and may respond again to the same prices. Depending upon the price and the trend, the reaction may be the same or the opposite. This action and reaction to price stimuli is called support and resistance.

3. History repeats itself. An attempt to understand the future stems from the study of the past. Price movements often trace out patterns or chart formations at similar junctures, which could indicate the direction of the next price move. Chart patterns and formations that have worked historically are likely to continue to work in the future.

Types Of Charts

Charts are created from the open, high, low, and close prices (commonly abbreviated as OHLC) of the share being analyzed.
There are four types of commonly used charts:

- Bar charts
- Line charts
- Point and figure charts
- Candlestick charts

**Bar Charts**

Bar charts are the most widely used as they are simple to understand and provide the necessary information to obtain a clear picture of previous market action. Chart 5.1 below is an example of a daily bar chart.

**Chart 5.1 Bar Chart**

The horizontal x-axis displays the timeframe across which the price has been plotted. The price range is shown on the vertical y-axis. On each bar, the top of the bar represents the highest price the share traded for the time period (whether daily, weekly or monthly), with a line drawn down to the lowest price traded for the period.

A small horizontal tick to the left of the bar is drawn at the opening price and the horizontal tick to the right is the closing price. Volume is the number of shares traded for the period being analyzed and is plotted in separate section below the corresponding price bar, usually as a histogram.

Over time, a picture of the flow of prices begins to emerge. Chartists are looking for price relationships, such as:

- The close in relation to the range. Is it in the top or bottom half of the range?
- The close in relation to the open. Is it higher or lower?
- Is the close higher than the previous close and higher than the previous high?
- Is the share making higher highs and higher lows?
- Is volume rising with higher closes?
A longer-term perspective may be gained by plotting a weekly chart with Monday’s open, the high and low of the week and Friday’s close. A weekly chart can give the analyst a clearer picture of the major trend. After gaining a feel for the bigger picture, the investor could analyze shorter-term charts to determine specific entry points.

**Line Charts**

Line charts, (see Chart 5.2 below), are constructed by joining the closing prices of each trading session.

**Chart 5.2  Line Chart**

They have less detail as they do not show the open or the range. Some analysts believe they present more of an overview of the market as they eliminate some of the noise – irrelevant fluctuations from the price movements.

**Point and Figure Charts**

Chart 5.3 below is a point and figure chart. It records only closing price action, which could make it easier to see important features such as support and resistance levels, patterns and trendlines. As with a line chart, a lot of noise is potentially eliminated. The time axis is only used to display how long it took for a series of moves to occur.

**Chart 5.3  Point & Figure Chart**
Point and figure charts use alternate columns to show the direction of price movements up or down. Each X represents the price moving up and O represents a down move. The box size is the amount the price must move, on a cumulative close to close basis, before adding another X or O. In this example, the box size is $.05 cents. After adding an X, a close $.02 cents higher the following day and another $.03 cent higher close the next day, would require another X. Each column shows prices moving in only one direction.

If the market continues to rise, the chartist continues to add Xs to the column (and vice versa), until prices move $.15 cents in the opposite direction, called a 3 box reversal. With a reversal that is a price decrease, move over one column, down one level and add three Os to represent a price decline of $.15 cents. You now stay in this column, continuing to add Os for each cumulative fall of $.05 cents, until a price rise of $.15 cents, 3 box reversal, occurs.

Candlestick Charts

Chart 5.4 is a Japanese candlestick chart. This charting technique, developed in the seventeenth century, displays the open, high, low and closing prices in a format that quite clearly shows the relationship between the open and closing prices. The body of the candle is the range between the open and the close. If the close is above the open, the body is left white. If the close is below the open, the body of the bar is black. The vertical lines at each end of the body represent the high and low and are called shadows.

Chart 5.4   Candlestick Chart

The interpretation of the charts is based primarily on pattern formation over a period of one to three days. Note the predominance of white bodies in a rising market and black bodies in a falling market.

Many analysts believe this shows which traders are in control, the amateurs who set the open or the professionals who exert a major influence on the closing price.
Recognition of Candlestick reversal patterns can be an invaluable tool for short term traders. They are examined in more detail in the section on Chart Patterns later in this Chapter. Louise Bedford’s “The Secret of Candlestick Charting” is recommended reading for those traders wanting more information on this ancient charting technique which has regained widespread interest by modern day traders.

Trends and Trend lines

A basic tenet of chart analysis is that price movements are not a series of random events. Prices move in trends, a general or prevailing rise or fall in prices. The advantage of identifying and following trends is significant as it can increase the probability of successful trading.

The simplest definition of a rising trend is a market that is characterised by a series of higher highs and higher lows. A downtrend has a series of lower highs and lower lows. Chart 5.5 below shows a series of higher highs at points (1), (2) and (3). The series of higher lows are seen at points (A), (B) and (C). By this definition, it is clearly a rising trend. These higher highs and higher lows are also known as pivot points.

Chart 5.5  Rising Trend With Higher Highs and Higher Lows

Trend lines are used to help define the prevailing trend and to alert the trader to a possible change in trend. They are drawn below prices in a rising market and above prices when a market is falling.

There are many different techniques for drawing trend lines. Their importance, as with all subjective charting techniques, is questionable. What chartists are working with is probabilities. If a technique has been successful historically, the probability is that it will work in the next time frame.
One technique for identifying trend lines is to connect the lower lows referred to earlier. In Chart 5.6 below, the starting point is the lowest point before the price started trending higher. From the low, prices had a two day rise to $5.72 and retraced to $5.58 at (A).

When the market moves off this low, a tentative trend line is drawn from the low to point (A) and extended to the right side of the chart. This tentative trend line has little value at this time and only gains validity and importance when prices establish the first higher high at point (1).

This trend line provides support at point (B) and prices make a higher high at point (2). The higher low at point (C) results in another trend line, (B) to (C) and extended to the right.

**Chart 5.6 Rising Trend lines**

Once a trend line is established, chartists are looking at future support areas and the potential break of the trend line to signal a reversal in trend. The significance of a trend line increases with the amount of time it exists and the number of times it is tested. The slope of the trend line is also important.

If it is quite steep, it should be treated with caution as even a sideways, trendless move will break the line. Many analysts place the greatest value on a trend line rising or falling at approximately a 45 degree angle.

This might be a good idea, but with most software charting packages, the angle is changed by expanding or contracting the scale.

For **uptrends**, the trend line is drawn to connect the lows at as many rebound points as possible. In comparison, for **downtrends**, the trend line is drawn to connect the peak highs.

The weekly chart of BHP, Chart 5.7 below, shows a falling trend line touching a series of lower highs at points (1), (2) and (3). Lower lows are at (A), (B) and (C). The share is clearly in a down trend until the break and **potential** reversal of the trend in March 1999.
The share moves considerably higher, but a break of trend line alone is not enough to justify establishing a trading position. **Weight-of-evidence** requires a number of indicators to be present and in agreement before any action is taken.

*(Chapter 8, Trading Strategies, has more information on this.)*

**Chart 5.7 Falling Trend line**

**Support And Resistance Levels**

Support and resistance may be thought of as the memory of the market, as previous highs and lows become important future reference points. These levels appear on the chart as horizontal lines.

**Support** is a price range where buying could develop to prevent prices from falling lower. It acts as a **floor** under prices. In Chart 5.8 below, prices first traded around the $11.00 level in November and December at point (A). This became a support level after prices held at this level in February at (B) and again in May at point (C).
One reason support might occur is because many buyers, having missed out on buying at this lower price, are all thinking “If the price ever falls back to $11, then I will buy”.

They wait patiently for sellers to force prices down to the support level where buying could create a rebound in prices, often from an oversold condition (refer to RSI in Chapter 6).

Resistance is a price range where selling could develop to prevent prices from rising. It acts as a ceiling above prices. Prices in Roc Oil, Chart 5.9 below, are having difficulty moving above $1.98, with prices experiencing resistance at points (A), (B), and (C).

One reason resistance might occur is because many sellers, having missed out on selling at this higher price, are all thinking “If the price ever climbs back to $1.98, then I will sell”.

They wait patiently for buyers to lift prices up to the resistance level, where selling often creates a retracement in prices.

Support and resistance levels often occur at psychological price levels such as round numbers e.g. 10c, 50c, $1.00, $2.00, $5.00, $10.00, $20.00 and $50.00, as inexperienced buyers and sellers queue up to place their buy or sell orders at these exact price levels.

Experienced traders buy near support and sell near resistance.

**Beware of the major pitfall** that many inexperienced traders fall into by trading in reverse – they donate their funds to more experienced traders by buying near resistance and selling near support.

In terms of trading it may be seen that support and resistance levels gives the chartist clues as to where price moves are likely to halt and where trends are likely to reverse.

Two time factors influence the efficiency of support and resistance levels:

1. The distance in time between similar price levels - the greater the distance the greater the potential influence.

2. The amount of time a market spends in a congestion area that existed at an earlier date is directly related to the influence the support and resistance level should have at a subsequent time.

**Chart 5.9**  

![Chart 5.9](chart5.9.jpg)  

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Support and resistance levels becomes an even more valuable tool when they become polarised.

Polarity is the state of having two directly opposite tendencies. A chartist would be particularly interested in a support level that was previously a resistance level. Westpac Bank, Chart 5.10 below, has two examples of support / resistance polarity. The first shows resistance at points (1) and (2), with subsequent support at (3). The second example shows resistance at points (A) and (B), with subsequent support at (C).

**Chart 5.10 Polarised Support/Resistance Levels**

**Chart Patterns**

Pattern identification is a key element of chart analysis. Patterns fall into the two main categories:

1. **Reversal** – a reversal pattern occurs at market bottoms or tops and signals a potential halt and reversal of the current trend.

2. **Continuation** - continuation pattern occurs when the current trend is interrupted with a consolidation pattern. A break from these patterns should see the market continue in the direction of the prevailing trend.

**Reversal Patterns**

The most important prerequisite to a reversal pattern is a prior trend. The more substantial the trend the more likely it could reverse. Also, the larger the pattern, the greater the significance.

**Topping** formations are usually shorter in duration and more volatile than bottom reversal formations. Market tops often occur when traders are at their most optimistic and fully invested with favourable fundamentals and news. When traders sense a change in trend, panic selling can send prices sharply lower.

**Bottoms** are usually typified by a lack of interest, resulting in smaller trading ranges. They usually develop over a longer period of time.
Sometimes bottoms occur as ‘capitulation moves’ as the last of the sellers panic at the very lowest levels. For example, at the end of the three year bear market in mid March 2003, the All Ordinaries Index, Chart 5.11, dropped 390 points in 38 days, then rebounded sharply, to mark the start of the next bull run.

Chart 5.11  Capitulation Bottom

![Capitulation Bottom Chart](chart.png)

**Head and Shoulder Pattern**

One of the most reliable chart patterns is the head and shoulder pattern. Brambles, Chart 5.12, below, shows a bearish head and shoulder pattern with the neckline drawn from one side of the head (A), to the other at point (B) and extended to the right. Confirmation is the break of this neckline. Many chartists also look for declining volume as further confirmation. As prices rise to create the head, volume should be less than on the left shoulder and less again on the right shoulder. The right shoulder’s failure to make a new high is an early warning signal of a reversal, as markets need to make higher highs to maintain a rising trend.

Chart 5.12  Bearish Head and Shoulder Pattern

![Bearish Head and Shoulder Pattern Chart](chart.png)
Chart 5.13 below, shows a bullish inverse, or reverse, head and shoulder pattern.

**Chart 5.13  Bullish Head and Shoulder Pattern**

![Bullish Head and Shoulder Pattern](image)

**Key Reversals**

A **bearish** key reversal pattern is formed when the day’s, or week’s, high is higher than the previous high and the low and close are lower than the previous low.

A **bullish** key reversal pattern is formed when the day’s, or week’s, low is lower than the previous low and the high and close are higher than the previous high.

Each pattern gains significance if it occurs at, or near, the absolute top or bottom of the move. Charts 5.14 and 5.15 below, are examples.

Chart 5.14 is an enlargement of the Brambles head and shoulder pattern from Chart 5.12. A bearish key reversal formed at the absolute top of the move. The high was higher than the previous high and the low and close were both lower than the previous low.

**Chart 5.14  Bearish Key Reversal Pattern**

![Bearish Key Reversal Pattern](image)
Chart 5.15 shows a bullish key reversal on the weekly chart of Amrad. The reversal is at the absolute bottom of the move.

**Chart 5.15  Bullish Key Reversal Pattern**

![Chart 5.15](image)

**Double And Triple Top And Bottom Patterns**

These formations, Charts 5.16 and 5.17 below, are straightforward patterns. The prices at the peaks or troughs need not be at exactly the same price.

The patterns are alert or early warning signals, depending on whether they occur at a bottom or top, respectively. Bullish patterns or indicators in a falling market are alerting the investor to the possibility of a change in trend and a buying opportunity. Bearish patterns or indicators in a rising market are warning shareholders of the possibility of a change in trend and to monitor stop-loss orders to protect profits.

They are often the first signal the analyst receives that suggests a potential change in trend.

A correction, or retracement, from a recent high or low creates the first peak or trough. Prices moving back to this area will offer future support or resistance as investors remember the levels at which shares established recent highs or lows.

This memory of the market applies irrespective of whether the investors are using charts. Chartists simply view these support and resistance levels but even investors that reject charting are remembering important trading levels at some level of consciousness.

Once a double bottom or top is established, weight-of-evidence will assist with the decision to trade and timing of the entry or exit.
Bullish Wedges

The reversal pattern, in Chart 5.18, is called a bullish wedge. It is not a frequently occurring pattern. It displays a contraction of trading ranges as it makes marginally lower lows, appearing to run out of downside momentum.
The bearish traders are still in control but it would take very little in the way of rising prices to change market sentiment. Volume should decline as the wedge forms, confirming the current move down lacks strength.

**Chart 5.18  Bullish Wedge**

Some patterns are specific to candlestick charting. For many candlestick reversals, there is a bearish candlestick or combination of candles in a recognisable bearish pattern at the top of an uptrend, with a corresponding bullish reversal candle or combination of candles exhibited in reverse at the bottom of a downtrend. The following charts show examples of candlestick reversal patterns.

**Evening and Morning Stars**

An Evening Star pattern, in Chart 5.19 below, is a small body seen above and between the two bodies on either side.

**Chart 5.19  Evening Star**
It is a three candle pattern that formed in November on the PBL chart and later becomes part of a double top. Prior to the evening star the market is clearly in an uptrend with closes consistently higher than the opens.

The day of the star also looked promising, with prices making higher highs, but indecision appears when the market closes near the open and in the lower half of the range. The pattern is completed the following day with the isolation of the star and a close below the open, suggesting the sellers are in control.

A Morning Star is the opposite, forming at a market bottom.

**Engulfing Patterns**

A Bearish Engulfing Pattern, Chart 5.20 below, is formed at the top of an uptrend when a large body engulfs a previous, smaller body of opposite colour. It is a two candle pattern that formed in May on the Mayne Nickless chart at a triple top.

The first candle has a white body as the close is higher than the open for the third day in a row. The following day the market closes below the open, creating a black body that is greater at both ends than the previous body and signals a potential change in trend with the sellers in control.

**Chart 5.20  Bearish Engulfing Pattern**

Conversely, a Bullish Engulfing Pattern, is formed at bottoms.

**Doji**

A Doji is a pattern with the same opening and closing price. It signifies indecision as the market is balanced, with neither the buyers or sellers in control.
Doji candlesticks may take the form of a small cross on a chart, or may have an excessive wick above, as shown in Chart 5.21.

Doji are advance warning signs in the market. At the top of the market, some short term traders tighten stops below dojis and exit if prices retrace below the low.

Particularly bearish is a **Gravestone Doji** (see Chart 5.21 below), where a market opens, trades sharply higher but fails to hold the gains, closing back at the open.

Doji are reliable reversal patterns if they appear predominately at tops and bottoms. If they are scattered throughout the chart their importance is significantly reduced.

**Chart 5.21  Gravestone Doji**

An **Harami Cross**, Chart 5.22 below, is a Doji, preceded by a large body.

It is a two day pattern that is considered a significant formation at tops and bottoms. The first body confirms the direction of the prevailing trend. The second body shows indecision with the open and close at the same price.

**Chart 5.22  Bullish Harami Cross**
Continuation Patterns

Continuation patterns are formations representing congestion areas and occur after a trend has been underway for some time. Lower volume and reduced volatility are usually associated with the congestion area. All the patterns are variations of two formations:

1. Triangles, which are abundant, and
2. Much rarer channels. Channels are formed where parallel lines can be drawn connecting points at the top and bottom of congestion areas.

In both formations, a signal is generated on a breakout from the congestion area in the direction of the prevailing trend.

Charts 5.23 to 5.29 are examples of continuation patterns.

Each of the continuation patterns has the same characteristics. Ranges and volume should contract during the consolidation and expand on the breakout from the pattern.

Chart 5.23  Bearish Channel

![Chart 5.23](Image)

Chart 5.24  Bullish Channel

![Chart 5.24](Image)

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Chart 5.25  Bullish Pennant (Channel)

Chart 5.26  Bearish Pennant (Channel)

Chart 5.27  Ascending Triangle

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Gaps

A gap is an area where no trading occurs. The price seems to jump over a particular level when either buyers or sellers are dominant. In an uptrend, a gap would exist if today’s low is higher than yesterday’s high. In a downtrend, a gap would exist if today’s high is lower than yesterday’s low.

Gaps are significant since they come suddenly and occur in a variety of ways in conjunction with differing patterns. They also reflect extreme strength or weakness and can become important support or resistance levels. The theory is that all gaps are eventually filled by subsequent price action.

This means that prices will eventually retrace to the level created by the gap. In practice, not all gaps are filled.
Common Gap

Common gaps occur in the middle of a trading range, are usually quite small and often filled. Any gap that ultimately proves of little value is labelled common.

Breakaway Gap

This gap can occur when prices break out of a consolidation pattern or as the first move in a change of market direction. It is not likely to be filled for quite some time. A breakaway gap is shown in Chart 5.30 below.

Chart 5.30  Breakaway Gap

Runaway Gap

Runaway gaps occur during an extended move, often near the moves midpoint. It is confirmation that the trend is intact.

Exhaustion Gap

Exhaustion gaps appear toward the end of a market’s move. This type of gap is often the final, volatile action before a market changes direction.

In a down trend, it could be the point where traders finally abandon ship after holding the position too long.

In an up trend, it could be where traders, who missed the initial move, scramble to buy into the bullish euphoria.

Telstra, Chart 5.31 below shows a Runaway Gap at point (A), approximately midway through the down move.

An exhaustion Gap is at point (B), with a Key Reversal confirmation at (C).

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Chart 5.31  Bearish Runaway Gap, Exhaustion Gap and Bullish Key Reversal

More information on candlestick charting, identifying exit signals, channel trading strategies and setting profit targets for ascending triangles may be found in the *Atkinson-Guppy Articles* ebook.

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
CHAPTER 6

TECHNICAL ANALYSIS

- Indicators

- Moving Averages
- Relative Strength Index
- Stochastic
- MACD
- Bollinger Bands
- Parabolic (SAR)
- On Balance Volume
- Accumulation / Distribution
- Chaikin Money Flow
CHAPTER 6. TECHNICAL ANALYSIS – Indicators

Technical Indicators are mathematical formulae that use price and volume in their calculation. Gauging the probable direction of the next move is done by grouping these indicators together and testing them over previous price action. The grouping of indicators is essential. Investors basing their trading decisions on any one indicator, pattern or fundamental, are usually doomed to failure.

Some traders will swear by their favourite indicator, focusing on the positive results while ignoring some of its false signals. In fact, there is no ‘holy grail’ single indicator for successfully trading markets 100% of the time.

Technical analysts, using indicators, are not attempting to predict the future but are working with probabilities. If a group of technical indicators, chart formations and patterns, worked historically then the balance of probability is they will work in the next time frame. Technical analysts react to price changes.

A chart shows previous price activity. At the end of each day, information on the open, high, low, close, and volume are added to the chart. Over the course of time, the chart becomes a picture that can be analyzed. The same information that is visible on the chart - the open, high, low, close, and volume - is used in technical indicators to measure the internal strength of the market.

The result is another picture that can be analyzed and compared to the original. Similarities and differences give the analyst clues to the next probable direction of prices. Analysts are attempting to shift the odds in their favour by studying the market and trading a security that has a high probability of moving in a specific direction, based on historical testing.

Moving Average

Moving averages are one of the most widely-used technical tools and are the basis for most trend following systems. They are calculated by adding the prices over a selected period and dividing by the unit for that period. For example, if you wish to calculate a 13 day simple moving average of closing prices, add together the 13 closing prices and divide by 13. This gives the average price over the last 13 days and has a smoothing effect on prices.

Many analysts believe this smoothed price is more important than any one day's price, as daily market moves ('noise') can cause volatile price fluctuations that eventually return to the average. In effect, the average becomes a support or resistance level as markets return to consensus of value. The average moves as the following day's closing price is added to the average and the price 14 days ago is dropped.

The shorter the term of the moving average, the closer it will hug prices. This is a plus insofar as it is more sensitive to recent price action.

The negative aspect is that it has a greater potential for whipsaws, which are numerous buy and sell signals. A longer term moving average provides a greater smoothing effect but will be slower to react to recent prices.

The weighted moving average assigns a different weight to each price used to compute the average. The reasoning is that the most recent close is of greater significance than each of the previous closes. So the average is front-loaded.
The **exponential** moving average is a special type of weighted moving average. It is front-loaded and includes all previous prices, assigning progressively smaller weights to each price.

The number of different ways to use moving averages is as varied as there are different trading styles and philosophies. Some of the more popular uses of the moving average include:

- Comparing the price against the moving average as a trend indicator. For instance, a good gauge of the major trend is a close above a longer-term average on a weekly chart.

Once the major trend is established, the trader could analyze a shorter term chart for fine tuning the entry level.

- Using the moving average as a support or resistance level. When prices move sharply away from a moving average, a consolidation or retracement often occurs, bringing prices and moving average together. This return to consensus can present trading opportunities.

- Monitoring the moving average band, which is called an envelope. These bands are a certain percentage above and below the moving average. They contain a large percentage of the trading and serve as support or resistance levels.

- Watching the slope of the moving average. For instance, if the average levels off or starts to decline after a sustained period of rising prices, it may be a warning signal of a change in trend.

- Trading with a dual moving average system. A buy signal occurs when a shorter-term (faster) average of, say, seven days crosses above a longer-term (slower) average of fourteen days.

A sell signal occurs when a shorter-term moving average crosses below a longer-term average. Other commonly used periods are 10 and 30 day.

A 26 day simple moving average, Chart 6.1, generates buy signals when the closing price is above the average and a sell signal as it closes below.

**Chart 6.1  Moving Average Signals**
In this case, the signal was on the first close above or below the moving average. Other strategies could be to wait for two consecutive closes above or below or to wait for a percentage move through the average. Most moving averages use the closing price in their calculation but the open, high, low or mid-point could be used.

The long-term moving average on this chart of Rural Press, Chart 6.2, shows a rising trend. The arrows are at points where prices have moved sharply away from the average. Consolidation, or a retracement, brings prices back to the moving average, back to consensus of value.

Chart 6.2 Prices Reacting Back to Moving Average

A moving average envelope, Chart 6.3, is created with a 21 day exponential moving average with an 8% shift.

Chart 6.3 Moving Average Envelope

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
In a rising market, short term trading opportunities occur when the price receives support at points (A), (B), (C) and (D) near the lower band. Price objective is the band at the upper level of the envelope.

Oxiana Resources, Chart 6.4, shows the buy and sell signals generated by the crossing of two moving averages.

**Chart 6.4 Moving Average Crossover Signals**

This chart also shows how traders may enter after the moving averages cross over, only to sell on an exit signal soon after. They may repeat this exercise a few times, with nominal gains or losses, before managing to hitch a ride on a longer term trend.

**Oscillators**

An oscillator is an indicator that fluctuates between extremes of bullish and bearish sentiment. Centered oscillators fluctuate above and below a centre point line and banded oscillators fluctuate between overbought and oversold extremes.

Two of the most popular banded oscillators are Relative Strength Index (RSI) and Stochastic.

They offer several tools to the analyst:

1. Both indicators are plotted as a number between 0 and 100. An extreme reading in the oscillator may be viewed as indicating an **overbought or oversold market**. The potential is that the market is over-extended and vulnerable to a correction or a period of consolidation.

   The trader must be cautious because oscillators often reach extreme levels when markets are in a major trend. For example, if the major trend is up, a short term overbought reading should be ignored.

2. **Divergence between indicator and price.**

   Bearish divergence occurs when the security’s price moves to a new peak and the peak on the indicator is lower than that preceding it, within the same pattern.
Bullish divergence occurs when the price moves to a new low and the indicator is higher than the previous trough, within the same pattern. The pattern looks like this:

![Diagram of bullish divergence]

Prices at point B are making a lower low than at point A while the indicator at point D is making a higher low than at point C.

3. **Oscillators can confirm the force behind a trend’s move** by measuring the market’s momentum. Momentum measures the velocity of a price move by comparing price changes. A rapidly-changing indicator signals significant buying or selling power behind the move.

**Relative Strength Index**

The Relative Strength Index (RSI) is one of the most popular technical tools used by traders. Most software charting packages automatically calculate and plot the RSI and many traders closely monitor it. The RSI compares the average of rising price change to falling price change over a specified period. At reversal points the rate of change decreases from when the security is trending.

**Chart 6.5 RSI Divergence**

The weekly chart of CSR, Chart 6.5 above, shows RSI divergence. Closing prices are lower in April than in February and the RSI trough in April is higher than its previous trough in February. The share is trending lower while the indicator is signaling a potential change in trend. This conflict is called divergence.

---

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The Stock Trading Handbook

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.

The horizontal lines at 70 and 30 mark the overbought and oversold areas respectively. Most charting software packages allow the analyst discretion on where to place this line. A reading above 70 or 80 indicates a potentially overbought security. A reading below 30 or 20 indicates a potentially oversold security. Divergence should also take place at indicator extremes.

The weekly chart of the Bank sector, Chart 6.6, is showing bearish divergence. Prices made a higher peak in June than in February, while the peaks in RSI were lower in the corresponding time frames.

**Chart 6.6 RSI Divergence with Break of Trend line and Moving Average**

This conflict is often the first warning signal an investor receives. As it is only one indicator, it does not warrant any action. Subsequent price action and the signals from additional indicators add further weight to the possibility of a change in trend. In July, prices break below the valid trend line and the moving average. With the slope of the moving average declining, weight-of-evidence is gathering and indicating lower prices. The final attempt to move higher stalled at a support/resistance level in September.

**Chart 6.7 RSI Divergence with Break of Trend line and Moving Average**

The divergence on the weekly chart of the Australian Stock Exchange (ASX), Chart 6.7 above, indicated a potential change in trend from a bearish downtrend to a bullish up-trending market. Prices closed above the trend line in April and above the moving average in May.
Analysts often use weekly charts to determine the major trend and daily charts to fine-tune their entry points. The daily chart of ASX, Chart 6.8, shows the RSI reaching oversold conditions in August and November. Temporary oversold conditions, in a rising market, are significant trading opportunities as we will show in Chapter 8.

**Chart 6.8 RSI Oversold Areas in a Rising Market**

![Image of Chart 6.8](Image)

**Stochastic**

The Stochastic compares the latest closing price with the total range of price action for a specified period. Most software packages calculate and plot the Stochastic indicator.

As an oscillator, it provides overbought and oversold readings and signals divergences in a similar way to the RSI. The idea behind the indicator is the tendency for closing prices to be near the highs of the range in a rising market and near the lows in a falling market. The indicator is composed of two lines, the %K and the %D.

In Chart 6.9, the %K line is the solid line and the dotted line is %D. In this chart of Argo Investments (ARG), the stochastic is used in the moving average crossover method. A buy signal is generated when %K crosses above %D and a sell signal when crossing below.

**Chart 6.9 Stochastic Crossing Signals**

![Image of Chart 6.9](Image)
As mentioned earlier, analysts often use weekly charts to determine the major trend and daily charts to fine-tune their entry points. The daily chart of Argo, Chart 6.10, shows the Stochastic reaching oversold conditions in May and June/July. Temporary oversold conditions, in a rising market, are significant trading opportunities.

**Chart 6.10 Stochastic Oversold Signals in a Rising Market**

![Stochastic Oversold Signals in a Rising Market](image)

Stochastic divergence occurred over the September to November time period on this weekly chart of James Hardie (JHX), Chart 6.11. Closing prices are lower while the indicator has a higher trough in November than September. Falling prices and a rising indicator signals conflict, thereby indicating the potential for a change in trend. Note that the divergence took place at an extreme reading.

**Chart 6.11 Stochastic Divergence**

![Stochastic Divergence](image)
Moving Average Convergence Divergence (MACD)

The MACD uses three exponential moving averages and appears on the chart as two lines. A solid line is created by subtracting a slower exponential moving average (EMA) of 26 days with a faster EMA of 12 days. This solid line is called the **MACD line**. A dashed line, called the **signal line**, is made by calculating a 9 day EMA of the MACD line.

A crossing of the two lines gives trading signals, similar to the crossing of two moving averages. When plotted on a vertical scale, the MACD fluctuates above and below a zero line, with a move through the zero line considered a confirmation signal.

As with the RSI and Stochastic Indicators, MACD divergence can be a powerful tool.

Iluka Resources (ILU), Chart 6.12, shows three MACD buy signals, crossing from below the “0” line.

The first two would have provided only nominal % gains during a five month period, whereas the third signal resulted in significant growth in the following three months.

**Chart 6.12 MACD Buy Signals**

Many technical analysts use the **MACD Histogram** when searching for divergence.

The formula for the histogram is the 9 period EMA of the MACD line (signal line) subtracted from the MACD line. This can be calculated and plotted using most software programs.

The daily chart of Gunns Limited (GNS), Chart 6.13, is showing divergence using the MACD histogram.

Closing prices are lower in August than the previous lows in July while the MACD trough is higher in August.

The MACD is indicating that the market is not as weak as it looks and that there is a potential for a bullish change in trend.
Chart 6.13 MACD Histogram Divergence

In Chart 6.14 below, the MACD bearish divergence on Brickworks Limited (BRK) is indicating the market is not as healthy as it looks and a bearish change in trend is a possibility.

Chart 6.14 Bearish MACD Histogram Divergence

Bollinger Bands

Bollinger Bands are a combination moving average and envelope indicator that use standard deviation from the moving average (MA) to plot the envelope. While percentage bands are fixed a percentage distance above and below a moving average, Bollinger Bands vary in distance from the MA. This results in the envelope widening when a security becomes more volatile and contracting when volatility decreases.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Large moves are likely to occur after the band tightens, the result of a consolidation. When the price penetrates the upper or lower band, prices are likely to continue in the direction of the breakout. Also, prices tend to move from the lower band to the upper band, and vice versa.

A narrowing of the bands, Chart 6.15, at the arrows, indicates decreased volatility and the potential for a sharp move with increasing volatility.

However, Bollinger Bands do not necessarily provide an advance indication as to the direction in which this increased volatility will occur. Conservative investors therefore wait for confirmation of the direction to occur before taking a position.

**Chart 6.15  Bollinger Bands**

In a rising market, Bollinger Bands, Chart 6.16, indicate buying opportunities when prices receive support at the lower band (arrows). Note how prices tend to move back and forth, from the lower to upper bands. If the percentage movement is sufficient (commonly chosen as greater than 10%), some traders will buy at the lower band and sell at the upper.

**Chart 6.16  Bollinger Bands**
Parabolic Stop-And-Reverse (SAR)

This indicator was created for trading the futures market, where traders often reverse their position when there is a change of trend. The futures trading strategy is to always have an open position and to stop-and-reverse that position when a signal is generated. In this way, the futures trader will never be out of the market when a major move commences.

In share trading, the SAR can be used as a lagging indicator to protect profits. In effect, the SAR is a stop-loss exit applied after the market is moving in the desired direction.

The name, Parabolic, is derived from the shape of the curve that is created by the SAR points. It should not be confused with the parabolic trend line, as developed by Daryl Guppy - which is a curve drawn to fit below price action and which gradually, then later rapidly, becomes steeper and steeper.

One of the major advantages of the SAR over other lagging stop-loss indicators, is its acceleration factor. When a market starts to rise rapidly, the SAR points also rise rapidly, giving increased profit protection to the trader.

SAR acceleration can be altered by changing the step size parameter. The software program MetaStock default setting of 0.02 means the SAR step will increase by 0.02 each day the security makes a new high. For example, if a security makes a new high for three consecutive days, the SAR step increases by 0.02 the first day, 0.04 the second day and by 0.06 the third day. A step size of 0.01 will decrease acceleration and a step size of 0.03 will result in an increase.

The second parabolic parameter is the maximum amount the SAR step can reach. The MetaStock default setting is 0.20. Chart 6.17 shows the Parabolic SAR on the share price of BHP.

Chart 6.17  Parabolic SAR

In the weekly chart of Mayne Nickless (MAY), Chart 6.18, the buy signal was generated by weight-of-evidence.
Chart 6.18 Weight-of-Evidence

The support line (A)-(B) is at a double bottom. At (C), prices broke through a falling trendline and are trading above a 34 week exponential moving average with a rising slope.

A stochastic crossing from oversold conditions is shown at (D). Profits are being protected with the SAR indicator, which signals an exit at (E).

**Volume Indicators**

Volume indicators attempt to measure volume effectively and to differentiate between accumulation and distribution.

They work on the concept that volume has a tendency to lead price movements; that volume levels peak, bottom and break before a similar action in price.

Three important volume indicators are On Balance Volume, Accumulation / Distribution, and Chaikin Money Flow.

**On Balance Volume**

On Balance Volume (OBV) relates volume to price change. It is calculated by adding the day's volume to a cumulative total when the security's price closes up, and subtracting the day's volume when the security's price closes down.

If today's close > yesterday's close then

- \[ \text{OBV} = \text{yesterday's OBV} + \text{today's volume} \]

If today's close < yesterday's close then

- \[ \text{OBV} = \text{yesterday's OBV} - \text{today's volume} \]

If today's close = yesterday's close then

- \[ \text{OBV} = \text{yesterday's OBV} \]

(For our less mathematical readers: '>' is greater than and '<' is less than)
On Balance Volume is a running total of volume. It seeks to show if volume is flowing into or out of a security. When the security closes higher than the previous close, all of the day’s volume is considered up-volume (accumulation). When the security closes lower than the previous close, all of the day’s volume is considered down-volume (distribution).

The basic assumption, regarding OBV analysis, is that OBV changes precede price changes. The theory is that smart money can be seen flowing into the security by a rising OBV. When the public then moves into the security, both the security and the OBV will surge ahead. **Traders analyze the slope of the OBV and are looking for divergence.**

In the chart of Tabcorp (TAH), Chart 6.19, bullish divergence of OBV is indicating the market is not as weak as it looks and a change in trend is a possibility.

**Chart 6.19 On Balance Volume Divergence**

---

**Accumulation / Distribution**

The Accumulation / Distribution (A/D) indicator is based on the assumption that market strength is usually accompanied by prices closing in the upper half of their daily range with increasing volume. Likewise, market weakness is usually accompanied by prices closing in the lower half of their daily range with increasing volume.

- If today’s close > range midpoint then \( A/D = \text{yesterday's } A/D + \text{today's } A/D \)
- If today’s close < range midpoint then \( A/D = \text{yesterday's } A/D - \text{today's } A/D \)
- If today’s close = range midpoint then \( A/D = \text{yesterday’s } A/D \)

On Balance Volume adds all volume on a day that closes higher than the previous day’s close. The A/D adds a percentage of the volume if the close is in the upper half of the day’s range, attempting to get a clearer picture of the number of traders who are truly bullish. Some traders analyse the slope of the A/D line and are looking for divergence.

---

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or 'buy' or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Accumulation / Distribution divergence, Chart 6.20, occurred during the November to December time period. Closing prices in December were lower than in late November while the trough in the A / D line was higher in the corresponding time periods. This bullish divergence is indicating the market is not as weak as it looks and a change in trend is a possibility.

**Chart 6.20 Accumulation/Distribution Divergence**

---

**Chaikin Money Flow**

The Chaikin Money Flow indicator is based on the Accumulation / Distribution line. It is created by summing the values of the Accumulation / Distribution Line for 21 periods and then dividing by a 21 period sum of the volume.

The interpretation of the Chaikin Money Flow & A / D indicator is based on the assumption that market strength is usually accompanied by prices closing in the upper half of their daily range with increasing volume. Likewise, market weakness is usually accompanied by prices closing in the lower half of their daily range with increasing volume.

If prices consistently close in the upper half of their daily high/low range on increased volume, then the indicator will be positive (i.e., above the zero line). This indicates that the market is strong. Conversely, if prices consistently close in the lower half of their daily high/low range on increased volume, then the indicator will be negative (i.e., below the zero line). This indicates that the market is weak.

The Chaikin Money Flow indicator can provide excellent confirmation signals of trend line and support/resistance breakouts. For example, if a security's prices have recently penetrated a downward sloping trend line (signaling a potential trend reversal), you may want to wait for further confirmation by allowing the Chaikin Money Flow indicator to cross above the zero line. This may indicate an overall shift from a downtrend to a new uptrend.
A divergence between the Chaikin Money Flow indicator and prices is also significant. For example, if the most recent peak of the indicator is lower than its prior peak, yet prices are continuing upward, this may indicate weakness. Chart 6.21 shows Chaikin Money Flow divergence in NAB.

**Chart 6.21 Accumulation/Distribution Divergence**

![Chart 6.21](image1)

Polarised support occurred in July 2003, January 2004 and again in August/September 2004 before the Chaikin Money Flow line crossed through the zero confirmation line in December.

**Chart 6.22 Chaikin Money Flow and Weight-of-Evidence**

![Chart 6.22](image2)


Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra, disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
CHAPTER 7

MONEY MANAGEMENT, EXITS AND POSITION SIZING

- 2% Rule
- Exits
- Profit / Loss Ratio
- Position Sizing incl 6% Rule
- Trailing Stop Loss Points
- Profit Taking
- Trading Plan Template
- Money & Risk Management Tools
CHAPTER 7. MONEY MANAGEMENT, EXITS AND POSITION SIZING

The first goal of trading is to **survive**. Proper **money management** will help investors avoid risks that will put them out of business. How much capital is risked on each trade is crucial to successful trading.

**A major pitfall to avoid:** Inexperienced traders often risk too large an amount and worsen their situation by increasing the amount during a losing streak.

In contrast, experienced traders risk a maximum of **2%** or less of their total funds in any position and decrease this amount, or cease trading, when difficult trading conditions are present.

The more an investor loses of his or her original capital the more difficult it is to recover.

Suppose a trader's starting capital was $100,000, but he lost $10,000 on each of eight trades in a row (which happened to many traders in the tech stock crash). His portfolio would be reduced to only $20,000 very quickly.

The cruelty of the market is such that if you lose 20% of your capital, you need 25% increase to get back to where you started. For a 50% total loss, 100% is needed to get back to par. For an 80% loss, as per the example above, you would need to make 400% to get back to where you began – all that resulting from just eight losing trades!

With a consistent and reasonable return of 20% to 30% per year it would take several years to recoup the loss ....... so many traders give up, 'burnt' by the market, having experienced a very expensive education.

**The 2% Rule**

Experienced investors calculate how much they are going to risk on a trade before they place an order. They use risk management tools to control losses and achieve a reasonable rate of return.

Inexperienced traders are shocked when they realize a $5000 profit, a 25% return, on a $20,000 account is a significant achievement. Their ultimate dream of combining lifestyle and income through investing, is shattered as they exclaim, "Who can live on $5000 a year and how much equity is necessary?" A 20% return and an income expectation of $50,000 to maintain current lifestyle would require an equity base of $250,000, with no provision for capital growth.

The amateur's solution is to take bigger risks to achieve a higher return. This is financial suicide as extensive tests have shown that risking any more than 2% of equity on each trade is gambling.

Most fund managers, and experienced traders, risk less, between 0.5% and 1.5% of equity on any single trade.

They understand that it is **much easier to improve profitability by controlling and reducing the amount lost on losing trades** compared with the amount gained on winning trades, rather than by increasing the percentage of profitable vs losing trades.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or 'buy' or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The cliché “Cut your losses and let your profits run” is a winning formula.

In his book ‘Active Investing’ Alan Hull explains that the 2% rule allows 115 straight losses in a row before all of a trader’s capital has been lost - and 230 consecutive losses at 1%.

Compare that with only 23 straight losses if a trader risks 10% of his portfolio on each trade!

The 2% rule means that an investor with a $25,000 account can risk no more than $500 per trade. A trader with a $100,000 account may not risk more than $2000 on any single trade.

The 2% rule refers to the percentage of portfolio which is at risk by entering each trade and the stop is later triggered, not the trade size or percentage of the individual trade.

There is a big difference, as shown in Table 7.1 below.

<table>
<thead>
<tr>
<th>Portfolio Value</th>
<th>Trade Value</th>
<th>Trade Size</th>
<th>Trade Risk</th>
<th>% Trade Risk</th>
<th>% Portfolio Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20,000</td>
<td>$5,000</td>
<td>25%</td>
<td>$400</td>
<td>8%</td>
<td>2%</td>
</tr>
<tr>
<td>$50,000</td>
<td>$10,000</td>
<td>20%</td>
<td>$1,000</td>
<td>10%</td>
<td>2%</td>
</tr>
<tr>
<td>$100,000</td>
<td>$15,000</td>
<td>15%</td>
<td>$1,000</td>
<td>6.7%</td>
<td>1%</td>
</tr>
</tbody>
</table>

**Exits**

How, and when, a trader exits the market is the tool he or she can use to control profits and losses. Having a strategy for getting out of a losing trade is essential to becoming a successful investor.

With no protection in place, it only takes one serious losing trade to completely counteract the profits gained from many previous months of profitable trading. An experienced trader therefore wants to lose the least amount of money possible when he or she has a losing trade.

The first exit established is a stop-loss exit based on a worst case scenario. If an investor buys shares in a company and the price falls, there must be a point at which the position is liquidated.

This exit point is determined by simple chart analysis before the shares are purchased, while the investor is in a calm state of mind.

This stop loss price is also used as part of the calculations for the position size to be purchased, as explained later in this Chapter.

There are a number of obvious levels to place a stop-loss exit. Three of the most commonly used stop-loss exit points are:

- Below a recent low, Chart 7.1
- Below a trendline, Chart 7.2
- Below a polarized support / resistance level, Chart 7.3

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise: Refer also to our Terms of Use.

JBEbook090610Aa
Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra, disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
It is also worth taking a close look at a stop based on market volatility, discussed in Chapter 8.

A stop-loss 2 or 3 times Average True Range (ATR) from the closing price on the day of entry is considered a logical level to protect the trader from random market noise. Chart 7.4 is an example of a stop-loss placed at 3 times ATR.

**Chart 7.4 Stop Loss Based on Volatility (Three Times ATR)**

![Image of stop loss based on volatility with ATR](image)

**Profit / Loss Ratio**

The initial stop-loss point is also the basis for determining the profit / loss ratio. A 2:1 profit / loss ratio means that for every $1 lost on losing trades, a gain of $2 is achieved on successful trades. The ratio of profits to losses an investor needs to be successful will vary according to the success rate of their trading system.

Investors whose systems are successful 50% of the time will lose or win on half their trades. A 2:1 profit / loss ratio would be sufficient for them to make money. Investors with a 35% success rate would need a considerably higher profit / loss ratio. A disciplined trading strategy with a 50% success rate and a high profit / loss ratio is a powerful combination.

**Position sizing**

Position sizing is crucial to the risk management process. After going through the rigorous analysis of choosing trading candidates, it is equally important to work out how much money to commit to each trade.

The entry point and a stop-loss figure are two of the numbers needed for the investor to work out how many shares to purchase.

It works like this:
Example 1

$20,000 account
2% risk = $400
Entry price - $1.04
Stop-loss - $.95
Stop-loss amount - $.09
$400 divided by $.09 = 4444 shares

This means owning 4,444 shares that fall $.09 in value will result in a loss of $400.
The investor buys 4000 shares (rounded off) at a price of $1.04, which is an outlay of $4160.

The third number that may affect these calculations is the margin. This is the maximum amount of money the investor allows to trade on any one company – akin to “not having all your eggs in one basket”.

The term ‘margin’ here should not be confused with ‘margin lending’ an advanced topic for experienced traders only and beyond the scope of this Handbook.

With an equity balance of $20,000, an investor would not want to take a position in one share that used $12,000 of his or her capital. With only $8000 left to purchase shares in one or two companies, the investor would have a poorly diversified portfolio.

A diversified portfolio is necessary so that an adverse price move in any one share will not significantly affect the overall performance of the portfolio.

The margin figure, should be somewhere between 10% and 25%, depending upon the amount of equity available to trade. An investor with a $100,000 account might adopt a maximum margin of 10% of his portfolio or $10,000 per trade; while an investor with a $20,000 account might want to diversify into four different companies at a maximum of 25% or $5,000 each.
The example above, an outlay of $4160, meets this requirement.

If the outlay exceeds the $5000 limit, calculate the number of shares to purchase by dividing the share price into the maximum margin limit chosen. It works like this:

Example 2: Maximum Margin

$20000 account
2% risk =$400
Entry price = $1.04
Stop-loss = $.99
Stop-loss amount = $.05
$400 divided by $.05 = 8000 shares
If the investor buys 8000 shares at a price of $1.04, it is an outlay of $8320. This is too large an amount of the investor’s equity to spend, as it will limit their ability to diversify when purchasing further shares. The maximum margin has been set at 25%.

Remember, 25% of $20,000 = $5000. This maximum margin ensures that the investor will diversify into at least four different companies. $5000 divided by the $1.04 entry price equals 4800 (rounded off) shares for purchase.

Owing 4800 shares that trigger the $.05 stop-loss at $.99 will result in an adjusted loss of $240 or 1.2% of total equity.

Every trader should calculate the potential percentage loss on every trade he or she is analysing. It is good training and planning ahead is a key to successful trading.

Traders with a reasonable equity account will eventually realize common sense and a comprehensive trading plan will ensure losses are always contained within the 2% limit. Here’s an example:

### $100,000 Equity Account -

**Money Management / Position Sizing Rules:**

a) 2% maximum risk per trade

b) Maximum 10% margin

c) Maximum 10% price decline

Spreadsheet, Figure 7.2, shows a trader with $100,000 and ten positions, with each stop loss less than 10% from the entry price. A maximum of $10,000 is allocated to each trade. The number of shares is rounded down to result in a total investment of $97,702. Every trade would lose less than 1.0% of total capital if all stops were triggered.

#### Figure 7.2 Margin ($10,000) Spreadsheet & Percentage Loss

<table>
<thead>
<tr>
<th></th>
<th>ENTRY PRICE</th>
<th>MAX. STOP 10%</th>
<th>MAX. $ LOSS PER SHARE</th>
<th>MAX. MARGIN</th>
<th># SHARES ROUNDED</th>
<th>COST</th>
<th>MAX. $ LOSS</th>
<th>% OF $100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>TRADE 1</td>
<td>1.15</td>
<td>1.04</td>
<td>0.11</td>
<td>$10,000</td>
<td>8,650</td>
<td>$9,948</td>
<td>951.50</td>
<td>0.951%</td>
</tr>
<tr>
<td>TRADE 2</td>
<td>2.25</td>
<td>2.03</td>
<td>0.22</td>
<td>$10,000</td>
<td>4,100</td>
<td>$9,900</td>
<td>968.00</td>
<td>0.968%</td>
</tr>
<tr>
<td>TRADE 3</td>
<td>3.65</td>
<td>3.29</td>
<td>0.36</td>
<td>$10,000</td>
<td>2,700</td>
<td>$9,855</td>
<td>972.00</td>
<td>0.972%</td>
</tr>
<tr>
<td>TRADE 4</td>
<td>4.87</td>
<td>4.39</td>
<td>0.48</td>
<td>$10,000</td>
<td>2,050</td>
<td>$9,984</td>
<td>984.00</td>
<td>0.984%</td>
</tr>
<tr>
<td>TRADE 5</td>
<td>5.54</td>
<td>4.99</td>
<td>0.55</td>
<td>$10,000</td>
<td>1,800</td>
<td>$9,972</td>
<td>990.00</td>
<td>0.990%</td>
</tr>
<tr>
<td>TRADE 6</td>
<td>7.32</td>
<td>6.59</td>
<td>0.73</td>
<td>$10,000</td>
<td>1,350</td>
<td>$9,882</td>
<td>985.50</td>
<td>0.986%</td>
</tr>
<tr>
<td>TRADE 7</td>
<td>9.56</td>
<td>8.7</td>
<td>0.96</td>
<td>$10,000</td>
<td>1,000</td>
<td>$9,660</td>
<td>960.00</td>
<td>0.960%</td>
</tr>
<tr>
<td>TRADE 8</td>
<td>11.87</td>
<td>10.69</td>
<td>1.18</td>
<td>$10,000</td>
<td>800</td>
<td>$9,496</td>
<td>944.00</td>
<td>0.944%</td>
</tr>
<tr>
<td>TRADE 9</td>
<td>13.54</td>
<td>12.19</td>
<td>1.35</td>
<td>$10,000</td>
<td>700</td>
<td>$9,478</td>
<td>945.00</td>
<td>0.945%</td>
</tr>
<tr>
<td>TRADE 10</td>
<td>15.88</td>
<td>14.3</td>
<td>1.58</td>
<td>$10,000</td>
<td>600</td>
<td>$9,528</td>
<td>948.00</td>
<td>0.948%</td>
</tr>
</tbody>
</table>

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (”Avestra”) AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Spreadsheet, Figure 7.3, shows a trader with $100,000 and six positions, with each stop loss less than 10% from the entry price and a maximum of $15,000 allocated to each trade.

The number of shares is rounded down to result in a total investment of $89,695. Every trade would lose less than 1.5% of total capital if all stops were triggered e.g. due to a market correction or poor analysis.

**Figure 7.3 Margin ($15,000) Spreadsheet & Percentage Loss**

<table>
<thead>
<tr>
<th>TRADE</th>
<th>ENTRY PRICE</th>
<th>MAX. STOP</th>
<th>MAX. $1 LOSS</th>
<th>MAX. STOP MARGIN</th>
<th># SHARES ROUNDED</th>
<th>COST</th>
<th>MAX. $1</th>
<th>% OF $100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>TRADE 1</td>
<td>1.15</td>
<td>1.04</td>
<td>0.11</td>
<td>$15,000</td>
<td>1,300</td>
<td>$14,950</td>
<td>1,430.00</td>
<td>1.430%</td>
</tr>
<tr>
<td>TRADE 2</td>
<td>2.25</td>
<td>2.03</td>
<td>0.22</td>
<td>$15,000</td>
<td>5,650</td>
<td>$14,963</td>
<td>1,463.00</td>
<td>1.463%</td>
</tr>
<tr>
<td>TRADE 3</td>
<td>3.65</td>
<td>3.29</td>
<td>0.36</td>
<td>$15,000</td>
<td>4,100</td>
<td>$14,965</td>
<td>1,476.00</td>
<td>1.476%</td>
</tr>
<tr>
<td>TRADE 4</td>
<td>4.87</td>
<td>4.39</td>
<td>0.48</td>
<td>$15,000</td>
<td>3,050</td>
<td>$14,854</td>
<td>1,464.00</td>
<td>1.464%</td>
</tr>
<tr>
<td>TRADE 5</td>
<td>5.54</td>
<td>4.99</td>
<td>0.55</td>
<td>$15,000</td>
<td>2,700</td>
<td>$14,958</td>
<td>1,485.00</td>
<td>1.485%</td>
</tr>
<tr>
<td>TRADE 6</td>
<td>7.32</td>
<td>6.59</td>
<td>0.73</td>
<td>$15,000</td>
<td>2,050</td>
<td>$15,006</td>
<td>1,497.00</td>
<td>1.497%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$90,000</td>
<td>$89,695</td>
<td></td>
</tr>
</tbody>
</table>

With common sense, discipline and a comprehensive trading plan it is not difficult to keep losses under 2% of total equity.

**The 6% Rule**

This rule is designed to ensure that while each individual trade risk is kept to a maximum of 2%, the **total portfolio risk** of all combined trades is also structured not to exceed 6%.

The 2% stop loss rule is aimed to protect against what Dr Alexander Elder refers to as a ‘shark attack’. In his book, ‘Come into My Trading Room’ Dr. Elder also introduced the 6% rule to protect against ‘piranha attack’.

A pack of piranhas can attack the largest of animals with such a mass of bites that the victim collapses and can be very quickly stripped to the bone. The 6% rule is designed to save investors from being nibbled to death through a series of losses.

For example, investors may:

- Structure a portfolio to have only three positions, each with 2% risk or 6 at 1%, etc.
- Stop trading for the month if the value of the trading account falls 6% below its closing value at the end of the previous month

**Trailing Stops**

The second exit an investor needs to calculate is the trailing stop. Once the market is trading in the desired direction the initial stop loss is no longer needed. Yet no investor would be pleased to see a profit disappear and result in a loss.

The trailing stop is designed to keep the investor in the position while the market is trending and to protect a significant portion of the profit if the trend is reversed.
Three popular trailing stops are:

- **Moving Average**
- **Parabolic (SAR)**
- **ATR Volatility**

### Chart 7.5 Moving Average Trailing Stop

![Moving Average Trailing Stop Chart](image)

My preference is a **Volatility Trailing Stop**. I exit the position after two consecutive closes below trailing stop. The stop is two times the **ATR** subtracted from the close. This indicator rises and falls with the level of volatility and higher or lower closing prices.

**Disclaimer**: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are **not** provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra, disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our **Terms of Use**.
I never want to lower the trailing stop, so I adjust the formula to stay at the highest level reached for a period of 15 days or weeks, depending on the chart time frame.

**Chart 7.7 Volatility Trailing Stop**

![Volatility Trailing Stop Chart]

**Profit Taking**

The third exit is optional and is designed to take profits, rather than protecting a profit with a trailing stop. Taking a profit can be more difficult than taking a loss. Investors quickly learn the importance of discipline in setting a stop loss but more variables will need to be considered when taking a profit, such as trailing stops, profit targets and topping formations.

Inexperienced traders, without a clear strategy, will ride a roller coaster of emotions as they add up unrealized profits and wrestle with the decision to let the profit run or cash in before a fall in price. Alternating emotions of fear and greed can become constant companions and further erode the ability to make clear decisions.

There are several strategies the investor can use for taking profits. One strategy is to use profit targets, such as a percentage move in the price of the share; deciding on an exit at a significant overhead resistance level; or setting pattern-based projection targets e.g. flags and ascending triangles.

Another strategy, used by some short term traders, is to exit when an indicator, such as the Dynamic Momentum Index (DMI) in Chart 7.8 below, signals a short term top.

The DMI is similar to the Relative Strength Index (see Chapter 5) but it uses variable time periods. This means the time periods vary from between 3 and 30 units, depending on the volatility of the market. A short term top and exit signal is generated when the indicator breaks above the “70” level.
Again, my preferred profit taker is based on volatility. The JB Profit Taker indicator signals when the security has moved too far too fast and has created a profit taking opportunity.

When prices move too far too fast, the balance of probability is that the price action will subsequently retrace.

This provides the short term trader with the opportunity to take profits and wait for prices to pull back to a lower level for another entry or look elsewhere for the next trade. See Chart 7.9.

The formula for the **JB Profit Taker** combines a moving average of the highs with ATR (10) volatility. A clear close above the **JB Profit Taker** signals the profit taking opportunity and the position is exited on the following day's opening price.

**Chart 7.9 JB Profit Taker**
TRADING PLAN TEMPLATE

There is a well worn cliché “If you fail to plan then you’re planning to fail”. Unfortunately for far too many traders and investors, this is very true. We cannot emphasize strongly enough the importance of having a Trading Plan which, at the very minimum, should list how an investor will:

- Evaluate market conditions
- Choose investing and trading strategies
- Select which share, fund, index etc to buy
- Detail methods for:
  - Entry and exit conditions
  - Money and risk management, including Position Sizing
  - Stop Loss calculations
  - Protecting profits
  - Setting profit targets

Trading Plans must be written down, kept in a prominent position and most importantly, followed with discipline. In his books, Dr Alexander Elder emphasises the importance of keeping accurate records of all open and completed trades. These can then be used as a basis for reviewing the success of the Trading Plan and for subsequent updates.

Many readers may already be aware of their need to have a Trading Plan but may be wondering how to start or update their current plan.

Private trader and investor Tim Wilcox has prepared an invaluable Template for setting up a Trading Plan, by collating the priceless thoughts and experiences of many traders and investors at the Trade2Win.com forum.

Tim Wilcox says: "Traders with a plan have the ability to monitor their performance. They can evaluate their progress continually, day-by-day, in a way that is objective and comprehensive. This enables them to trade without emotion and with minimal stress. The trader without a plan is not able to do this and their trading tends to rely upon gut feeling, hunches and tips etc. Trading for them is a nail biting, emotional roller coaster ride of stress that, inevitably, results in financial loss..........

... Emotional issues will become very powerful when real money is on the line and, as likely as not, force you into making irrational decisions. With the correct trading plan, your every action should be spelled out, so that in the heat of the moment you do not have to make any decisions, you just follow the trading plan rules.

Key benefits of following a detailed trading plan include:

- Relaxed, stress free trading that is simpler with a plan than it is without
- Ability to monitor progress, diagnose faults and amend the plan accordingly
- A plan helps to prevent many psychological issues from taking root
- A plan that is adhered to strictly will reduce the number of bad trades
- A plan will help prevent irrational decisions in the heat of the moment
- A plan enables an investor to control the only thing he or she can control themself
Professional traders are highly disciplined. A plan will instill a large measure of discipline into all trading. Gamblers tend to lack both discipline and a plan.

A plan will enable investors to trade outside his or her comfort zone. Traders often let a loss run and cut a profit short because it was the comfortable thing to do. A plan, executed with discipline, will help to prevent this from happening.

A plan is a roadmap which will enable investors to get from wherever they are now to wherever they want to be – i.e. consistent profitability.

The template (and, by implication, the trading plan) – is designed in such a way that if an investor takes a ‘wrong turn’ on their roadmap, he or she will know about it very quickly and have the opportunity to correct the problem before losses spiral out of control.

Tim Wilcox put together a Template of over 50 questions and added his own suggested answers in his original ebook, based on his own experience as a short-term trader.

With Tim’s permission, we progressively featured all of Tim’s work in our weekly ‘Investing & Online Trading’ mentoring-style newsletter and added our own detailed responses to his sample questions, based on our own trading strategies. These include our two short-term trading strategies and our longer-term, more conservative investment strategy for shares in Australia and international markets.

This has now been collated as an ebook ‘How to Write Your Own Stock and Futures Plan’ featuring Tim’s work plus our complete responses to Tim’s Template questions. It is a comprehensive example of a Trading Plan - as progressively developed for the notional portfolio in our newsletter. It includes full details of our money and risk management rules.

Figure 7.4 below shows the results of using our short term strategies for some of the first notional trades in late 2005.

**Figure 7.4: Investing & Online Trading Newsletter Short Term Notional Trades**

<table>
<thead>
<tr>
<th>Stock Code</th>
<th>Notional short term profit</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC</td>
<td>14%</td>
<td>1 month</td>
</tr>
<tr>
<td>ARQ</td>
<td>14%</td>
<td>4 days</td>
</tr>
<tr>
<td>COU</td>
<td>15%</td>
<td>1 month</td>
</tr>
<tr>
<td>BIL</td>
<td>15%</td>
<td>1 month</td>
</tr>
<tr>
<td>DOW</td>
<td>15%</td>
<td>1 month</td>
</tr>
<tr>
<td>ENE</td>
<td>15%</td>
<td>2 weeks</td>
</tr>
<tr>
<td>SLX</td>
<td>27%</td>
<td>1 month</td>
</tr>
<tr>
<td>SMM</td>
<td>21%</td>
<td>5 days</td>
</tr>
</tbody>
</table>

The Trading Plan ebook, featuring questions and responses from two different styles of trader/investor, is designed to function as a base from which investors can then create his or her own Trading Plan - to suit their lifestyle, personality and financial situation.

With Tim Wilcox’s permission, below is a sample selection of some of his Trading Plan Template questions:
Why do You Want to be a Trader?
What Sort of Trader are You?
What are Your Strengths and Weaknesses?
Are You in the Right Frame of Mind to Trade?
What are Your Income Targets?
Which Markets will You Trade?
Which Instruments will You Trade?
Which Timeframes will You Trade?
What is Your Daily Pre-market Routine?
Have You Analyzed Yesterday’s Trades?
What are the General Market Conditions?
What Will You Do Today?
What is Your Attitude Towards Risk?
What is the Overall Market Risk?
What is the Sector Risk?
What is the Strategy Risk?
What is the Probability of a Successful Trade?
What is the Risk-Reward Ratio?
What is Your Risk Per Trade?
Where Will You Place Your Stop Loss Orders?
When Will You Stop Trading?
Large Draw-downs and Profits – What Will You do?
Which Money Management Approaches Will You Utilise?
How Will You Lock In Profits?
How Will You Determine Your Position Size?
Losing trades – Which Signals Will See You Exit?
Winning Trades – Which Signals Will See You Exit Completely?
Which Strategies Will You Trade?
What are Your Setups?

How Will You Find Your Setups?
Which Signals Will Trigger Your Entry?

Did You Execute Your Trades According to Your Plan?

Have You Completed Your Trading Journal?
What Questions do You Ask After a Winning Trade?

What Questions do You Ask After a Losing Trade?

What Steps do You Take to Learn More About Trading?

What are Your Top Ten Golden Trading Rules?

Suggested detailed responses to the above questions and more are presented in the ebook ‘How To Write Your Own Stock and Futures Trading Plan’ at ShareTradingEducation.com.

Money & Risk Management Tools

In his book ‘Come into my Trading Room’ Dr Alexander Elder wrote:

“Keeping good records is the single most important contribution to your success. If you maintain scrupulous records, review them and learn from them, your performance will improve. If your money management is in place to ensure survival during the learning process, you’re sure to be a success.......Records are more important to your success than any indicator, system or technical tool. Even the best system is bound to have some holes, but good records will allow you to find them and plug them up.........Show me a trader with good records and I’ll show you a good trader.”

There are many Portfolio Management programs available. Some are simplistic, such as those provided free by most online brokers, which mainly show your current positions and open profits. Various account keeping packages, such as Microsoft Money and Quicken are available for purchase.

There are also specialist Money and Risk Management software programs, designed by traders for traders, which provide far more detail and facilitate detailed trade review.

John Atkinson is my business partner and co-author of the Investing & Online Trading, stock market newsletter.

From real life experience and lessons in portfolio management learnt the hard way, John originally designed a series of two Money and Risk Management spreadsheets to help his own trading.

These spreadsheets have evolved into simple to use and very affordable tools to help traders and investors plan and manage their portfolios using effective Money and Risk Management.

Many investors and traders do not spend enough time evaluating the risk of individual trades and their potential affect on their portfolio. Many do not plan, accurately track or review their progress at all.
Most investors believe that diversifying their portfolio into several large positions in safe blue chips is the correct way to address money & risk management. They do not realise that overloading in too many positions, or too large a position, can put their portfolio seriously at risk.

The Atkinson tools are based on various world’s best practice principles and strategies taught by the Investing & Online Trading, stock market newsletter, Daryl Guppy’s books and by other trader authors such as Alan Hull, Louise Bedford, Dr Alexander Elder, and Dr Van Tharp. These tools comprise the:

- **Atkinson Portfolio Planner ©** - pre-trade planning of sector & stock selection & portfolio risk
- **Atkinson Trade Optimizer ©** - pre-trade analysis of which stock to buy from a qualified group of companies that meet specific trading criteria

**Atkinson Portfolio Planner**

This tool is designed to help investors:

- Create a balanced portfolio and avoid over-exposure to a single company, volatility group or sector.
- Plan the size of open positions to ensure that individual trade risk and total portfolio risk do not exceed specified criteria.

**Figure 7.5 Atkinson Portfolio Planner ©.**

This easy-to-use tool allows investors to check his or her planned allocation of:

- Mix of high, medium and low volatility shares
- Mix of shares between sectors
- Individual risk of each position as a % of your portfolio
- Maximum % of your portfolio in any one position
- Total risk of your combined portfolio
It is the responsibility of the user to research and select the criteria to be applied for his/her Trading Plan and as key input to the Portfolio Planner.

After the investor enters his or her requirements, the Atkinson Portfolio Planner will calculate the above essential factors and flag red alerts if any planned or open positions exceed the personal risk profile.

This allows the user to ensure, in pre-trade planning, that hard earned capital will be apportioned correctly to conform to risk levels selected by the investor’s own Trading Plan.

When first using the Atkinson Portfolio Planner, sample data is available to show the user how it works. The user's data is simply input into the orange cells on the Atkinson Portfolio Planner.

The user needs to consider the following in the decision process:

- Personal psychology and risk management are an important part of trading.
- Once a stock is purchased, the investor has no control over price movements. An investor has control over when to get in, when to get out and how many to buy or sell.
- Successful traders and investors take the time to plan their individual trades and create his or her portfolio before they take a position. The Atkinson Portfolio Planner allows you to do both, before you enter the market.
- It only takes one large losing position to completely offset a series of smaller profits on other trades.
- Which trade will contribute the most growth to the portfolio?
  - Projected high % return on volatile stock that, because of money and risk management rules, ends up with a much smaller position size
  - A larger position in a less volatile stock with a smaller projected % profit
- The key to survival and future profitability is minimizing risk through:
  1) Careful pre-trade planning
  2) Management of individual positions
  3) Total portfolio management

Atkinson Trade Optimizer

The Atkinson Trade Optimizer quickly and easily compares the risk and reward outcomes of potential trades to assist investors in optimizing the selection of which stock(s) to buy with the funds available and the corresponding position size(s) applicable - all based on selected risk and target criteria.

Based on the investor’s chosen parameters, the aim is to filter the list of potential stocks and buy those which appear to offer the best reward, in terms of portfolio growth and portfolio risk.

It may also be used to compare outcomes to select one trade from a list of many possibilities, when there are limited funds.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra, STE and its Associates disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The Atkinson Trade Optimizer © consists of two spreadsheets with macros:

- Sheet 1 calculates the maximum allowable position size for up to 4 potential trades (Figure 7.6).

**Figure 7.6 Sheet 1: Maximum Position Size**

<table>
<thead>
<tr>
<th>Potential trade details</th>
<th>Trade 1</th>
<th>Trade 2</th>
<th>Trade 3</th>
<th>Trade 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target Purchase price</td>
<td>$2,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Target Sale price</td>
<td>$3,490</td>
<td>$2,800</td>
<td>$2,800</td>
<td>$2,800</td>
</tr>
<tr>
<td>Initial Stop Loss</td>
<td>$2,490</td>
<td>$2,490</td>
<td>$2,490</td>
<td>$2,490</td>
</tr>
<tr>
<td>Risk reward</td>
<td>$0.700</td>
<td>$0.400</td>
<td>$0.400</td>
<td>$0.400</td>
</tr>
</tbody>
</table>

Sheets 1 calculates the maximum allowable position size for up to 4 potential trades (Figure 7.6).

At the bottom of this sheet, the Atkinson Trade Optimizer © calculates the adjusted maximum allowable number of stocks to buy for up to four potential trades, based on the user’s specified criteria for the lower of:

- Available funds
- Maximum Equity Risk (MER) %
- Maximum position size as a % of total portfolio

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or ‘buy’ or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The charts on Sheet 1 then graphically compare the projected outcomes for each of these potential trades in terms of:

1. **Risk Reward Ratio**

2. **Target Growth as % of total portfolio**

- Sheet 2 (shown in Figure 7.7) is very similar and compares the revised projected performances and risk profiles, based on position sizes chosen by the user. The maximum allowable outcomes are also shown for completeness.

**Figure 7.7 Sheet 2: User Input**

<table>
<thead>
<tr>
<th>User selections</th>
<th>TRADE COMPARISON</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinvest max stakes to buy</td>
<td>0.091</td>
</tr>
<tr>
<td>Total investment value (incl. trade)</td>
<td>$ 47,433.30</td>
</tr>
<tr>
<td>Risk values</td>
<td>$ 2,760</td>
</tr>
<tr>
<td>Portfolio risk %</td>
<td>2.4%</td>
</tr>
<tr>
<td>Net profit target</td>
<td>$ 1,661.26</td>
</tr>
<tr>
<td>Target net trade % profit</td>
<td>23.8%</td>
</tr>
<tr>
<td>Target growth on total portfolio</td>
<td>4.1%</td>
</tr>
</tbody>
</table>
To compare more outcomes than the four shown, simply save the whole spreadsheet as a separate file and enter additional potential trades in this file.

Putting all or most of one’s available funds into one stock; planning to risk more than you target to make; or placing at risk a large % of one’s portfolio in a single trade are recipes for potential disaster.

Traders and investors have varying rules for money and risk management. The following are some typical examples:

- **Aim for a risk reward of 3:1 or more i.e. the target profit should be at least 3 x initial risk**
- **Maximum Equity Risk (MER): No more than 2% of portfolio to be placed at risk in any one trade**
- **Maximum position size as a % of total portfolio: commonly 20-25% maximum, down to 10% for larger portfolios.**

To discover more on the Atkinson Portfolio Tools [Click Here](#).

Disclaimer: Purchase and use of these spreadsheets are subject to the Terms and Conditions at the [www.ShareTradingEducation.com](http://www.ShareTradingEducation.com) web site and to those attached as part the spreadsheet itself. These are educational tools and do not take the place of your financial advisor or stockbroker.

**Summary**

Risk management is the single most important component of a successful trading system. Beginning investors often spend too much time perfecting entry techniques, in relation to their importance to successful trading. Professional traders believe it is Money and Risk Management that separates the winners and losers.

Proper risk management techniques will have a greater impact on the bottom line than finding new indicators, entry points or a better way to anticipate tops or bottoms. All trading systems will have a large number of entry signal failures.

It is an area where traders have a limited amount of control. The ultimate direction of the market is out of the trader’s control. What traders can control is risk, how much he or she is willing to lose on every trade.

Position management gives traders control over planning process and their open positions. Traders are in control when they plan and monitor the position size, set the initial stop and risk 2% or less of their equity. They are in control when they manage their position with exit strategies that lock in profits.

Disciplined position management allows traders to control how much they lose if the market goes against them and how much they make when right. Successful traders keep good records.

Trading is a business. A comprehensive business plan recognizes costs and risks.

Losers don’t plan to fail, they fail to plan. A serious business requires a disciplined Trading Plan.
CHAPTER 8
PROFITABLE TRADING STRATEGIES
that really work

- Timing
- Where to Start
- Paper Trading
- Tools and Parameters
- Parts of a Trading System
- Sector Analysis
- Fundamental and Technical Analysis Combined
- Website Research
- Potential Candidates
- Check List
- Trading Different Timeframes
CHAPTER 8. PROFITABLE TRADING STRATEGIES That Really Work

Introduction

The previous four chapters have been about tools. This chapter is about grouping tools to create a trading system for a long term, conservative, investment strategy. The system uses weekly charts and will combine fundamental and technical analysis. It is a trading strategy that would suit a certain type of investor and markets exhibiting specific behavior.

The system outlined here is an example of one, of perhaps hundreds, of different ways to trade the market, for there are as many different trading strategies as there are markets and time frames to trade. To highlight the relevance of matching the timeframe with the goals of the market participant, some short-term trading examples, using similar analysis techniques to those already covered, are included in the latter part of this chapter as we analyse shorter and shorter time frames.

Weight-of-evidence is an important aspect of the system. It means a buy or sell signal is generated only when a number of concurrent fundamental and technical criteria are present at the same point in time. This means that any single tool, mechanical or subjective, will have limited influence until grouped together to create weight-of-evidence. In this way the two different styles of analysis complement each other.

My intent in presenting this trading system is to give beginning traders an example of the process of putting together a system. It is not intended that this system will ever be used exactly as presented, as each investor’s personality and trading philosophy will differ and result in a personalized trading strategy that suits the individual.

This could lead to an incalculable number of successful investors each using a different trading system, as there is more than one way to do it right. The process the beginning trader goes through, in creating their own trading system, is to explore a number of different trading styles, selecting the tools that might fit together to produce weight-of-evidence.

This chapter should help the beginning trader better understand the process of creating a trading system.

This is covered in more detail in my 2 Home Study Courses ‘Trading Strategies with Metastock’ and my complete all-in-one JB Combo package of charting/data/home study and email support.

Timing

Fundamental analysts are fond of saying, “time in the market is more important than timing”. Then they bring out figures showing that 90% of market gains are made in only a few months of rising prices each year.

This is their proof that you must have a long term investment outlook and plenty of patience. But the gains in their figures are based on an index and few technical analysts are index benchmarking. There are often sectors-and shares in that sector-that are rising, regardless of the direction of an index.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or ‘buy’ or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise: Refer also to our Terms of Use.

JBEbook090610Aa
Conversely, just because an index is rising does not necessarily mean that all shares that make up the index will rise at the same percentage - or that some will rise at all.

This is completely contrary to investors’ expectations who invest in real estate such that if the average price of houses rises in a suburb, then there is a strong likelihood that most homes within that suburb will rise accordingly.

There are also a number of different strategies for trading markets that are not in a rising trend, including trading channels, writing covered call options and short selling falling markets. A long-term buy and hold strategy also does not take into account situations where the market should be avoided. Technical analysts often stand back and assess the market for its suitability to their style of trading. Knowing when not to trade is as important as when to trade.

If “time in the market” were referring to the value of compounding, this time the fundamental analysts would have it right. Often called “the miracle of compounding”, this concept should never be underestimated. Below is a table showing a compound return of 15%, after tax, on a $50,000 account, over ten years.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>Initial Amount</th>
<th>Return</th>
<th>Final Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$50,000</td>
<td>115%</td>
<td>$57,500</td>
</tr>
<tr>
<td>2</td>
<td>$57,500</td>
<td>115%</td>
<td>$66,125</td>
</tr>
<tr>
<td>3</td>
<td>$66,125</td>
<td>115%</td>
<td>$76,043</td>
</tr>
<tr>
<td>4</td>
<td>$76,043</td>
<td>115%</td>
<td>$87,449</td>
</tr>
<tr>
<td>5</td>
<td>$87,449</td>
<td>115%</td>
<td>$100,566</td>
</tr>
<tr>
<td>6</td>
<td>$100,566</td>
<td>115%</td>
<td>$115,650</td>
</tr>
<tr>
<td>7</td>
<td>$115,650</td>
<td>115%</td>
<td>$132,997</td>
</tr>
<tr>
<td>8</td>
<td>$132,997</td>
<td>115%</td>
<td>$152,946</td>
</tr>
<tr>
<td>9</td>
<td>$152,946</td>
<td>115%</td>
<td>$175,887</td>
</tr>
<tr>
<td>10</td>
<td>$175,887</td>
<td>115%</td>
<td>$202,270</td>
</tr>
</tbody>
</table>

Over a twenty year period the balance grows to $818,285.

Using a starting account of $100,000 and an after tax return of 20% produces results of $619,173 over ten years and $3,833,759 over twenty years. Make sure the value of compounding is working for you.

**Where to start**

Beginners on the market are often paralysed when faced with the daunting task of creating a trading system. The investor needs to determine the type of market and the most suitable time frame to trade before starting the time-consuming process of reducing the vast amount of available indicators to a workable number and combining them into a trading system.

Most systems are more effective in a market that is displaying specific characteristics, such as trending, consolidating, forming a base or breaking out of a pattern on momentum. Also, most systems are designed with a specific time frame in mind.

It would be a waste of time for the long term conservative investor to develop a short term trading strategy. Starting from scratch, creating a trading system will take months, if not years, to complete. But the frustrated beginning trader has to start somewhere.

One of the easiest ways to develop a trading strategy is to “borrow” a system from another trader. The borrowed system is used as a base to test and eventually build a trading strategy that suits the investor’s personality and trading philosophy.
It is extremely important that the investor feels confident their trading system suits them and they believe their investment strategies will make money.

Gaining this confidence and belief is accomplished by testing the trading system on both historical and real time data (see ‘Paper Trading’ below). Real-time testing of a trading system is essential to prove a system worthy of implementation but can take a considerable amount of time, especially when testing a long term strategy.

Testing a trading system over previous price action to determine its rate of success historically is called a back-test. The back-test takes considerably less time and provides the investor with enough information to determine if it is worthwhile to proceed with testing in real time.

There is no guarantee a system that worked historically will be successful in real time.

It is likely, though, that a system which cannot make money on historical data is unlikely to be able to produce profits in the future. The back-testing process requires the trader to go back one or two years in time and meticulously monitor and record the details of every trade generated by a written trading plan.

It is an information gathering exercise to determine whether the specific trading system has the potential to generate income in a real time trading environment.

For example, Justdata’s Scanvest can be used by the beginner and advanced trader to build a simple or advanced trading system, using pre-saved or custom-built, individual or multiple strategy scans.

This allows back testing of technical, fundamental and statistical analysis indicators and tools to check their historical performance.

Scanvest summarises all positions for each stock into a single record, as shown in Figure 8.1

**Figure 8.1 Scanvest Summary of Positions**
Colour coded reports highlight recently opened and closed positions and include figures for net profit, profit/year, max drawdown & profit factor.

The Synopsis tab conveniently averages all the summaries into a single overall synopsis of the trading system, as shown in Figure 8.2.

Figure 8.2 Summary of results of a Scanvest System Scan

This example shows that the sample system tested earned an average net profit of 388% over an average of 13 years (or an average of 30% per annum).

The profit factor was reasonable at 2.18 and the longest decline was fairly severe at 38.84%.

Looking back over the most recent three years, we can see that the best year for this sample system was 2004.

While it takes considerably longer, some traders prefer a manual back-test to a mechanical back-test for two reasons. The first is the inability of mechanical back-testing programs to include valuable subjective analysis tools such as trendlines, support / resistance levels and patterns. These tools need to be taken into consideration and cannot be factored into a mechanical back-testing program.

The second reason is the valuable experience gained from manually back-testing.

The trader will eventually get a feel for the trading system and how it reacts in different markets. The increased knowledge and understanding of a trading system will enable the trader to gain a belief in his or her system and begin investing with confidence.

The information gathered from back-testing should include the following:

- Technical and fundamental reasons for entering and exiting each trade.
- Each entry and exit price.
- Initial and trailing stops.
- What you feel about taking the trade. This will demonstrate that if you trade what you feel you will lose your money.
- Money management principles and position sizing.
- The result of each transaction.
- The percentage of successful trades.
- The profit and loss ratio.
- The number of consecutive losing trades.
- The drawdown ie the difference between the peak high and lowest total open portfolio value.
The trading system outlined in this Chapter, adapted for either long-term or shorter-term timeframes, provides an example of the process of combining indicators to create a trading system. Many of the investors attending my seminars over the last three years have borrowed this system as the basis for creating their own successful system.

Beginning traders may also wish to study the trading systems of Louise Bedford, Daryl Guppy, Alan Hull, Chris Tate, Stan Weinstein and Dr. Alexander Elder. The trading systems of each of these authors could be borrowed as a base system or combined in new ways to create something unique.

There are hundreds, if not thousands, of different ways to trade the market successfully. The right way to trade is the way that makes money for each individual.

Once the chosen system is borrowed it can be altered to suit the personality and philosophy of the individual investor.

The process of making a system one’s own is done over time as the trader experiments with different time frames, discards indicators that are not combining well and learns and incorporates new techniques into his or her trading strategy.

**Paper Trading:**

Having chosen a proven trading system to ‘borrow’ which matches your personality and lifestyle, it is important not to trade with real funds until you feel comfortable that you have back tested it and are confident that you can trade the system profitably.

The way to do this is to paper trade without using real money. Do all your analysis; trade selection; set initial stops; calculate position size; place your hypothetical buy & sell orders; keep a trading diary; monitor your positions; move up your trailing stops; enter your records – all as if you are trading the market for real - but do it on paper only.

Do this for as long as it takes – some investors do it for several months – then analyse your paper trading results to check:

- Win loss –ratio
- Size of your winnings vs. size of your losses
- Expectancy #

When you are convinced your system is profitable, then start with one small position with real funds and do it again. It’s at this point that you will probably experience a few more emotions than you had while paper trading. Go back and read Chapter 3 again as it will mean more to you, now that you are trading with real funds.

Even experienced investors, when they find a new indicator, strategy, system, instrument, paper trade it without using real funds to gain confidence in this new trading tool. If it doesn’t work, the most it has cost is time and effort – not valuable trading capital.

# For more information on Expectancy, you may wish to refer to Dr van Tharp’s *Trade Your way to Financial Freedom* or the ‘Atkinson-Guppy Articles’ ebook, both available at www.ShareTradingEducation.com.
Tools and Parameters:

The following is a sample trading system which is provided as an example of a trading system which I have developed. It has provided profitable results in the past when used as part of a strict Trading Plan, with Money and Risk Management Rules in place (refer Chapter 7) and when executed with non emotional discipline (refer Chapter 3).

However, be aware that past performance is no guarantee of future results.

The following system is provided in good faith. Please refer to the disclaimer at the start of this Handbook. Also, as noted at the start of this Chapter, it is not intended that this system will ever be used exactly as presented, as each investor’s personality and trading philosophy will differ and result in a personalized trading strategy that suits the individual.

It is provided here to help the beginning trader better understand the process of creating a trading system.

The tools and parameters consist of:

- Fundamental Analysis
- Weekly Charts
- Moving Average (34 Week)
- Volatility Trailing Stop
- Chart Patterns

Parts of a Trading System:

- Setup Conditions:
  - Industry Group
  - Share
- Timing of Entry
- Stops:
  - Initial
  - Trailing
- $$ Management – Position Sizing

Every Trading System has parts that need to be specifically researched, tested and analysed to create a complete trading strategy.

Parts of a Trading System is the outline I use for creating all trading plans. Every combination of subjective charting tool, fundamental analysis and mathematical indicator is manually tested before inclusion.

Each section’s trading rules are carefully detailed before final testing is complete. Having a trading plan and the discipline to follow it removes the guesswork from investing. The trading plan should have a course of action for every price move in a market.

Follow the Rules becomes a mantra. When trading becomes difficult and indecision appears, repeat the mantra.
The following trading system is a conservative investment strategy I use for investing in my Self Managed Superannuation Fund (SMSF)

Parts of a Long Term Trading System:

- **Setup Conditions:**
  - **Industry Group & Share**
    - Trade with trend of the weekly chart
    - Close > moving average
    - Moving average rising
    - Breakout

- **Timing of Entry**
  - **Monday opening**

- **Stops:**
  - **Initial:**
    - Recent low (pivot point)
    - Support/resistance level
  - **Trailing:**
    - Volatility Trailing Stop (weekly)
      - (Second consecutive close below trailing stop)

- **$$ Management – Position Sizing**
  - 2% rule (see Chapter 7)

Industry Group Analysis

Industry group analysis is an important starting point for investing. At any given time, regardless of the direction of the major indices, there will be industry groups that are rising. There will be fewer rising industry groups in bear markets, but there will nevertheless be some that offer trading opportunities. Buying quality shares (deduced from fundamental analysis) in rising industry groups is usually a commonsense investment strategy.

A number of shares in each industry group are combined and weighted to produce an index for each industry group. Index levels, and individual share prices, are available daily from data service providers. With a software charting package investors can create files or folders that will allow them to open all 22 industry group indices simultaneously. It takes only a few minutes to scroll through the charts, looking for weight-of-evidence trading opportunities.

In the first edition of this book I analysed the 24 sectors that have since been re organized into the present 22 industry groups. It is worth revisiting those sectors and the shares analysed to monitor subsequent price action. I will hence refer to the original 24 sectors as ‘old’.

In early 2000, The old Energy sector, Chart 8.1 below, was showing an example of a setup.

It displays the criteria that are necessary to determine the sector is rising. For most traders it will be a combination of patterns, trend, indicators and other criteria. It is not necessary for every tool to be present to generate a signal.

Signals from several technical tools is sufficient to create an interest in a sector or security as a trading candidate.
The **old** Energy Sector was in a downtrend from July, 1999.

This implies the shares in this sector were out of favour with institutions and private traders and investors buying shares in this sector were trading against the majority opinion. This **contrary opinion** is important as the majority can often be wrong.

Buying after a market fall has the additional advantage of matching price with value.

During a sustained market fall, brokers and market commentators often focus on the emerging value of a share or sector, as a result of the fall. They will point out the value after a fall of 5%, better value after a fall of 10%, better again after a 15% fall, etc.

They may be accurate in their analysis that the fall in price is increasing the security’s value and that prices will eventually rise. Companies with attractive valuations often continue to decline for months. Technical analysis helps the investor determine when the time is right to buy that value.

In chart 8.1, the horizontal line at 1150 has polarity. It joins support at (A), resistance at (B) and subsequent support at (C). Also shown is Relative Strength divergence. The final confirmations, the trigger area, are at (D), where prices break a valid downtrend line and close above the moving average - and the slope of the moving average is rising.

At this point I consider this a rising sector and am interested in finding quality companies in this sector.

The Infrastructure and Utilities Sector, Chart 8.2, after being out of favour for over a year, also gave a buy signal in 2000.

The positive technicals were a double bottom, trend line break, closing above the moving average, RSI divergence.
Fundamental and Technical Analysis Combined

The next step is to find which companies, in these sectors, are the healthiest and carry the lowest risk. By combining technical and fundamental analysis, the investor can find the two or three shares from this sector that belong in a conservative portfolio.

There are several ways of obtaining fundamental information on companies, including brokers, research newsletters, websites and software packages. Time management considerations means my preferred fundamental tool is the software package, MarketScan as it is fast, efficient and simple to use.

MarketScan looks at balance sheet analysis and profit and loss fundamentals that are provided by every ASX listed company. It combines fundamental and technical scanning criteria in an online application. MarketScan has a number of built in scans (see Figure 8.3) and allows the investor to create their own scans and watchlists.

Figure 8.3. MarketScan Searches

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The entire ASX, or individual sectors, can be ranked with specific criteria, such as market capitalization, dividend yield, earnings, growth etc. An investor with a limited knowledge of fundamental analysis could find the best shares by simply ranking them in each of the fifteen categories.

The best shares would consistently appear high in the rankings. Fundamental and technical weight-of-evidence are then combined to choose the best companies for inclusion in a portfolio. Figure 8.4 is an example of a 2005 scan showing the percentage price change of securities, with a market capitalization greater than 200,000,000, in the Healthcare sector.

**Figure 8.4. Healthcare Sector**

![Figure 8.4](image)

Figure 8.5 shows a 2005 scan of the largest companies in the Diversified Financials sector, ranked by market capitalization, with columns displaying earnings and dividend yield.

**Figure 8.5. Diversified Financials Sector**

![Figure 8.5](image)

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra, disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Further to my explanation of fundamental analysis in Chapter 4, my fundamental search of rising sub industry sectors, Figure 8.6, has the following criteria:

- **Mkt. Cap.** > 100,000,000
- **P/E Ratio** < 25
- **Return on Equity** > 5%
- **EPS Growth** > 5%
- **Net Profit Margin** > 0.01%

**Figure 8.6. JB MarketScan Search**

To create a search:
- Follow steps 1, 2 and 3 below to create a criteria, click Add Criteria to add it to the search, repeat creating and adding criteria until search is complete, click Run Search to run the search.

<table>
<thead>
<tr>
<th>Type</th>
<th>Condition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Symbol</td>
<td>&gt;</td>
</tr>
<tr>
<td>Capitalisation</td>
<td>&gt; 100000000</td>
</tr>
<tr>
<td>P/E Ratio</td>
<td>&lt; 25</td>
</tr>
<tr>
<td>SubIndustry</td>
<td>= AskMe(SubIndustry)</td>
</tr>
<tr>
<td>ReturnOnEquity</td>
<td>&gt; 5</td>
</tr>
<tr>
<td>OneYearEarningsGrowth</td>
<td>&gt; 5</td>
</tr>
<tr>
<td>NetProfitMargin</td>
<td>&gt; 0.01</td>
</tr>
</tbody>
</table>

Figure 8.7 is an example of a 2005 JB Search on the Diversified Financials sector.

**Figure 8.7. JB MarketScan Search on Diversified Financials Sector**

The **old** Energy sector breakout was the first week of June. A quick scroll through the sector would be interesting, comparing the various company charts to the index chart.

Some company charts will be at a similar stage of development to the index and will look the same. Some will be lagging behind, still in the downtrend or forming a bottom, and others will be ahead, having given a buy signal at an earlier date. The setup does not need to be the same as the index, but each share must have a weight-of-evidence buy signal.

At the time of writing the first edition, the top companies, fundamentally, in the **old** Energy sector were Woodside Petroleum (WPL), Santos (STO) and Novus Petroleum (NVS).

Each company’s share price, from early June had healthy rises over the next several months. (Charts 8.3-8.5). A matter of personal preference might influence which security, or securities, were included in an investor’s portfolio.
Woodside Petroleum is ahead of the sector index chart. Woodside Petroleum formed a solid support level at $9.00 in June, November and March and resistance in July & August 1999 and January 2000. Prices closed above a rising moving average and broke to new highs in May 2000.

Buying the new high the first week of June would result in holding a losing trade for ten weeks before breaking even. Waiting for the return to support levels gives a lower entry price closer to the initial stop, below the support/resistance line. Entry is Monday’s open after the weekly entry signal.

My initial stop is placed below the low, below a recent pivot point or below a support/resistance line, no greater than 10% from the entry price.

The use of a stop-loss is one of the major differences between fundamental and technical analysts.

A fundamental analyst will tell you that he or she is investing for the long term and is not concerned with short term fluctuations. Many brokers advise clients to buy a portfolio of shares, review it once a year and expect results in three to five years.

They may explain that a few of the shares are likely to experience a fall in price but the shares in the portfolio with rising prices will balance out the losses and the portfolio will eventually return a profit. Investors holding shares, based on fundamental analysis, are often willing to accept a considerable fall in their value.

A few months prior to the April 2000 tech wreck, two U.S. fund managers, queried on their reaction to share declines of greater than 50% in shares they were holding, both responded with, “we’re in the market for the long term”.

This is how fundamental traders rationalize holding shares in companies with falling prices. It is a dangerous way to invest.
A good reason for not adopting a ‘BHP’ (‘Buy, Hope and Pray’) approach long term is that over the 20th century there were three 20 year time periods when buying and holding shares for the entire 20 years produced negligible profits.

Long term buy and hold investing is only suggested as an acceptable investment strategy provided that it is based on the company’s present and future health and its current price action.

**Chart 8.4 Santos Weight-of-Evidence**

Santos had an initial support level in September and resistance in October, December, January and May. Prices closed above a rising moving average and broke above resistance in May and returned to support the first week of June. Entry is Monday’s open after the weekly entry signal. Very good entry level and close to initial stop, below the support/resistance line.

**Chart 8.5 Novus Petroleum Weight-of-Evidence**
Novus Petroleum formed a support level in October and April. Prices closed above a rising moving average and broke a trend line in May. Entry possibility first week of June but there is no clear price level to place the initial stop.

There is no recent pivot point or support/resistance level and the recent low was at $1.32, more than 10% from the entry price of $1.55.

**Results:**

Santos was a buy in the same week as the sector chart, providing a good entry and a commonsense place for the initial stop.

Woodside was a buy in the same week as the sector chart and when prices returned to the support/resistance line,

Novus Petroleum was **not** a buy because of the problem with setting the initial stop.

The *old* Infrastructure and Utilities sector breakout was the second week of May 2000. At the time of writing the first Edition, the top companies, fundamentally, in the *old* Infrastructure and Utilities sector were Macquarie Infrastructure Group (MIG) and Australian Gas Light (AGL).

Each company’s share price had healthy rises over the next several months. (Charts 8.6 & 8.7).

**Chart 8.6: Macquarie Infrastructure Group Weight-of-Evidence**

Prices of Macquarie Infrastructure Group closed above a rising moving average and broke a trendline in July, but there is no clear price level to place the initial stop.

The recent pivot point low is $1.16, more than 10% from the entry price of $1.44.

---

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Chart 8.7 Australian Gas Light Weight-of-Evidence

Australian Gas Light formed a support level in October and February and resistance levels in February and April.

Prices closed above a rising moving average and broke a down trendline and support/resistance level in April. Entry was the same week as the sector breakout.

Entry is Monday’s open after the weekly entry signal. Initial stop is below the support/resistance level at $8.47.

Results:

Australian Gas Light buy signal occurred the same week as the sector chart.

Macquarie Infrastructure Group buy signal occurred eight weeks after the sector chart and was not a buy because of the problem with setting the initial stop.

Potential Candidates

At the time of writing the first Edition, I showed the charts of three old sectors which had the potential to break out that year and provide substantial returns to investors targeting specific companies in those sectors.

One advantage of updating previous work is checking the accuracy of the analysis.

We will now look at the original charts, the analysis, the share selection and the subsequent price action.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The old Food and Household Goods sector is shown in Chart 8.8. Prices retraced to support/resistance levels in June and I suggested that if prices closed above a rising moving average, potentially near the circled area in June – July, I would be interested in buying healthy, low risk companies in this sector.

The companies meeting my fundamental criteria, at that time, as listed in the first Edition, were Coca-Cola, Goodman Fielder, National Foods and Ridley Corporation. The old Food and Household Goods sector generated a buy signal in August and each company’s share price rose substantially (see Charts 8.9 – 8.12)

Chart 8.9 Coca-Cola Share Price Rise
Chart 8.10  Goodman Fielder Share Price Rise

Chart 8.11  National Foods Share Price Rise

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Each of these companies in the **old** Food and Household Goods sector experienced a significant price appreciation. It is not likely that an investor would buy all four of these shares.

Factors that might influence which shares to trade are:

- Personal preference.
- Diversification.
- Initial Stop > 10% from entry price.
The **old** Media sector retraced to the support/resistance level in April and then rose to the falling trend line. I suggested that if prices closed above the trend line and a rising moving average I would be interested in buying healthy, low risk companies in this sector.

**Chart 8.14 Media Sector Update**

Prices closed above the moving average and trend line in August but the moving average did not rise. Three companies met my fundamental criteria but the sector chart did not generate a buy signal until 17 months later. **Jumping the gun** and taking a position in companies in this sector would have been a high risk strategy.

**Chart 8.15 Old Gold Sector**

Prices in the **old** Gold sector formed a triple bottom through a 12 month period, April to April 2001 and broke above support/resistance in May.

Closes were above the moving average and the moving average was rising.

I suggested that this was a rising sector and that I would be interested in buying healthy, low risk companies in this sector.

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are **not** provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The companies meeting my fundamental criteria, at this time, and listed in the first Edition, were Normandy Mining, Newcrest Mining, Delta Gold, Goldfields, and Hill 50.

Subsequent price moves in the old Gold sector are shown in Charts 8.16 to 8.21.

**Chart 8.16 Old Gold Sector**

![Chart 8.16 Old Gold Sector](image)

**Chart 8.17 Normandy Mining Share Price Rise**

![Chart 8.17 Normandy Mining Share Price Rise](image)

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or "buy" or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person's investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or ‘buy’ or ‘sell’ recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Each of these companies in the old Gold sector experienced a significant price appreciation. It is not likely that an investor would buy all four of these shares.

Again, factors that might influence which shares to trade are:

- Personal preference.
- Diversification.
- Initial Stop > 10% from entry price.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Note: At the time of the publication of the first Edition, my fundamental criteria were not as comprehensive as at present. These criteria have now been expanded and shown in this updated Edition.

Summary:

Three sectors were analyzed in the first Edition, with nine companies suggested to be placed on watch lists as potential trades.

With hindsight, we now see that after publication, two sectors generated buy signals and all nine shares in those sectors experienced rising prices.

Shorter Timeframe – Trading With Volatility

Up to this point, all analysis has been conducted on weekly charts. We have been looking at a long-term conservative trading strategy, targeting entries on the initial sector breakout after a decline in prices. We’ll now look at a shorter-term time frame using weekly charts to determine the major trend and daily charts for the entry signal. This strategy is designed to capture trading opportunities for those investors wishing to be more active in the market.

Recapping our notes from previous - Every Trading System has parts that need to be specifically researched, tested and analysed to create a complete trading strategy. Parts of a Trading System is the outline I use for creating all trading plans. Every combination of subjective charting tool, fundamental analysis and mathematical indicator is manually tested before inclusion. Each section’s trading rules are carefully detailed before final testing is complete. Having a trading plan and the discipline to follow it removes the guesswork from investing. The trading plan should have a course of action for every price move in a market.

Parts of a Short Term Trading System:

- **Setup Conditions:**
  - **Weekly:**
    - Trade with trend of the weekly chart *(Established with 34 week moving average)*
    - Higher Highs & Higher Lows
    - Close > moving average
    - Moving average rising
  - **Daily:**
    - RSI(7) Oversold

- **Timing of Entry**
  - ATR Volatility Entry

- **Stops:**
  - Initial:
    - Recent low
    - Support/resistance level
  - Trailing:
    - Volatility Trailing Stop *(Second consecutive close below trailing stop - Ignore exit signal following first thrust through JB Profit Taker)*

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Profit taking:
- JB Profit Taker
  (Ignore first thrust through Profit Taker)
- 25% Return

$ Management – Position Sizing
- 2% rule (see Chapter 7)

Let’s now examine and work through these parts of a trading system step by step:

Setup Conditions:

a) Weekly:
- Trade with trend of the weekly chart
  (Established with 34 week moving average)
- Higher Highs & Higher Lows
- Close > moving average
- Moving average rising

The chart 8.22 below shows the weekly setup conditions in Australian Gas Light (AGL).

Chart 8.22 Weekly Setup Conditions

A potential weekly low was made in September and a potential high in October. Higher lows are at (A), (B) and (C). Higher highs are at (D), (E) and (F). Price closed above a rising moving average in December.

- Setup Conditions:

b) Daily:
- RSI(7) Oversold

The next step is to find temporarily oversold ‘alert’ conditions on a daily chart, using the Relative Strength Indicator (RSI) (see Chapter 5). An RSI at “30” or below is the setup condition. See Chart 8.23 below.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
The RSI (7) fell below “30” level in May.

- **Timing of Entry**
  
  **ATR Volatility Entry**

Volatility can be measured with a calculation based on the ranges over a number of days. The average range over a 10-day period would be the sum of the difference between the high and the low for each day, divided by ten. This calculation does not take market gaps into consideration so most software packages use true range to measure volatility.

True range is the greatest of the following for each period:

- The distance from today's high to today's low.
- The distance from yesterday's close to today's high.
- The distance from yesterday's close to today's low.

The **Average True Range (ATR)** is simply the average of the true ranges over the past \( x \) periods (where \( x \) is specified by the user). A 10 day ATR is used in the following examples.

The trigger entry level is two times the ATR from the lowest price over the previous 20 days A blue bar is programmed to appear on my chart when my volatility entry conditions are met.

This entry level is triggered as the market is moving in the desired direction. Buying earlier, when the RSI is signaling an oversold condition, is premature. RSI is a leading indicator. That means, it is suggesting that the market is oversold, that the market could be at a bottom.

An investor buying this bottom is predicting a rising market from this point in time and no one can predict the future. Technical analysts react to the information they receive from the chart and indicators.

In this case we are reacting to a number of important criteria.

1) **Rising share** *(big picture with weekly chart)*

2) **Temporarily oversold condition in a rising market** *(RSI on daily chart)*
We then respond to the volatility entry when the market is moving in the desired direction, by taking action.

The blue bar volatility signal occurred on May 12\textsuperscript{th}. Traders that are following the market throughout the day would enter on the close. Traders with real jobs would arrive home in the evening, download data, check their charts and see that the entry signal occurred that day.

My trading systems and education are designed to help people who do not sit in front of his or her screen every day, by choice or other reason. Their entry is on the following day’s open at $11.57. The Initial Stop is set below the recent low $11.17.

- **Stops:**
  - **Initial:**
    - Recent low
    - Support/resistance level
  - **Trailing:**
    - Volatility Trailing Stop
      
      \textit{(Second consecutive close below trailing stop - Ignore exit signal following first thrust through JB Profit Take)}

The Initial Stop is used until prices trend higher and then the Volatility Trailing Stop takes over.

The Volatility Trailing Stop is set below current price action and \textit{would} rise and fall in relation to ATR volatility and the closing price. I do not want to lower my trailing stop, so program the indicator to hold the highest level reached for 15 days. The aim is that as prices rise, the stop loss is progressively ratcheted up, locking in open profits.

This leaves two minor problems:

- The trailing stop might take several days to move below prices
- The trailing stop might fall if a consolidation lasts more than 15 days

**Chart 8.24 Volatility Trailing Stop and JB Profit Taker**
**Profit taking:**
- **JB Profit Taker**
  *Ignore first thrust through Profit Taker*
- **25% Return**

The **JB Profit Taker** also uses ATR volatility and is set above the current price action. It is a moving average of the highs plus 2 times the ATR.

Profit taking opportunities exist when markets move too far too fast. My entry signals are triggered after a retracement, usually during a consolidation that has low volatility.

Prices often break out from this consolidation with a surge in volatility that pushes closes above the profit taker.

This happened in June when prices rose sharply and closed above the JB Profit Taker on the 24th at $12.30.

I ignore the first thrust through the profit taker and the subsequent reaction if it breaks below the trailing stop – in expectation of a better profit taking opportunity later.

However, if the first thrust results in a profit of 25% or greater, the trade is closed and the profit taken.

Chart 8.25 below shows the next close above the **JB Profit Taker** on August 26th.

The close on this day was $13.20 and the profit taker was at $13.17 (see Data Window). The exit is on the following day’s open at $13.20 (+ 14%).

**Chart 8.25 JB Profit Taker**
Short-term Trading Examples

Analysis:

Aristocrat Leisure (ALL) – Blue bar volatility entry in May after RSI oversold. Entry on following day’s open at $10.20. Initial stop set under the recent low at $9.27. First thrust above the JB Profit Taker on July 22nd. Exit at $12.75 with +25% profit.

Chart 8.26 Aristocrat Leisure (ALL)

Analysis:

Australian Stock Exchange (ASX) – Blue bar volatility entry in May after RSI oversold. Entry on following day’s open at $20.40. Initial stop under the recent low at $19.37. Initial thrust above the JB Profit Taker on May. Exit at $25.50 with +25% profit.

Chart 8.27 Australian Stock Exchange (ASX)
Analysis:

**Oxiana Resources** - Blue bar volatility entry in July after RSI oversold. Entry on following day’s open at $.93. Initial stop under the recent low at $.86. Initial thrust above the JB Profit Taker ignored on August 3rd. Second close above JB Profit Taker on August 10th. Exit on following day’s open at $1.18 with +26% profit.

Chart 8.28 Oxiana Resources

Analysis:

**Zinifex(ZFX)** – Blue bar volatility entry in July after RSI oversold. Entry on following day’s open at $3.04. Initial stop under the recent low at $2.83. Ignore first thrust through JB Profit Taker. Exit at $3.80 with +25% profit.

Chart 8.29 Zinifex

---

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avenue Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
Analysis:

Smorgan Steel (SSX) – Blue bar volatility entry in July after RSI oversold. Entry on following day’s open at $1.23. Initial stop under the recent low at $1.14. Initial thrust above the JB Profit Taker on August 16th. Second close above JB Profit Taker on September 1st. Exit on following day’s open at $1.52 with +24% profit.

Chart 8.30 Smorgon Steel

Analysis:

Rural Press (RUP) – Blue bar volatility entry in July after RSI oversold. Entry on following day’s open at $10.70. Initial stop under the recent low at $10.47. Ignore first thrust through JB Profit Taker. Second close above JB Profit Taker on August 25th. Exit on following day’s open at $11.70 with +9.3% profit.

Chart 8.31 Rural Press

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.

JBEbook090610Aa
Analysis:

**Australian Worldwide (AWE) – Blue bar** volatility entry in May after RSI oversold. **Initial stop** under the recent low at $1.53. Initial thrust above the **JB Profit Taker** on June 2nd. Exit at $2.07 with +25% profit.

**Chart 8.32  Australian Worldwide**

![Chart](image)

**CHECKLIST:**

As a review, the following is a checklist of the signs to look for in the short-term trading strategy:

1. **Rising share** (big picture with weekly chart)
2. **Temporary oversold ‘alert’ condition in rising market** (RSI on daily chart)
3. **Volatility entry signal when market is moving in desired direction.**

The JB Volatility Entry indicator, JB Volatility Trading Stop and JB Profit Taker shown in the charts in Chapter 8 are included:

1. **For Metastock users:**
   - In Jim Berg’s **JB Volatility Charting Template**
   - As part of Jim’s ‘**Trading Strategies with Metastock’** Home Study Course

2. **Within Jim Berg’s:**
   - **JB Premium Charts** – also available as part of
   - **JB Combo**, Jim’s complete all-in-one Charting/Data/Home Study package

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or ‘buy’ or ‘sell’ recommendations are **not** provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our **Terms of Use.**
Epilogue

In the introduction to this Handbook I stated that my aim was to help those inexperienced at trading shares to understand the share market and take the first steps to investing successfully.

Throughout this ebook I have provided information on share trading and important related issues that could affect investment decisions. I have explained the basic tools available to the trader and showed how I combine the tools to create weight-of-evidence both fundamentally and technically in a trend following system.

Not all trading systems are necessarily trend following, but I find the advantages of following the trend is significant as it increases the possibility of being right. Physics students learn that an object that is in motion tends to stay in motion.

So it is with a trend. At any given time there will always be markets that are in a rising trend. Identifying markets that are reversing trend and those that are already in a trend is an important part of my trading strategy.

This big picture view of the market is done with weekly charts. A market can trend for weeks, months or years before reversing direction. I can’t predict when a trend will end so I trade with the trend until technical weight-of-evidence produces enough warning signals to shift my attention to other, more favourable, markets.

My trading strategy targets two types of technical setups:

- The big picture reversal of a downtrend identified with weekly charts.
- A temporary oversold condition in a rising market, identified using daily charts.

The rising market condition is established with analysis of the sector and the share using weekly charts. My entry point is based on a volatility move from the recent low and in the desired direction. This results in me reacting to a move in the market rather than trying to predict a bottom from an oversold condition. Technical and fundamental weight-of-evidence are combined in both types of setups.

It is hoped that this guide-book will have helped the beginning trader understand that a trading system is more than just a method of deciding where to enter the market. Knowing where to get in is important, but not as important as knowing where to get out.

Nor is the entry point as important as risk management, position sizing or understanding trader psychology. Each one of these is an important component of a comprehensive and disciplined trading system.

Where to start? Borrow the trading system outlined in this manual. Change it to suit your personality and trading philosophy. Back-test the system to determine if it works on historical data.

If it fails to make money historically, change indicators, alter parameters and re-work the system until you are confident it will generate profits. A system that is unable to make money on historical data is unlikely to make money in real time.

When you are confident in your trading system, trade it in a virtual competition. Entry fees are minimal and many competitions are free.

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
In a competition you risk no money but experience many of the emotions you will experience when risking your hard earned dollars in real time trading. You may change your strategy in the middle of a trade and wonder how you could be so dumb.

You will ignore an exit signal and watch in frustration as a falling share price wipes out all profits.

You may exit a trade but then watch the share price for several days, hoping the share price will fall and confirm your decision to sell was the correct decision.

You will feel and learn to control the stress and anxiety of trading caused by indecision, fear, greed, anger, denial, hope, and revenge. A virtual trading competition will prove an invaluable experience while causing minimal damage to your equity balance.

There are complete books written on the various topics presented in this Handbook. For many beginning traders, this is the first step on a journey that will include exploring each of these topics in greater detail when it is more appropriate and convenient.

It is a journey that will never end as it is not possible or necessary to know everything there is to know about the markets and trading.

It is a never-ending quest for knowledge that will, for most investors, prove the saying “the journey is as important as reaching the destination”.

If you have any questions about the topics covered in this ebook or in our Investing & Online Trading mentoring style newsletter, simply Contact Us

If you have any general questions about the market (i.e. not stock specific), you can find me at the unique ‘Ask Jim Berg’ section at the popular ShareScene.com forum.

This Australian share market discussion forum combines modern technology with a rapidly growing member base of savvy investors. Keep up to date with the latest finance, business and investment related information and benefit from thousands of combined years of share trading experience.

You will find this page by registering at www.sharescene.com then going to ‘Ask Jim Berg’.

May you trade with ‘Weight-of-evidence’

To your success,

Jim Berg

June 2009
BIBLIOGRAPHY

Elder, Dr. Alexander, *Trading for a Living*, USA, John Wiley & Sons, 1993
Elder, Dr. Alexander, *Come into my Trading Room*, USA, John Wiley & Sons, 2002
Tate, Chris, *The Art of Trading*, Australia, Wrightbooks, 1997
Taylor, Catherine, Audio+Workbook packages, 2007 to 2008:
- Your Antidote for Fear
- Maximize Your Trading Performance
- You and Your Goals
Steenbarger, Brett N. Ph.D *Enhancing Trader Performance* John Wiley & Sons 2006
Wilcox, Berg and Atkinson *How To Write Your Own Stock and Future Trading Plan* (FREE to Members)

GLOSSARY

- Advance/Decline Line
- All Ordinaries Accumulation Index
- All Ordinaries Share Price Index (All Ords)
- American-Style Option
- Arbitrage
- Ask
- Asset Allocation
- Asset Backing

These are just some of words defined in our A to Z Glossary of Terms of over 20 pages.

You are invited to download the Glossary with our compliments.

Use Jim Berg’s Resources to Trade with ‘Weight-of-Evidence’ to Increase your Probability of Success

“The goal is to provide analytical tools that will last students a lifetime”
(Edward Tufte)

We hope you have enjoyed reading this Handbook. The aim of this Handbook, as stated in the Introduction, is to help investors understand the share market and improve their trading performance.

A craftsman uses precision tools to hone his skills.

To easily find other resources, we have provided a series of hyperlinks within the document which you can click on to discover further information on the web.

The following pages provide hyperlinks to Jim Berg’s Resources .........

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or ‘buy’ or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.
...... **Click on the Following Links** to discover more about **Jim Berg’s profitable trading and investing strategies that really work:**

Jim’s weekly mentoring-style

**‘Investing and Online Trading’ newsletter**

Jim’s **All-in-One JB Combo** package of:

1. **JB Premium Charts** program
2. 12 months Data + history
3. Several hours of DVDs of Jim Berg ‘Live’
4. Email support for 1 month from Jim PLUS
5. Home Study Course - ‘Trading Strategies with JB Premium Charts’

**More >>>>>**

**For Metastock Users:**

Jim’s Home Study Course:

**‘Trading Strategies with Metastock’,** with 1 month email support and Jim’s:
- Volatility Charting Template of JB Volatility Indicators
- Berg List Creator

**JB Premium Data** for ASX and USA, suitable for Metastock, Market Analyst, Amibroker etc –

Take your **Free 3 week Trial** of ASX, USA and Singapore Data – including a **FREE stock charting program!**

**Disclaimer:** Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or “buy” or sell recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd (“Avestra”) AFSL 292464, and ShareTradingEducation.com (“STE”), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our **Terms of Use.**
The Stock Trading Handbook

Disclaimer and Copyright: Direct investing in the stock market can result in financial loss. Past performance is no indication of future performance. 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 each year.

In preparing this ebook ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra Capital Pty Ltd ("Avestra") AFSL 292464, has not taken into account the investment objectives, financial situation and particular needs of any particular investor. Before making an investment decision on the basis of this ebook and the accompanying material, the investor needs to consider, with or without the assistance of an adviser, whether the advice is appropriate for them in view of their individual financial circumstances. Any projections made in this letter are estimates only and no guarantee is provided that those projections will be realised. Further, STE and/or Avestra do not warrant the accuracy of the information in this ebook. STE and/or Avestra and its officers, employees, agents, associates and alliance partners ("Associates") may have or may obtain an interest in the securities referred to in this letter and will receive commissions, brokerage and other fees from dealing in the securities or advising in respect of the proposed listing of the securities.

Avestra and/or STE believe that the information contained in this letter was accurate at the time it was compiled. Avestra and/or STE do not warrant that the information contained in this letter is accurate, complete, reliable or up to date and to the fullest extent permitted by law disclaims all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. This publication, which is generally available to the public, falls under the ASIC Media Advice provisions. These analysis notes are based on the authors’ experience of applying technical and fundamental analysis to the market and are designed to be used as a tutorial showing how fundamental and technical analysis can be applied to a chart example based on recent trading data. Stock tips or ‘buy’ or ‘sell’ recommendations are not provided. This ebook is a tool to assist you in your personal judgment. It is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs because readers come from diverse backgrounds, with diverse objectives and financial situations.

Liability: This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. The authors and publisher expressly disclaim all and any liability to any person, whether the purchase of this publication or not, in respect of anything and of the consequences of any thing done or omitted to be done by any such person in reliance, whether whole or partial, upon the whole or any part of the contents of this publication. Whilst all care has been taken, Avestra and/or STE and their officers, employees and agents or the authors or contributors of this ebook accept no liability for any reliance upon any material and information provided by them and no responsibility is accepted for any losses, charges, damages or expenses which may be sustained or incurred by any participant or otherwise by reason of any reliance upon the materials or information given.

Copyright: The information contained in this ebook is copyright and for the sole use of trial and prepaid readers. It cannot be circulated to other readers without the permission of the author. Each issue incorporates fingerprint protection that enables us to track the original source of pirate copies. Contributed material reflects the personal opinion of the authors and is not necessarily those of the publisher. Articles accurately reflect the personal views of the authors. ShareTradingEducation.com does not receive any benefit or fee from any of the companies’ stocks reviewed in the ebook. ShareTradingEducation.com is an independent financial education organization and research is supported by subscription fees and affiliate rebates. OFFICES; Head Office, 16 Vista Ave, Copacabana, NSW 2251, Australia; and 3 Clonarg Street, Glen Iris, Victoria, Australia.

Disclosure of Interest: Avestra/STE and their associates and authors of the Investing & Online Trading Newsletter® team may hold shares in the companies featured in this ebook. Further Conditions are specified in the Terms of Use at www.ShareTradingEducation.com.

*** HAVE YOU TAKEN YOUR ULTIMATE $1 TRIAL YET ***

to the ‘Investing and Online Trading’
Mentoring-style Newsletter?

Click Here Now

Disclaimer: Direct investing in the stock market can result in financial loss. Historical results are no guarantee of future returns. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. Stock tips or ‘buy’ or ‘sell’ recommendations are not provided. This educational information is not designed to replace your Licensed Financial Consultant or your Stockbroker. It has been prepared without regard to any particular person’s investment objectives, financial situation and particular needs. This information is of a general nature only so you should seek advice from your broker or other investment advisors as appropriate before taking any action. The decision to trade and the method of trading is for the reader alone to decide. Avestra Capital Pty Ltd ("Avestra") AFSL 292464, and ShareTradingEducation.com ("STE"), as Corporate Authorized Representative of Avestra disclaim all liability of Avestra, STE and its Associates for any loss or damage suffered by any person by reason of the use by that person of, or their reliance on any information contained herein, whether arising from the negligence of Avestra, STE or its Associates or otherwise. Refer also to our Terms of Use.