

Ciao!

Last week, we talked about trends and how that they should be easy to recognized. Otherwise, it isn't a trend. I used the following figure to illustrate that trends should be obvious.

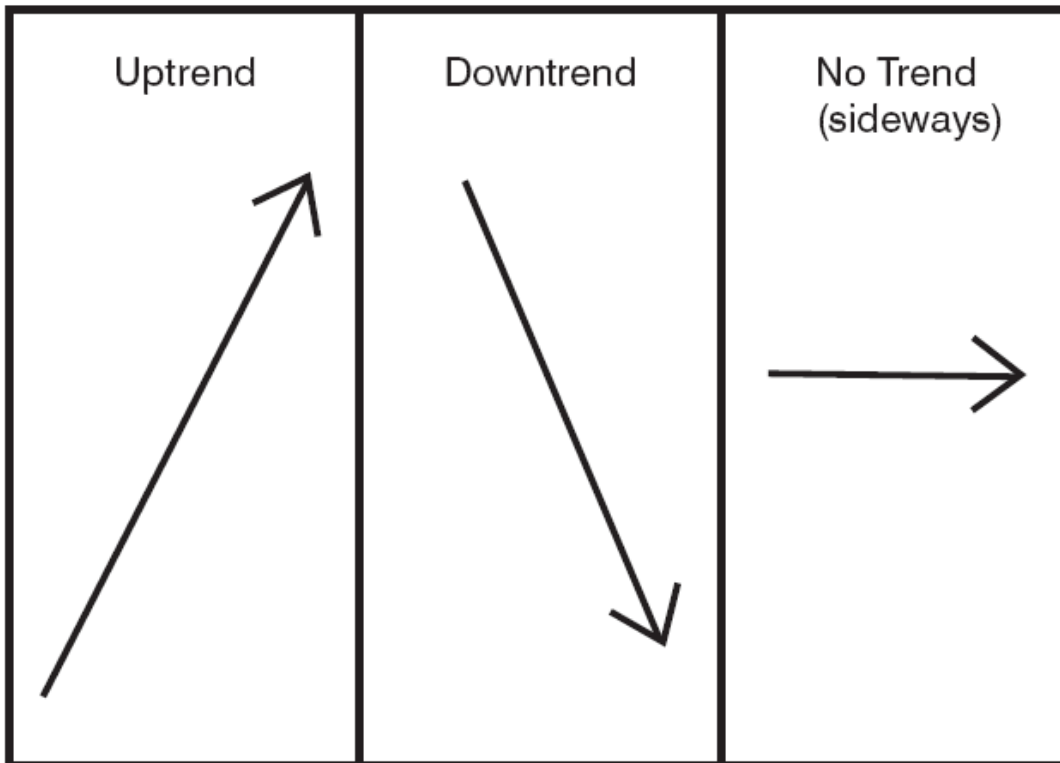


Figure 2

After I submitted the article, I began to think, my Italian brothers are probably wondering what good are a bunch of lines? My answer to this came a few days later. I received an email asking me about what they should do with their position in American International Group (AIG). The stock had been in a longer-term downtrend and a freefall in more recent times. It was called to open even lower--and it did. On 09/16/08 the stock traded down to \$1.25, losing over 70% of its value overnight.

How can one avoid such losses? Simple, by following the above figure on trends. Only *consider* buying stocks that are in obvious uptrends\* and only consider shorting stocks that are in obvious downtrends\*.

\*Or are making a transition in trend-See last week's article.



(charts courtesy of Telecharts Platinum)

Notice in chart 1 that AIG has been in an obvious downtrend for a considerable amount of time. Quite simply, an arrow can be drawn to indicate the direction of the trend. I'm not implying that trading is easy. What I am saying is that losses (like the above) can be avoided by NOT fighting obvious trends.

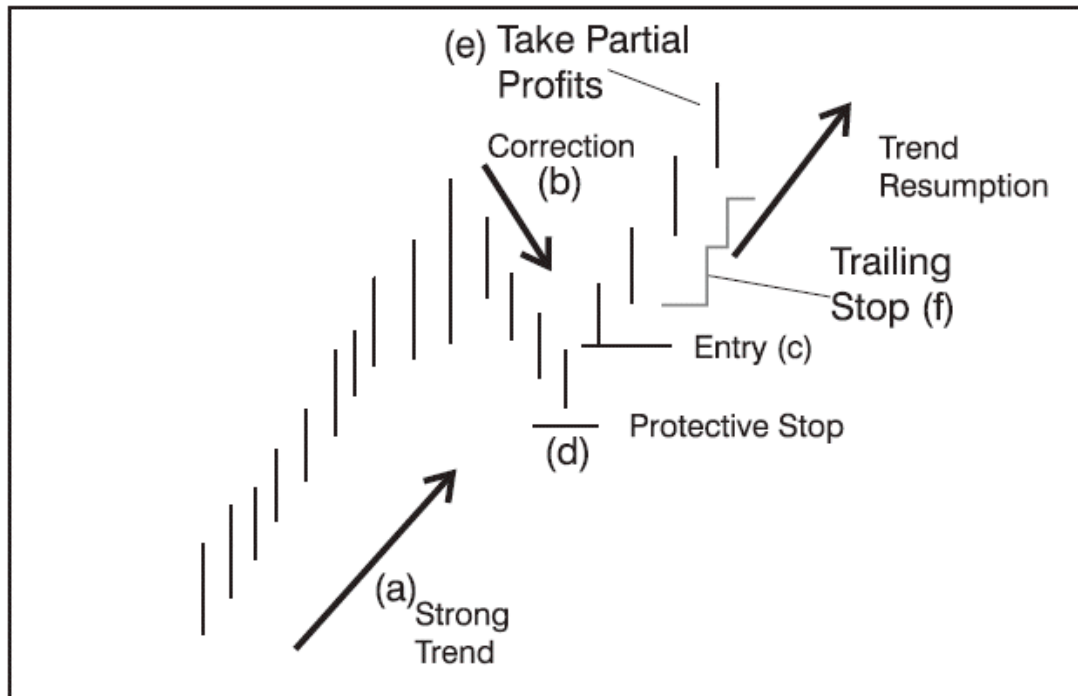
Last week, I said that "just because a market is trending it doesn't mean that you should just blindly buy it (or sell it short). Trending markets are prone to correct. And, you never know if what initially appears to be a correction, may in fact be the end of a trend. Therefore, it's much wiser to wait for the correction to occur and then look to enter if (and only if!) the prior trend begins to re-assert itself. In other words, wait for a pullback."

All of my patterns are pullback in nature. So let's look at the concept:

## TRADING PULLBACKS

I believe "The Trend Is Your Friend" is the truest market adage. And, the best way to enter trends is on pullbacks. Referring to Figure 1, they consist of a market in a strong trend (a) that has begun to correct (b). An entry is triggered when the trend begins to resume (c) and a protective stop is placed just in case the trend does not resume (d). As

the trend continues, partial profits should be taken (e) and the stop on the remaining shares should be trailed higher (f).



In articles, books, and presentations, I have spent a considerable amount of time on each of the above concepts. For now, let's just look at them in their simplest form:

A) Strong Trend: The market should be in a strong trend.\* Trend can be gauged with “trend qualifiers\*\*” or my favorite technique—simply looking at the chart and drawing an arrow in the direction of the trend (if any!).

\*Or, making an obvious transition in trend.

\*\*See Dave Landry On Swing Trading. Again, in future articles, I will discuss all of these concepts in more detail.

B) The “pullback”: The stock should then pull back over a period of 1 to 8 days. The depth of this correction varies depending on the volatility of the stock and conditions of the market and sector overall. Volatile stocks can pull back deeply and still be in an uptrend. In longer-term orderly bull markets, pullbacks are often shallow in nature. Also, markets also only pullback briefly (in both time and depth) when they are forming transitions.

C) The entry: The entry helps to ensure that the market is moving in the intended direction. If it doesn't “trigger” an entry, then the trade should be avoided. Entries vary depending on the price and volatility of the stock. The entry should be far enough away to help ensure that you're not triggered by noise alone. However, it shouldn't be so far away that you give up too much of the trend.

D) Protective Stops: Once the stock triggers, a protective stop should be placed just in case the market does not cooperate. Keep in mind that on EVERY trade there is a risk of loss. Therefore, stops must be used! Stops are a bit of a science and a bit of an art. There's no precise area they should be placed. Tight stops help to mitigate large losses but they almost guarantee that you will lose since they are likely to get hit on noise (normal market fluctuations) alone. Loose stops help to ensure you stay in a market long enough to capture a resumption of the trend. However, when the trend does not resume, the losses are larger. Stops must be placed based on the volatility of the underlying market. For example, if a stock bounces around 5 points a day, the stop must be outside of that range---otherwise you will be stopped out on noise alone.

E) Taking Partial Profits: In my style of trading, I like to take a relatively small initial gain (usually equal to the initial risk) and then move my stop to breakeven on the remainder of the position. The worst I can then do (barring overnight gaps), is to breakeven on the remaining shares. Should the trend continue longer-term, it allows me to "play with the market's money."

F) Trailing Stops: Should the market continue to move in my favor, the protective stop is trailed higher so I do not give up too much of the trend should it reverse. Obviously "too much" is somewhat arbitrary and would depend on the volatility of the stock. Like protective stops, the looser you're willing to trail the stop, the better your chances of capturing a longer-term trend. However, you will lose more open profits when the trend finally does reverse. I tend to loosen the trailing stop as the position moves more and more in my favor. For instance, suppose my initial stop is 5 points. Once I have 7 or 8 points of open profit, I might loosen my trailing stop to 6 points. As the stock continues to move in my favor, I might loosen the stop even further (within reason). This allows me to (hopefully!) participate in a longer-term move.

In coming weeks, we'll discuss my specific patterns, trader's psychology, money management, and classical technical analysis. For now, just remember that the trend is your friend. And, the best way to enter trends is on a pullback.

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