

The Importance of Knowing Your Methodology: It Take Time To Catch A Momentum Cycle

One of the most important aspects of trading is to know your methodology. Understanding your methods will keep you from getting too euphoric in good times and will help you maintain your confidence in less-than-ideal conditions.

Those who have recently looked at my recommendations cannot believe how well my methodology has done. Instead of being smug, I try to temper their expectations. I explain to them that trading in the swing to intermediate-term time frame it usually takes 6-8 months to catch a good momentum cycle. This prompted the following question earlier this week:

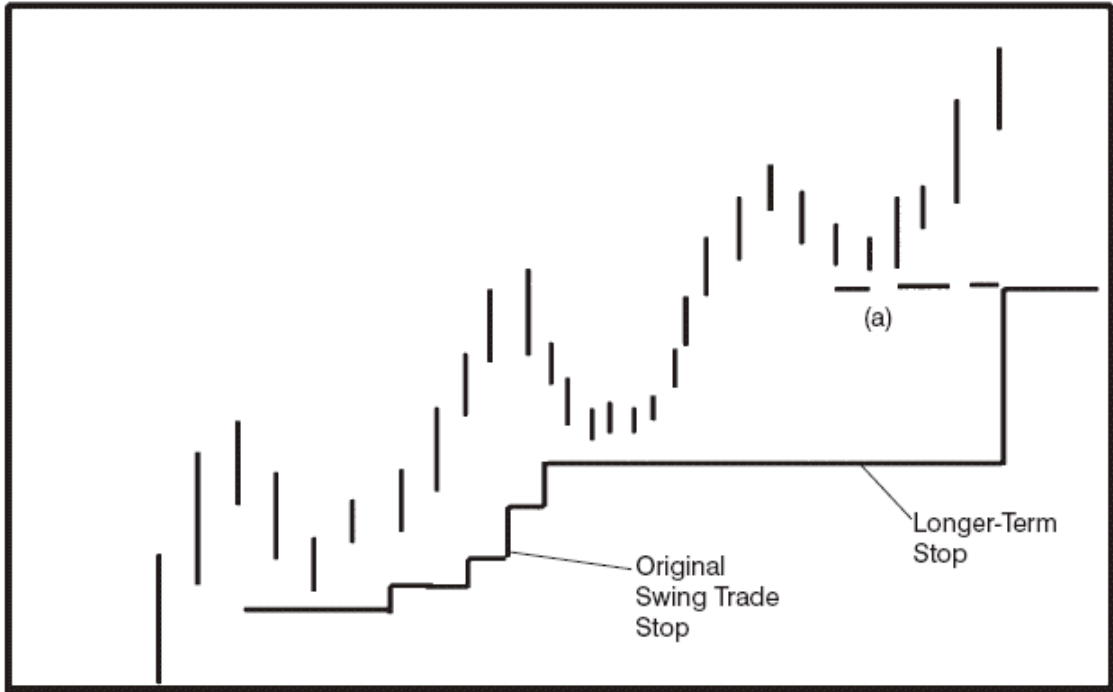
When you say 6-8 months to catch a trend – from my understanding swing traders are buy/sell in days to weeks. A trend can happen in 1 or 2 months, no? Just wait for the set up, know your target, risk/reward, set stops and capture profits.

Not sure I get why you say it takes 6 months..

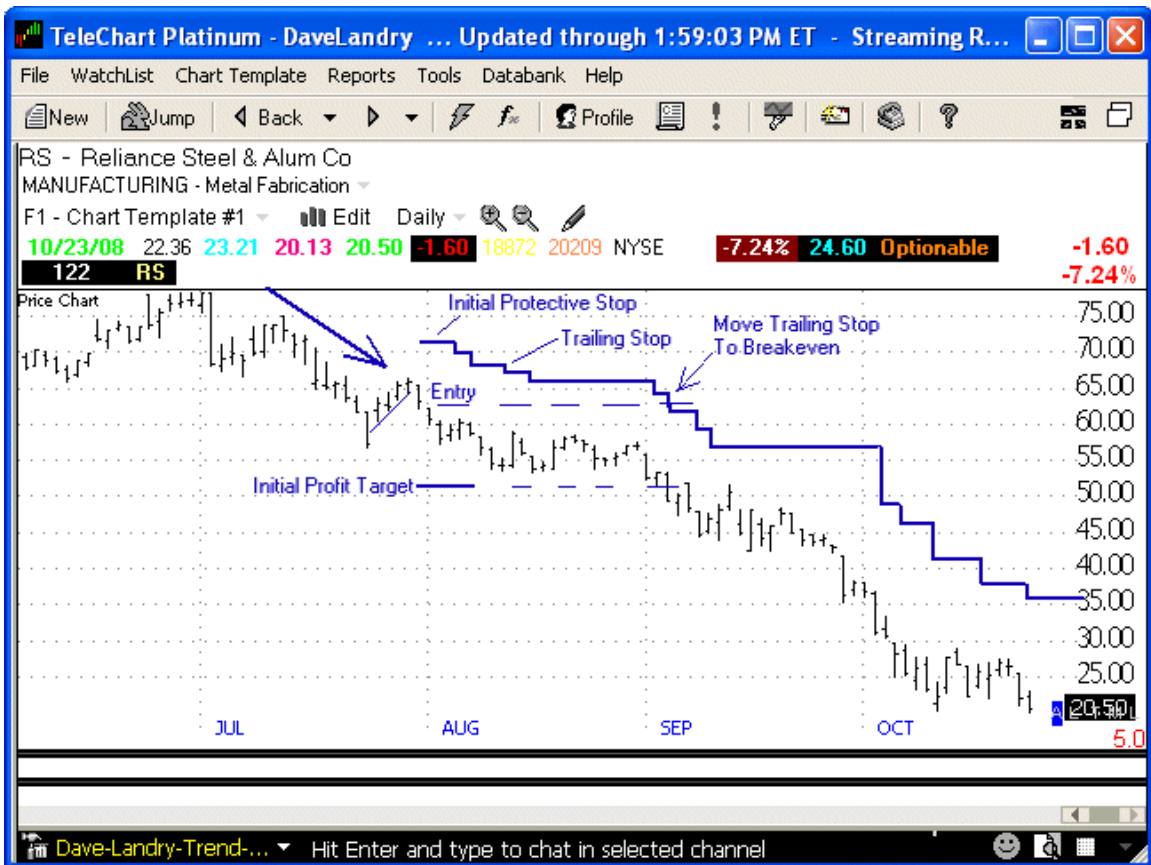
As we discussed in last week's article on trailing stops, my goal on EVERY setup is to capture a short-term gain and hopefully be able to stick around for a longer-term gain. I let the money management/position management take me out (i.e. I don't set time limits). This puts me somewhere in between a swing trader and an intermediate-term trader.

In short-term trading your gains are generally limited but so are your losses. Longer-trend trading has the potential for unlimited gains but you are susceptible to much larger losses. Therefore, by taking a short-term mentality but willing to stay with positions longer-term my goal is to have the "best of both worlds." I strive to be an intermediate-term trader with better entries and position/money management.

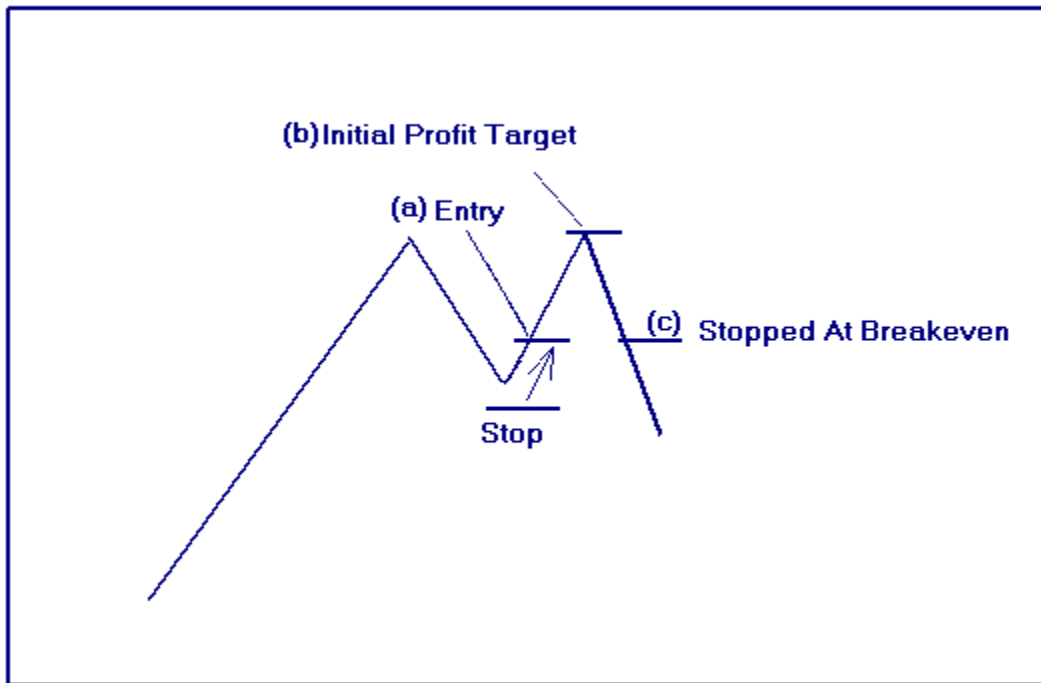
Referring back to the figure from last week, this is illustrated below. What started out as a swing trade eventually becomes a longer-term trade through adjusting the stop from a shorter-term trader mentality to a longer-term trade mentality as the position continues to move in my favor. This allows us to hopefully ride out subsequent corrections and continue to participate in a longer-term trend.



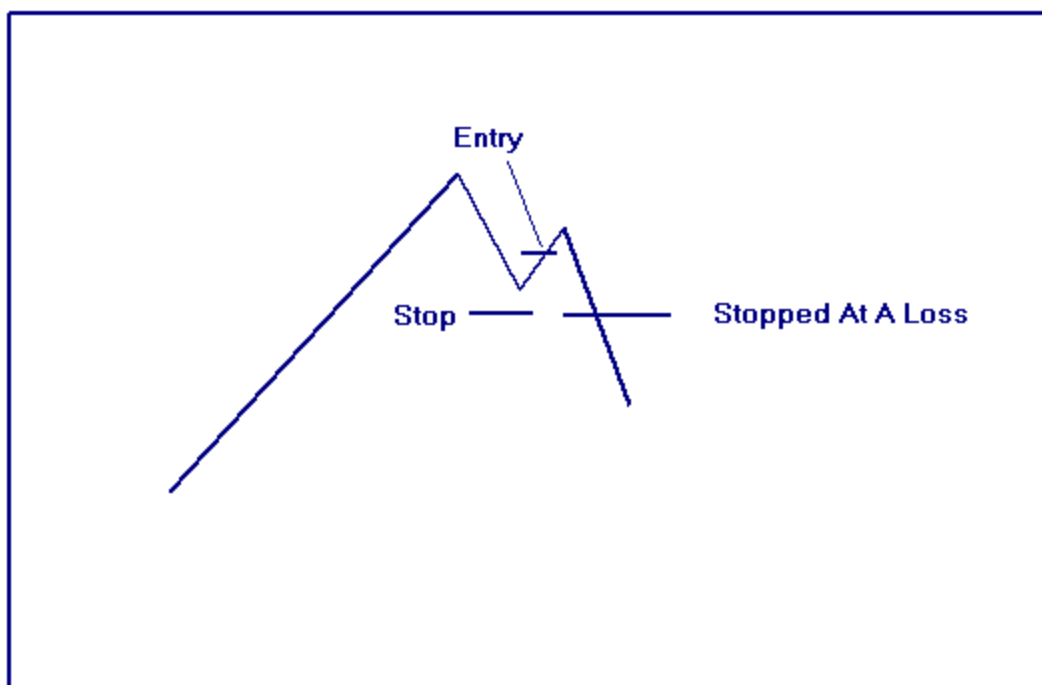
In last week's article, we used the following "real world" example from my trading service to illustrate this:



Unfortunately, the above (obviously!) doesn't always occur. Referring to the illustration below, in less than ideal conditions, the best thing that often happens is that you enter a position (a), it rallies enough for you to take partial profits (b), you move your stop to breakeven---the same as the entry(a) but you get stopped out on the remainder(c) at a scratch (barring overnight gaps of course). Overall, the position is profitable but you're not making a killing.



And, hopefully, in less-than-ideal conditions the worst thing that happens is that you enter a position and get stopped out at a small loss. This is illustrated below.



When the above occurs repeatedly (win/scratch/stop), you essentially "keep your head above water" or at worse, you don't give up too much ground (i.e. the drawdowns are mitigated).

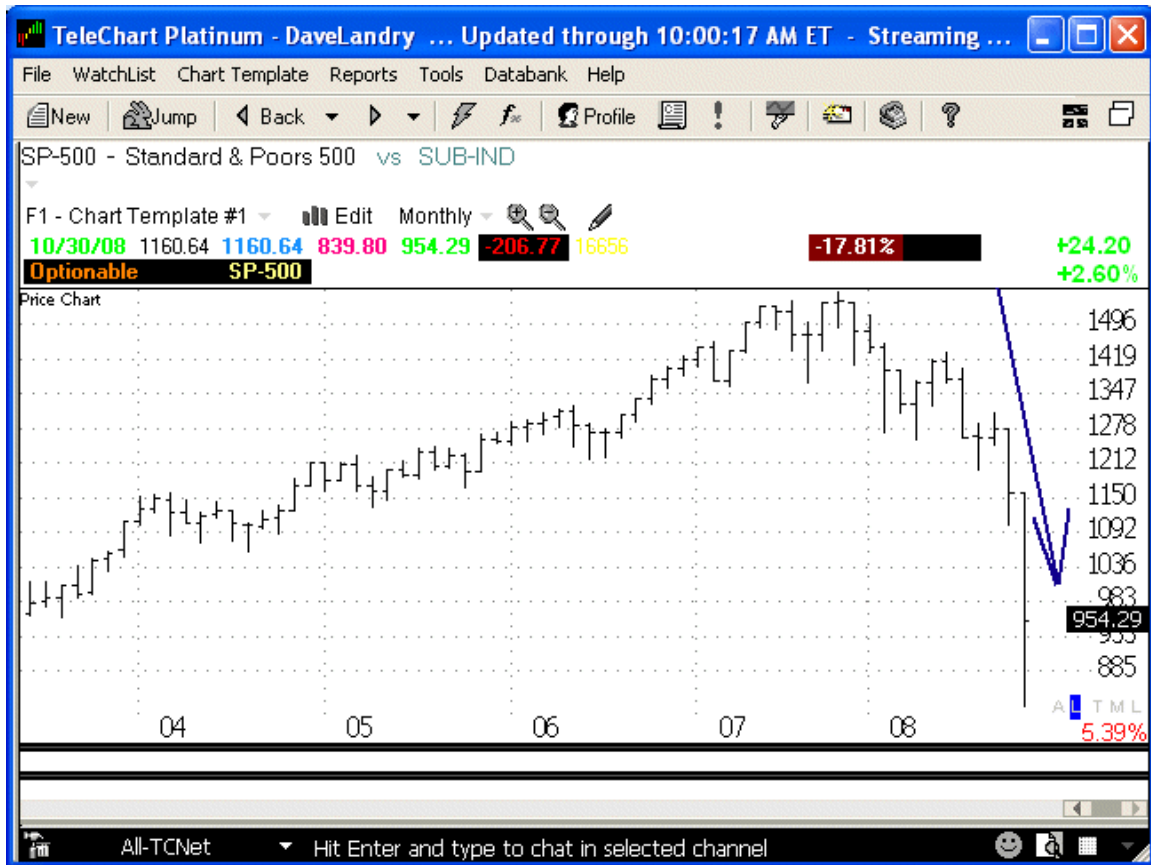
If all you accomplished was the above, you really wouldn't get very far with my methodology. As illustrated at the beginning of this article, the REAL money is in big trends. Unfortunately though, big trends don't occur every day. You have to be willing to "tough it out" while waiting for next big trend. Again, this USUALLY takes 6-8 months.

The good news is, you'll get fewer and fewer setups the longer the market doesn't trend (i.e. remains choppy). Therefore, you're trading less and less and (eventually) end up *mostly* waiting for opportunities. Further, the longer the market doesn't trend, the bigger the trend that ensues when it finally does. Because no one knows exactly when the next big trend will begin, you have to continue to do your homework and "chip away" at it until you catch a good trend. As they say in many contests, "you must be present to win."

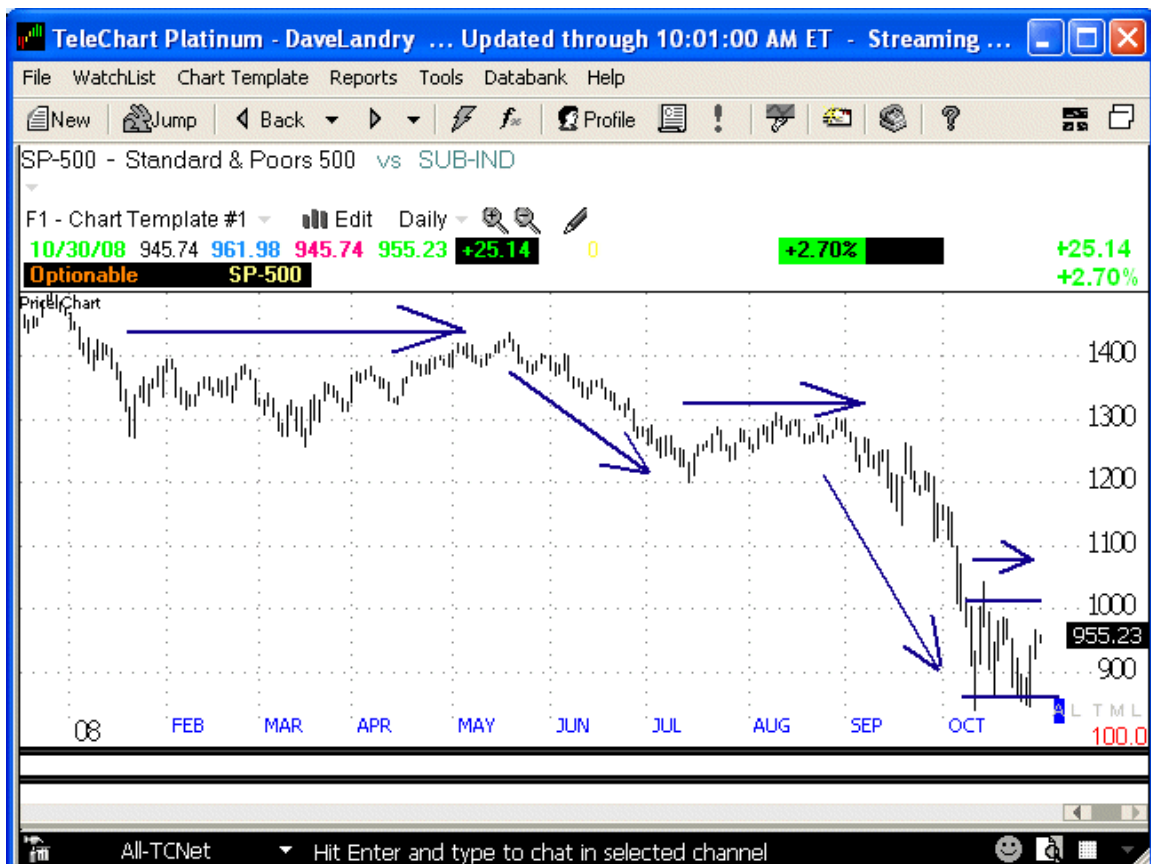
You cannot give up on trend following just because it appears to have stopped working. Time and time again, I see people give up right before big trends hit. As one prior client once said while looking at the large gains in the portfolio: "I feel like I just broke up with my fiancée and the following Saturday she wins the lottery."

I can't speak for other methodologies but I do know that every methodology has its "sweet spot." And, it takes time to hit that sweet spot. Even the shortest of short-term traders will have strings of losing months in less-than-ideal conditions. You have to be willing to stick with *any* viable method longer-term.

2008 will likely down in history as the year the market was in a strong downtrend. In fact, looking at the monthly S&P, the market appears to have gone straight down.



However, when you look at the daily chart (which we trade off of), you'll see that it went straight sideways for 6 months at the beginning of the year, trended down for a month and then it went sideways again for 2 months coming into the fall (no pun intended). In more recent times, it has gone mostly sideways for nearly 3 weeks.



As you can see, there were some very nice trends in 2008 but there were also come less-than-ideal conditions in-between.

In summary, it's important to know your methodology. Swing-to-intermediate trend following works and works well, but only with a longer-term approach.