The Best of Both Worlds

Trading For Both Short-term & Longer-term Gains

By Dave Landry

<u>My Loss, Your Gain?</u>

Ph.Ds 10
TFMs 0

You might notice that the writing in this article is a little more formal than my normal "folksy" style. This is because it was originally written for an article contest. I lost. I knew going into the contest that my chances were low. I knew that I couldn't compete against the complex theories they would likely receive but I was hoping that a practical approach to trading the markets would be a breath of fresh air. I was hoping that at the least, it would get some recognition. It didn't. So who won? 2 Ph.Ds with 8 Ph.Ds selected as finalists and not one TFM*.

<u>Synopsis:</u> The real money is in longer-term trends but only short-term trends can be predicted with any degree of accuracy. Unfortunately, longer-term trading has its pitfalls which include increased risk in both exposure and lower accuracy. This creates large drawdowns. The good news is that the short-term vs. longer-term trading decision does not have to be a mutually exclusive one. By taking a hybrid approach through proper position and money management, traders can capture both short-term and longer-term gains. This helps to increase accuracy and mitigate drawdowns while still allowing for longer-term gains.

The Dilemma

<u>Only the short-term can be predicted</u>

"When predicting the weather, the longer your forecast, the tougher it will be to get it right. If it is cloudy and thundering, chances are it is going to rain soon. However, this obviously does not mean it will be raining this time next week or next month. Similarly, although market forecasts are based on probabilities, predicting short-term moves is much easier than predicting the longer term.

Furthermore, the longer you are in a market, the better the chances are that you are going to get soaked. Short term trading keeps risks relatively small due to limited length of exposure."[1]

Where The Money Is

Although short-term trading has its advantages, it also has its disadvantages. The biggest disadvantage is that gains are limited by the brief exposure to the market. Big trends often take time to develop. The real money *is* in longer-term moves.

The Problems With Longer-term Trading

Although the real money is in longer-term trading, it is not without its pitfalls. Longer-term trends are impossible to predict with any degree of accuracy. Again, the longer your forecast, the less certainty. This can be best illustrated with a probability cone using historical (aka statistical) volatility. Referring to Chart 1, notice that the cone widens the further you look out.

[1] The Layman's Guide To Trading Stocks by Dave Landry

Chart 1-Probability Cone. Based on historical volatility, a prediction into the future illustrates how uncertainty increases with the length of the forecast.

Keep in mind that markets aren't normally distributed (i.e., don't adhere strictly to statistics) and the author is only using the probability cone to illustrate a point. If a market has been volatile in the past, it will likely continue to be volatile in the future.

Even if the trend does continue in the intended direction, the market will still be prone to deeper corrections over extended time. Therefore, wider stops must be used to ride out these corrections. This is illustrated in Figure 1. Notice how the stop must be increased to compensate for the increasing "cone" of uncertainty.

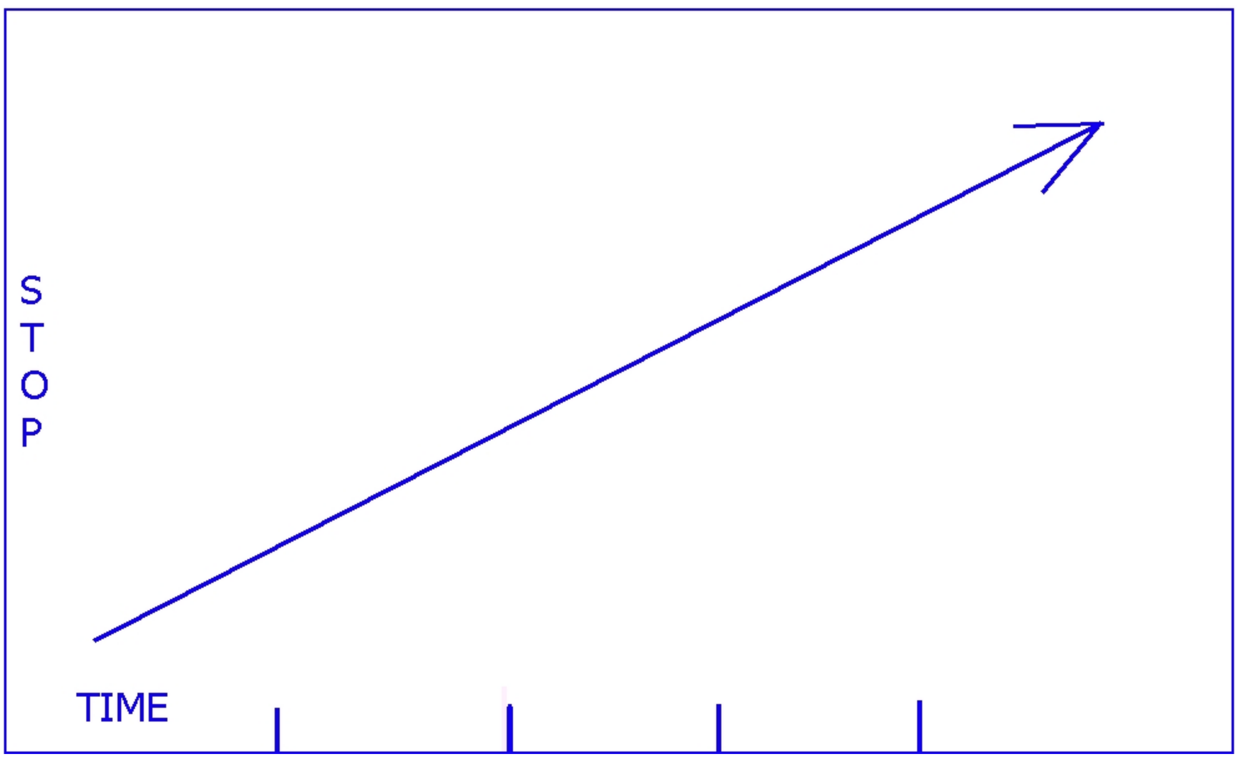

Figure 1: Stop vs. Time in market. The longer one plans to stay in a market, the wider the stop must be in order to survive corrections in the trend.

The combination of wide stops with low accuracy is a recipe for large drawdowns. Books have been written about many famous longer-term trend followers who amass great sums of money. What's often left out of the story is that many have subsequently blown up.

The Best of Both Words—A Hybrid Approach

If long term trading has bigger opportunities but risks too much and short term trading has smaller risks but does not make enough, what's a trader to do? Simple, it is not a mutually exclusive decision. Why not trade for short-term gains, but also be willing to stay with a portion of the position as long as the market moves in your favor? This allows you to have your cake and eat it too.

Considering the above, the author seeks out stocks and other markets that have the potential for both a shorter and longer-term gain. If the market moves in his favor, he locks in a short-term partial profit (half of the position) and then keeps the remainder on as long as the market continues to move in his favor. The stop is then gradually widened in order to make the transition from a short-term to a longer-term trade. Before we break this down further, let's look at how to predict both short and longer-term moves.

Keeping It Simple

It's beyond the scope of this article to get into in-depth patterns and systems to predict market moves. The good news is, only a basic system is needed. In fact, in actual markets, simpler is often better.

The author's approach to the markets is to look for an established trend (or obvious transition in trend[2]) and then enter that market after it has corrected. In other words, he trades pullbacks.

The idea is to capture a short-term move as the market reverts back to its mean, which is hopefully followed by a longer-term move as the longer-term trend resumes.

Predicting the Short-term

Referring to figure 2, markets tend to vacillate between overbought (ob) and oversold (os). This can be akin to walking a dog on a leash. When the dog reaches

[2] See Bibliography

the end of the leash at the edge of the sidewalk, he tends to wander back to the other side of the sidewalk.

Obviously, with markets, no one knows exactly where the “end of the leash” is. Overbought can always become even more overbought. Likewise, oversold can also become even more oversold. Metaphorically, the leash does occasionally break (a propensity we actually use to our advantage). This is why trading an ob/os system in and of itself is not a good idea. In general though, markets don’t go up or down forever. Again, they tend to vacillate between overbought/ oversold.

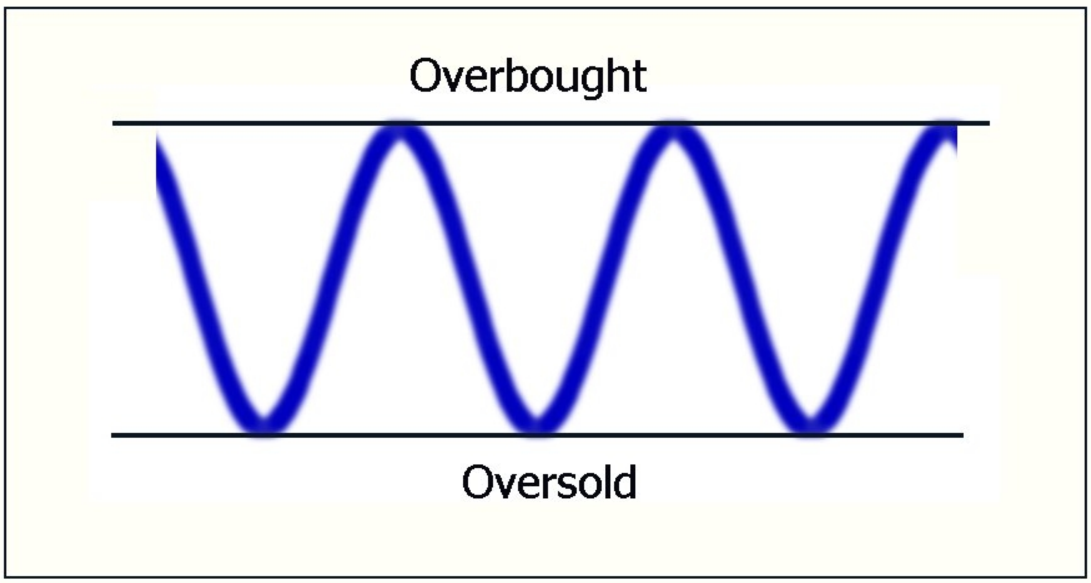

Figure 2 Overbought/Oversold. Markets tend to swing from overbought to oversold and then back again.

Keep in mind that “overbought” (ob) and “oversold” (os) are relative terms. Markets that are higher in volatility can have significant moves and still not be ob/os. Conversely, lower volatility markets making similar moves would certainly be classified as being ob or os. For example, a 10% move in a mature food company or a short-term bond would likely signify that market is ob/os. On the other hand, a 10% move in an emerging technology company might only be a typical 1-day move. Further, markets that have made sharp moves in the direction of the trend will tend to have deeper corrections against that trend as they move from overbought to oversold (or vice versa).

For equities, if the overall market and corresponding sector is also ob/os, then the odds of capturing a short-term reversion to the mean type move are increased as all three---the market, the sector, and the stock--are ripe to revert back to the mean.

The odds of capturing a reversion to the mean type of move can be increased even further by trading in the direction of the major trend. And, this is exactly what the author does. He seeks to capture reversion to the mean moves in the direction of the underlying trend. Again, he trades pullbacks. This is illustrated in figure 3. Notice the trend (as illustrated by the arrow) continues until the market corrects from its overbought condition to become oversold. A buy is triggered when the market begins to revert back to the mean in the direction of the underlying major trend.

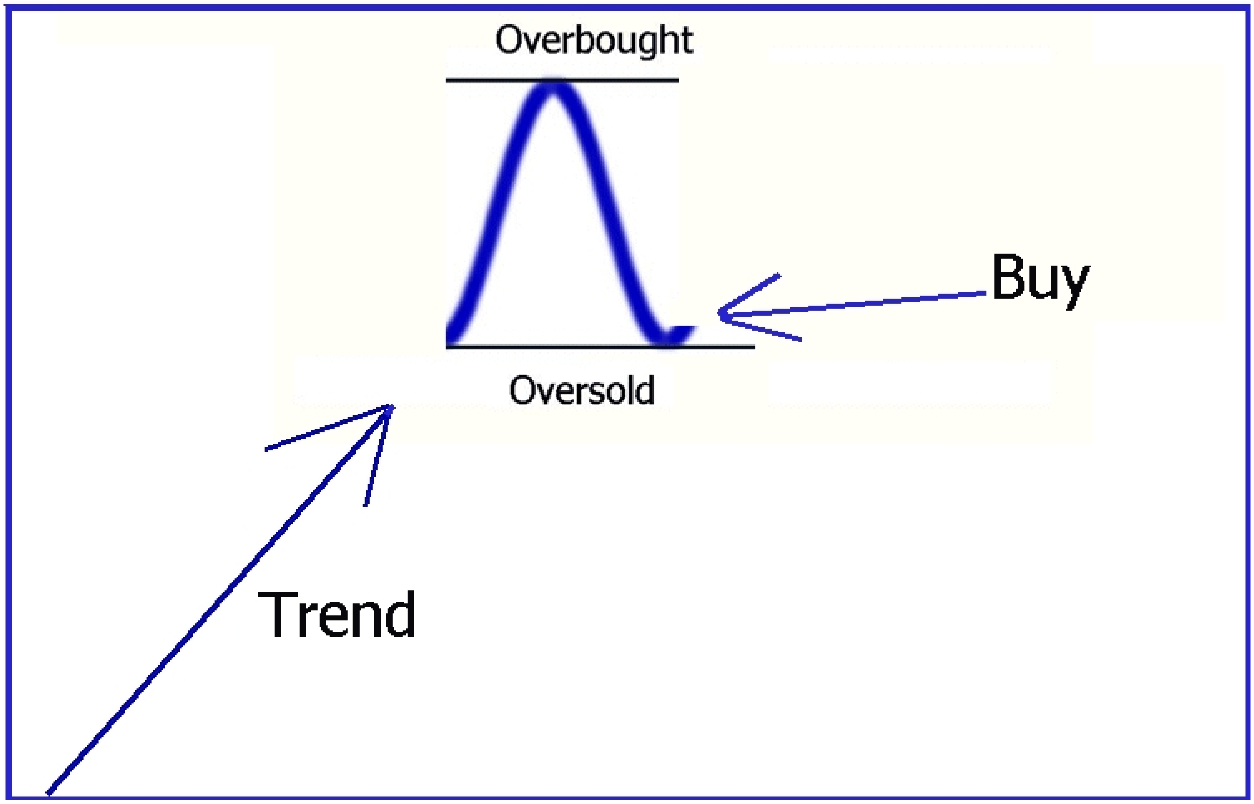

Figure 3 Trading reversion to the mean moves in the direction of the underlying trend-AKA Trading Pullbacks.

Referring to figure 4, trading the short side would be just the opposite. You look to short an overbought market in an established downtrend just as it begins to revert back to the mean in the direction of the major downtrend.

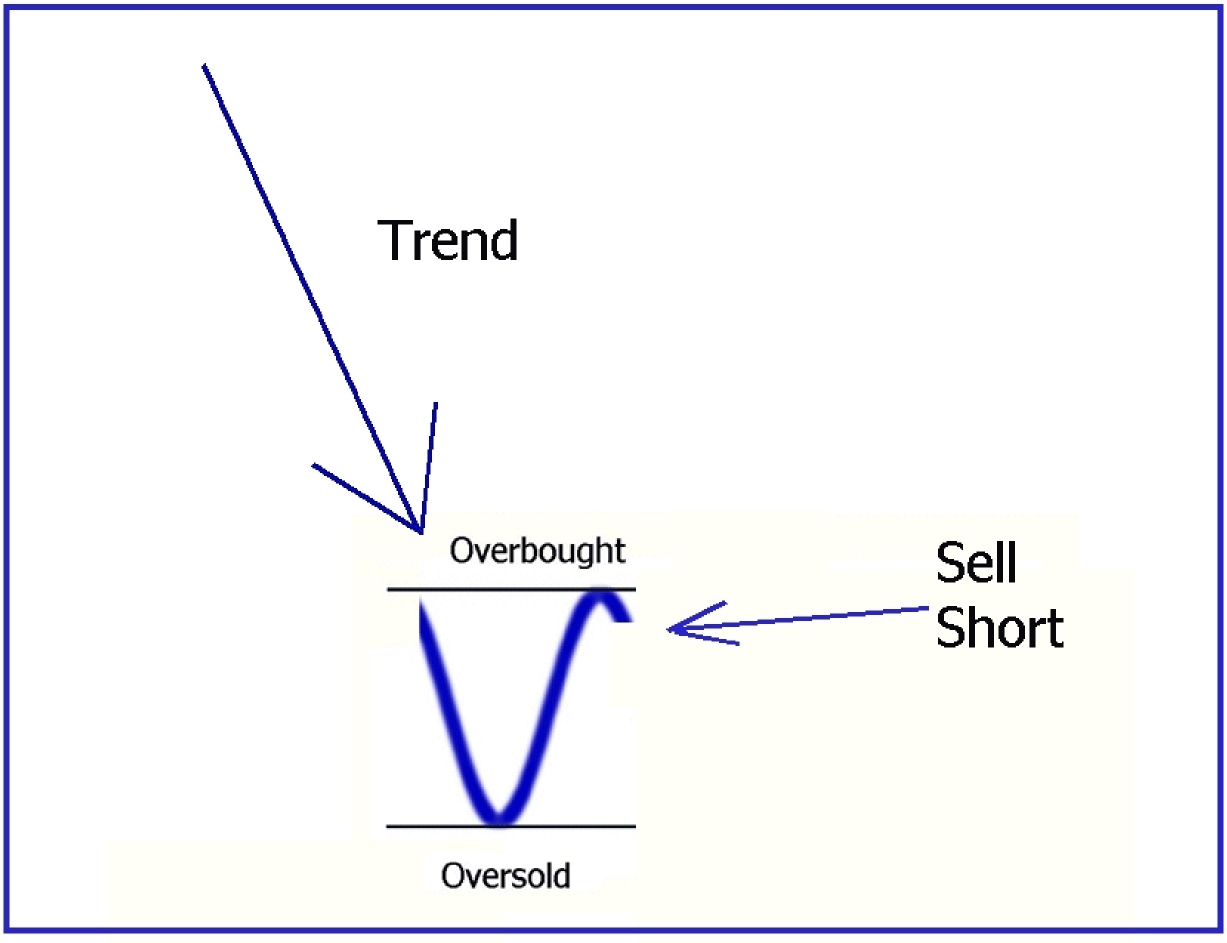

Figure 4 Shorting a market by trading reversion to the mean in the direction of the downtrend.

Predicting the Longer-term

Trend followers seek out markets that have been trending with the hopes that the trend will continue. Therefore, in order to follow a trend, one must first recognize when an existing trend is in place.

There are numerous indicators for determining trend. Unfortunately, since these indicators are price based, there will be lag. The good news is that determining a trend is not difficult. In fact, the best way to determine an existing trend is to simply eyeball a chart. Keep it simple. The trend should be obvious. The author believes that if there is a trend, then you should be able to draw a big arrow on the chart. This is illustrated in figure 5.

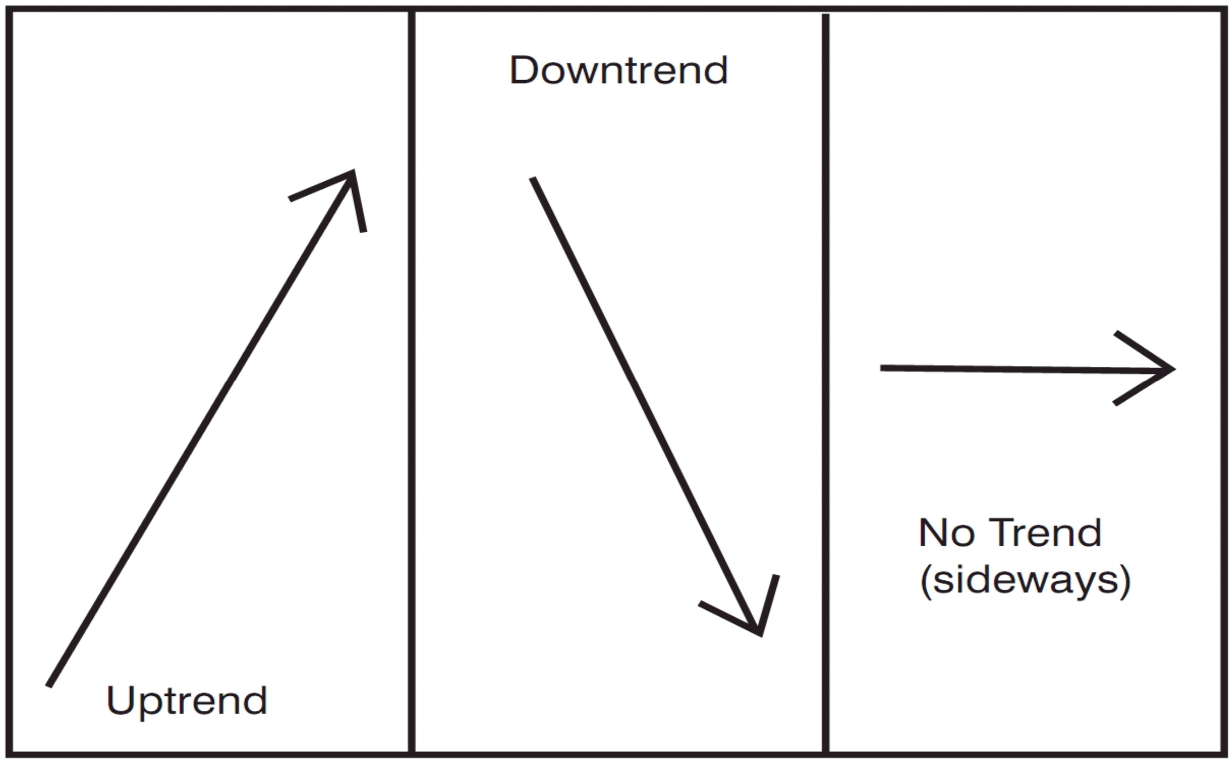

Figure 5 Trends: Up, Down, & Sideways

In addition to drawing arrows, one of the best predictors of trends is persistency. Persistency means that a market tends to follow through from one day to the next. Mathematically, this can be measured with linear regression. The author prefers to keep things simple though, and just draws a line *through* as many bars as possible. This is illustrated in figure 6.

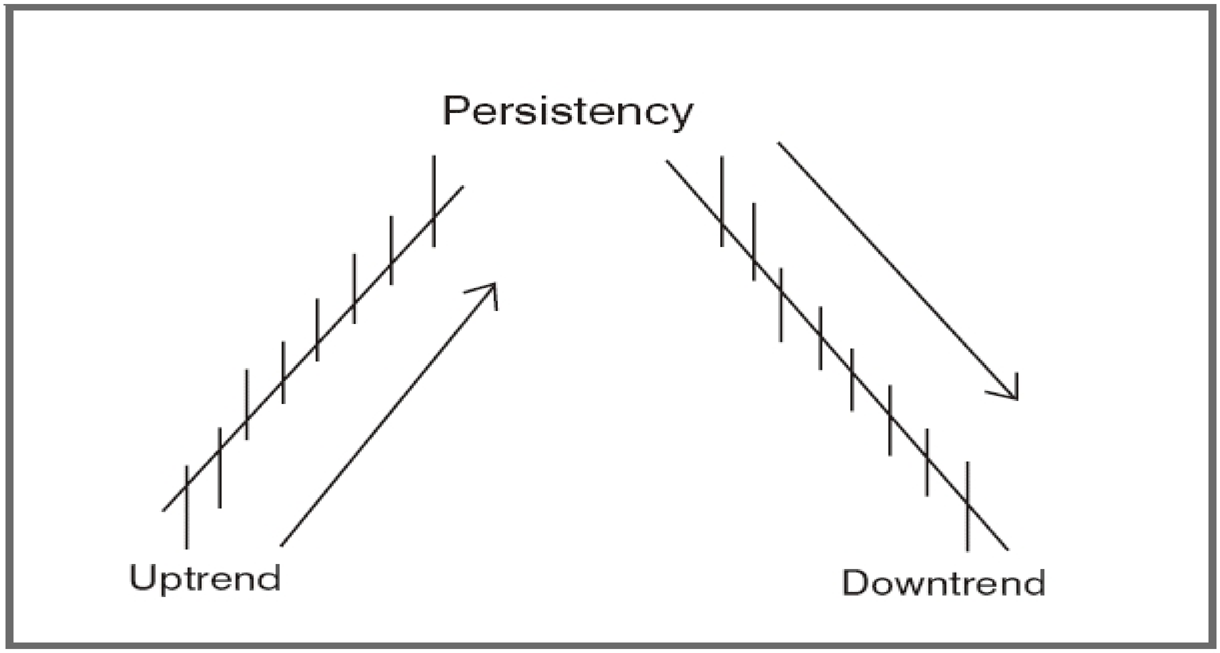

Figure 6 Persistency: A market that tends to persist in the direction of the trend day after day.

Essentially, if a market has been trending, especially if it has persisted in that trend for some time, then chances are that the market will continue in that direction. This doesn't mean that it won't correct. In fact, the more overbought (or oversold) it is, the more dangerous it is to enter because it is due to correct. Therefore, the accuracy of catching a resumption of trend can be increased further by waiting for the market to correct and then look to enter the market as it begins to resume its trend from overbought (for downtrends) or oversold (for uptrends). This was previously illustrated in figures 3 and 4.

This simple technique, trading Persistent Pullbacks[3], will generally keep you on the right side of the market. In fact, during the bear market of 2008, the author could not find any Persistent Pullbacks on the long side.

Combining Overbought/Oversold With Trend

By combining an established uptrend and (ideally) a persistent uptrend with an oversold condition, you position yourself to capture a fairly certain short-term move as the market reverts to its mean, and hopefully, a less certain longer-term move as the longer-term trend resumes. Metaphorically, you're looking for the

[3] Dave Landry's 10 Best Patterns and Strategies by Dave Landry

overbought “leash to break” in the direction of the longer-term uptrend. This is illustrated in figure 7.

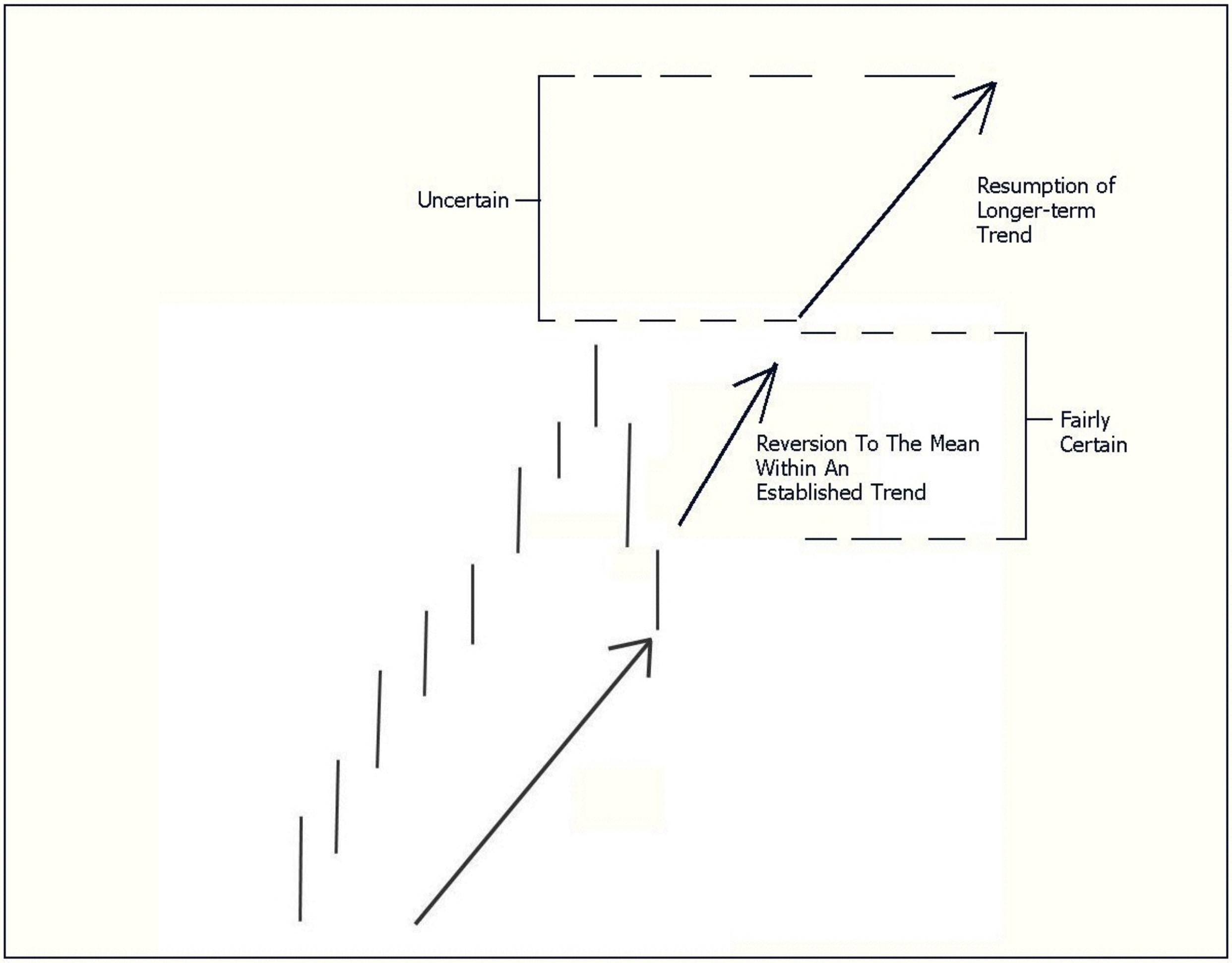

Figure 7: Short-term reversion to the mean forecasts within an established trend can be fairly certain. However, longer-term forecasts are less certain.

The same principle applies to the short side by combining a downtrend with an overbought market.

<u>The Methodology In A Nutshell- Trading Pullbacks in *Trending* Markets</u>

The author believes “The Trend Is Your Friend” is the truest market adage. And, the best way to enter trends is on pullbacks. Referring to figure 8, the precursors for trading pullbacks consist of a market in a strong trend (a) that has begun to correct (b). A trade (c) is triggered when the trend begins to resume and a protective stop is placed (d) should the trend not continue. As the trend persists, partial profits (e) should be taken and the stop on the remaining shares should be trailed higher (f). In a nutshell, this is the author's entire methodology. The rest is just details.

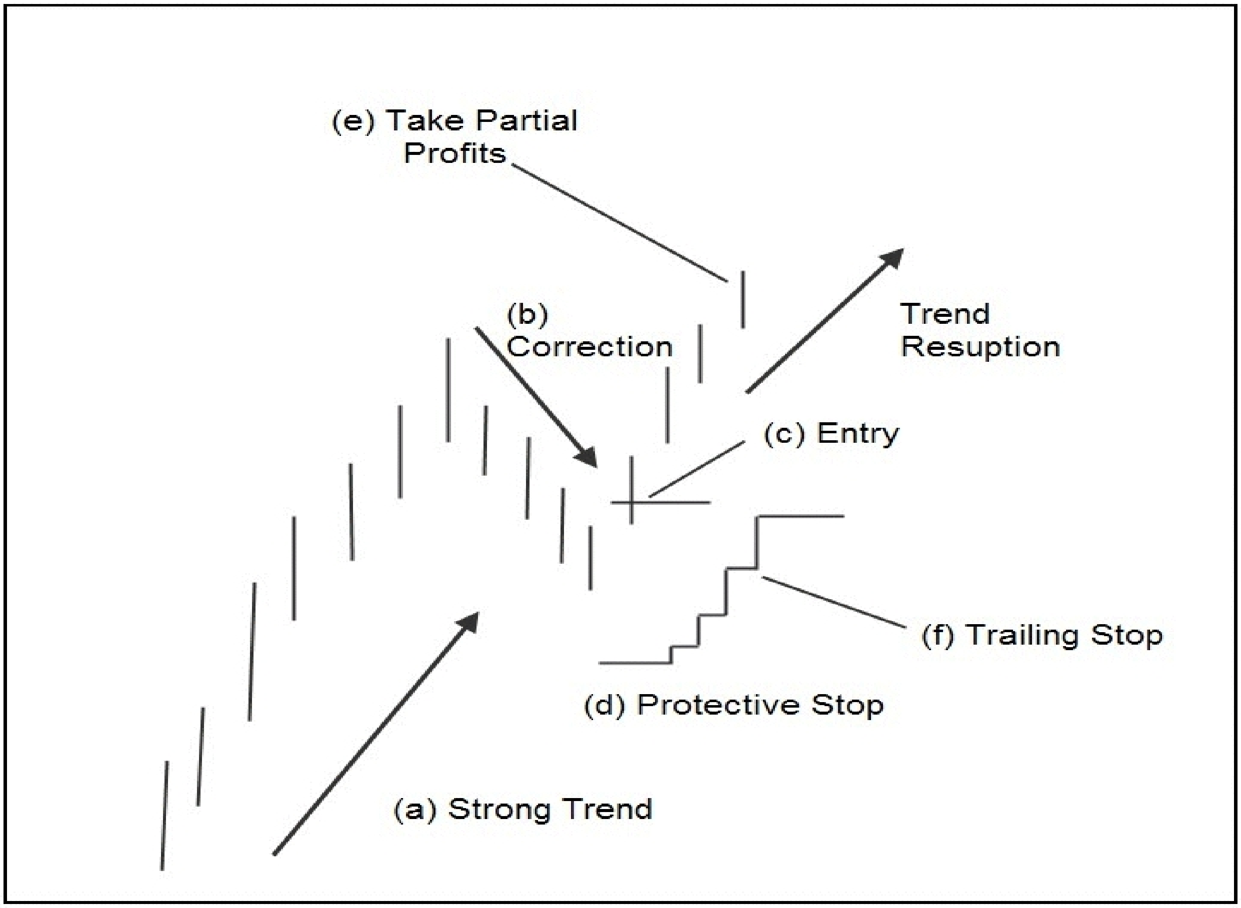

Figure 8 Trading Pullbacks In Trending Markets

Some Details

Obviously, all of the details about trading pullbacks cannot be covered in this article. Entire texts have been dedicated to the subject--the author has written three. However, if you understand the following crucial concepts, then you will understand the crux of the author's approach.

(a) Trend: The most important thing to notice is that this section is titled Trading Pullbacks in *Trending* Markets. Trending is the key word in that sentence. If markets are not trending then they should be ignored. And, ideally, for equities, the corresponding sector/other stocks within the sector and the overall market should also be trending.

Markets don't always trend, so there will be times where there is no action to be taken. This can create performance anxiety for the individual trader looking for income or the fund manager who is under pressure to produce results. Although it's beyond the scope of this article, the author would be remiss if he didn't mention the psychological aspects of being patient. For a trending methodology, the trader must be able to sit through extended sideways markets and resist the temptation to try to make something happen where no opportunities exist.

(b) Correction: For uptrends, the market must correct by moving to oversold. Again, "oversold" is a relative term based on the market's previously measured volatility.
(c) Entry: The trade is taken if, and only if, the trend shows signs of resuming. If it does not, the trade is avoided. This helps to avoid losing trades based on false moves. The further the entry is away from the current market price, the less likely it will trigger and more false moves will be avoided. In trading though, there is always a tradeoff. Higher entries give up more of the reversion to the mean move. Further, if the longer-term trend does not resume, it's possible that an entry too far away from the current price would trigger just as the reversion to the mean exhausts itself.
(d) The protective stop. No matter how great a potential trade may look, there's always the potential that it might not work. Therefore, a protective stop is always used. Based on the volatility of the underlying instrument, the stop is placed far enough away to avoid the normal noise of the market in an attempt to ride out a short-term "swing" type move as the market reverts back to its mean.
(e) Partial profits (half) are taken when the profits on the initial trade are equal to (or exceed) the initial risk.
(f) The stop is then trailed higher as the position moves in our favor. Initially, the stop is trailed fairly tightly--usually on a one for one basis—to keep risks relatively low. Once the market has proven itself by hitting the initial profit

target, the stop is then gradually loosened to hopefully ride out a longer-term winner.

Understanding this transitioning of the trailing stop from a short-term tight stop to a longer-term looser stop is crucial. It's what allows you to capture the occasional "homeruns." Without these, returns would be mediocre at best. It's the most important point in this article. It's what allows for the best of both worlds—capturing *both* a short-term and longer-term trend.

Riding The Trend Out: Money and Position Management

Finding the best stocks (or other markets) poised to make both shorter-term and longer-term moves is important. And true, a great offense can be a good defense. However, this is only part of the equation. Many spend too much time focusing on this while forgetting about the importance of money and position management.

<u>Negative Expectancy?</u>

By now you may have noticed that partial profits are being taken on a 1-for-1 risk vs. profits basis. Anytime a one-for-one gain vs. risk is mentioned in money and position management, the question of negative expectancy always (and should always!) arises. In trading you will often be wrong, so you must make significantly more than you lose. By limiting yourself to only 1-for-1 gains, an inevitable bad streak will deplete your account. Therefore, any money management system where risks equal reward on a one-for-one basis will have a negative expectancy. Said alternatively, you will eventually lose more than you will make.

There is good news. Since we are positioning ourselves to ride out a longer-term trend and letting the market make decisions for us, there is no limit to what can be made on the remainder of the position. In fact, just catching a few longer-term trends will make all the difference in the world in the portfolio's performance.

<u>Staying With The Trend</u>

Since longer-term trends will have bigger corrections, larger stops (percentage wise) must be used.

We don’t know that a position will turn into a longer-term winner, so stops are *gradually* loosened as the position proves itself by moving more and more in our favor. This is often accomplished by not doing anything. For instance, suppose the protective stop is 5 points away from the current price and the price subsequently rises an additional ½ point. By doing nothing—leaving the stop where it is—you have effectively widened your stop to 5 ½ points. This gradual loosening of the stop gives the position room to breathe, thereby increasing the chances of capturing a longer-term trend. This is accomplished without adding any additional risk based on our original risk parameters (barring overnight gaps). True, open risk does increase but there’s no way to eliminate all risks when trading. With risk often comes reward.

The gradual widening of the stop in an attempt to stay with a longer-term winner is illustrated in figure 9. Notice that the stop is trailed more tightly early on but then subsequently loosened after the initial profit target is hit and the trend continues.

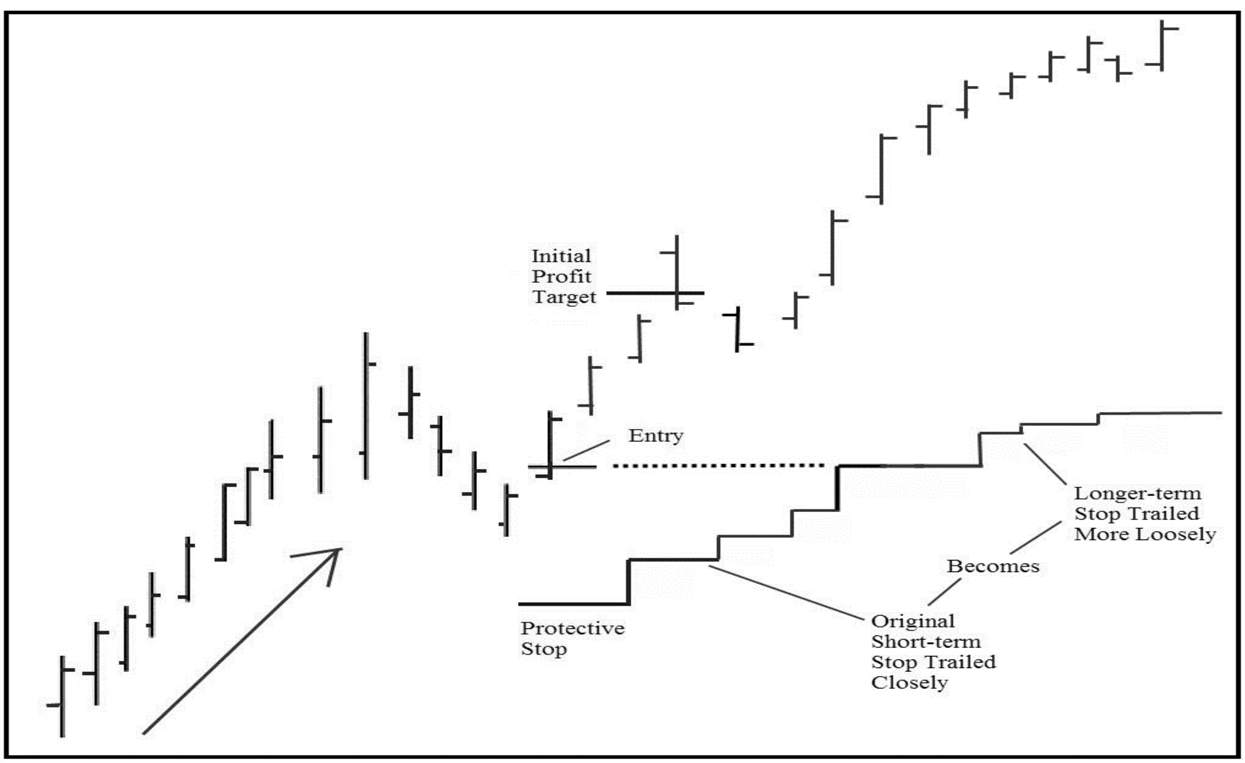

Figure 9: Transitioning From A Tight Short-Term Stop To Longer-term Stop.

In The Real World

Now let's look at a real world example. Referring to Chart #2, XL Capital Ltd. (XL) sets up as a pullback that looks like it has the potential to make both a short-term and longer-term move. Notice that the stock has rallied nearly 300% in just over 2 months. The trend has been a persistent one–a line can be drawn *through* most of the bars throughout the trend. And finally, and most importantly, an obvious big arrow can be drawn in the direction of the trend.

Chart #2 XL sets up as a pullback.

The stock corrects by dropping 25 percent. This may seem like a fairly sharp drop, especially in a world where the media defines a bear market as a market that has dropped 20% or more. However, based on the magnitude of the prior move and volatility of the stock, this is only a normal and healthy correction.

The stock is now oversold and due to revert back to the mean in the direction of the trend. In other words, it has pulled back.

Referring to chart 3, an entry (9.40) is placed above the market to help ensure that the reversion to the mean move has begun. And, once triggered, the stop is placed far enough away (6.90) to hopefully ride out a short-term move should the correction not be complete or worse, should the position fail. A quick word about position sizing: the number of shares will be based on a small percentage of the trading account if stopped out. For example, assuming a 100,000 account and risking 2%, then 2,000 divided by the risk of 2.5 (entry – stop) = 800 shares. The point is to keep risks the same for each position taken regardless of the size of the stop. More volatile markets will require looser stops and therefore, fewer shares/ contracts will be traded. Conversely, tighter stops can be used in less volatile markets. Therefore, more shares/contracts will be traded (within reason). Obviously, there's a lot more to position sizing than this, but you get the general idea--keep risk in check.

Chart #3: Determining the entry, protective stop, and initial profit target.

Now let's look at what happens. Referring to chart 4, notice that the stop is initially trailed tightly (on a 1 for 1 basis) and partial profits are taken fairly quickly for a short-term "swing" trade. The stop is then gradually loosened to ride out a longer-term trend. In fact, what started as a short-term swing trade turned into a position that was held for over 2 ½ years.

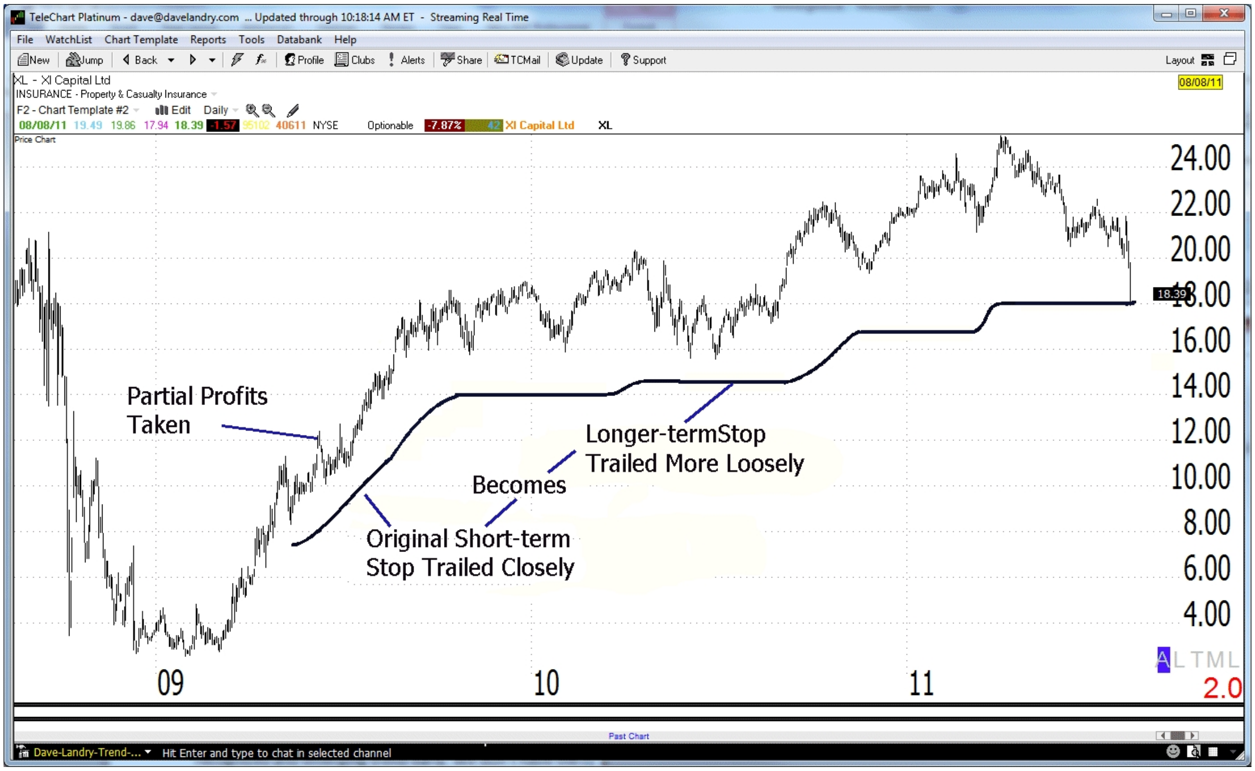

Chart #4 Riding out a longer-term winner on the long side.

Now, let's take a look at an example on the short side. Before we do though, a few words about shorting: "They slide faster than they glide" is one of the few true Wall Street adages. Things are destroyed much faster than they are built. Although longer-term trend resumption in established trends does occur (especially in longer-term bear markets), the real opportunities on the short-side usually occur very early in the trend. Therefore, for shorting, it's important to recognize an emerging trend aka "trend transition" early[4]. We usually don't have the luxury of waiting for extended confirmation because, by that time, it may be too late.

[4] See article bibliography for more on trend transitions.

Notice in chart 5 that GMCR makes all-time highs then begins to slide. Since this is a potential short position, we cannot wait for the trend to be well established. Therefore, on the first pullback early in the developing trend (aka a First Thrust pattern, see bibliography for more info on transitional patterns), we look to short the stock.

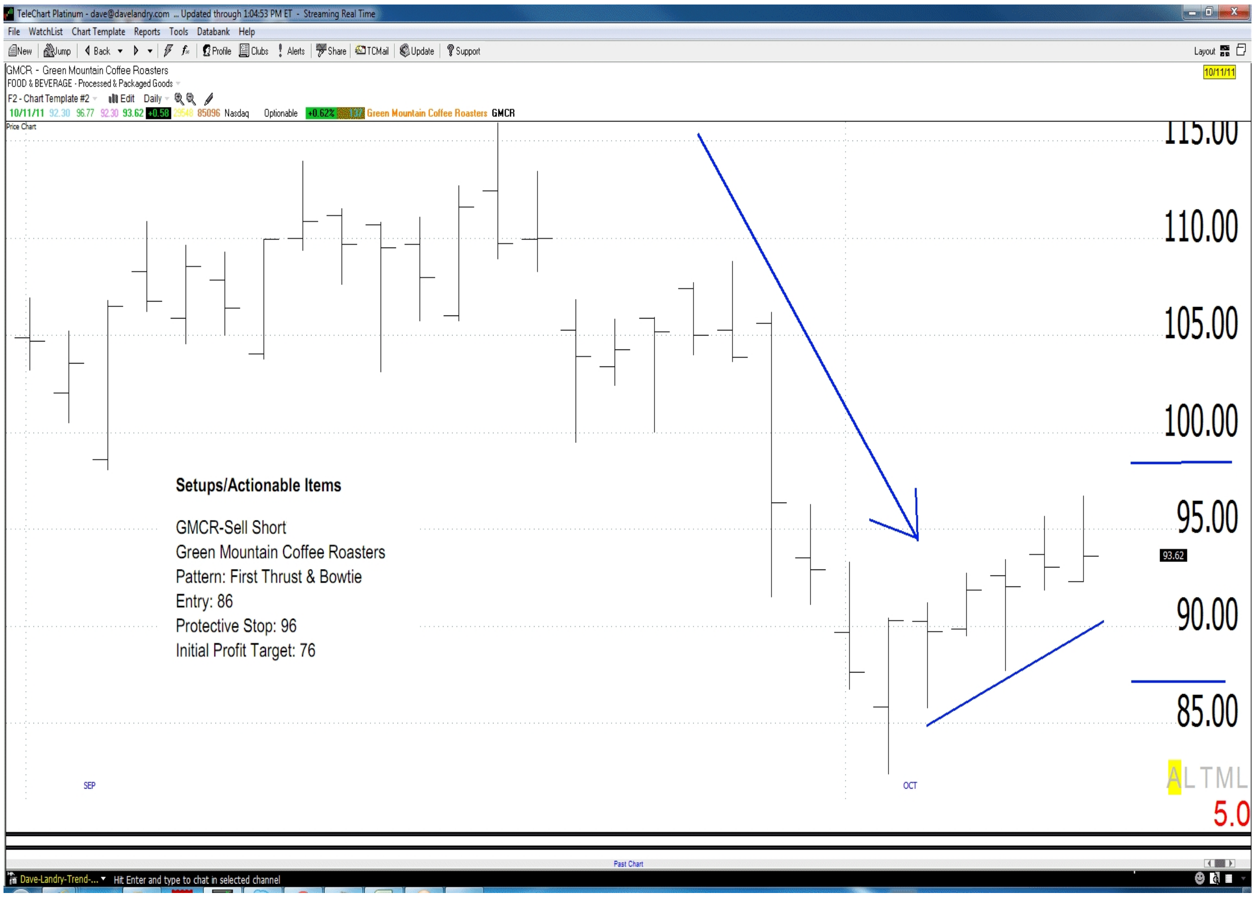

Chart #5: A setup on the short side.

Now let's look at what happened. Referring to chart 6, notice that a quick "swing trade" profit is taken several days after entering the trade and a trailing stop is loosened as the position moves more and more in our favor. Although it didn't turn into a multi-year winner like the previous example, it did make a very nice move in a little over 2 months.

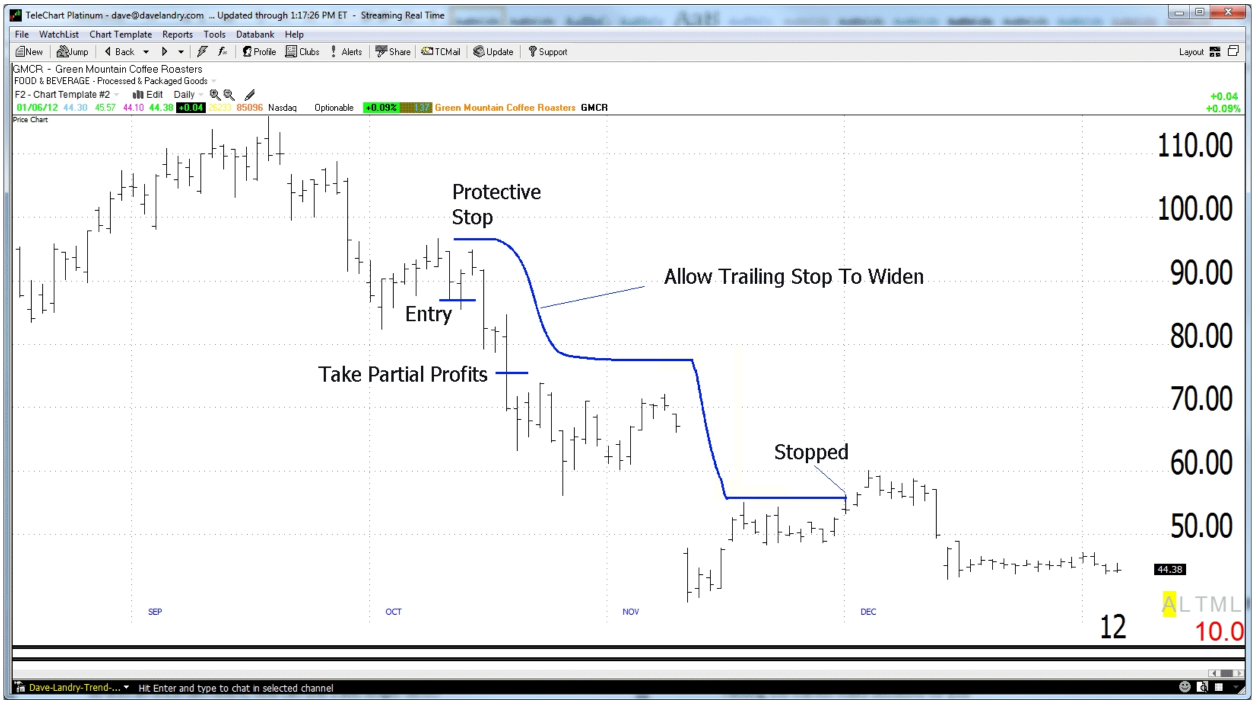

Chart #6. Staying with a winning trade on the short side.

As you can see, nice trends with relatively low risks can be captured in the real world through transitioning a short-term swing trade into a longer-term trend following trade.

Summary

The future is uncertain. Only the short-term can be predicted with any degree of accuracy. Unfortunately, although short-term trading has less risk, it doesn't make enough money. The real money is in capturing longer-term trends. The trader can position himself for both short and long-term moves by finding trending markets that are due to revert back to the mean. A fairly tight stop can be used until the position proves itself. Once that occurs, the stop can be gradually allowed to loosen as the position moves more and more in your favor. Short-term vs. longer-term trading does not have to be a mutually exclusive decision. Why not trade for short-term gains but be willing to hold onto positions for longer-term gains?

*Trend following moron

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About the author

Dave Landry has been actively trading the markets since the early 90s. In 1995 he founded Sentive Trading, LLC, (d/b/a www.davelandry.com)--a trading and consulting firm for both retail and institutional clients. He is author of Dave Landry on Swing Trading (2000), Dave Landry's 10 Best Swing Trading Patterns & Strategies (2003), and The Layman's Guide to Trading Stocks (2010). His books have been translated into Russian, Italian, French, Japanese, Chinese, and Korean. He has made several television appearances, has written articles for several publications including Technical Analysis of Stocks & Commodities, Active Trader, Currency Trader, Traders-Germany, and Traders Journal-Singapore. He has been publishing daily web based commentary on technical trading since 1997. He has spoken at trading conferences both nationally and internationally. He holds a Bachelor of Science in Computer Science and has an MBA. He was registered Commodity Trading Advisor (CTA) from 1995 to 2009. He is a member of the American Association of Professional Technical Analysts.