Twelve “Must Know” Secrets to Gain the Trader’s Edge

**Most of these secrets can be applied by either stock or option traders.**

**Secret #1**

Bear markets or days within a correction often open higher at the start of the day, but then close down for the day. Bull markets, on the other side, can open the day lower but close the day up. Hold your positions until after the first morning reversal period, so you are not shaken out unnecessarily.

**Secret #2**

Always exit your trade on the same rule you used to enter the trade. If you used a PPO cross up to enter a call trade, use a PPO cross down to exit the trade. If you used an oversold indicator such as Stochastics or Williams%R to buy a block of stock to be held short term, then exit the trade once the equity moves out of an overbought condition.

This rule eliminates second guessing. It prevents changing the rules of the game once you’ve entered a trade. It gives you a firm exit point that is a “known factor” at the time you purchase the stock or option. It takes your emotions out of the equation so you’re not apt to look at another indicator and say, “But, maybe, the pullback is just temporary. Look at the ADX or RSI, I still have some time left on my position.”

Congratulate yourself for following through with your trading rules. Preserve your profits. Even if the equity does an about-face and you miss a little more profit, stick with the rule on future trades. It will serve you well on 10 times out of 12 trades.
Secret #3

How do you know if a rally attempt is really the start of a new uptrend? What is the confirmation so you don’t get faked out on the first or second up day of a sucker rally that turns back down?

If one of the major indices posts a significant increase (+1.75% or more) on high volume (higher than the day before) on the third day of the attempt, the fourth up day will then be the confirmation day of a rally that started on the first day up. The confirmation day of a new uptrend usually comes between day four and seven of a rally attempt. Declining markets often attempt to rally for a few days, and then if the indices’ volume picks up but closes down for the day, it can be a signal that the rally attempt is failing and will resume its downtrend.

Secret #4

Always purchase stock or enter your option positions towards the end of the day, during what traders call “professional hour.” During the last hour of the trading day, the equity’s price is known, rather than chasing the stock’s price in the morning as you try not to miss out on its anticipated movement.

If not during the last hour, then place your orders well after the first hour of the trading day, “amateur hour.” This is not an actual hour, but a name for the period of time when orders that were placed before the market opened are cleared through the brokers.

Secret #5

It is advisable to have at least 25 institutional holders of the stock you are interested in because they are the big movers of the stock through their purchases. Institutional buyers do their research and seldom buy cheap, low-priced, low-quality stocks that have poor backing, so why not follow in their tracks. A list of institutional buyers for your stock can be found at—http://www.reuters.com/finance/stocks/financialHighlights?symbol

Secret #6

What other qualities should you consider for companies you’d like to purchase stock or options on?

10 Steps in Equity Selection Funneling:

1. Locate a few stocks with lofty Relative Strength Ratings. Investor Business Daily (IBD) lists stock, depicting their ratings from 99-1. 99 being the highest.

2. Earnings per share in the last quarter should be up at least 25% (preferably more) versus the same quarter the previous year. These figures can be compared at http://earnings.com.

4. Select leading Sector and Industry Groups- identify leading stocks from within these groups. (This weekly information is provided at http://www.finviz.com/groups.ashx. Assess each stock’s price and volume action from the stocks on your list that fit into one of these top sector or industry groups.

    The market trend dictates the direction of 3 out of every 4 stocks. Sector and industry group strength plays a major part in the stock’s performance. Each market cycle is led by specific groups, so why not benefit from this added momentum.

5. Are small, mid or large cap stocks leading the market? Concentrate your search for stocks within that classification.

6. Look at the stock’s technical and fundamental picture. Check to see if the stock is completing a new base or pullback to the 50 SMA. Head and Shoulders or Inverted Head and Shoulders pattern? Cup & Handle? Double Bottom? Base on Base? Is it nearing to a buy point?

7. Locate support and resistance levels and analysis the distance to each, making sure you have room to reach your price target goals before the stock reaches these levels.

8. Fundamentals are key. Survey recent quarters’ earnings and sales growth. Is profit growth ramping up or slowing down? Accelerating earnings, new contracts or increased sales are a plus.

9. Read through the latest news and press releases on the company of interest.

10. Be aware of the stock’s next earnings date. You don’t want to be caught unaware. Earnings dates and past results can be easily checked at www.Earnings.com.

Secret #7

Stocks with a price range up to the $70-80 price range will usually continue their upward price movement until they reach $100. And stocks that reach $100 will usually climb until they reach $120-130 price range.

This may sound like an over simplification but this price movement concept stands as a reliable prediction of further price increases over the long term.

It stands to reason that the stocks growing their company’s earnings and net worth are the same ones whose price will reach the $70-80 price range, and $100 after that. And, those reaching 52 week highs are the cherries on the stock-market-sundae.
Often stocks that reach the highest levels of $130 will split. You can check the agenda of the next stock holders’ meeting for presentation/discussion/vote on the split. If a stock has had a recent stock split, it should be evaluated on the pre-split price i.e. a stock that is currently trading at 60 after a 2-1 split should be evaluated as trading at 120. Earnings.com lists stocks that are splitting each day. A trader can check ahead in the month if they are interested in trading a split-strategy.

Also, stocks that have split in the past will often split a second or third time when the reach the previous pre-split price level.

Secret #8

Traders new to options are taught to purchase options on contracts that show open interest of more than 100. They are also taught to recognize support and resistance levels as seen on a stock’s chart, indicating price movement.

Examining a stock’s open interest on the option chain (the number of put and calls at various strike prices) is useful for zeroing in on another type of support and resistance. If the strike price of greatest put open interest is 65 and the greatest call open interest is 80, we will often see the stock’s price contained between 65 and 80 strikes through the expiration day of those options.

Why do these levels act as potential support and resistance points? First, traders like round numbers and these number levels tend to serve as support and resistance, as investors view pullbacks to levels such as 65 as good entry points for long (calls) or potential close out points for short (puts) positions.

In this same manner, traders will sell their long positions or go short following rallies to resistance levels such as 80. Short buyers will consider 80 a good entry point if the stock indicates a reversal at this level and overall market conditions support this movement.

Please note that these strikes do not always act as precise resistance/support levels, but often do. Thus, it helps to be aware of open interest to know why a stock behaves in a way that most traders do not understand.

Make a note of these open interest levels on your “Trade Planner” forms. Be alert once a stock comes close to these levels. Is it time to sell to preserve profits? Is it time to buy?

Secret #9

Accept losses in the same non-emotional-vein as you accept your winning trades. Become desensitized. Profits are achieved by selling stock and option contracts at prices that gain in excess of average losses. It’s a fact of trading life, you “will” experience some losses. The goal is to limit those losses as they are more than offset by much larger profits that you will achieve on your successful positions. For example, during a period of market downtrend, you could lose 50 percent on all your call positions, but profit by an average of 100 percent on your put positions for an excellent overall gain.
Remember there will always be losing trades, but the idea is to cut losses short and let profits run the full course.

A solid trading strategy is to always achieve 100% return, especially if you work with the leverage of options. It might stand to reason to exit a losing trade if it develops into a 25-30% loss. This will usually allow you to achieve a 3 to 1 profit-loss ratio. Taking small losses is essential to investing success. A trader can take many small losses and still make 100% overall return with just one 200-300% winning trade.

To determine percentage of loss or gain, divide gain/loss by the opening trade amount (amount paid for stock or contract/s). 2 contracts @ $5.00 premium = 200 x $5.00 = $1,000. Closing transaction $3.50 x 2 (200) contracts = $750, a loss of $250. Percent of loss = 250 divided by 1,000 = 25% loss.

Do the math prior to entering a trade. Multiply the amount paid for the contracts by 20-30% to determine how much of a loss is within your risk tolerance. Once it reaches that point, you’ve taken out the emotional decisions. Cap the loss by selling. $1,000 x (20-30%) 25% average = $250. The 3 to 1 ratio is calculated by dividing total profits by total losses and is a good overall yardstick of reward, versus risk.

Further explanation of risk-reward 3 to 1 ratio, $1,000 invested in an option that achieves a 100% target profit (doubling the premium price) will realize a profit of $1,000. If two other $1,000 positions are cut short, resulting in losses of 25% or $500 ($250 x 2 contracts). This $500 loss equates to a net profit of $500 ($1,000 profit – $500 loss), which is a 17% gain on the $3,000 total investment (3 contracts @$1,000).

Secret #10

Select a trading system that fits your trading style. Ask these questions: Does the system work in the current market? Does it require more time than you can devote? Does it have a larger risk than you are willing to take? Does each trade risk an appropriate percentage of your portfolio?

Secret #11

Based on the strategy that you are implementing and the intended term of holding the investment, determine your target exit point and your projected close date before you enter the trade. A target exit point is the stock or option price that results in a substantial, yet attainable profit. The close out date determines when the position is to be closed if your target exit point is not achieved.

In the case of options, that target exit is often 30 days prior to expiration to avoid accelerating time deterioration

If you utilize an expiration month short term strategy, the target exit point might be 50% and the closeout date might be days or hours before the close of expiration Friday.
Secret #12

The hardest part about trading a system is following the rules. Emotions often get in the way, and tug you away from adhering to the disciplines. Stop, don’t do that! It’s almost a certainty that you’ll be wrong because your emotions will overlook the system’s statistics and overall performance.

Bonus
Secret #13

High volatility is based purely on expectations. If implied volatility on an option you are looking to trade is far higher than the historical volatility of the stock, particularly if the recent stock’s volatility has not been high, the option is overpriced. Do not purchase the option. Since implied volatility is incorporated in the calculations of the option’s premium, it will be overpriced and the spread will be excessively high.

A rule of thumb is to avoid options where the implied volatility is greater than one and one half times the historical volatility. Example: historical volatility of 24, trade on options with no more than 32 implied volatility.

It is a sad story to be right in your stock’s movement but not make any money because the option’s premium was overpriced right from the get-go.