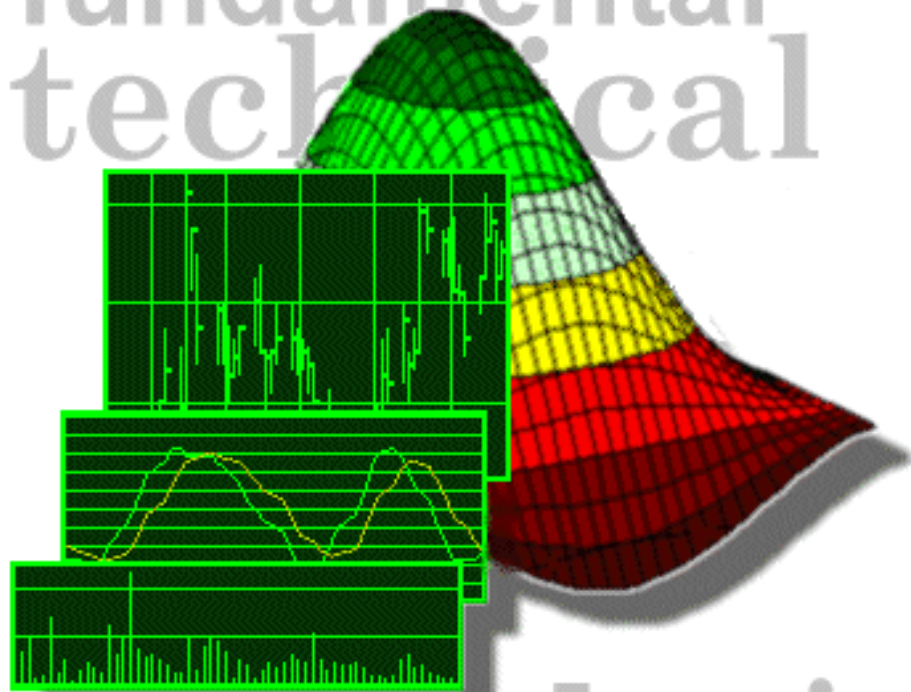


fundamental
technical



analysis

Provident Investing

Bob Robertson

Basic information to get you started,
with tutorials on technical and fundamental
analysis and writing covered calls

Provident Investing

1. Introduction	
1.1 Intro	2
1.2 Why invest	6
1.3 Variation (stat-think)	13
2. Fundamental Issues	
2.1 Fundamental analysis	15
2.2 Market indexes	23
2.3 Commissions and margin	33
3. Next Steps	
3.1 Order strategy	42
3.2 Paper trades	51
4. Market Emotion	
4.1 Risk	63
4.2 News	78
4.3 Financial reports	82
5. Technical Analysis	
5.1 Intro (supply/demand, indicators)	87
5.2 Moving averages	92
5.3 Trading bands	99
5.4 Oscillators	111
5.5 Wilder's RSI	121
5.6 MACD	130
5.7 OBV	137
5.8 Technical Summary	143

SECTION I - Introduction

1.1 Intro

What does a reasonably intelligent individual need to invest profitably in today's stock market? Where do we begin? Beginners may be someone caught up in the toils of life, too busy earning a living to make any money, unable to find a little risk capital to invest. Time is the culprit with too little of it to do so much - to learn the language of the market and to understand market forces that cause prices to change.

A beginner may also be someone told that "buy & hold" is the only way to invest, but who is dissatisfied with the 5 to 15% return each year and who wants to diversify a little on his/her own.

Other beginners include seasoned veterans who recognize the changes that have taken place in the market with the baby-boomer investors and the increased influence of the internet. And the *classic* beginner is the student, serious about what the future offers and how to increase the likelihood of a reasonable piece of the pie.

As potential investors we are faced with monumental issues: *what* should we invest in, *how much*, *when* and guided by *what* strategies.

The mission of **Provident Investing** is to simplify these issues, helping the novice and/or seasoned trader focus on what is meaningful. Above average returns with minimized

risk is the focus of this work. We steer clear of high-risk ideas and juicy promises. Our desire is to provide tools necessary to wheel around the investor's work-place, understanding the relevant issues. There are no quick schemes here to open the money windows in the sky. Rather, an understanding of how it works, the inherent risks and those self-imposed that can be minimized by careful and decisive action on our part.

We believe that *your* reasonable intelligence is sufficient to understand these principles and that you don't mind having a little fun. With these understandings you can make profitable choices on your own.

Several *investing/trading* strategies will be considered to meet these objectives (and just what *is* the difference between these two). All thorough studies of success-stories in the stock market agree on one thing. Success can be found in every possible strategy. (If we think about it, why would a strategy be proposed if someone *hadn't* made money on it?) But the *consistent* theme with success-stories lies in the *discipline* investors devote to their own version of the game.

I have never known a truly successful trader who rode in on someone's coat tails. Market success comes not from finding the silver bullet, the perfect system, the Holy Grail of investing. Rather, each trader brings his/her own risk tolerance, expectations, intuition, training and a host of other issues. All these, taken together, make each of us very unique and different. What works for one will not work for

all. As we struggle to find the system that works best for us, we need to experience different options. That is, gain experience in the good, the bad, and the ugly of as many as possible. ***Provident Investing*** offers exposure to several strategies, trading styles, and investment methodologies. This will give the reader a glimpse of their role in formulating a success-strategy that belongs to them. The difference between success and failure in the market is razor thin. That balance is tipped predominantly to those that learn as much about themselves as the market.

The strategies covered in this book deal more with short-term trading than with buy-and-hold investing. However, as we progress through these pages we will find many traits common to both. There are ways these two methods support each other. ***Swing trading*** characterizes this work as well as any other handle, though broad and loosely defined. Rolling stocks are included, an investment strategy finding favor in recent years, primarily because of its simplicity. It is easy to understand, yet not so easy to implement. Writing covered calls is an options play, relatively low risk with higher than average returns. This strategy can be confusing without a gentle hand leading through the labyrinth of terms and procedures. We will lead you through these strategies with ease.

This is written in a simple but thorough format to help the beginner or seasoned veteran enjoy a level of comfort. We hope to tilt the risk/reward table in the reader's direction. The key to success is not in making perfect decisions every time. It is in making more good choices than bad ones.

1.2 Why Invest?

Why invest in the Stock Market? The best reason of all financial times is at our fingertips!

The Computer

Historically, the stock market has provided the greatest return of all investment vehicles. That is number one. Add to that the cheap computing power available and the knowledge (information) it brings, *why not invest?* For example, with the all the information and potent tools at our disposal, a boring 12% growth stock can return five times that value.

Point: Delta Airlines rose from \$21 to over \$70 in 20 years. That's a return of almost 12% each year.

Because of the inherent volatility of the market, Delta didn't make this rise smoothly, but rose and fell on its way up. Had we bought Delta each time near the bottom of its channel and sold each time near the top, the annualized return would have been near 60%, five times higher.

Peter Lynch, former manager of the gigantic Fidelity Magellan mutual fund, averaging over 26% a year for 15 years, has suggested that the amateur investor has built-in advantages that should result in outperforming the experts and the market in general. Why?

1. When institutional investors find a stock they like, they buy huge blocks of shares, not the few hundred shares we might buy in an average trade. They must acquire those shares patiently and slowly to avoid driving up the price before they reach their goal. The same is true when they want to sell. They must dispose of their shares gradually to keep the price up before they unload their fund's shares of the stock. You and I can sell our few hundred shares the minute we smell a change.
2. Professional money managers look for value in their stock picks. A company that is undervalued is a good candidate since its value is likely to go up. Over valued companies represent the opposite, with odds that its stock price is more likely to go down. Identifying such prime candidates is as easy as a click of the mouse with today's sophisticated investment software.
3. Another advantage the computer provides lies in patterns created as the institutions favor specific industries. Since institutional investors account for 70% of all trading, their impact has created the concept of industrial group rotation. As large amounts of institutional money flows into segments of the market, those market sectors respond with rising prices. Similarly, falling prices result as these same institutions move out of an industry group. Computer tools highlight this ebb and flow, which if taken advantage of can turn an ordinary group of stocks into an exciting portfolio.

4. Insider trading has always signaled movements in stock prices. When insiders buy their own stock it means one thing; those close to the action think the price will eventually go up. This type of trading is a matter of public record today, and is another ready bit of information off the computer links to strengthen our position as investors.

5. The ability to scan thousands of stocks and sort by hundreds of different criteria has made many stogy investment strategies come alive. An example is the Rolling Stock strategy (called channeling or simply Buy Low/Sell High). This strategy was popularized by Wade Cook, who coined the term "Rolling Stocks" (*Wall Street Money Machine, Stock Market Miracles*, Lighthouse Publishing, 1997).

6. On-line brokers have given us the opportunity to invest and deal from the comfort of our home. A good location on the web to see an Internet Broker Scorecard is www.Gomez.com. On-line brokers that have been rated high include:
 - a) Charles Schwab & Co.
 - b) Fidelity
 - c) E-Trade
 - d) CSFBdirect
 - e) TD Waterhouse
 - f) Suretrade
 - g) Quick & Reilly
 - h) Datek
 - i) NDB
 - j) Merrill Lynch

(not necessarily in order) This is a fiercely competitive arena with prices between \$5 and \$30 a trade. This will surely change as new faces make their entry. Some may offer free trades (read the fine print). Contact directly those you are considering. Discount trading prices make computer investing even more attractive.

7. There are three fundamental reasons to invest:

- Income
- Tax Protection
- Growth.

Each reason has its place in an investor's portfolio. However, this work is focused on Income. Investments in the market should be treated as a business, a way to conduct the affairs of our own personal business life. Income is what we need to do this, to buy a home and pay the mortgage, to get the kids through college, to build a portfolio of strong growth stocks for retirement, and all the rest of the needs we face in today's market place. This book is devoted to that purpose, providing the tools we need for financial success!

John Ballen:

"It has gotten easier to beat the market, not harder, over the last five years. The reason is that, in some sense, the market has gotten more irrational and random. There are a lot of new players out there, especially on the momentum side, who create great disparities and huge volatility in the market. You can notice that, with stocks up 50% or down 50% in one day. Those become opportunities. From volatility emerges opportunity."

Investment Guru's, Peter Tanous, New York Financial Institute, 1997. Quotations from INVESTMENT GURUS by Peter Tanous. Copyright (c) 1996. Reprinted with permission of Prentice Hall Press, a Division of Prentice Hall Direct. Available in bookstores.

1.3 Variation

Statistical thinking: This philosophy (Stat-think) relates to how people take in and process information (learning) as well as how they respond to it (action). It is based on the following:

1. Variation exists in all processes.
 - a) That is always true, a fact of life! (In fact, in a micro-sense, everything is made up of rapidly moving particles. Nothing is solid. Variation is motion.)
 - b) All variation is the result of two separate causes:

[Dr. Walter A. Shewhart, of Bell Telephone Laboratories, developed a theory in the 1920's where he identified two components of variation in all processes; a steady component and an intermittent component. The first, called common or random variation, is caused by chance. It occurs randomly. Intermittent variation, the second type, results from assignable causes (causes we can discover)]

- c) A look at any stock price chart will show both systems of causes;
 - i. A trend is the result of an assignable cause, for instance, a company with improving business fundamentals.
 - ii. The day-to-day variations in stock prices have a lot of noise (random variation) along with any assignable variation.

2. Understanding this principle of variation is important to our investment success.
 - a. "Stat-Think" separates statistical ***thinking*** from ***methods***. ("methods" measure behavior, called number crunching. We're more interested in the "thinking" aspect)
 - b. Using "Stat-think" properly we are more apt to understand and to take advantage of the variation we deal with in all things, specifically in the market.

So, how do we use Stat-Think in investing?

3. A person with his Stat-Think cap on looks at market volatility and sees a wealth of opportunity.

Peter Lynch: "I have traditionally liked a certain formation. It's what I call the EKG of a rock. It's never changing. Now you know if something goes right with this company, the stock is going north. In reality, its probably just going to go sideways forever. So if you're right it goes north and if your wrong it goes sideways."

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4. Peter Lynch sets up both causal systems in this paragraph. When he speaks of a 'never-changing' stock chart he is referring to one with no "assignable" trend.

As that chart goes sideways, however, there will always be a system of random variation. Therein lies the opportunity.

5. It is this ***principle*** of variation that gives us such a great opportunity with market volatility. Stephen R. Covey (*The 7 Habits of Highly Effective People*, and *Principle-Centered Leadership*, Simon and Schuster) has trained us well in the use of principles, that is, natural systems that work under all conditions. Stat-think is such a principle.

Consider two versions of a popular market theory:

6. ***Efficient market:*** Stocks are always correctly priced since everything that is publicly known about the stock is reflected in its market price.

(If the market is perfectly efficient, nothing is required for success except rich and thorough business analysis of existing companies)

7. ***Random walk:*** The majority of market behavior is random. Therefore, attempts to predict prices are useless and unprofitable.

(If stock prices are merely a random throw of the dice, in all the meaning of the term "random," stock picks can be made with darts and the financial page which has been done with a reasonable return)

8. The truth lies somewhere in the middle. Opportunity exists because of the human emotions in the market:
 - a. Warren Buffet tells us the most common cause of low prices is pessimism. He likes to do business in such an environment because of the prices it produces. He says that optimism is the enemy of the rational buyer.
 - b. The market will continue to overvalue and undervalue common stocks because of human emotions. These patterns can be used to our advantage with modern computer tools to sort through thousands of stocks and zero in on the ones that are the best buys.

The investor/trader who keeps his/her Stat-Think hat on will make decisions based on an understanding of market variations (volatility) and find comfort in the result.

SECTION II - Fundamental Issues

2.1 Fundamental Analysis

There are two kinds of investors. The first, a more conservative type, will pick a stock by looking at the fundamental value of a company. This investor believes that so long as a company is well run and keeps making more money, the stock price will go up. Fundamentalists try to buy *growth* stocks, those that seem likely to keep growing longer term.

The second investor tries to guess how the market may behave based on the psychology of people in the market and other market factors. This type is known as a technical investor, or "*Chartist*." For them the market is like an auction, where the price of a stock soars as eager buyers bid it up – often in ways quite unrelated to its real value. They take higher risks with higher potential returns (and losses).

We will deal with both types and the kinds of tools each uses to reduce their risks and to increase returns. In fact, most successful investors use tools out of both camps for this purpose. We will begin with the first, the *Fundamentalist*.

To find the intrinsic *value* of a stock, many factors must be considered. When the price of the stock reflects its value, it will have reached the goal of an "*efficient*" market. Again,

Efficient market theory: Stocks are always correctly priced since everything publicly known about the stock is reflected in its market price.

(Or, analyzing stocks is a waste of time because all available information is already reflected in current prices.) Basic truths:

- Price is set by the stock market and what pessimistic and optimistic investors pay.
- Value is determined by analysts who weigh all information known about a company.
- Price and value are not necessarily equal.
- If the efficient market theory were always correct, prices would instantly adjust to all available information. However, stock prices move above and below company values for many reasons, not all rational. An example is the irrational influence news has on the market, both national and global.

Fundamental Analysis attempts to forecast the future value of a stock by analyzing current and historical financial company strength. Analysts try to see if the stock price is over or under valued and what that means to its future. There are dozens and dozens of factors used for this purpose. We consider the following sufficient to make sound fundamental decisions on investing in these strategies.:

1. **Earnings:** Company earnings are the bottom line – they are the profits after taxes & expenses. The stock & bond markets are driven by two powerful forces, earnings and interest rates. The flow of money into these markets is

ferociously competitive, moving into bonds when interest rates go up and into stocks when earnings go up. It is a company's earnings, more than anything else, that creates value.

- a. Earnings per Share **EPS**: The amount of reported income, on a per share basis, that the company has available to pay dividends to common stockholders or to reinvest in itself. This can be very powerful to forecast the future of a stock's price by giving a more complete view of the company's condition. Earnings Per Share is probably the most widely used fundamental ratio. In a growth stock, EPS is expected to increase some amount each year. This EPS growth rate becomes another important indicator.
- b. Though EPS is more important, the price/earnings (**P/E**) ratio is another useful measure of whether a stock is fairly priced. If the company's stock is trading at \$60 and its EPS is \$6 per share, it has a multiple, or P/E of 10. This means that investors could expect a 10% APR cash flow return:

$$\$6/\$60 = 1/10 = 1/(\text{PE}) = 0.10 = 10\%$$

If it's making \$3 per share, it has a multiple of 20 (20 times \$3 equals \$60). In this case, what we're saying as investors is that we will accept a 5% cash flow return;

$$\$3/\$60 = 1/20 = 1/(\text{P/E}) = 0.05 = 5\%$$

- c. Certain industries have different P/E's. Banks have low P/E's – say, in the 5 to 12 range. High tech companies have higher P/E's – say, around 15 to 30. (...and we all remember the three digit P/E's of the internet-stock bubble. These were stocks with no earnings but sky-high P/E's. So much for the *efficient market!*)
- d. If your bank P/E is at 9 and the average is 8, you are paying a premium for the stock. It's okay if you expect higher earnings. If your retail sector P/E is 16 and the company you're considering has a P/E of 12, then you're getting it at a discount, but be wary of why!
- e. A low P/E is not a pure indication of value. You must consider its price volatility, its range, its direction, and any news that is worthy. The best use of the P/E is to compare companies in the same industry.
- f. The *Beardstown Ladies* suggest that any P/E under 5 and over 35 is suspect. The market average has been between 5 to 20 historically.
- g. *Peter Lynch* suggests that we should compare the P/E ratio with the company growth rate. If they are about equal, he considers the stock fairly priced. If it is less than the growth rate, it may be a bargain. In general, a P/E ratio that's half the growth rate is very positive, and one that is twice the growth rate very negative.

- h. *William J. O'Neal*, founder of the Investor's Business Daily, found in his studies of successful stock moves that a stock's P/E ratio has very little to do with whether a stock should be bought or not. He says the stock's current earnings record and annual earnings increases, however, are indispensable.
 - i. A key issue: The value as represented by the P/E and/or Earnings per Share are no good to you prior to your stock purchase. You make your money after you buy the stock, not before. Therefore, it is the future that will pay you – in dividends and growth. That means you need to pay as much attention to future earnings estimates as to the historical record.
2. **Debt Ratio:** This ratio shows the percentage of debt a company has in relationship to shareholder equity.
- a. Smaller is better. Under 30% is good, over 50% is horrible.
 - b. A company's debt load can suck the life out of what might otherwise be a successful operation with growing sales and a well marketed product. Earnings are sacrificed to service the debt.
3. **Equity Returns (ROE):** Return on equity is found by dividing net income after taxes by owner's equity.

- a. Many analysts consider ROE the single most important financial ratio applying to stockholders and the best measure of a firm's management performance.
 - b. What is important with this number is whether it has been increasing from year to year.
4. **Price/Book Value Ratio (aka *Market/Book*):** A ratio comparing the market price to the stock's book value per share. Essentially, the price-to-book ratio relates what the investors believe a firm is worth to what the firm's accountants say it is worth per accepted accounting principles. A low ratio says the investor's believe the firm's assets have been overvalued on its financial statements. This is another important measure to help us not overpay for the stock.
- a. Theoretically, we would like the stock to be trading at the same point as book value. In reality, all stocks trade at a premium (some value above book) or at a discount (when the share price is below book value).
 - b. Stocks trading at 1.5 to 2 times book value are about as high as one should go, unless solid earnings justify a higher price. What one should look for are stocks below book value, at wholesale prices.
 - c. Companies with low book value are often targets of a takeover.

- d. Book value is very important. Look for low book values but keep the data in perspective.

- 5. **Beta:** A number that compares the volatility of the stock to that of the market. A beta of 1 means that a stock price moves up and down at the same rate as the market as a whole. A beta of 2 means that when the market drops or rises 10%, the stock is likely to move double that, or 20%. A Beta of zero means it doesn't move at all and a negative Beta means it moves in the opposite direction of the market.

- 6. **Capitalization:** The total value of all a firm's outstanding shares, calculated by multiplying the market price per share times the total number of shares outstanding.

- 7. **Institutional Ownership:** The percent of a company's outstanding shares owned by institutions, mutual funds, insurance companies, etc., that move in and out of positions in very large blocks. Some institutional ownership can provide stability or contribute to the volatility with their buying and selling. This is an important indicator to us because we can piggy-back on the extensive research done by these institutions before they take it into their portfolios.

As mentioned earlier, the market will always overvalue and undervalue common stocks due to the human emotions that drive it. Our task is to take advantage of this pattern with modern computer tools to find those most undervalued as

well as those responding to the markets patterns, rolling within a channel.

Peter Tanous, after interviewing the most prominent investors in the market, "*Investment Gurus*," New York Institute of Finance, 1997, came away with this conclusion:

"I think that our gurus proved the point without a doubt. The efficient market theory is flawed. There are simply too many examples of stocks that were discovered by a great manager before anyone else knew what was going on. Does that mean the market is inefficient? No. Here is the conclusion I have arrived at: The market is not perfectly efficient at all times. However, the market is constantly in the process of becoming efficient. By that, I mean it takes time for efficiency to be achieved." Peter Tanous

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And that is why we must do our homework! The guidance provided in this book can be a big help in making more informed stock selections.

2.2 Market Indexes

As we study the fundamentals on interesting stocks, nothing is more important than the industry or sector that stock is in. It is tough for a company to make positive advances in an arena where everyone else is in a slump. In the same way, a growing sector will pull a lot of marginal stocks along with it. Market indexes give us a quick view of the general condition of the market. We can also take a look at specific sectors to see how they are performing. This is easy and helpful as we navigate through the complex world of high finance. It is not necessary to consider thousands of stocks to get a temperature reading of market health.

Why is this important? Most market observers agree that about 70% of a stock price movement is tied to the total market. That is why life is so great during a bull market, when everything seems to be so right. However, if a market sector is going through the dumpers with a nasty negative trend, we perhaps shouldn't hope for a stock in that sector to perform to our expectations.

Lets take a look here at what this means and how we can benefit. We will examine four major market indexes with charts, pictures that talk!

Dow Industrial 30
Standard & Poors 500
Nasdaq Composite Index
Russells 2000

These major indexes gives us a good indication of the heartbeat of the market activity. If plotted together they would usually all look to be about the same. However, this is not always true and offers important insights when differences do occur.

1. The Dow

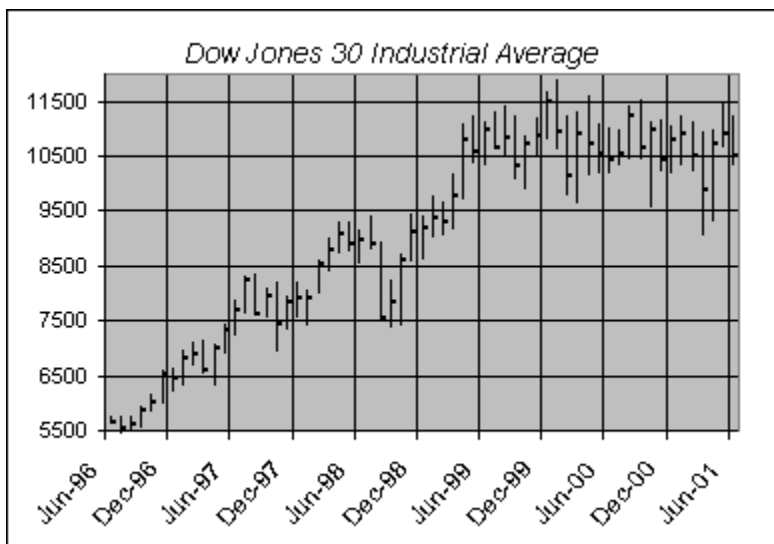
The Dow is the most popular and the one reported most often during the market day. It is considered THE measure of market activity. However, it fails to measure up in terms of an “average” market indicator. It is anything but average, made up of 30 industrial giants, all leaders in their fields. These are the cream of the crop. What this means is that if we don’t “beat the Dow,” we are still in pretty good company.

The Dow is a “price weighted average,” meaning it is calculated by adding the stock price of all 30 stocks in the index. This number is then adjusted for changes in total shares represented, providing the number known as the Dow Jones Industrial Average. This is just a number, where other indexes are expressed in dollars. The Dow is not an average at all, but an index designed to express the health of the companies represented.

This index began in 1894 when it included nine railroads and two manufacturers. It has seen many face-lifts since that time. Recent changes in 1999 saw Microsoft, Intel, SBC, and Home Depot replace Sears Roebuck, Chevron, Goodyear Tire Company, and Union Carbide. In short, a healthy and

robust economy will see the DJIA climb up the chart. Only one of the original 11 is still on the Dow today, General Electric.

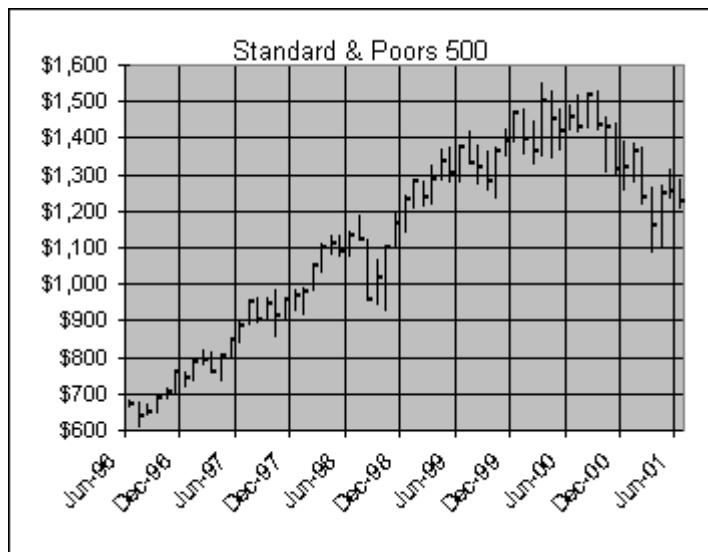
Look at the chart of the Dow for the past five years. Each bar represents one months activity, with the length of the bar a measure of the index volatility. Notice how the volatility appears to be less on the left and greater as time moves on. These charts are plotted on an arithmetic scale which shows ever widening swings as price moves up. The % change, however, between the lower and upper bounds is fairly constant. If the charts were plotted on semi-log scale the variation (volatility) would appear to be bound by parallel lines.



We see the dramatic bull market through the first of this period, the severe correction in 1998, and the malaise of the final two years. Notice how much information is contained in this snapshot about the nations economy.

2. S & P 500

Check the next chart, Standard & Poors 500, for the past five years. This index is a measure of 500 stocks from a broad range of industries. This is a more reasonable indicator of a market “average.”



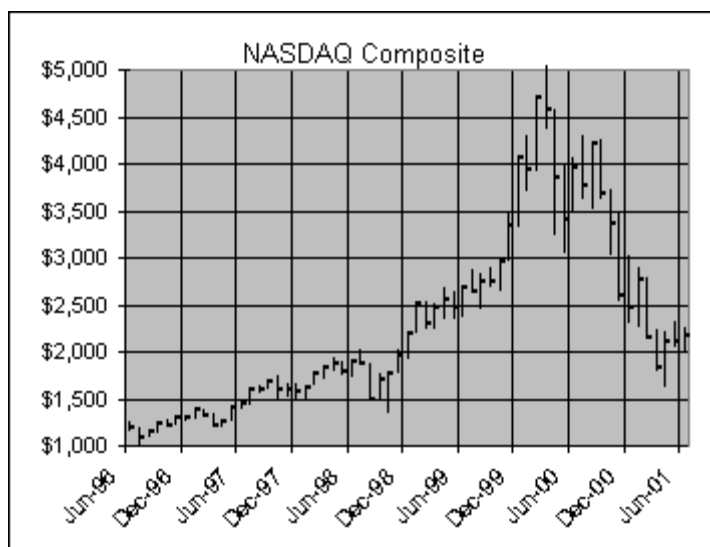
This has about the same pattern as the Dow. However, it was hit much harder the last year of this snapshot. While the

Dow was reasonably flat during that time, the S&P reflected more trouble in the economy.

3. NASDAQ

Now consider the NASDAQ Composite Index, which measures all common stocks listed on the NASDAQ Stock Exchange. This includes over 5,000 companies, the largest number of a standard market index. This is a very broad-based index, heavily weighted in technology companies and is widely followed and quoted.

Here is the five-year chart for comparison:



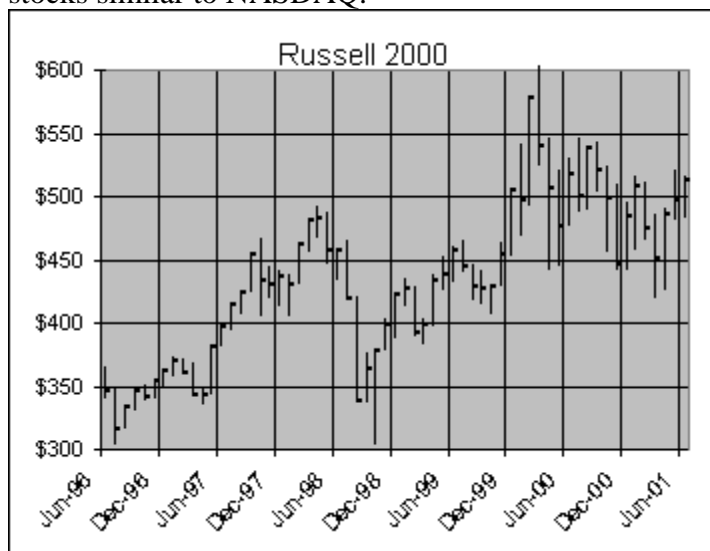
Again, the pattern is similar on this five-year scale, but we see a much steeper decline the last year. This of course was

due to the heavy technology factor in the NASDAQ. Technology led the way in what became a bear market. Also notice the length of the price bars are widening, telling us the NASDAQ is a more volatile index.

4. Russell 2000

Lastly, consider a similar chart for the Russell 2000 index.

This is an index of stocks traded on the three major exchanges, NYSE, AMEX and NASDAQ. This tracks the performance of 2,000 smaller company stocks in the U.S. in varying industries. It is considered a fair measure of smaller cap stocks and represents stocks often used as rollers. Notice the Russell index shows wide swings and represents volatile stocks similar to NASDAQ.



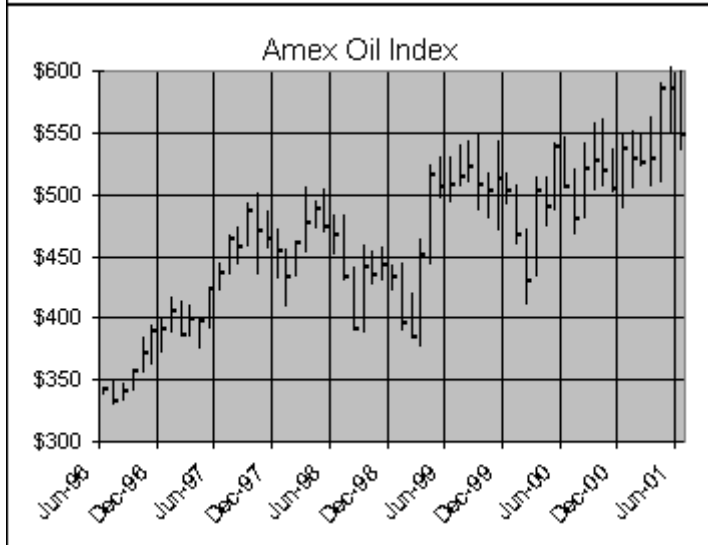
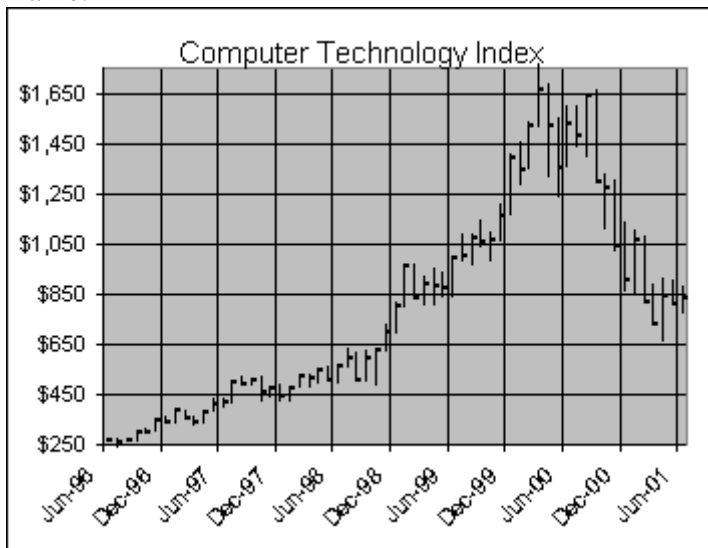
The “messages” in these index charts show us the reality of the market during this time frame. Having access to, and being able to quickly scan these market indexes will help hone our instincts for greater market success. As we discussed earlier, the S&P 500 is more representative of the general economy’s health since it includes more companies in a broader range of the market. This includes 400 industrial, 40 utility, 40 financial, and 20 transportation companies including about 70% of the dollar volume in the market. For this reason the S&P is more closely followed by market watchers. The Russell 2000 is an index of 2000 smaller and newer U.S. companies listed primarily on NASDAQ. This makes this index more useful for the securities we consider using the strategies in this book.

5. Sector Indexes

The four market indexes just considered provide broad help as we study the market and make investment decisions. However, just because the market is up, that doesn’t mean all stocks will be up. To gain the greatest benefit from market indexes we need to target specific industries. These are classified as sectors and can be found in sector indexes in most financial newspapers or in real-time charting programs.

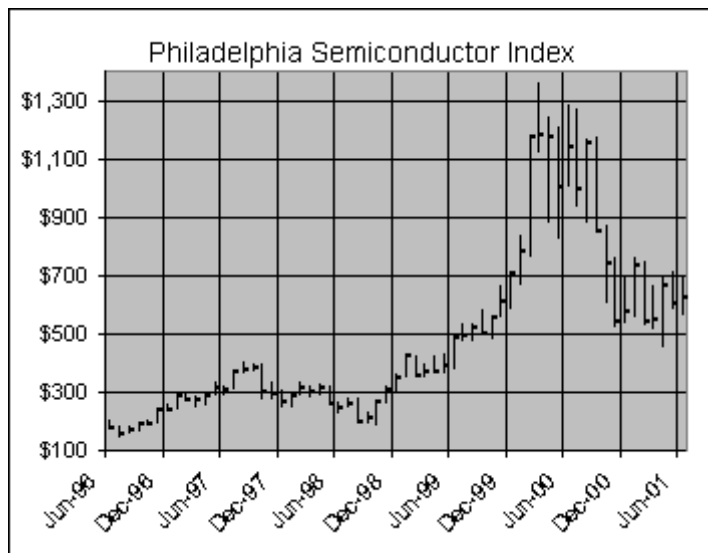
For example, we will feature three sectors below for the same time frame as the previous indexes. First look at the chart for the Computer Technology sector. This mirrors somewhat the pattern of the S&P 500. However, note the chart directly below for the oil and energy sector. We can see with these two charts how very different sector activity

can be. They don't even look like they are in the same time frame.



Not all sectors reach a top or bottom together (at the same time). In some cases they may lag by 1 – 2 years or more.

The next chart is the *semiconductor* sector which follows closely that of *computers*. But even with these two closely related industries there are times when their activity was out of sync.



These differences make it clear why one should monitor the strength of a sector before making any heady investments. This is an easy task, monitoring sector indexes. These are easy to view on commercial charting services, such as TeleChart 2000 which has over 80 indexes in its data base. It is helpful to have those industries in which one is

interested easy to review at least weekly. This way we can be on top of market trends, in specific sectors in which we're considering investing money. One may reconsider the timing of a stock purchase, putting it into more promising securities until the sector makes a turn.

To gain the greatest benefit from market indexes we need to target specific industries.

2.3 Commissions & Margin

To review why we are doing what we're doing, let's consider a very fundamental issue - commissions and money management. If we say that a stock returned 5% in seven days, did we make any money? It depends on how much we invested and how high were the commissions.

1. Commissions

For instance, consider the different scenarios shown below:

\$-IN	COM	\$-BUY	PRICE	SHRS	INC	\$-OUT	ACT	BREAK	EVEN	PRICE
\$5,000	\$8	\$4,992	\$30	166	5%	\$5,234	5%	\$5,016	0.3%	\$30.10
\$5,000	\$20	\$4,980	\$30	166	5%	\$5,209	4%	\$5,040	0.8%	\$30.24
\$5,000	\$60	\$4,940	\$30	165	5%	\$5,127	3%	\$5,120	2.4%	\$30.72
\$1,000	\$8	\$992	\$30	33	5%	\$1,034	3%	\$1,016	1.6%	\$30.48
\$1,000	\$20	\$980	\$30	33	5%	\$1,009	1%	\$1,040	4.0%	\$31.20
\$1,000	\$60	\$940	\$30	31	5%	\$927	-7%	\$1,120	12%	\$33.60
\$400	\$8	\$392	\$30	13	5%	\$404	1%	\$416	4.0%	\$31.20
\$400	\$20	\$380	\$30	13	5%	\$379	-5%	\$440	10%	\$33.00
\$400	\$60	\$340	\$30	11	5%	\$297	-26%	\$520	30%	\$39.00

We start with \$-IN, what we are able to invest. Next we subtract the commission cost (COM) to get what we can actually buy (\$BUY). For the share price of \$30, we can then buy "x" shares. Next the price increase (INC) in our example is 5%. If we sell at this new price, our money out (\$OUT) equals the number of shares times the new stock price less commission. The actual increase (ACT) is the shown. Reality sets in when we calculate the increase in price necessary to break even. For the two extremes, \$5000

invested with an \$8 commission requires only 3/10's of a percent increase to break even, while \$400 with a \$60 commission must have a 30% increase. That means the price of the stock has to rise from \$30 to \$39 to just break even.

This example demonstrates how futile it can be to invest small amounts in the market with high commissions. If we are trying to invest with only small amounts of cash it is clear we must be smarter with our money, making more clever use of what funds we do have.

Different investment/trading strategies can add to the difficulty of money-management. For example, the strategy called "Rolling Stocks" bring two emotional handicaps to the table:

The first problem lies in the simplicity of the strategy. Anyone can understand what is to happen. We buy the stock on the bottom of the channel and sell near the top. What could be easier? The problem lies in the difficulty of implementation. If we simply place special orders to buy and sell at fixed prices within a rolling channel, our return will be "x%." We quickly learn that the stocks don't continue to roll in our channel and we must step in to maximize (or repair) the changes. That effort increases our "x%" return.

As the yield gets higher, more work is required. Working rolling stocks is just that, a lot of work. The effort to find success through investing is not trivial. Using a broker to do

all the legwork can be helpful, expensive and usually not very rewarding.

The second problem deals with the fact that our rolling stock picks are usually low in price. As such, we may take liberties we wouldn't with "real" money. This IS real money. We must treat each purchase and sale as if it were our last penny. That means a lot of paper trades getting comfortable with the strategy before laying out the long green. If we cannot make successful paper trades consistently, we must learn what we're doing wrong!

2. Margin

Let's talk about margin.

Definition: [Margin Account] A brokerage account that permits an investor to purchase securities on credit and to borrow on securities already in the account. Buying securities on credit and borrowing on securities are subject to standards established by the Federal Reserve and/or by the firm carrying the account. Interest is charged on any borrowed funds and only for the period of time that the loan is outstanding.

In other words, the broker will lend us money to buy more stock. Why? Two reasons; He can sell more stock for a higher commission and he will also charge us interest on the monies borrowed.

Our advantage is one of leverage. We benefit from any increase on the additional shares purchased with the margin funds as the stock moves up. We pay interest on the loan portion of our purchase but do not repay the loan until the stock is sold. The profit is ours, we do not have to share it with the broker. Sounds like the best of all worlds.

With reward however comes the risk, buying on margin does have its downside. The broker does not assume any risk in a margin account as he uses the stock purchased as collateral for the loan. As long as the value of the stock is sufficient to pay the loan, the broker is happy. If the stock price declines the broker gets nervous. In fact, if the stock falls below 75% of the value at purchase, the broker will ask us to put additional money into our margin account or assume a lien on other stocks in the account. Today one can only borrow up to 50%, which has been constant for a number of years. In the 1920's before the market crash I believe it was 90%!

Definition: [Margin Call] A call for additional funds or securities in a margin account either because the value of equity in the account has fallen below a required minimum (also termed a maintenance call) or because additional securities have been purchased without funds.

Under the very worst of possibilities:

1. We buy the stock on margin, borrowing funds from the broker to match ours (50% ours, 50% his).

2. The stock price falls to the point where the broker issues a margin call for more money.
3. We are unable to come up with the cash
4. The broker sells the stock while there is still enough value to pay for the loan.
5. We are left with no stock, nothing to show for the money we initially paid.
6. The good news is the issue is closed, the slate clean. We can lose no more than we initially invest. If that is good news...

To help minimize these risks, the SEC has established some rigorous limitations (via rules & regulations) on this practice to help prevent financial disasters. For example, this paragraph shows how serious this can be:

During dramatic price decreases in the market, investors who are heavily leveraged (who have been buying on margin) may be unable to meet their margin calls. They panic, selling stocks to raise cash, causing further declines in the market. This becomes a snowball with disastrous results. The SEC has stepped in with regulations to prevent these type events.

Following are some of the rules we must now live with:

1. The leveraged portion of any margin purchase is limited to 50%. We cannot borrow more than half the purchase price of a stock.
2. To open a margin account we must deposit at least \$2,000 in cash or other eligible securities

(stocks the broker considers valuable). That represents the minimum margin requirement. All margin trades must be conducted through this “margin” account.

3. We cannot trade on margin with stocks under \$5 per share.
4. Margin levels must remain above 75%.
5. The broker defines the value of a security, in terms of collateral value. That is, all stocks are not marginable. It is the broker’s call.

Example: We purchase \$4,000 worth of stock XYZ (\$2,000 of our own money, \$2,000 of the brokers). If the value of the purchase declined to \$3,000, we have reached the limit set by rule 4. Any decline below that value would initiate a margin call. That is, if the value declined to \$2,800, we would be asked to add \$200 to the account to remain within the acceptable limits.

Living with these rules has greatly reduced the risk we encounter in today’s market. If we understand the “*rule of the harvest, we reap what we sow,*” margin can be an important element in our investment strategies. (or, there ain’t no free lunch!)

There is another side to this as well. If the value of the stock goes up, our collateral increases and we may be able to borrow more money to purchase stocks. Our *buying power* is determined by the broker based upon the value of the stock in our account. In our “margin account” we can have cash

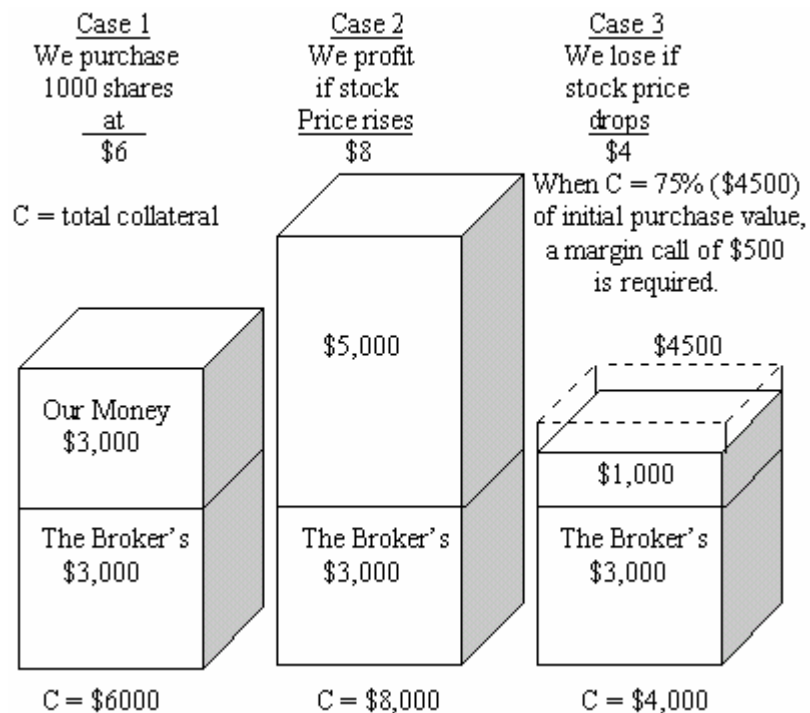
value as well as buying power, they are not the same. The broker's computer calculates both the buying power and cash value in our account continuously.

Margin accounts with internet brokers present some unique considerations.

1. It is more impersonal than with a full-service broker. The guy down the street can help keep us out of trouble with a phone call here, a nudge there. The on-line broker may not let you know the status of your account in a timely manner. You can get into the account details on line but the reports are not always easy to decipher.
2. When trading with many stocks in one on-line account, the sale of one stock and the purchase of another in a short time can cloud the issue. You may find margins attached to a stock if the funds aren't available from the sale before the purchase is executed.
3. The agreement you have with the brokerage is for a margin "account." You may have purchased some Intel shares for the full price, then invested in a less expensive stock on margin. The broker can attach the margin to Intel or other more valuable stocks. It is his choice. Just be aware of this so you are not surprised when you try to sell your Intel to find a portion of the sale paid for the loan on the other stock.

Here's an example of how it works:

We open a margin account with \$3,000 of our money and \$3,000 of the brokers money.



In this graphic, we buy 1000 shares of XYZ at \$6.00, half with our money, half with the money borrowed from the broker. Notice, all the stock purchased serves as collateral

for the loan. If the price moves higher, at \$8.00 in the middle case, we have increased our value by \$2,000, for a 67% gain. The broker does not profit from this price increase. In case 3, the stock price moves down to \$4.00 which reduces the collateral the bank holds for the loan to 67% of the value when the stock was purchased. Since this is below the 75% margin requirement, we will be asked to add \$500 on a margin call.

[Point: Buying stocks on margin is borrowing money to invest. There are those who counsel against this practice vehemently (Warren Buffett for one). This is a personal decision every trader must face.]

SECTION III - Next Steps

3.1 Order Strategy

Placing an order with a full-service bank or discount (internet) broker is where it all begins. We have chosen the discount route in line with our provident investing message, also because of the many benefits provided ***on-line***. Stock selection (which) and timing (when) are covered elsewhere in this book but there are important steps to take (how's) we need to cover at this time.

It could be as simple as walking up to the window at the broker's office and saying we'd like to buy 400 shares of XYZ, what's the price? Then writing a check for the amount including the commission fee and walking away with a smile and new investment in our portfolio. We don't do that when buying a car or a home, or other expensive asset. Why should we take that approach when buying stock? Particularly, in the auction-like environment of the stock market.

This chapter deals with special orders and how we might horse-trade to get a better position (better prices). If we could sit at the computer all day carefully watching price movements we wouldn't need special orders. We could just take action when required. However, these orders are important tools to help us buy and sell at the right times and avoid continual monitoring of market activity. They also help us keep our emotions in check as we make investment decisions.

To make them work for us we need to understand what they can and cannot do. So, let's consider these issues now. There are three basic types of orders; market, limit and stop.

1. **Market** - An order for the broker to immediately buy or sell at the next trade. A market order is guaranteed to fill but not at a specific price. This is the simplest order for the broker to carry out and may cost less, particularly with internet brokers.

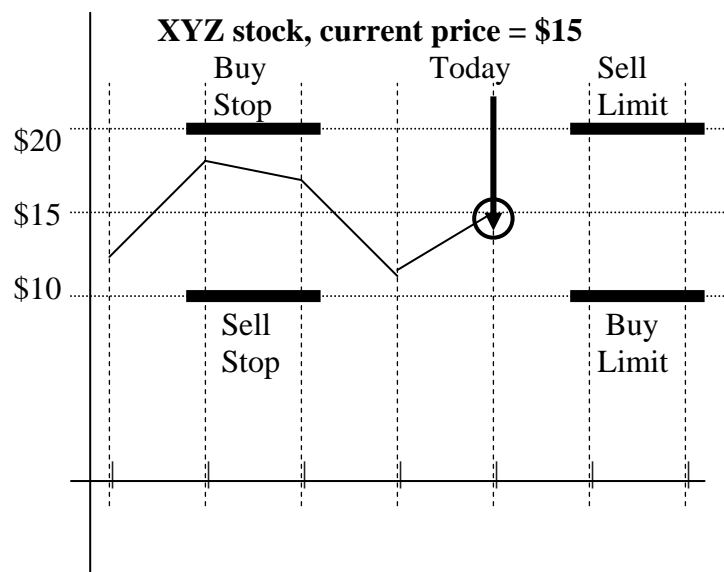
When we place a market order, we do not know the exact price. We've instructed our broker to act **now** to get the best buy or sell price available at the moment. We use this to sell a stock as soon as possible. This order will occur at the available price at the time the order is received in the marketplace.

2. **Limit** – A price limit is specified, telling our broker exactly where to buy or sell when the price is available. If the stock price does not become available at our limit price, the order will not fill.

Limit orders guarantee a price but not an execution. We place a limit on the amount we are willing to pay to buy a stock or the amount we are willing to accept if we sell. If the stock pays a dividend during the time the limit order is in effect, the price will be lowered to account for the dividend unless the broker is instructed otherwise.

3. **Stop** – A slight twist to the limit order is the Stop. This order, like the limit, will fill only when the specified price has been reached. The difference between the Stop and a Limit is that the stop becomes a market order when the stop price has been reached. The stop order is then a conditional market order. The action will be to buy at the lowest available price or to sell at the highest available price. This does not ensure the order will be made at the stop price.

Stop or limit orders can be used to buy or to sell. The chart below shows how they work.



In this figure we see four different ways we can direct our broker to execute an order without any further direction from us.

1. **Buy stop** – If the price rises to \$20, a *market* order is executed to buy the stock at the best price available. This may be at, above or below \$20. [**We buy when the price rises to our target**] A buy-stop is always set above the market price.
2. **Sell stop** – If the price falls to \$10, a *market* order is executed to sell the stock at the best price available. If the price gaps down dramatically the sell price may be well below \$10. In either case, buy-stop or sell-stop, the order *will* be executed. [**We sell when the price falls to our target**] A sell-stop is always set below the market price.
3. **Buy limit** – If the price falls to \$10, a *limit* order is placed to buy the stock at \$10 *if* it is available. If the order is executed, we will get the stock at the limit price of \$10. [**We buy when the price falls to our target**] This order is placed below the market price.
4. **Sell limit** – If the price rises to \$20, the stock will be sold at \$20 *if* a buyer can be found. [**We sell when the price rises to our target**] A sell-limit is placed above market. Again, if a dividend is paid they will automatically lower the sell limit.

When would we use any of these?

1. Buy-stop: If we want to buy a stock that looks near its bottom, we can set a buy-stop at some level above the current price and buy in when it starts back up.
2. Sell-stop: We bought U.S. Steel (X) at \$24 and it has gone up to \$28. We think it is headed lower so we place a sell-stop at \$27 to protect most of our profit. If the price hits \$27, the sell-stop will trigger a market order for the next available price. It could be lower than \$27. The play is called a **Stop-loss**, telling your broker to sell if the price falls to a certain level, in order to prevent further losses. This usually provides some degree of profit protection.
3. Buy-limit: We place a buy-limit order if the stock we want to buy is likely going lower. Here the broker will buy only when the price falls to the value we've named.
4. Sell-limit: Similarly, if we own a stock that's rising in value, we can place a limit order to sell only if and when it climbs to the pre-established price. This would be selling into strength.

Caveats: For each of these four plays there are dangers:

1. Buy-stop: A problem with all stop orders is they do not guarantee the execution price. If a stock spikes up, the buy trigger kicks in but by the time our order is filled the price may be much higher than we intended to pay.
2. Sell-stop: This play is called a **stop-loss** and we could suffer from what is called "whipsawing," (or being whipsawed). This is a rapid price movement followed by a sharp change in the opposite direction. **We place a sell-stop order and it kicks us out of a stock at a certain price, then the stock immediately goes back up in price.**

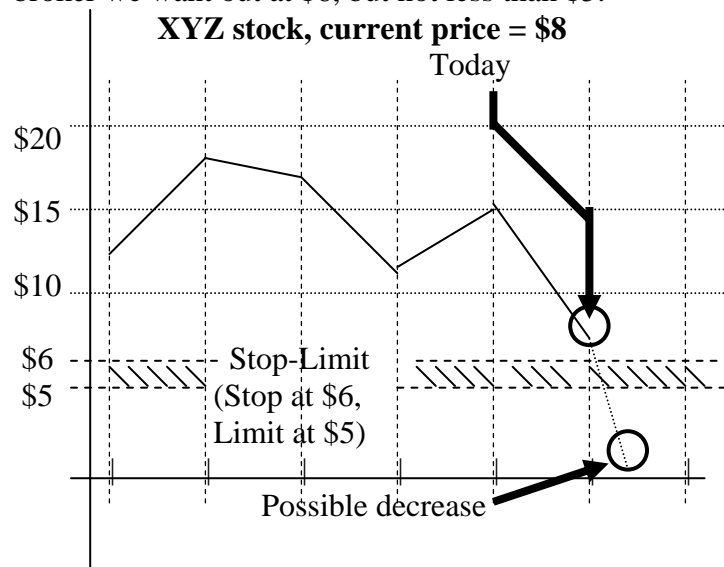
This is a very common experience! We can get into dizzying scenes trying to chase a stock. Careful selection of the stop price becomes important to minimize this possibility. That is, we must use wisdom in knowing how far from the current price to place the stop. This of course depends on the volatility of the selected stock. Similar to the buy-stop above, if the stock gaps down, by the time our order is filled we may sell for a lot less than we planned. Setting a sell-stop is an “art” in itself.

3. Buy-limit: While the intent here is to buy into a better position on a stock, having the broker buy when the price falls to some target can be counter to reason. While the stock is going down, that may be the wrong time to buy. Use this when you have good prospects of the stock eventually rising and you are willing to hold for that rise to occur, i.e. long-term investing.
4. Sell-limit: Similarly, to sell when the stock is on the rise may sound at odds with reason. There are occasions when it is prudent to sell into strength, with the stock on the rise, but a lot depends on particular objectives. With rollers we may suffer some disappointments selling with the stock on an up-tick. A sell-limit can be used when a price objective has been reached such as nearing a previous high.

To reduce the uncertainty of a stop order, a ***Stop-Limit*** has been designed (a combination of the stop and limit orders). Here, we specify not one but two prices: a stop price and a limit price. This tells the broker to buy or sell at a specified price or within a specified range.

When the stock price reaches the stop price, then a limit order is created at the limit price. Hence, a stop-limit order is a **conditional** limit order. It becomes a limit order only when the stop price is surpassed. Like a stop, a stop-limit begins to execute once the stop price is reached. Rather than selling at market price, however, it will be sold at any price down to the limit. When (if) executed the sale price will be in a range between the stop and limit. This helps prevent selling off at a lower than expected price.

Let's demonstrate with a graphic where a "sell at \$6 stop, \$5 limit" stop-limit order has been placed. If the stock drops to the stop price (\$6), the stop-limit is invoked and the stock is offered for sale at that price. However, if the price drops below the limit price (\$5), the lower limit is exceeded, and the execution of any further sale is halted. We are telling the broker we want out at \$6, but not less than \$5.



A \$6 limit order would fill only if the \$6 price were available. A stop-limit as described will fill if any price between \$5 and \$6 is available. We can see why stop-limit will more likely be filled than the limit. This is how we reduce the uncertainty.

A stop-limit order with some internet brokers requires the stop and the limit be set at the same price. This would look like “sell at \$6 stop, \$6 limit” which means “I want out at \$6 and not less than \$6.” This becomes then simply a limit order. A quick poll last week found two on-line brokers who require the stop & limit be set at the same price, five allow different prices. When allowed, both the stop and limit price must be set below market for a sell, and above market for a buy. The on-line broker may require that stop-limit orders be placed on the telephone. Be sure you find out the rules for your own broker.

These special orders can be helpful to both buy and sell. When we are unable to watch price movements in the market continuously, special orders can keep us honest with our entry and exit strategies. For instance, emotions can thwart a sound strategy as we hesitate, should we sell now or wait for the next small up-tick? Should we buy now or wait for a few more cents drop? These orders become the “enforcers!”

Timing: Whenever we place an order, we must specify whether we want the order to be good for that day only or until we fill or cancel. Four order types are available:

1. **Day:** A day order is just that, it simply expires at the close of trading on the day it was entered. All market orders are day orders.
2. **Good until cancelled (GTC):** The orders considered above require time for prices to advance or decline. To keep the order active for many days or weeks, we use the GTC. Check with your own broker to see how long they will allow a GTC order to remain active. 60 days is common but may be more or less. **Red Flag:** *If a GTC order is filled over several days when there are not enough shares available to fill at once, we get charged a commission on each day's transaction.*
3. **All or none (AON):** To prevent the problem noted with GTC multiple commissions, we can specify the order is to be executed only if all the shares can be executed at once. **Red Flag:** *Placing a condition on the order may prevent us from buying the stock. AON are low priority orders.*
4. **One cancels the other (OCO):** This order tells the broker to execute only one of two possible transactions. For instance, if we want to sell when the price rises to \$12 but protect our downside with a stop at \$4, we place a sell-limit at \$12 and a stop-loss at \$4. The first order to occur will cancel the other automatically. When this option is available, some creative stop/limit combinations are possible. I have not found an internet broker who provides this order type. Their computer system will not accept two orders for the same stock. That may change in the future. A full service broker handles this transaction manually, canceling the other when the first order fills. That is some of the service we pay for.

Style: The use of special orders becomes a matter of style. That is, the orders to use depend on specific strategy. For instance, consider the two extremes of the market sandbox, **Long Term Buy & Hold** and **Day (short-term) Trading**:

1. Buy & hold strategists tell us to use market rather than limit orders in most cases. Rather, identify stocks with good fundamentals & positive technical signals and the stock price should be moving steadily higher. A limit places unnecessary conditions on a purchase, like “don’t pay more than \$42, etc.” Nitpicking over fractions of a point may keep us out of a good stock.
2. A short-term trader will usually stick with limit orders, defining the exact price for an execution. Some refer to market orders as *a license to steal!*

The next chapter will put all these strategies to work on real price charts, identifying *which* to use *where*, and *when*

3.2 Paper Trades

Last chapter we detailed the several orders to be placed with our broker. Specifically, we covered market, limit, and stop orders. The market order has the broker immediately buy or sell at the next available trade. This is both the simplest and fastest order type. Limit and stop orders are conditional by nature, giving us some control over both when and under what conditions the order is to be filled.

Let's consider now how they might be used on actual market orders. Our goal is to find a successful strategy that will work most of the time. Remember, most on-line brokers will not allow us to place two orders on the same stock. That is, if we want to place a GTC sell-limit on the upside and a sell-stop (stop-loss) on the downside, we may have to limit our trades to a full service broker.

Most proponents of market activity suggest we spend a lot of time doing paper trades before we invest real money. That is to provide us with skills and understandings to limit our losses as we venture into the real market. But no one ever tells us how to do paper trades. It is assumed we will simulate trades and monitor the results, having the opportunity to make mistakes and corrections without dollar losses. I wish it were that easy. Particularly with the types of orders we have just reviewed in the last chapter. So, let's begin with some guidance on paper trading to take advantage of all we've learned about buying and selling stocks.

Let's explain the columns and calculations in this worksheet:

Paper Trade Worksheet: (left side)				N	BREAK	10%
	COMMISSION =			\$8.00	EVEN	TARGET
	BUY	BUY	TOTAL		SELL	SELL
TICKER	DATE	PRICE	\$ OUT	SHARES	PRICE	PRICE
	A	B	C	D	E	F
XYZ	12/18/01	\$3.50	\$1000	283	\$3.56	\$3.91
A	Date of stock purchase					
B	Price of stock at purchase					
C	Total dollars invested					
D	Total shares purchased (dollars invested minus commission, All divided by the share price: $D = (C - N) / B$					
E	Break-even sell price (the increase must cover the cost of two .commissions) : $E = (C + N) / D$ (Note: C already includes .one commission)					
F	10% Target sell price (increase required for a 10% return: $F = (C \times (1 + 0.1) + N) / D$ In the spread sheet version, .the cell with 10% above F can be changed to any value as .a target, and the price in F will change accordingly.					

Paper Trade Worksheet:
(right side)

ORDER TYPE	SELL DATE	SELL PRICE	TOTAL \$ IN	% GAIN IN/OUT	DAYS IN	% ANN.
G	H	I	J	K	L	M
SELL LIMIT	2/24/02	\$4.00	\$1124	12.6%	68	67%
G	The type of order placed to sell the stock, for reference.					
H	Date of the sale of the stock.					
I	Price of the stock at sale.					
J	Total dollars into our account (shares times price, less .commission) : J = D x I - N					
K	Percent gain (Increase divided by dollars invested) K = (J - C) / C x 100%					
L	Days the stock was in our account, from the date of purchase .to the date of sale. This can be calculated in the spreadsheet .version: L = H - A					
M	Percent gain annualized (APR) The percent gain times 365 .divided by the days in: M = K x 365/L					

Using our paper-trade worksheet as a reference, we can watch the action of prospective stock patterns. Using the adage, “Buy low, Sell high,” We can watch a stock go down to a price where it would be attractive to buy. However, to buy into a declining stock, we must be very careful. *The first assumption before going forward is that we have selected a population of tickers that satisfy our “Fundamental Analysis” criteria.* We should never consider a falling stock unless it was in sound financial condition as described in the previous chapter on fundamentals. This may exclude many stocks found on the NASDAQ.

We should never put a GTC at some level on the downside. We shouldn't buy just because it reaches our selected "buy" point. Wait for the price to show some strength, such as two up-ticks in succession. Here is how we can exercise an alternative order to help reduce our risk as we buy in:

1. Watch for two successive up-ticks in the price as proof of strength.
2. Place a buy-stop order a few percentage points above the last price.
3. If the price increases further, the stop will trigger and we will take a position in the stock at or near our buy-stop price.
4. If the stock turns down, we don't fill and may want to watch for support at a lower (better) buy level.

We could do this without a buy-stop by carefully watching the price movement. However this is one way we reduce our

risk. Is the magic number of up-ticks 2, or 1, or 3 or more? What is the best level above the last up-tick to set the buy-stop? These are questions we must all decide for ourselves after getting a feel for the “spirit” of the market, after paper-trading sufficiently to strengthen our trading skills and develop a sense, called market insight. It is an “art.”

But back to our paper trade, let’s watch the price movement for our next action. To get the most benefit out of this type of exercise we must actually try to guess where the market is going and take action accordingly, on paper. It sounds stupid but believe me, the rewards are worthwhile. There is no substitute for taking the wrong action, revisiting the chosen strategy and learning alternatives. Here is what I like to do; get a full page printout of the price chart over the time frame to consider. Then lay another sheet of paper over it so I can only see the latest day’s quotes. As I slide the cover to the right, showing new daily performance data, I take appropriate action based upon the strategy I am testing. And most importantly, I write down each step on the worksheet. There is a sense of permanency in this action, of capturing lessons learned for future reference. I can make profound comments with magic markers on the worksheet as I discover new and exciting aha’s, then post them on the wall in my office as visual reminders! Current stock analysis software such as TC2000 makes this an easy and exciting exercise.

Once we take a position in a stock, our strategy is not complete without knowing where or how we will get out. We *always* define exit points on both the upside and the

down side. First, we can protect ourselves with a safety net on the downside by placing a sell-stop order at some level below where we bought in. No matter how cleverly we choose the stock or how strong the fundamentals and technicals are, they can and do go south. This may occur on a fourth or more of the stocks we pick. The key, however, is not in always making correct picks, it is in cutting our losses quickly on those that do turn bad, to lose as little as possible when we are wrong. That is the role of the sell-stop order. The alternative is to hope, hope the stock will stop falling, hope it turns around before it falls any further, hope after hope. The biggest obstacle is our inability to admit we have erred and should sell at a small loss rather than hope.

There is another unique use of the sell-stop on the upside. In defining an exit strategy to get out of the stock we have two alternatives. First, we can specify what we expect to get and sell when that point is reached. We can do that with a sell limit, selling when the target is reached. It is not difficult to know what can be expected from a stock having looked at the historical record and use that as a basis for an exit. However, we have all had those experiences where we sold on our expected return only to have it move up another 5 or 10 points. Carefully watch the stock, as the price increases, for signs that it has reached resistance by looking for down-ticks, in the same way we bought in.

That is, if we wait for a couple of down-ticks, then place a sell-stop a few points below the last price, we have protected our position if the stock falls but we haven't given up on the upside.

Additionally, this order can serve as a “trailing loss” by increasing the sell price steadily as the stock price moves up. This will protect our profits whenever the price falls. Placing the order at a value so that one doesn’t get wiped out on a price dip requires a lot of experience.

To execute these strategies, it is not necessary to watch the stock price continually. We can use the Good Til Canceled (GTC) order to let the computer do the walking. Particularly as the stock rises towards a sell target. This is the most favorable feature of using a buy-limit as an exit strategy. It takes more effort on our part to move the sell-stop higher as the price increases or to place a sell-stop after two (or 1 or 3?) down-ticks. This is another insight we can gain by continuous paper trades.

Observations:

1. Trading stocks is a lot of work, much more than long term investing.
2. To trade effectively, we must understand this is a trading strategy, not an investment strategy. We buy to sell, not to hold.
3. Paper trading can help us develop both skills and market insight. There are no silver scientific bullets to do our thinking for us. This is both an art and a science.

4. Before buying a stock at some low price, define an exit on the upside, or “When we are going to sell!” We also need an exit strategy in place on the downside, that is, if the stock refuses to move up after we buy, how low will we let the stock fall before bailing out.
 - a) We’ve seen suggestions on the downside to put a stop-loss at 30%, 50% or as high as 80% below where we bought in.
 - b) William J. O’Neal, founder of the Investors Business Daily, uses 8% as a stop-loss on all his investments. His risk is limited to 8% for all conditions.
 - c) That may be too tight for trading since we expect more volatility than we would tolerate with a growth stock. We must find the level we are comfortable with and realize this is an insurance game. We can’t feel bad when we bail-out at our down-side stop on a stock that wouldn’t roll up... and then does.
 - d) A reality shock is in order: All of our picks will not be winners. Some will go up as expected, others will not. A grand market maxim reads “cut your losses short and let your winners run!” Every successful trader has learned this lesson. How do we cope? We lose less on losers and earn more on winners! That is, we get out of losers quickly, with minimum losses. You can see how critical this business of setting a stop-loss is.

5. Always confirm the value of a stock you consider trading with fundamental and technical analysis before jumping in. Don't buy just because it is low-priced and appears on a down-cycle. Especially watch its group performance.
6. Common sense is an important feature in successful trading. This is our ability to look at a situation, make judgments and separate us from the "black box" that would suggest the computer make all our decisions.
7. The ability to trade successfully comes with experience. It is more important initially to become familiar with a set of rules to stick by and get our experience conservatively. The most conservative strategy is to gain that experience with a lot of paper trades. Once having a reasonable set of rules, *discipline* becomes the key, to stick by them.
8. Other personal matters to minimize risk:
 - a) Consider the size of the company, measured by its capitalization (there is less risk with a larger company)
 - b) In the same vein, higher daily volume also means less risk. If your choice is between two stocks, pick the one with higher average daily volume.

SECTION IV - Market Emotion

4.1. Risk

As we each choose a path to our investment goals, we must consider investment *risk*. If all we worried about was the rate of return then the lottery provides our greatest hope. Imagine, \$1.00 in, with \$14,000,000 out on a weekly basis! How about that for a return! On the other hand there is the metal box with our \$20 bills hidden in the attic. Now that is safety! It is quite clear, we need some balance between return and safety, or between reward and risk. Let's consider this balance.

1. Investing & Gambling

The lottery example raises the obvious question: what is the difference between gambling and investing? There are those who feel there is no difference, that one is as bad (or good) as the other. The late Benjamin Graham, dean of Wall Street and mentor to Warren Buffett, defined two ways to tell the difference. First, he said the security purchase must promise safety of principle, and secondly a reasonable return. Any purchase not meeting these two tests were speculation (a gamble). Any wager in a casino does not meet the first test since we can lose all of the principle. It also violates the second criteria since a wager can return many times the amount wagered. That is not a reasonable return.

In Graham's opinion, investments promising a return of over 50% a year were too good to be true. That means the risk is

probably unacceptable. A more reasonable return viewed by Graham would be more like 5% to 30% a year.

How can we be reasonably sure that an investment promises safety of principal? One way is to pay a price that is low relative to other companies with similar earnings. Buy shares so cheap that any good news will drive the price up and any bad news will have little downside effect. This principle then satisfies both of Graham's investment criteria. It is indeed increasing the odds of success, which is simply good business. Not gambling. Warren Buffet defines investing as buying \$1 in company value for 50 cents.

2. Risk

We have all been taught to choose our investments in a way to maximize "expected return" within our own "tolerance for risk." Most guides deal only with the "expected return," without saying much about risk tolerance. I suppose we're supposed to go away and get our own feel for whatever that is. However, few of us really have an accurate understanding of what our own risk tolerance is. The result is we may steer clear of many higher-return investments because we've heard they are more "risky."

What is risk in the market? Traditionally, "risk" has been tied to the "volatility" of prices which is a measure of how much the price fluctuates around its average value. The assumption is that the more volatile the price, the riskier the investment. We know that to be untrue with our experience playing rolling stocks. Volatility is the meat upon which we

feast. A changing price does not increase the risk! That is true in both short-term rolling plays and in a buy-and-hold strategy which waits out the fluctuations in price.

The risks we must consider as we make investment decisions deal with those events that can occur over which we have no control;

- a) **Market risk** - This is always a factor, the likelihood that the general market will decline (remembering, that it always goes up again). We understand that about 70% of the stock price is tied to the general market.
- b) **Interest rate risk** - This is the likelihood that interest rates may rise and decrease the value of our investments.
- c) **Opportunity risk** - With money in low yielding, secure investments, we miss out on the chance to make more. This is the problem with the money in the metal box. The longer we tie up money in long-term contracts, such as long-term CD's, the higher the opportunity risk. We should use money-market funds only as short-term vehicles waiting to put the money to work at market lows. In our rolling strategies, when a roller doesn't, that is, does not turn back up from support, we can hold on waiting for it to do so or get out and back in to a better position to minimize this opportunity risk.

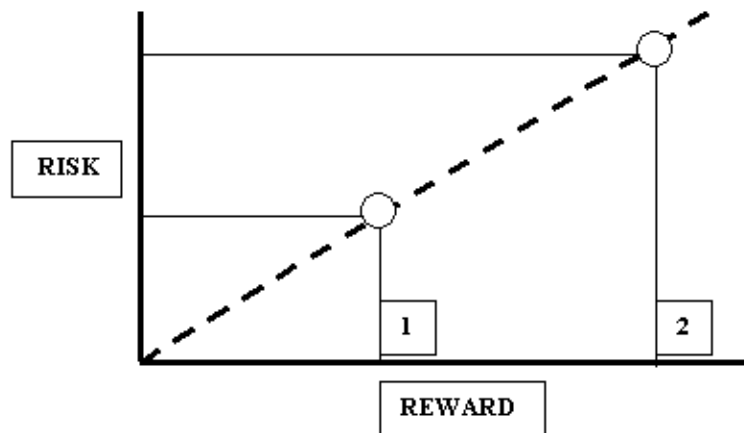
- d) **Cyclical risk** - The risk that the industry your security is in will go through down cycles. We need to understand that if one or two major companies in an industrial sector is losing money, there's a good chance the whole sector is facing decline.
- e) **Inflation risk** - The chance that inflation will be higher than our investment return, with an actual loss of buying power. That is why a 2% return in passbook savings really costs us money, with inflation over 3% each year.
- f) **Liquidity risk** - If we buy a security, it goes up, and we are unable to sell to take our profit, its increase didn't do us much good. Thinly traded stocks are often hard to sell quickly and cancel any quick return. Particularly, this risk is high on penny stocks and junk bonds. We limit our stock picks to those with an average of over 50,000 shares traded daily.
- g) **Diversification risk** - The old adage about having all eggs in one basket is as true today as ever. This means more than just investing in several stocks. They should be in diversified industries or sectors to avoid the cyclical risk above as well as events beyond our control. Disasters occur without considering our positions in the market. They occur without asking! The key is to mix it up. Spread the risk across a variety of stocks, but not so many that keeping track of them is difficult. A good number (to start) is 5-10.

3. Risk & Reward

It should be clear that a single paramount principle is in operation:

Risk and reward are Siamese twins, tied as closely together as possible. It is impossible to increase the yield (reward) on an investment without incurring an increased risk.

During the bull market of the 1990's it was too easy to focus only on the high returns. It's easy to neglect the risk-half of the equation when it doesn't seem like anything can go wrong. This principle is clear in the graphic below, with two different scenarios displayed. We can move from reward position 1 to a higher position 2 only with the corresponding increased risk.



So What?

How will that help us in our short-term trading strategies? How do we understand our own tolerance for risk?

Look at two views of an example related somewhat to the stock market for a moment. Suppose we're paying an 8% mortgage off and have an additional \$600 a month at our disposal. Should we pay down the mortgage or invest this extra in the market? Our risk tolerance will have a lot to do with our decision.

Case 1: *Invest the money in the market:* If we pay off the mortgage early it would seem to earn a guaranteed 8%, that is, interest we would not pay in the future. However,

- Since mortgage interest is deductible, we may only be "earning" about 6% net, depending upon the age of the mortgage, how much interest we pay with each payment.
- An investment in an index fund might return 12% gross, with an after-tax net of around 8%.
- Therefore, the market play brings more than paying down the mortgage.

This first view ignores the risk placed on the home to get a mere 2% or 3% difference in return.

Case 2: *Pay down the mortgage*: Another view considers market risks and feels we shouldn't indulge if we have debt.

- Treasury Bills are considered "risk free" investments with a low return. We simply do not get returns higher than T-Bill rates without assuming substantial additional risk.
- Our mortgage rate is certainly higher than T-bill rates, so on an "apples to apples" comparison, paying off the mortgage first is a no-brainer.
- We get a risk free pay-off (the pay-down of the mortgage) at better than the current "risk free" return (a Treasury Bill rate).

This second view believes only "risk capital" belongs in the market. "When the house is paid for, and we have accumulated savings to cover emergencies, then we should get involved in the market."

Which of these two scenarios do you feel most comfortable with?

These two viewpoints represent two extremes. That is, we may feel some comfort level in-between, putting some of the cash into the market and the rest on the mortgage. Or, assessing spending in other areas, where we might find money in our budget to begin investing that won't put basic needs at risk. This is the kind of gauge we need to assess our personal risk tolerance as we enter the investment arena. We must each find the balance right for our own situation.

Everyone has his or her own risk tolerance and we should never make any investment that makes us feel uncomfortable. That is not to say we should not be concerned with our investments. There is a profound difference between "concern" and "distress." When I drive to work each day I am very concerned with the traffic, with using my rear-view mirrors, keeping a safe distance from the car ahead, and defensively watching for "crazies" doing something over which I have no control. But I do not lose any sleep the night before stressing over the upcoming drive. Similarly, with our investments we can "drive defensively" without distress, when we each find our own reward/risk balance. That is, being able to sleep at night.

Reviewing how this affects our decisions playing rolling stocks is informative. During the recent bull market we have been able to play rollers that were less than stellar in terms of fundamental performance. What this means is that our risk/reward balance will change with market conditions. In a bear market, we can still play stocks as rollers in the same manner. However, with the market trend down, stocks with less substantial fundamentals will be less likely to turn up from an established support level. We study our picks carefully each week to find those that satisfy our criteria of good fundamentals and supportive technicals with good news. In a down-market, we must be less risk-tolerant to protect our positions.

In the drive to work, with bad weather, road-work, or an accident ahead, listening to Sky-chief helicopter traffic may alter the route we choose.

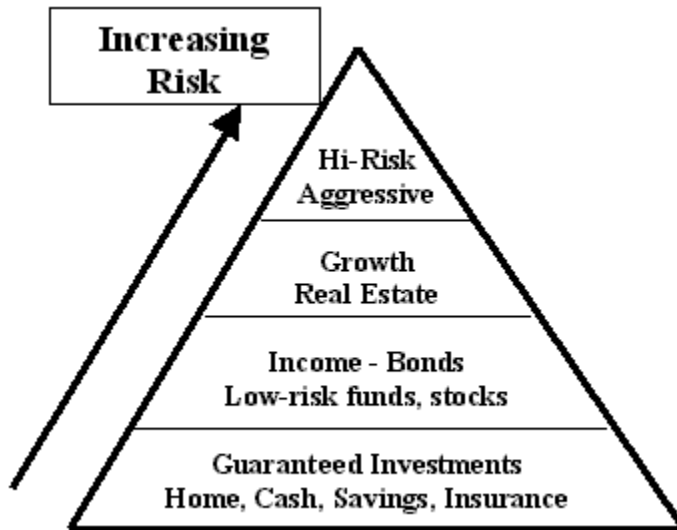
4. The Risk Pyramid

A most helpful graphic in understanding how we can react to this matter is what is called the Investment or Risk Pyramid. Any course of study dealing with investments will feature this graphic, primarily because of its simple nature in explaining the issues we all need to consider.

First, lets revisit a definition of risk as it applies to our current investment strategies. The most common definition is simply the risk we take that we might lose some or all of the money we invest. That's okay, but it fails to consider the opportunities or the lack thereof that are so meaningful today. A better definition would consider what is termed an absolutely risk-free investment as a benchmark reference. How about, "risk is the chance we take that we'll earn less from an investment than the interest available from insured savings certificates or U.S. treasury notes." Or more simply, the chance that we'll earn less than 4% or 5% on our money. If we can't expect to do better than that, there is no reason to take the risk. (There is always the possibility of the country going bankrupt, but lets not consider that!)

Given that definition, lets look at the Risk Pyramid as a visual to help reduce our risk. We begin with the pyramid divided into four levels, each level becoming smaller as it

moves towards the top.



- a) The bottom level has wide base of financial security:
- a home
 - insured savings
 - insurance to cover health, auto, home, disability
 - cash
- b) The next level, not as wide as the first, represents space available for some risk in our financial plan. Low-risk mutual funds are usually placed here along with low-risk dividend paying stocks. The greater the risk in an investment, the higher up it goes in the pyramid and accordingly, the less money we should put in it.

- c) The higher we go, the more narrow the level. On the third step we have space in our portfolio that is available for investments involving more risk. The greater the risk of an investment, the higher up the pyramid it goes. And thus, the less money you should put into it. Real-estate investments are often placed on this level. Land real estate has ongoing taxes and usually little income until sold.
- d) The top of the pyramid is for high-risk investments, the ones we are told not to get into: penny stocks, commodities, limited partnerships, etc.

For us, what is placed into each level is not nearly as important as the graphic itself. We must define for ourselves what we place into each level in our own pyramid. This does not mean we should avoid all high-risk investments. It means we must understand the risk/reward relationship we discussed earlier and keep the high risk stuff at the top of our pyramid.

As we generate income from our rolling stock strategies, we must remain balanced and keep salting a portion of our returns into our base. The road to success is like driving from New York to Los Angeles. If our goal is Los Angeles, there are a multitude of paths we can take. Each path will have its own personality, its joys, its difficulties. In the same way, our path to success can be as varied. Our particular set of strategies need not copy those of any one guru. We must find our own.

5. Measure Your Risk Tolerance

In previous sections we've discussed the nature of the risk we take with our stock market plays. I recently heard on the radio a commercial that said something like, "The Dow is up, the Dow is down. Isn't it about time you invested your money in a risk free money market account? Ours has consistently outperformed other money market accounts by "x" % over the past "y" years...." The implication was, of course, that the market is more risky than their money market. However, we considered one element of risk as "...the chance that we'll earn less than 4 or 5% on our money." If that is the stable return on a money-market account, we have no benefit from the risk taken. Unless! Unless that is the level of risk we can tolerate without losing sleep.

Before we leave this discussion on risk, let's take a self-exam on our own risk tolerance. The following is like exams found in the investment literature and will help us understand our own risk tolerance. In this exam we'll find questions that deal with facts (our age, our assets, our obligations) as well as how we react in various circumstances. Exercises like this will help us examine our comfort zones in making investment decisions. Answer each question, keeping track of the score for each answer:

1. Years before you will retire:
 - a. 1 - 5 (0 points)
 - b. 5 - 10 (5 points)
 - c. 11 - 20 (10 points)
 - d. More than 20 (15 points)

2. Personal assets, home equity, bank accounts, CDs, stocks, mutual funds, bonds:
 - a. Less than \$5,000 (0 points)
 - b. \$5,001 to \$10,000 (4 points)
 - c. \$10,001 to \$20,000 (6 points)
 - d. \$20,001 to \$50,000 (8 points)
 - e. More than \$50,000 (10 points)
3. Will cash be needed from these accounts during the next five years?
 - a. Definitely (1 point)
 - b. Probably (4 points)
 - c. Might (6 points)
 - d. Probably not (8 points)
 - e. Definitely not (10 points)
4. You are on a TV game show and can choose one of the following. Which one would you choose?
 - a. \$1,000 cash (0 points)
 - b. A 50% chance of winning \$4,000 (3 points)
 - c. A 20% chance of winning \$10,000 (5 points)
 - d. A 5% chance of winning \$100,000 (10 points)
5. You've invested \$1,000 in a new business venture started by an acquaintance. The concept still appears sound, but additional capital is needed to actually launch the business. How much money would you be willing to invest -- in addition to your \$1,000 -- to have a chance to recover your initial investment and perhaps make a profit?
 - a. None. You'd accept your \$1,000 loss and not put any more at risk (1 point)
 - b. \$200 (2 points) c. \$500 (5 points)
 - d. \$1,000 (8 pts) e. More than \$1,000 (10 pts)

6. A month after you buy a stock, it jumps 25% in price. Which would you do?
 - a. Sell now and take your profit. (0 points)
 - b. Hold it and hope it continues to increase. (3 pts)
 - c. Buy more, expecting it to rise. (5 points)
7. You buy stock that drops 25% a few weeks later. You still believe the company is sound. What would you decide to do?
 - a. Buy additional shares at the new price. (5 pts)
 - b. Hold the stock and wait for the price to recover. (3 points)
 - c. Sell immediately to cut losses short. (0 points)
8. Your annual salary increase is 5% of your pay. Your boss gives you the option of taking the raise now or being paid a bonus of 50% if the company makes its profit goal for the coming year. However, you won't get the raise or the bonus if the goal isn't met. Which would you take?
 - a. The certain 5% raise now. (0 points)
 - b. The chance for a 50% bonus. (5 points)

Maximum score for exam: 70 points.

The designers of this self-exam would rate you accordingly:

Score	Risk Tolerance
0 - 14	Extremely conservative
15 - 28	Conservative
29 - 42	Moderate
43 - 56	Moderately aggressive
57 - 70	Aggressive

Nothing about this exam is absolute. Our risk tolerance will change with our age, with our understanding of market fundamentals, with our changing economic position in our career path and with our increased obligations to family and other responsibilities. It is our position that the most important feature of balancing our personal risk tolerance with available resources is one of understanding.

4.2. News

Take a look at a price chart for Safety-Kleen (SK) from the New York Stock Exchange (NYSE).



1999 Price Chart - Safety-Kleen (SK)

This stock closed on Friday July 2nd at \$19.13 with a very promising outlook going forward. Let's examine the data that supported that promise:

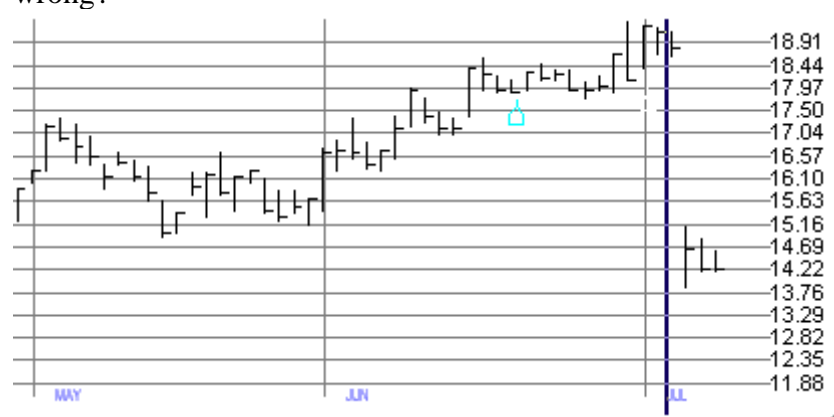
1. Strong fundamentals, what to buy (see chapter 2.1). We use Investors Business Daily's "SmartSelect" corporate rating system to evaluate fundamentals:
 - a) **EPS**, Earnings per share rating: SK was ranked a 72 in this category, meaning that the company's bottom-line earnings results were in the top 28% of the more than 7000 companies measured.

- b) **RS**, Relative price strength rating: SK had an 84 here, meaning the cold, realistic auction-market's appraisal of the stock outperformed 84% of all others during the past 12 months.
 - c) **Industry Group Relative Strength**: We have said how strong an influence the market has in individual stock performance and doubly so for the sector or group the ticker is in. This indicator is rated from A to E, with A being the top 20%, E the bottom 20%. SK was an **A**, the strongest industry group rating.
 - d) **Sales + Profit Margin + ROE** rating: This is a composite rating of important fundamentals telling us how well the company is being managed. SK was rated a **B**, in the top 40% of companies rated.
 - e) **Acc/Dis**: This next indicator is an IDB proprietary measurement based on price and volume changes over the latest 13 weeks, telling us if the stock is being accumulated (institutional buying) or being distributed (institutional selling), rated from A (best) to E (worst). SK had an **A** rating.
 - f) This is a very strong stock, fundamentally. We would term this a "value" stock, one that should ride out the turbulence of the market fluctuations.
2. Supporting technicals, when to buy and sell: We cover this dimension of market trading in Section 5. Let it suffice at this point to say the technicals

were equally attractive for the near-term success of SK.

For these reasons SK looked promising on that Friday in July. Does this guarantee continuing success for SK? What have we said about guarantees? Death & taxes... However, we arm ourselves with tools and understandings with this fundamental/technical data to increase our odds of success. This is not gambling, this is good business. So, let's turn the page and see what happened.

The dark vertical line is July 2nd, Friday's close. A 33 cent decrease at close on Tuesday the 5th after the holiday. That wasn't bad, but on Wednesday the 6th, the price plummeted to \$14.63, a 22% drop. What happened? Where did we go wrong?



SK Price Bar Chart

We list another important market maxim quite relevant at this point:

"News over-rides everything else, fundamental, technical, or any other analysis. A news item can cause a stock to go either up or down with no apparent logic."

Consider the role "news" played on SK at this time:

- July 6 (Tuesday after the holiday) the price closed at \$18.80. At 5:36pm, after the market close that day, Safety-Kleen announced 3rd quarter operating results **"..net income was \$0.30 per share for the quarter... an increase of 58% over \$0.19 per share... reported in the prior year."** Sounds okay, right? But the next day...
- July 7, 1:19pm, **"SK price fell to \$14 on lower than expected third quarter net income. Income for the quarter was 30 cents a share, lower than the 32-cent average estimate of analysts."**
- Nothing about the company changed. Its inherent value remained intact. There were no changes in management, strategy, or resources. Yet its price drops on a report of increased earnings! Why? It missed estimates by 2-cents! That, good friends, is the irrationality of the market. This reaction is based more on emotion than logic.

For us to be in tune with market-emotion, our number one lesson is to pay attention to the news as we trade our way to

higher returns. It is simply in our best interest to learn all we can about companies with which we trade. We can learn when quarterly reports are to be issued which may have helped us with a purchase of SK. However, this cuts both ways where 2-cent earnings over the analysts estimates could have kicked the price up. We just need to understand the rules of this game. We will continue to learn by engaging in the process. Paper trades can provide this experience with very low cost (no cost, save the time invested).

A post-script to the SK story: Safety-Kleen was engaged in the disposal of toxic waste and had a serious track record with the EPS. With 20/20 hindsight, there were warnings in early 2000 where significant insider selling was going on in January and March. It was being investigated for possible accounting irregularities which insiders apparently knew about and had prepared for its demise. SK filed for bankruptcy and is currently not being traded. This is a wonderful example of how things can go wrong.

4.3 Financial Reports

The last chapter left us with the question, “What if the only news on a company is the annual or a quarterly report - is that good news or bad?” Let’s look at the question in light of what we learned looking for the news in the last chapter.

The news we'll find on the net will be primarily in the form of press releases and news wires. By their nature, they will be brief. When the news item relates to company performance reports, either quarterly or annual, they are often referred to as "highlights," or "condensed reports."

A full and complete company report will contain at least the following:

- a) Balance Sheet - a picture of the company on one particular day, the last day of the reporting period.
- b) Income or Operations Statement (Profit & Loss, P&L) - a cumulative report of the period's operation.
- c) Statement of Stockholder's Equity - the difference between assets and liabilities.
- d) Statement of Changes in Financial Position - a picture of the increase or decrease in working capital, an important indicator of future performance.
- e) Footnotes - explanations of statements in the report that may not be obvious. Some of the most revealing information will be found here.

What we will find in the news items will usually include condensed versions of a), b), and e) with c) often included as part of a). The extent of the offering depends on the size of the company, smaller company - smaller report.

The SEC has strict rules regarding disclosure and presentation of information. However, anything written by a

company about itself will always lean to the positive. Their purpose is to make the company look good. We need to temper what we read with healthy skepticism. There are many ways a written text can be slanted in a company's favor without actually being false. For instance, a company may explain declining sales as "recession related."

With the case stacked against "easy" disclosure, we have to look for inconsistencies in the information, clues to potential problems. The best tool we have is that of comparison, current period compared to previous period. By comparing the current quarter to the same period last year, an apples-to-apples comparison is possible, unbiased by seasonal or other factors. By looking at a company's operational results for two consecutive and equivalent periods at the same time, we can see if the company improved. In so doing, we look for inconsistencies. Differences between two reporting periods can signal business problems or opportunities.

To help readers with these comparisons the reports are consistent. For instance, if we are looking at the third quarter report on company XYZ, four columns of data will be shown on the Statement of Operations (Income Statement):

The first two columns will be for the most recent quarter, this quarter and the same quarter a year ago.

Columns 3 and 4 will be for the fiscal year to date. Since this example is a third quarter report, these two columns will read Nine Months Ended (current year) - (previous year). This allows us to compare both the

most recent current data with the same period a year ago as well as the longer “year-to-date.”

Significance: A change in indicator more than about 5% between periods that is a warning of significance. When this occurs some "cause" is important, as opposed to random fluctuations or noise in the numbers. We try to find the cause of such changes and how that might impact our decision to invest or not to invest.

Another warning sign is when a company's debt to total capital ratio is more than 50%. This weakens a company's resolve in difficult times. Debt is shown on the Balance Sheet but it is not easy to determine the debt ratio. This is found more easily in 3rd party reports on the net.

Back to our objective, ferreting out suspect information. An extreme example would be a company selling off a subsidiary and then announcing a profit of 12 cents a share for the quarter. 18 cents profit was realized on the subsidiary that quarter, which meant the announced 12 cent per share profit actually covered up a 6-cent per share loss.

Where could we find this information? Footnotes! Anything this blatant would require a qualifying paragraph listing the sales revenue as an extraordinary item. All creative bookkeeping and out-of-the-ordinary features should be footnoted. It is in these footnotes where real facts are found for those who take time to read them.

Let's look at a report on a rolling stock, HMGN (12/11/98). A Business Wire report on May 12, 1998 was titled "Hemagen Diagnostics Profitable for Eighth Consecutive Quarter." The first paragraph, however, reported increased earnings in spite of a 9% decrease in sales. On the condensed Statement of Operations the revenues for the six months ending March 31 between 1997 and 1998 were down 9.7% (my calculation; \$5,584,164 1998 vs. \$6,181,991 1997). Three months later the same Business Wire report (August 11, 1998) for HMGN was titled "Hemagen Diagnostics Reports Record Earnings for Third Quarter." This time, revenues for the nine months ending June 30 between 1997 and 1998 were down only 4.2% (\$9,037,276 1998 vs. \$9,435,742 1997). That means substantive progress, a plus for the stock.

Companies use a reporting system termed GAAP (Generally Accepted Accounting Principles) that provides investors a common language for interpreting and analyzing financial reports. However, the handling of details in these reports is not consistent.

SECTION V - Technical Analysis

5.1 Intro (supply/demand)

Earlier, we took a look at our risk tolerance. Remember, there is no correct, or optimum level of risk tolerance. It's an individual issue. What is important is to understand where we actually are in the mix. Further, as we gain new insights and understandings, our risk tolerance will change.

It has always been our contention that we are comfortable with what we understand. There is little comfort with the unknown. For this reason we have included these chapters on Technical Analysis; what it is, what it can do for us, and how to use it. If we are to find any value in technical analysis, we must understand technical analysis. Is that a dumb & obvious statement? I hope not. Much of what passes for magic bullets in the form of some chart pattern by itself does not bring the comfort of understanding. The intent of this section will be to add understanding to the tools of the technical analyst.

Let's start with what technical analysis is. Graphics - Pictures - How we all love to *see* concepts. And with seeing, feel and understand the principle involved. This could get us side-tracked into a right-brain/left-brain dialog but let it suffice that technical analysis can provide new dimensions to our understanding. Our intent then is to strengthen understanding, and with that understanding, bring greater comfort with reduced investment risk.

Technical analysts are lovingly called "chartists." Their most basic tool is a price chart which visibly displays price movements with respect to time. The value of a chart is that it can tell us at a glance how a stock has performed over any period of time. If it did no more than this, it would still be a top choice. But it does more, much more.

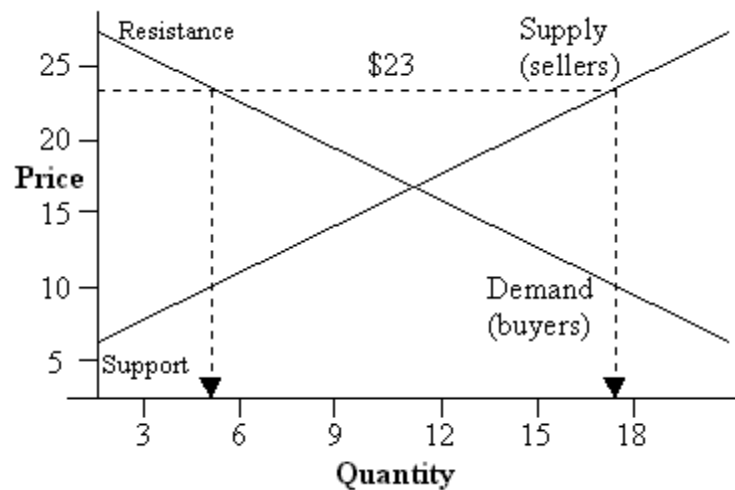
The price chart reveals buying and selling patterns found in no other way. Consider the difficulty in trying to "see" a trend, or a trend reversal, by simply reading the stock quotes from the daily financial page in today's newspaper.

The second tool in the chartist's bag of tricks is the companion trading volume, usually plotted below the price chart. The story told by these two pictures, price and volume, is a great object lesson in economic theory. If we could boil the market down to a single phrase, it would be "supply-demand." When demand increases, relative to the supply, the price will rise. Likewise, when the supply is greater than the demand, prices will fall.

1. Supply and Demand

The relationship between supply and demand plays an important role in our study of rolling stocks. In fact, the channel that defines the support and resistance levels in our rollers is nothing more than an expression of the supply-demand relationship. For instance, in the figure below, we have two diagonal lines, supply and demand. The supply line shows the number of sellers willing to sell at a given price. The "Quantity" refers to the number of buyers/sellers.

The demand line shows the number of buyers willing to buy at a given price. Quite simply, as the price increases, the number of buyers willing to buy decreases. In the chart below, resistance occurs where the price bumps the ceiling because there are no buyers willing to pay the higher price. Support occurs on the left side of the supply line where sellers are no longer willing to sell at the low prices. The position of these lines changes continually during market action, reflecting the changing opinions and expectations of investors. The chartist looks for signals in the price and volume relationships to discern the direction of the changes.



In this figure, when the price equals \$23, there would be about 5 willing buyers and 17 willing sellers. Which direction do you suppose the price will move? The dynamic of free-market activity is profoundly evident in this example. Trading volume is the primary indicator of supply and demand. Used with the price charts, volume data can help us look ahead to where the price is going. If the volume is heavy when the price is rising, the rise is likely to continue. However, if the price is rising on declining volume, it will probably not continue its rise for long. It is from the combination of price and volume that all technical indicators derive their value. We must add timing to this duo since the charts are all plotted with respect to time.

Fundamental analysis tells us what a stock *should be* doing. Stock charts tell us what the stock *is* doing. This means technical analysis can be viewed as a short-cut. The chartist can analyze a stock without plowing through all the fundamental data. It is enough to say, when a stock's price is rising, the market considers its fundamentals bullish. The chartist does not care what those fundamentals are.

2. What Technical Indicators are available?

The chartist utilizes Price, Volume and Time to look at three basic patterns:

1. Correlation between price and volume activity.
2. The direction of price movement (rising or falling).
3. Support and resistance levels (the prices where the pattern changes direction).

A group of technical indicators tell us the status of these three patterns. The chapters in this section cover these important indicators.

The most important principle that guides this study of market activity is termed momentum. We were taught the principle of inertia early, first defined by Sir Isaac Newton over 300 years ago, which says that a body will continue in its present state of motion unless acted upon by some external force. As we drive down the road and turn to the left, the force of inertia will move us to the right. We'll turn with the car because the force of the turning auto becomes that external force to change our direction. This is Newton's first law of motion.

In the market this principle remains valid and is termed momentum. Each indicator utilizes the principle of momentum to help explain both what the price movement has been and what it is likely to be. The following will be covered in this section:

- a) Moving Averages
- b) Trading Bands
- c) Oscillators
- d) Wilder's RSI
- e) MACD
- f) OBV
- g) ROC
- h) TC-2000

5.2 Moving Averages

When asked, "How many people attend your seminars?" I'll respond, "about 25, on average." While not precise, it satisfies. The idea of an "average" is very important to communicate ideas.

We often use averages to convey important information, especially when the numbers vary. It is easier to put data (numbers) in buckets (averages) than to deal with all the noise (variation).

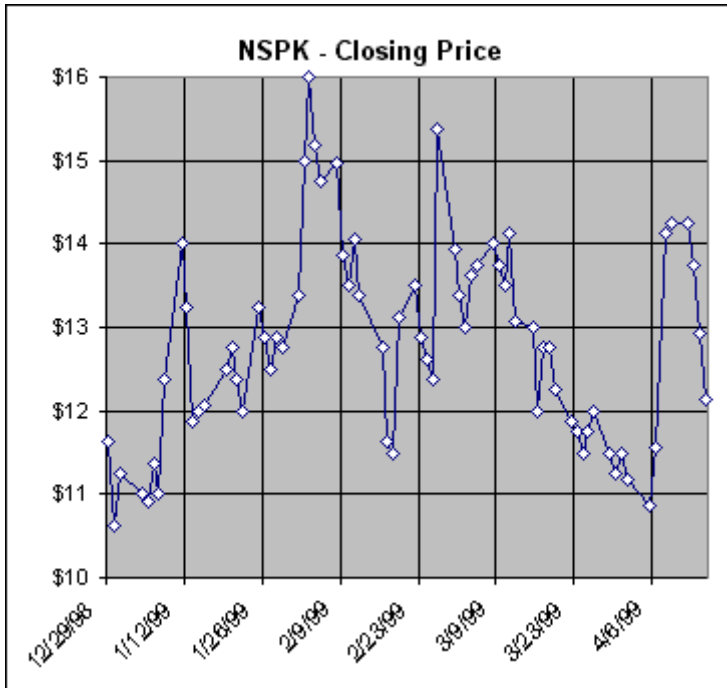
Averages play an important role in the technical analysis of stock prices. On a price chart, averages smooth the data to give us a better view of the underlying trend.

Two caveats about using averages:

- When asked, "How many children do you have?", it would raise a few eyebrows if we respond with an average. There are occasions where an average does not help.
- "My heads in the oven and my feet are in the freezer, but on average, I'm pretty comfortable." The average by itself doesn't tell the whole story. We need a measure of the spread of the data, how much variation is represented in the sample.

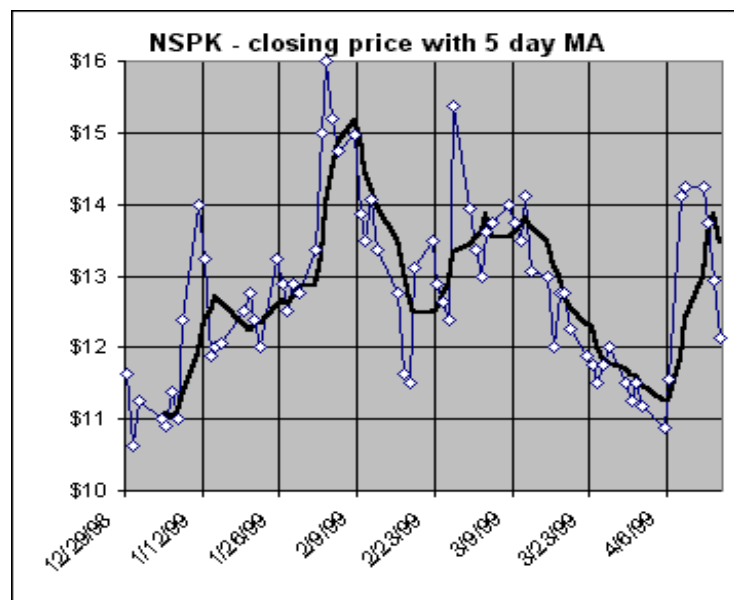
In the chart below, we show closing prices for NSPK from December 29th to April 15th. The data for the chart follows. Question: Is there a trend? Which direction? Our most important goal is to identify market

trends and then to know when a trend is making a change.



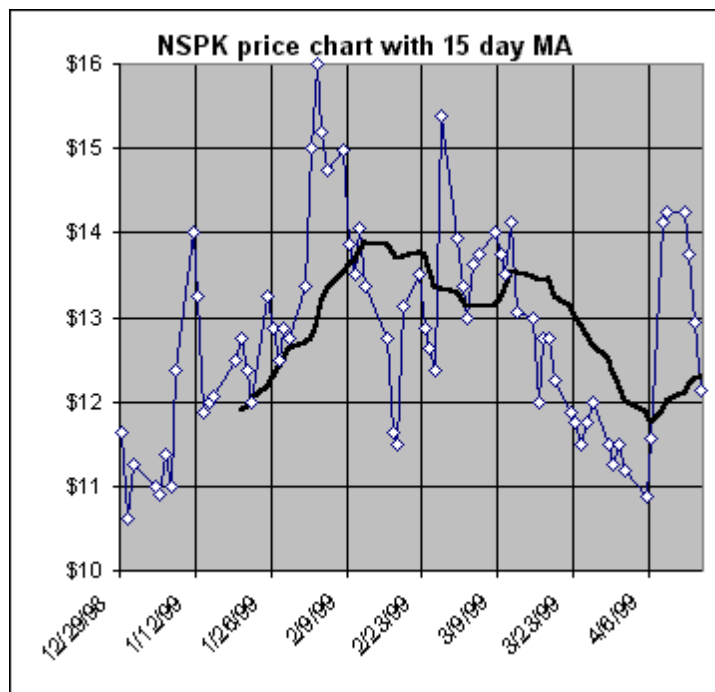
We might say there are several trends, but let's see what a moving average can do for us. The first 13 data points in the table are shown here with calculations for a 5-day moving average. The first average, \$11.08, equals the sum of the five data points all divided by 5. The second average drops the first data point and includes the 6th, and so on. Each five-point average smooths the data, with the result plotted on the price chart below.

1	12/29/98	\$11.63	Average			
2	12/30/98	\$10.63				
3	12/31/98	\$11.25				
4	1/4/99	\$11.00				
5	1/5/99	\$10.91		\$11.08	=	$(11.63+10.63+11.25+11.00+10.91)/5$
6	1/6/99	\$11.38	\$11.03	=	$(10.63+11.25+11.00+10.91+11.38)/5$	
7	1/7/99	\$11.00	\$11.11	"	"	
8	1/8/99	\$12.38	\$11.33	"	"	
9	1/11/99	\$14.00	\$11.93	"	"	
10	1/12/99	\$13.25	\$12.40	"	"	
11	1/13/99	\$11.88	\$12.50	"	"	
12	1/14/99	\$12.00	\$12.70	"	"	
13	1/15/99	\$12.06	\$12.64	"	"	



Notice the darker moving average line for the 5-day MA does not start until the fifth data point. This is a smoother plot, with the underlying trends a little more obvious.

Now lets extend the concept to more data points in each average. The following is the result for a 15 point MA. Here the dark line does not begin until the fifteenth data point:



Why are we doing this? What value does a moving average provide? Look carefully at the chart above

where the price chart crosses the moving average. Technical analysts compare the MA to the price line and note the relationship between the two. For instance, in the chart above, a buy signal occurs when the price rises above its moving average. When the two lines cross, a change in the trend is the message. Notice the clear signal on 4/6/99. Similarly, a sell signal occurs when the price crosses down through the moving average.

Very simply, a trend is considered moving up when the moving average is below the price chart. This reverses when the price line moves below the moving average.

The moving average is a "lagging" indicator. It tells us a change has occurred, after the fact. This is not a system that will get us out exactly at the top nor get us in at the very bottom. It will help us understand the prevailing trend and help us to buy not long after the bottom and to sell not long after the top.

We have shown one moving average example. What is the best number of points to include? Here is an area where paper-trading with historical data can help us focus on the right moving average for the particular trading strategy we use. With hindsight, we can find the moving average that would have returned the greatest profit.

The best moving average depends on our time frame. If we are concerned with very long market cycles, a longer moving average is more appropriate. For instance:

- Long-term (6 months to several years): 200 day MA
- Intermediate-term (1 to 6 months): 50 day MA
- Short-term (less than a month): 15 or 20 day MA

These are only guidelines. If a stock rolls every two months, a good MA would be 30 days. A general rule of thumb would have us use a moving average of half the cycle length. A roller that cycles in 30 days would use a 15 day MA, etc.

Look at the 14-month price chart for the Dow Jones Industrial Average. Notice how the correction was signaled by the shorter 50 day MA in June, but the 200 day MA responded in August. Shorter period MA's are more sensitive, but can also provide more false signals.



Other indicators we will consider in this series can serve as leading indicators, helping us anticipate changes in the trends.

When used together, all of the indicators will push a few more chips to our side of the table, increasing our likelihood of success. Risk, as discussed previously, is not left to fate or a roll of the dice. Risk can be managed, which is the intent of the Provident Investor.

Summary:

- The moving average (MA) is one market indicator that can help us execute market strategies.
- Although it can signal changes in trends, it is a lagging indicator. We will always buy and sell late.

5.3 Trading Bands

Last chapter we discussed using averages to understand market trends. The trend in a price chart tells us the direction the price is moving. This is helpful as we consider the purchase or sale of a stock.

There will be times when a stock price (or a total market) will move sideways, without any apparent trend. These are periods of indecision, often merely a pause in the existing trend. Other times the pause may forecast a change in direction. The figure below shows such a price pattern.

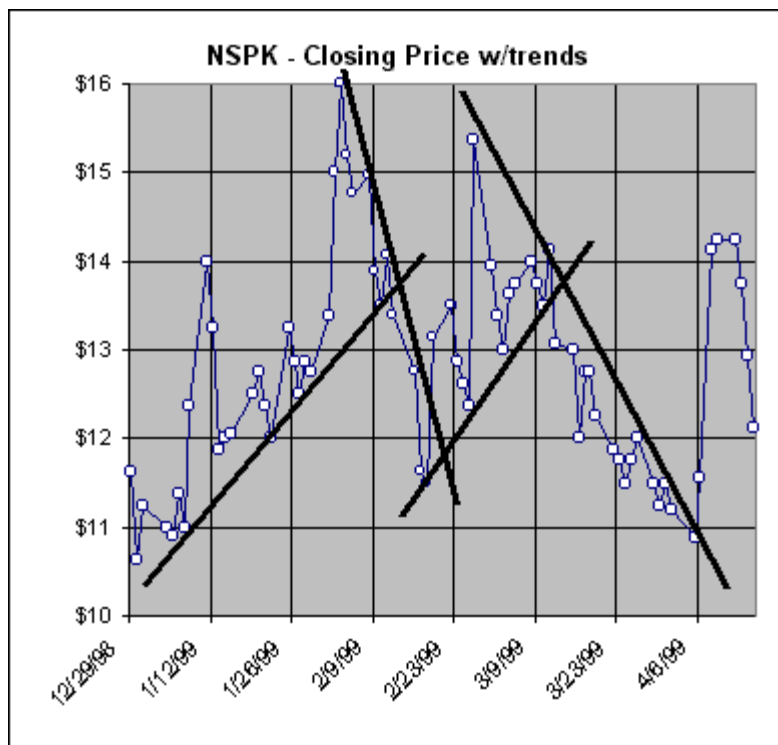


Price Chart for VLNC

What looked like a good up-trend faltered and seems to be waiting for some signal. These periods of indecision provide

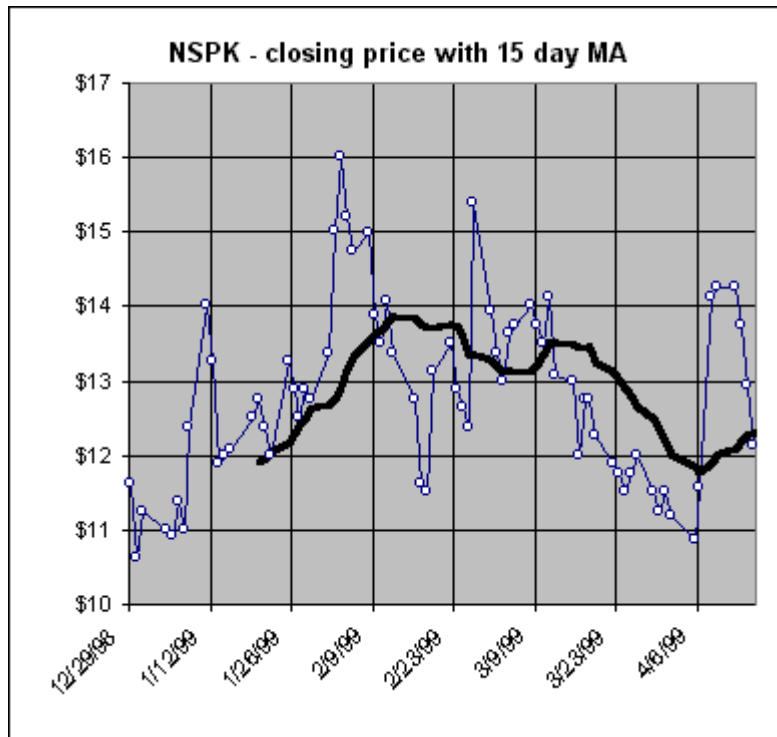
great rolling opportunities. However, the indecision is not permanent. We may only get a few more rolls.

To help spot these periods of opportunity, we introduced the Moving Average in the last chapter. This tool in our bag of tricks helps identify trends. However, even before the moving average, we can spot trends by eye and draw them manually. The next figure shows the price chart we used in the last chapter with eye-balled trend lines.



Notice how the trend lines are drawn on the price chart. An up-trend is connected to the bottom of the price pattern, while they are connected to the tops on the down-trend. The reason for this convention is we are looking for a break in the trend as a trigger. On an up-trend, the change will be a break down through the trend line. The reverse is true on a down-trend.

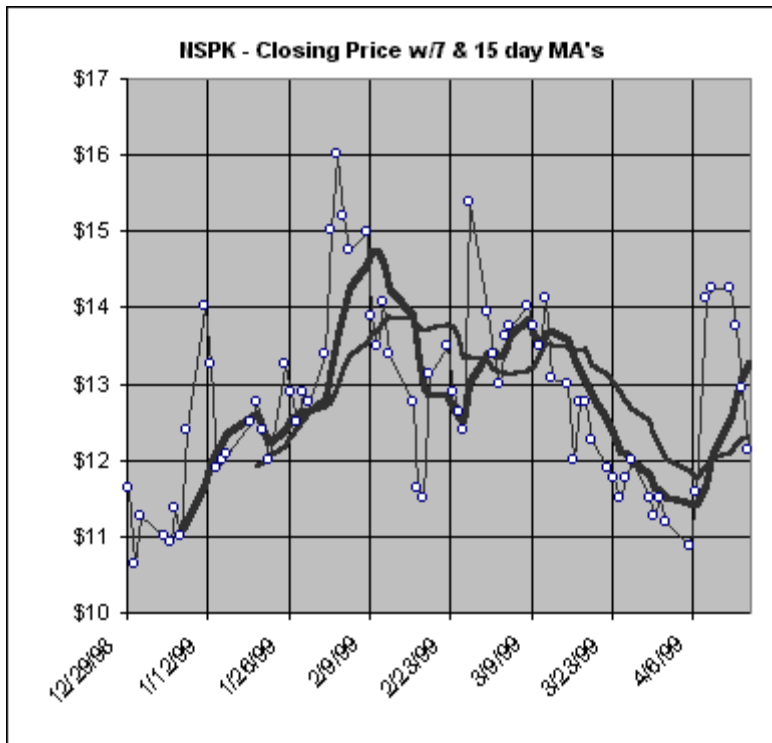
The moving average helped identify these triggers with less eye-ball and more data. We repeat the 15 day MA chart below for NSPK. Triggers occur where the moving average crosses the price line. When the price line moves up through the MA, this signals bullish strength and is generally a buy signal. The opposite occurs as the price moves down through the MA.



On most charting software we are given the option to select Simple or Weighted moving averages. The simple MA was the focus in the last chapter. The difference between these two is one of choice where some analysts prefer to give more weight to recent price action. The "exponentially smoothed" is the most common weighted average which we will feature in chapter 5.7. At this point just understand that it is available. We can experiment with these factors as we develop our own trading strategies.

The moving average plays another role in generating trading signals, using two MA's together. The strength and/or weakness of a trend can be implied from the relationship between the two MA's. Longer term investors commonly use 200-day and 50-day MA's together and study their relationship. The shorter MA is more sensitive to change, following the price chart more closely. The longer MA smoothes the pattern more. When these two MA's cross on a price chart a signal is generated. For instance, when the shorter MA crosses above the longer, that signals strength and is bullish.

Traders, those dealing with shorter time frames, use the same principle but with shorter MA's. 7-day and 15-day or 10 and 40-day pairs are common. Look carefully at the crossover points of the two MA's. The concept seems to work, however the signal is always late. This has been the case in each example of the moving average which is a lagging indicator. We need to improve this strategy to make money.

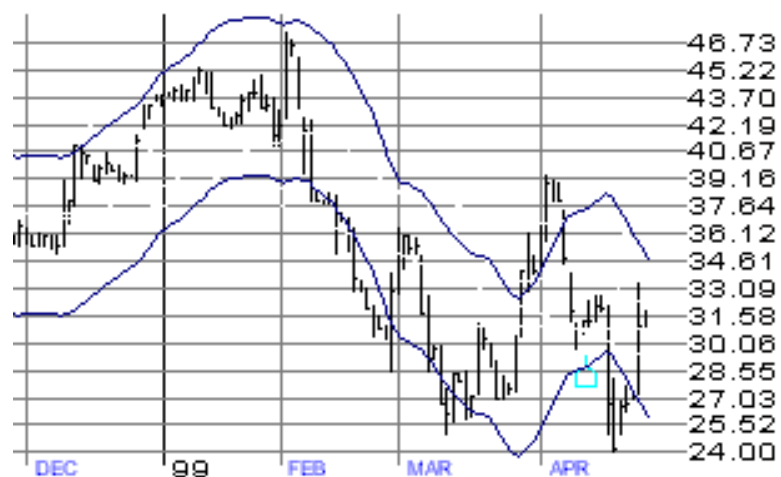


Closing Price with 7 & 15 day moving averages.

Trading Bands

A trading band, or envelope, is created by adding parallel moving averages above and below the center MA. The envelope then defines the upper and lower limits of the normal trading range for a stock. The width of the envelope can be adjusted to account for the volatility of the price pattern. When the stock price reaches the upper band a sell

signal is generated. Likewise, as the price decreases to the lower band, "buy" is the signal.



Moving Average Trading Band Envelope

Charles Dow outlined the reason why trading bands work in a series of articles in the Wall Street Journal back at the turn of the century. The Dow theory was built around several assumptions regarding the general stock market that work equally well on individual stocks. The most important for this discussion are:

- The market is comprised of three trends, Primary, Secondary and Minor. The first usually lasts more than a year and as long as several years. A bullish primary trend will have successively higher highs and higher lows. A bearish primary trend will have the opposite. Secondary trends are one to three month reactions within the

primary, where Minor trends last from one day to three weeks. Dow suggests the minor trends are unimportant and often misleading.

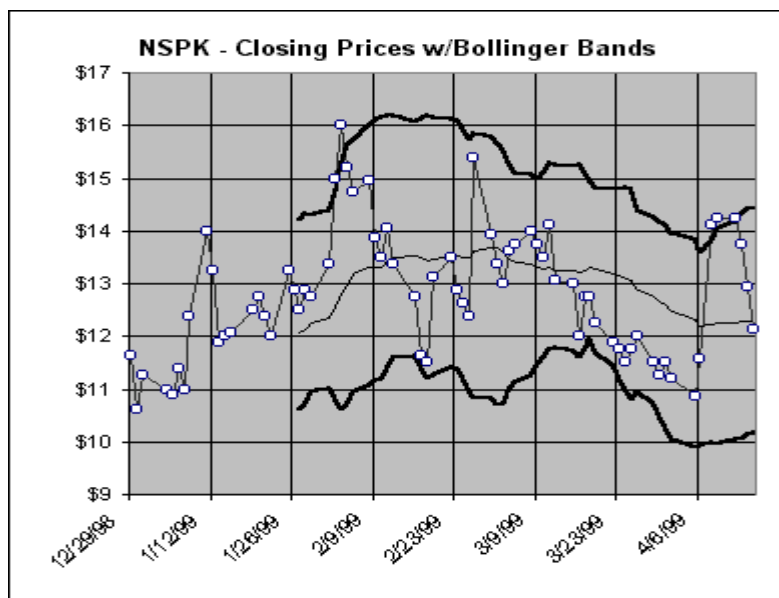
- Primary trends go through three phases, a result of market psychology. First, price is down, gloomy outlook, lack of enthusiasm. Smart investors load up on the bargains. Second phase reflects increased corporate earnings and good economic conditions, continued accumulation by savvy investors. Third phase finds even better earnings, improved economy and now an encouraged public who see the price going higher and higher. This leads to a buying frenzy while the savvy investor begins to unload expecting the prices to drop.
- Trends remain in place until acted upon by a significant market force. This is termed momentum, or the tendency of a moving body to remain in motion unless acted upon by some outside force. Longer trends are more likely to continue in their direction than shorter trends. Trends will continue until a definite signal for reversal is given.

We see from the chart above how price seems to bounce off the trading bands. The trading envelope becomes support on the bottom and resistance on the top. Support and resistance lines represent a resistance to change.

There are periods in the chart, however, where the price is less volatile and does not come close to the bands. That is, where the price pattern is not changing much, the trading envelope is of little value. A trading envelope with constant band-width leaves some of the price pattern out of the

picture. John Bollinger created a trading envelope where its width changes with volatility, called Bollinger Bands.

The difference between Bollinger Bands and envelope trading bands is that envelopes are spaced some fixed percentage above and below a moving average, whereas Bollinger's are plotted some number of standard deviations above and below the MA. Since standard deviation measures variability, the bands adjust themselves, widening during volatile times and narrowing during calmer periods.

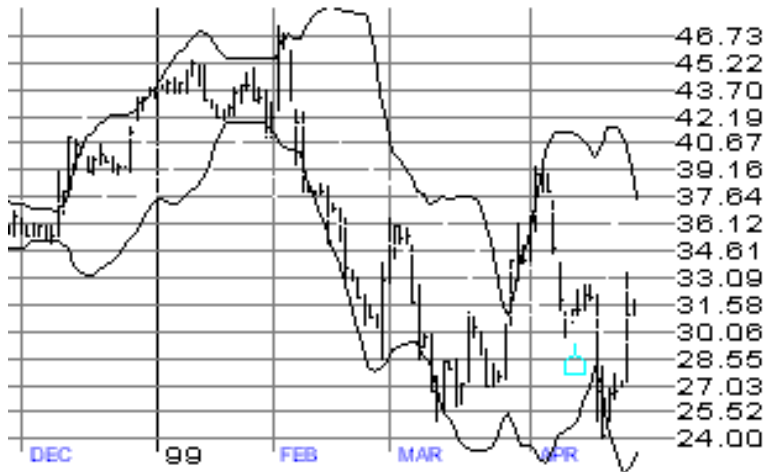


Bollinger Band Trading Channel

Bollinger uses the standard deviation of the price data to set the bandwidth of the envelope. This makes the trading envelope more sensitive to price fluctuations.

The basic principle is that prices tend to stay within the upper and lower band. The spacing between the bands varies with the volatility of the prices. During periods of extreme price changes (i.e., high volatility), the bands self-adjust, widening to contain prices. During calmer periods, these same bands contract to further contain prices.

With the Bollinger Bands, we can select the width of the band as required to optimize the trading signals. Bollinger recommends a band-width of 2 standard deviations (that is 2 above and 2 below) and a period for the moving average of 20. The chart below shows Bollinger Bands on SUPC.



SUPC Price Chart with Bollinger's Bands

Notice on this chart how the relationship between price changes relative to the trading bands provide information about where the price is likely to go. It is this relationship that provides value in forecasting price changes. The bands narrow when there is a change in trend. We will cover indicators that work best with side-ways patterns in later chapters. It is their combination that will increase our probability of success.

Summary:

- Trends can be plotted on price charts manually to help identify changes in the nature of a price pattern. These changes can serve as powerful trading signals.
- Moving averages provide a "better than the eye-ball" approach to identify changes in trends. As trends

change, trading signals are generated. Using these trading signals we are more likely to remove emotion. This alone will heighten our likelihood of success.

- Moving averages answer some of the oldest truths of successful trading, letting profits run and cut losses short. This forces us to obey the rules by providing specific buy and sell signals based on those principles. However, since *MA's* follow trends, they work best when markets *are in a trend*. They perform less well when markets get choppy and trade sideways.
- Trading signals based on moving averages follow the trends, therefore they lag the action. All moving average trading signals will be late.
- The value of the moving average concept is enhanced when trading bands are placed above and below the moving average.
- Trading envelopes position lines parallel to the moving average on either side of the MA at some constant percent above & below the MA.
- Bollinger Bands are a more sensitive version of this principle where the width of the envelope depends on the volatility of the stock. The band is self-adjusting. It is calculated from the standard deviation of price data.
- Moving averages and trading bands find their greatest value with stocks that trend. They are less effective when the price action is sideways.

5.4 Oscillators

We need “leading” indicators to help us predict what prices will do next. Sound too good to be true? We will examine this class of indicators here, understanding that we assume more risk with the chance of greater reward.

Leading indicators measure how “overbought” or how “oversold” a stock is. When a stock is “overbought” it has moved up to the point where the money available has already been poured into the stock. Traders will pause and take profits causing the price to slow and to correct downward.

On the other side of this cycle, buyers will appear for bargains when the stock price falls. When this occurs the now attractive stock is termed oversold. Stock prices cycle between these two extremes. For our money, it is usually better to buy a stock when it is oversold and to sell when it’s overbought.

Because of *this cyclical pattern*, particularly those trading in a side-ways pattern, these indicators are called Oscillators, continually cycling between a top and a bottom. Momentum is the principle upon which oscillators are based. While the price chart tells us if the price is rising or falling, an oscillator chart tells us *about momentum*, or the *rate of change* of the stock price. *The oscillator* tells us whether the trend is gaining or losing momentum. As an up-trend starts to play out, the rate of change will usually slow. That is, the price increase will slowly level out as it nears the top. It will not move straight up and then move down at a

constant rate. Similar action will take place at the bottom of the cycle.

The slowing momentum can be measured by comparing the rate of increase today with the rate of increase a week or two ago. This often is not obvious on the price chart. That is why the oscillator can predict forthcoming price changes, before they happen. Thus, oscillators are called “leading” indicators.

1. Rate of Change - ROC

The concept is very basic. One indicator compares the most recent closing price to some price in the past. The “Rate of Change (ROC) oscillator divides the latest price by the price 10 days ago. If today's closing price is higher than 10 days ago, the ratio will be greater than one:

Closing price <u>today</u>	Closing price <u>ten days ago</u>	<u>ROC</u>
11.26	9.13	$11.26/9.13 = 1.23$
8.37	12.63	$8.37/12.63 = 0.66$

This ratio is positive and will vary above and below 1. If the ratio is larger than one, the price is increasing and vice versa. The size of this ratio is a measure of the rate of change. The larger the ratio, the faster the price is changing. The 10 day period is a choice for short term trades, but can be extended as desired for longer cycles. This indicator is available on most charting software, but lacks a reference point. That is, it does not

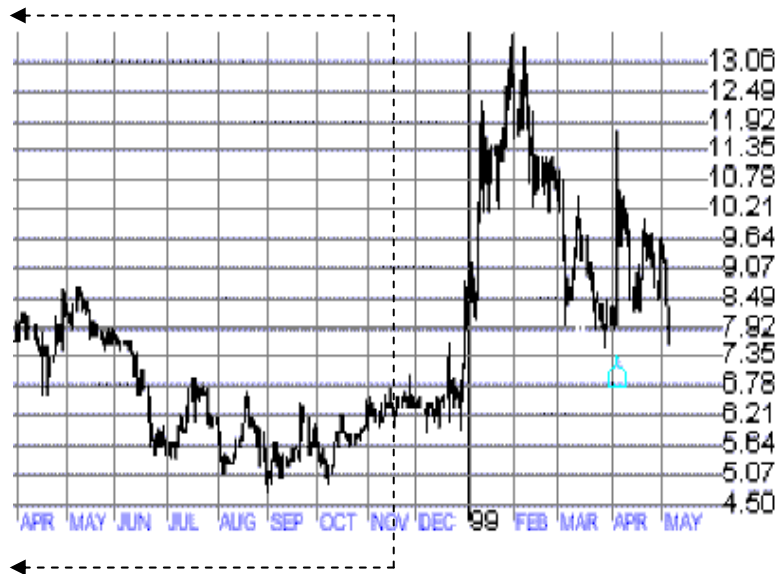
tell us how over-bought or how over-sold the price is. A better oscillator for that purpose is also available.

2. Wilder's Relative Strength Index - RSI

This index was introduced over 20 years ago and has become very popular for both long and short term traders. It does the same thing as the ROC but with a stronger basis. The major difference between these two oscillators is the RSI provides upper and lower boundaries to measure just how overbought and/or oversold a price is. The RSI indicator varies between 0 and 100, with readings over 70 considered overbought and under 30 as oversold. This boundary condition makes it easy to identify good “buy” and good “sell” candidates. It is calculated from its own past price performance and is not related to anything else.

Let's begin our study of this indicator by looking at the price chart of the ticker TTWO. This was chosen because of its low price and volatility. A more detailed discussion of the RSI is found later in this chapter.

Take-Two Interactive Software (TTWO)



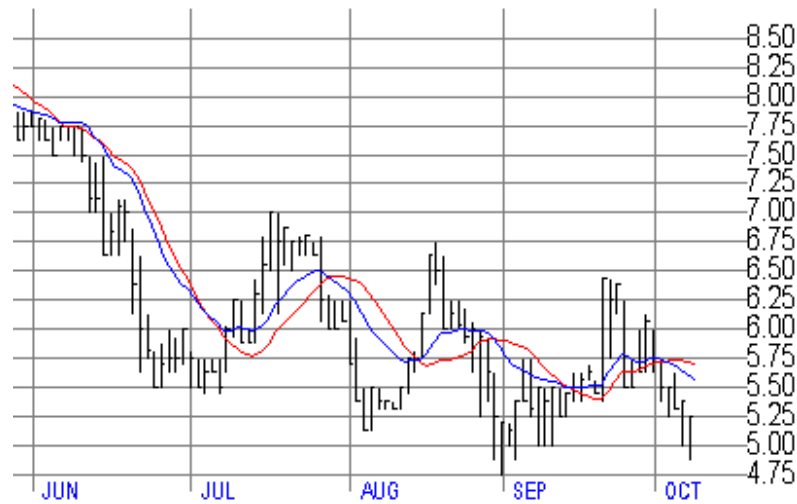
In the following chart, we choose only the first part of the price pattern of the previous chart and expand the scale to see more clearly what we like as a trading pattern.

TTWO Price Chart



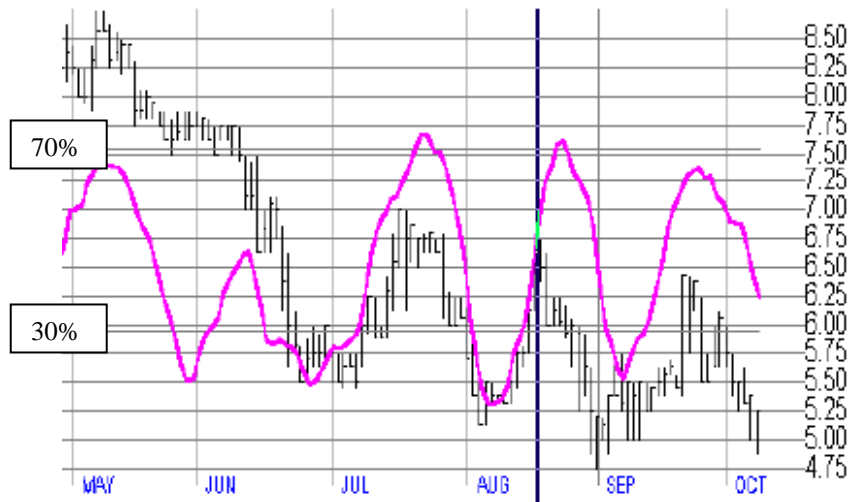
To demonstrate the value of the RSI, look at the next chart where we have imposed two moving average lines as a review of previous chapters. In the last chapter we explained the two options for a moving average, a simple or a weighted moving average. On this chart we have shown the same 15-day moving average (a simple MA) but have added a weighted (exponential) EMA. The EMA line places more value on recent prices in the 15-day sample which makes it react faster. The EMA line is ahead of the SMA line.

**Take-Two Interactive Software
(TTWO) with two 15-day MA
Lagging Indicators (one simple, one
exponential)**



This next chart has the RSI plotted on the price chart for illustration. The two pairs of lines near the one-third levels represent the 30 and 70 overbought and oversold levels for the RSI. Utilize the points where the RSI line moves above the 70% line as a sell signal and when it moves below the 30% line as a buy triggers. Looking at the chart, this strategy works well in the sideways trend, less well as the price is in a downward trend.

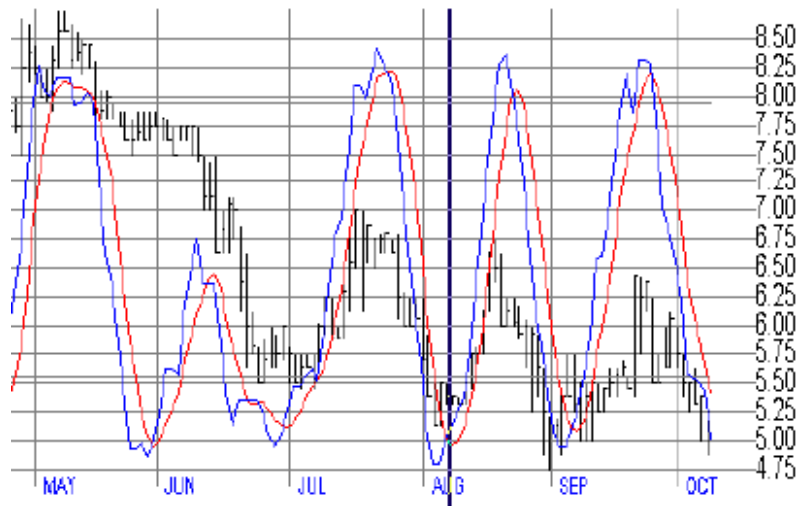
**Take-Two Interactive Software
(TTWO) with RSI
-Leading Indicator-**



3. Stochastics

The Stochastic is another “leading” indicator with the same price chart below included with this indicator for comparison.

**Take-Two Interactive Software (TTWO) with
Stochastics
-Leading Indicator-**



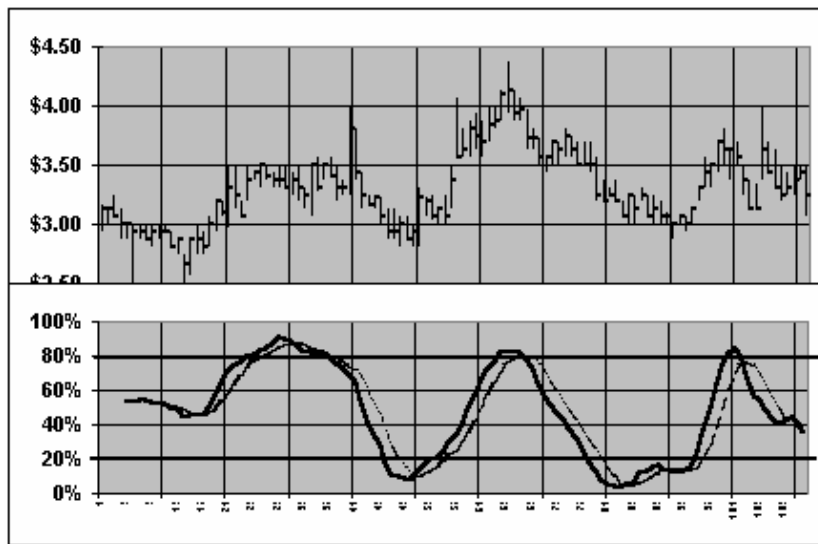
To gain insight into the way oscillators measure momentum, let's review how Stochastics are calculated. It uses price velocity, or momentum shown in the price bar chart on the next page. Each bar represents the price range a stock traded on that particular day. The top of the bar is the highest price reached that trading day and the bottom of the bar is the lowest price. The small nub on each bar is where it ended the session, the closing price.



Momentum Characteristic of Close to Price Bar

Notice how the closing price moves to the top of the price bar (the daily high) as the trend is moving up. On the downswing, the closing price moves toward the bottom of the price bar. As the closing price (the nub) moves away from the top on the upswing; “Hey, this stock is oversold, get ready for a decline!” Likewise, as it sees the closing nub back away from the bottom of the price bar as the price moves down; “Hey, get ready for an increase!”

The Stochastics oscillates between a high and a low, between 0% to 100% as shown below in the heavy dark solid line:



Stochastics: A measure of the over-sold and over-bought condition of a stock.

When the Stochastics cross above the 80% line, the stock is considered overbought (get ready to sell). Below the 20% line, an oversold condition exists (get ready to buy). This is very effective with a rolling stock, as opposed to one with a pronounced trend.

On the Stochastics chart above, a second dashed curve is shown which is a moving average of the solid curve. It is an important action signal when the moving average crosses the solid Stochastics. Many technical investors use this crossover point as their signal to buy at the bottom and sell at the top. Skill and experience is required to set the correct variables for calculating Stochastics. This varies with each stock and with time.

This indicator works best with solid rollers, less well with what might look like a saw-tooth. That is, a rapid rise from the bottom to the top, in a few sessions, then a slow return back down in many sessions. The statistical nature of the indicator finds greatest predictive value when the stock price follows regular price movements with high volume.

A caveat; While the Stochastics can identify over-bought or over-sold conditions, it cannot tell us how much further the price will go, either up or down. It can tell us when the market is about to correct, but not tell us exactly where to buy or to sell. That still requires our best judgment.

Summary:

- The importance of the “leading” indicators covered in this chapter lie in their ability to forecast changes in trends.
- They work better in sideways markets and less well during sustained up or down-trends. We might characterize the two conditions as trending (sustained trends) and as trading (sideways movements).
- Leading indicators work better in trading markets, while lagging indicators work best during trends.
- While it is fairly easy to determine if prices are trending or trading, it is difficult to know how long the condition will exist.

Our most formidable task as traders is to know when to utilize each of the types of indicators. During strong trending periods, moving averages perform best. When

prices swing back and forth, as in much of our trading activity, oscillators and envelopes perform better.

5.5 Wilder's RSI

In this section on technical analysis we detail three important factors the technician studies; price, volume & time. Let's review these and add breadth as a fourth. A technician studies these four input parameters and creates a set of technical indicators in an attempt to predict changes in a stock's price.

- Price - The price of a stock is a consensus of trader expectations; where one person agrees to buy and another agrees to sell. The supply/demand lines shift as these expectations change, causing prices to fluctuate. These changes follow trends and are often cyclic, repeating the price patterns.
- Time - The length of the cycle, or period of the change, is important in understanding the strength of the underlying action. The longer a price change takes, the stronger the change will be.
- Volume - This measures how intense the change in investor attitudes are. The relative volume accompanying a price change signals the stability of the change. That is, an increasing price with decreasing volume will not likely continue.
- Breadth - What is the rest of the market, or other stocks in a sector doing? There is strength in numbers and breadth provides an additional information gem.

In the last chapter we considered "Oscillators" where the indicator value continually cycles between some top and bottom. The principle upon which oscillators is based is termed "Momentum," a measure of how fast and in what direction the price is changing. Are we gaining or losing momentum?

The price momentum determines whether the stock is "overbought" or "oversold." An "overbought" stock has less money coming in as investors shy away from purchases. The price increase slows and flattens out before moving downward. A stock is termed "oversold" when the price falls and buyers reenter the market looking for bargains. We want to buy oversold stocks and sell when they become overbought.

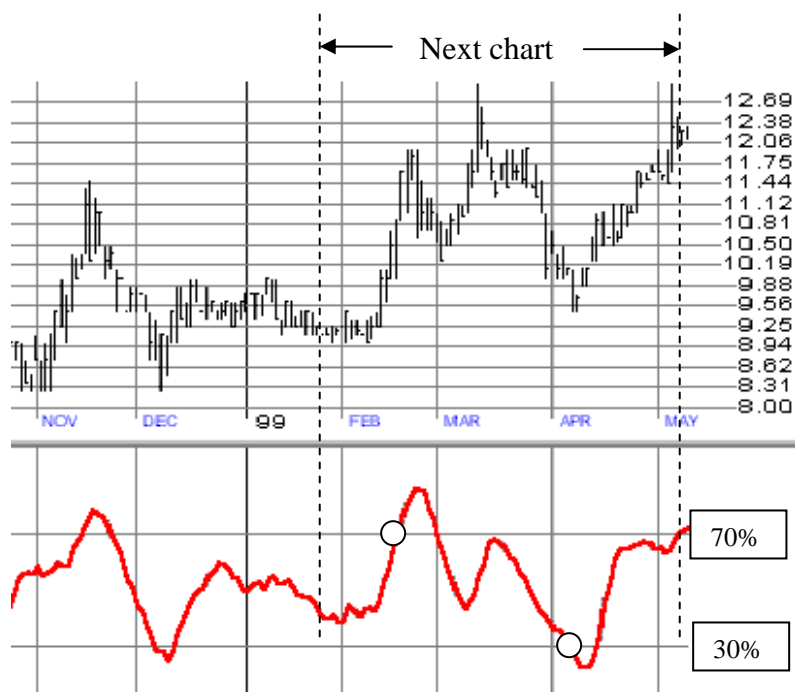
Here we will cover Wilder's Relative Strength Index (RSI) which is very popular with traders. See the sidebar at the end for an explanation of how it is calculated. The RSI provides upper and lower boundaries to measure just how overbought and/or oversold a price is. The RSI indicator varies between 0 and 100, with readings over 70 considered overbought and under 30 as oversold. This boundary condition makes it easy to identify good "buy" and good "sell" candidates.

Many market indicators compare the price strength of a stock with that of its sector or with that of some major index. This is termed a "Relative Strength" indication and helps us understand how a particular stock is doing against its peers.

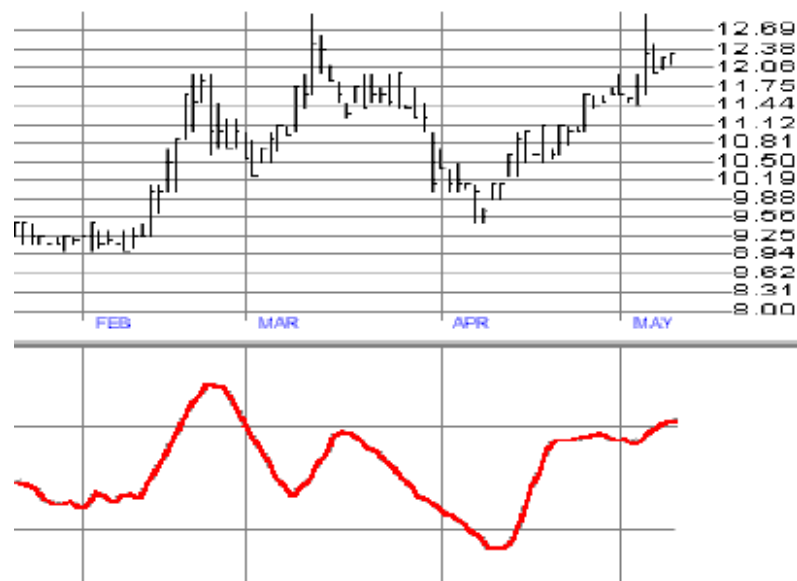
We do not want to confuse Wilder's RSI with these Relative Strength indicators. The Wilder RSI would be better named if it were called a measure of "internal strength," because it does not compare the stock to anything external.

In the following chart we show the price pattern for BMCC, with its RSI in the window below. Notice how the RSI follows the price.

BMCC Price Chart with Wilder's RSI



Let's expand the time scale to better see how the RSI might be used for buy and sell signals. Using the 30 and 70 lines to identify oversold and overbought conditions (the lines on the RSI chart are the 30 & 70 levels), what would the chart tell us? If we owned the stock going into this pattern, we should sell about the fourth week in February, buy back in the first or second week in April and get out again the second week in May. We would have missed a little action in March, but that sequence of trades wouldn't be too shabby.

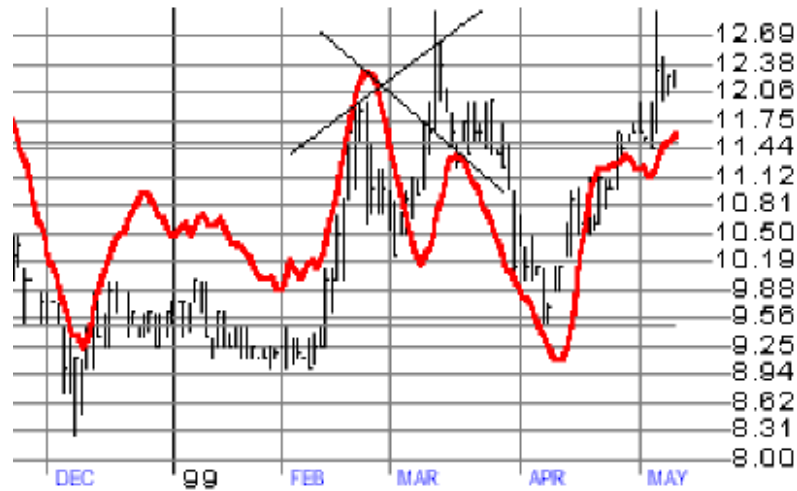


BMCC Price Chart

Good technical indicators have the "power to contradict!"
That means they will signal a forthcoming change before

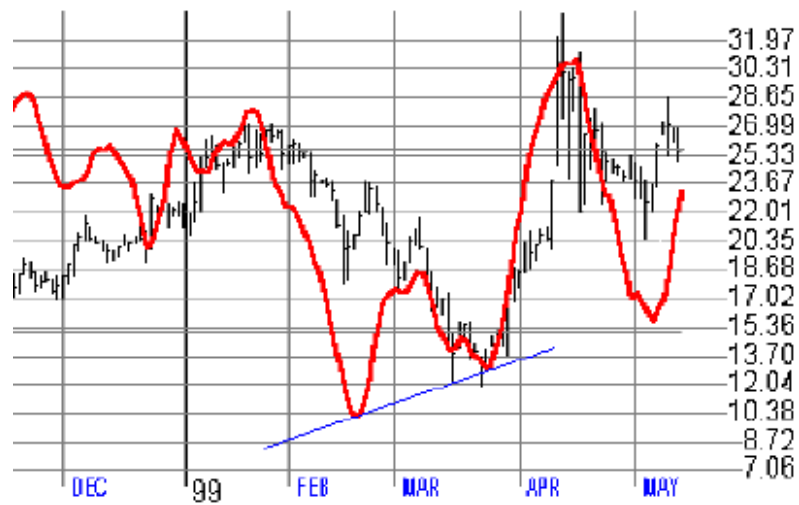
it is evident in the price pattern. They will contradict the price pattern. When we get contradicting signals, we have what is called a "divergence." The RSI is particularly helpful to identify and to take advantage of the messages contained in a divergence. In the next chart we have superimposed the RSI onto the price chart to help make this point. Look carefully to see the 30 & 70 level RSI lines, 70 just above \$11.44 and 30 just below \$9.56. It may be difficult to see the action with the charts on top of one another, but follow carefully: One line, slanting upward to the right, connects the tops of two peaks on the price chart. This means the price is rising, from one peak to the other. At the same time, however, the corresponding RSI peaks are connected with a line slanting downward to the right. What we see is a divergence. While the price peaks are increasing, the RSI is decreasing.

BMCC Price Chart with RSI superimposed



In the chart above, notice what happened to the price after this divergence became apparent. The divergence occurred when the price made a new high that was not confirmed by a new high in the RSI. The price usually corrects in the direction of the RSI, which is exactly what happened above. Consider, as you view the chart, how that information could have helped us get out of our position in March. The following chart illustrates an opposite case, where the falling price diverged with the "higher lows" (an increase) on the RSI line. Look where the price went after this divergence.

PLCM price chart with RSI divergence



In the next chapter we will deal with yet another oscillator, the Moving Average Convergence/Divergence (MACD) indicator. We will deal with this oscillator separately since it follows the trend, having value in both choppy and trending markets.

Sidebar - Wilder's Relative Strength Index Calculation:

RSI calculation											
	Closing	Change	Change	Sum	Sum	Avg	Avg				
	Price	UP	DOWN	UP	DOWN	UP	DOWN				
		A	B	C	D	E	F	G	H	I	RSI
1	\$10.25										
2	\$11.00	\$0.75	\$0.00	C & D are the sum of 10 cells each.							
3	\$11.44	\$0.44	\$0.00	The average E & F are C & D divided by 10.							
4	\$13.69	\$2.25	\$0.00	G is E/F							
5	\$14.13	\$0.44	\$0.00	H is G plus 1							
6	\$12.25	\$0.00	\$1.88	I is 100/H							
7	\$12.75	\$0.50	\$0.00	RSI = 100 - I							
8	\$12.50	\$0.00	\$0.25								
9	\$13.25	\$0.75	\$0.00								
10	\$13.13	\$0.00	\$0.13								
11	\$13.25	\$0.13	\$0.00	\$5.25	\$2.25	0.53	0.23	2.33	3.33	30.00	70.00
12	\$12.88	\$0.00	\$0.38	\$4.50	\$2.63	0.45	0.26	1.71	2.71	36.84	63.16
13	\$13.00	\$0.13	\$0.00	\$4.19	\$2.63	0.42	0.26	1.60	2.60	38.53	61.47
14	\$13.00	\$0.00	\$0.00	\$1.94	\$2.63	0.19	0.26	0.74	1.74	57.53	42.47
15	\$12.88	\$0.00	\$0.13	\$1.50	\$2.75	0.15	0.28	0.55	1.55	64.71	35.29
16	\$14.00	\$1.13	\$0.00	\$2.63	\$0.88	0.26	0.09	3.00	4.00	25.00	75.00
17	\$14.88	\$0.88	\$0.00	\$3.00	\$0.88	0.30	0.09	3.43	4.43	22.58	77.42

General Formula:

$$RSI = 100 - 100 \div (1 + RS)$$

$$RS = \frac{\text{Average of N period up-closes}}{\text{Average of N period down-closes}}$$

N = number of periods used.

5.6 MACD

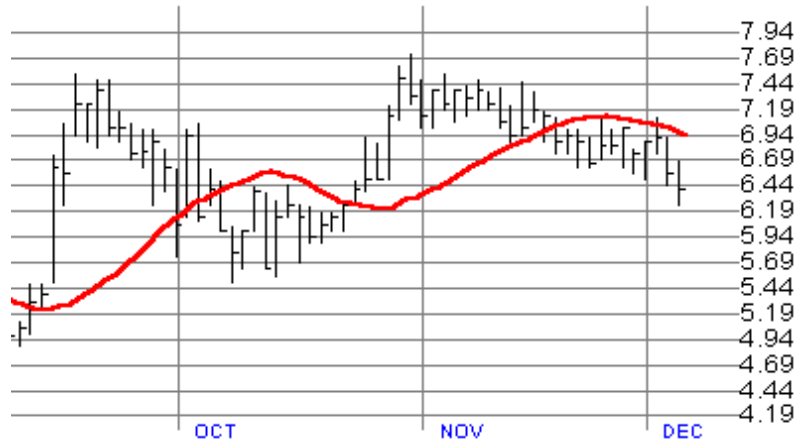
We began this section on Technical Analysis with a Moving Average indicator to help predict price movements. The disadvantage with this indicator is one of Lag! The message always comes after the fact. We then considered momentum indicators called oscillators to anticipate price changes, to Lead! This chapter deals with a trend-following indicator that also subs as an oscillator, providing advantages from both arenas. The MACD (Moving Average Convergence/Divergence) is a trend-following oscillator showing the relationship between two moving averages of prices.

As it was designed by Gerald Appel, the MACD is the difference between two exponential moving averages, 26 and 12-day MA's. Another 9-day exponential moving average of the MACD, not price, is called the "signal" line and is plotted on top of the MACD to show buy/sell opportunities.

Lets build the MACD one step at a time to help understand its value. The periods used in these moving averages is a matter of choice and must be fitted to the stock and time frame for that stock. We prefer 20 and 10-day exponential MA's and a 6-day exponential signal line with more volatile rolling stocks and will use these values in the discussion that follows.

Our first step is to plot the "long" moving average on the price chart as shown below (the 20-day exp. MA).

BTGC Price Bar Chart with 20-day exp MA

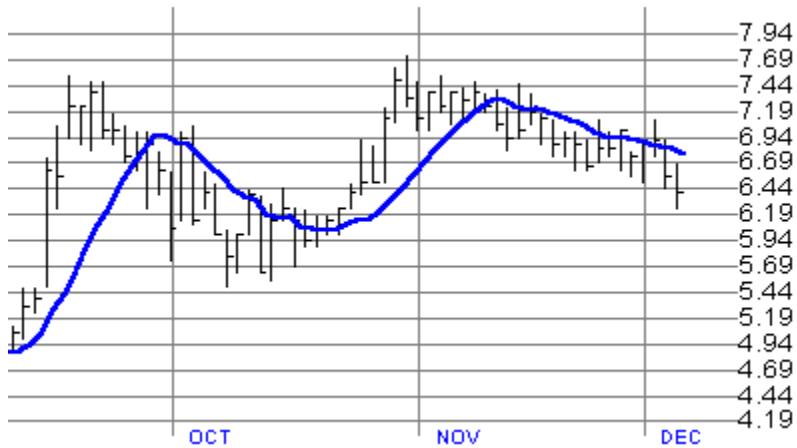


Remember from our discussion of Moving Averages, when the MA line crosses the price pattern, a signal is generated:

Sell when it crosses up, buy when it crosses down.

We can see how these signals lag the action with the moving average. Next place a shorter 10-day MA on the same price chart to see how the signals arrive in a more timely manner (less lag).

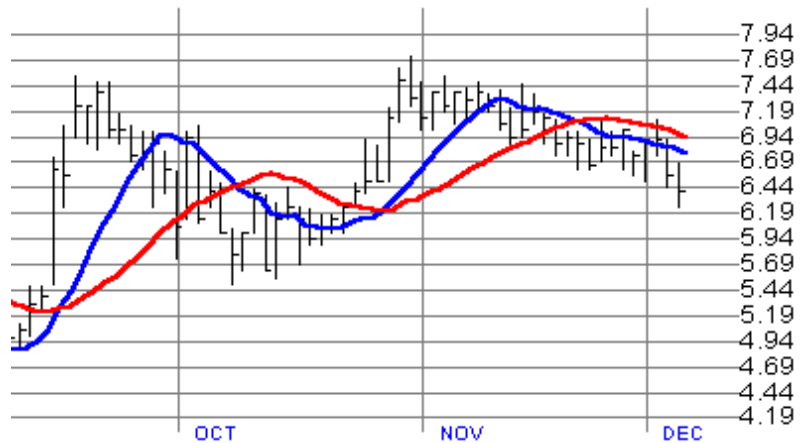
BTGC Price Bar Chart with 10-day exp MA



This picture shows the signals coming with less lag, improving our bottom line. The down-side to the faster action is the danger of false signals, leading to whipsawing. Remember, for each advantage we gain, we give up something elsewhere.

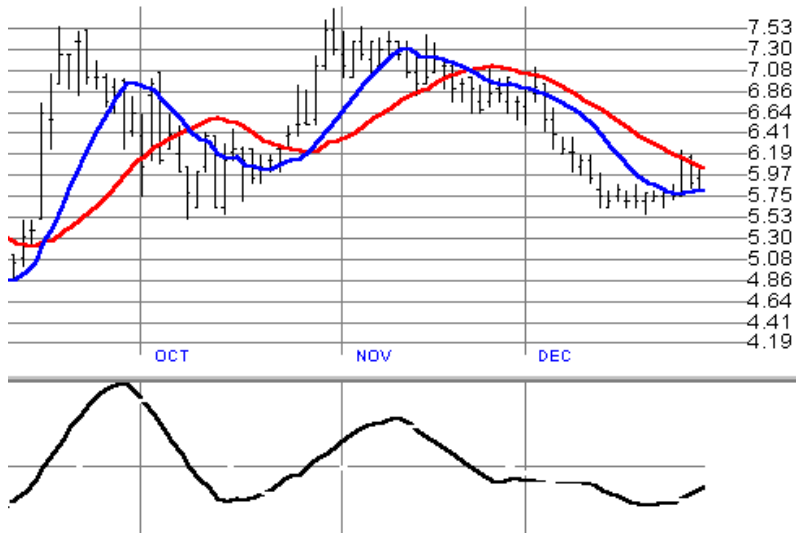
Now place these two moving averages together on the same price pattern, as shown below. It is easier to see how the longer term MA is a more stable, more smooth rendition of where the price chart is going, while the shorter MA is more sensitive to price changes and hugs the price pattern more closely.

BTGC Price Bar Chart with both MA's



Nothing jumps out at us from this chart, but next consider what a line would look like which is the difference between these two lines. That is, on each day (each bar on the price chart) subtract the Long MA line from the Short MA line. When the Short is above the Long, this difference will be positive, and negative when the Long is on top. The difference will equal zero when the two MA's cross. When we plot these differences as shown in the lower frame below, this new line is the MACD.

BTGC Price Bar Chart MACD as the difference between MA's



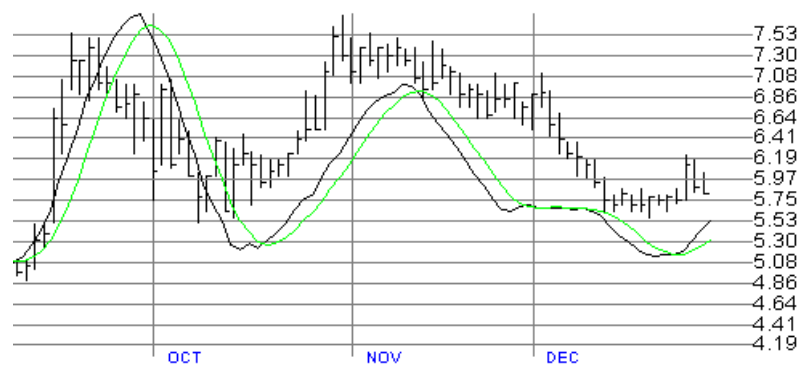
The MACD line then varies above and below zero. The zero line identifies points where the two MA's cross, or where they are equal, the difference being zero. This indicator is then an oscillator, moving back and forth above and below some reference line, in this case, the zero line. This identifies overbought and oversold conditions, with positive MACD signaling overbought, negative MACD a signal for oversold.

Unlike Wilder's RSI and the Stochastics, both of which have predetermined overbought and oversold levels, the MACD has no distinct levels to identify these conditions. It is up to

us to determine how far above and below zero for a particular stock the MACD provides signals. In the chart above, had we used the MACD peaks for signals, we would have been ahead of the signals generated by the moving averages.

The 9-day MA of Appel's MACD, mentioned above, is usually plotted on top of the MACD indicator. This "signal" line tells us when the MACD is changing direction. This is a prediction that the two MA's in point 9 are moving together. This is the same thing as the MACD moving toward zero (we use a 6-day MA for this line).

BTGC Price Bar Chart MACD with the Signal line



The MACD indicator finds wide use as an overbought/oversold indicator. When the shorter moving average (the 10-day MA in our case) pulls away from the longer 20-day MA (the MACD will be rising), the stock

price is likely overextending (it is an overbought condition) and will soon return to more realistic levels. We would know this by watching for the signal line to cross the MACD line (where the difference between the short and long MA begins to decrease).

When the MACD is above zero, the shorter MA is higher than the longer MA. This shows that current expectations (i.e., the 10-day MA) are more bullish than previous expectations (i.e., the 20-day MA). This implies a bullish, or upward, shift in the supply/demand lines. When the MACD falls below zero, the opposite is the case. The 6-day MACD MA (signal line) anticipates changes in the MACD direction and is then used as a signal line for action.

Point: The only signal we need to watch is the relationship between the MACD main and signal lines. We used the long and short MA's to calculate the MACD and to understand why it works, but the MACD with its 6-day signal line stands alone.

The MACD is most effective in volatile trading markets as opposed to long term trends. This indicator maintains value as a trend-follower being created from moving averages with the added benefits of an oscillator. It is used to identify overbought and oversold conditions and to spot divergences in price patterns.

As an oscillator it can signal likely trend reversals. This occurs when the MACD diverges from the stock price. A

bearish divergence occurs when the MACD is making new lows while prices fail to reach new lows. A bullish divergence occurs when the MACD is making new highs while prices fail to reach new highs. These divergences are most significant at the tops and bottoms of the oscillator pattern.

The MACD technical indicator finds an important role in our strategies and analysis of rolling stocks.

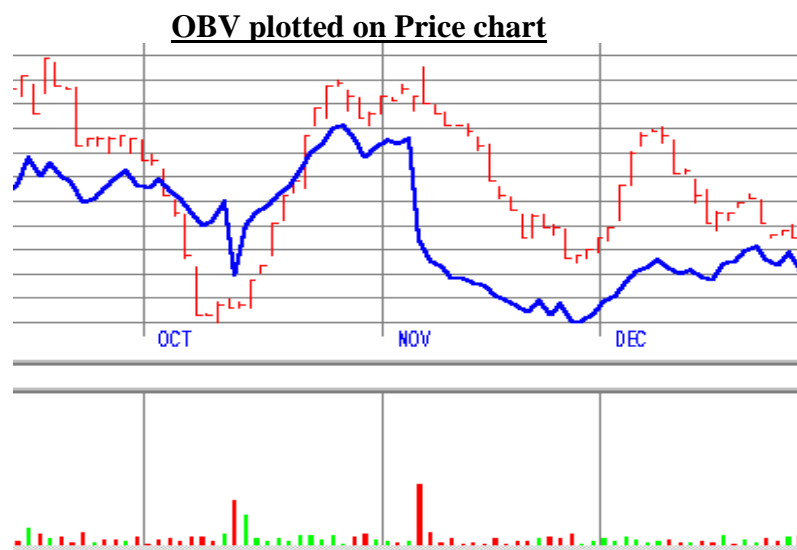
5.7 On-Balance-Volume - OBV

The indicators studied thus far have dealt with prices, their averages and patterns. Graphically, this has helped us predict the direction a price-line may take. We also discussed in an earlier chapters the important role volume plays in the supply/demand relationship, setting support and resistance levels for a rolling stock. We saw how volume can be used with price to determine the strength of a trend. That is, if the price is rising with heavy volume, the rise is likely to continue. If that same rising price is with declining volume, the rise is not likely to continue. In this chapter we pay homage to an easy to understand user-friendly volume indicator, the On-Balance Volume.

The On-Balance Volume (OBV) indicator, introduced by Joseph Granville in 1963, shows graphically the flow of volume in a stock. The OBV line is a running cumulative total of the daily volume numbers, adding volume on days the price goes up, subtracting on down-days.

In the next chart the OBV is plotted over the price showing how easy it is to compare volume changes to the price activity. This particular chart tells us that price follows volume, confirmation of our discussion on the supply/demand relationship. We will find the greatest benefit from these comparisons when volume does not confirm price action.

Note: The importance of the OBV line is its trend, the direction the line is going, not how high the line is. Lets say that in another way: The highest point in the OBV line is not where volume is greatest, or where volume flow provides the greatest support to the price line. We must watch the direction or slope of the line!



The OBV technique tries to uncover hidden accumulation and distribution patterns before a price change happens. If a stock closes higher than the previous day, then the day's volume is considered positive (accumulated or demand) volume. When a stock closes lower, then the day's volume is negative (distributed or supply) volume. We are paying attention to what really drives price - the volume.

The basic premise of OBV analysis is that volume changes occur before trend changes. This is because the strength of market action is reflected in a combination of volume and price. The theory is that "smart money" (institutions, funds, etc.) flows into a stock with a rising OBV before the stock trend rises. When the rest of us then move into the stock, its price and the OBV will rise.

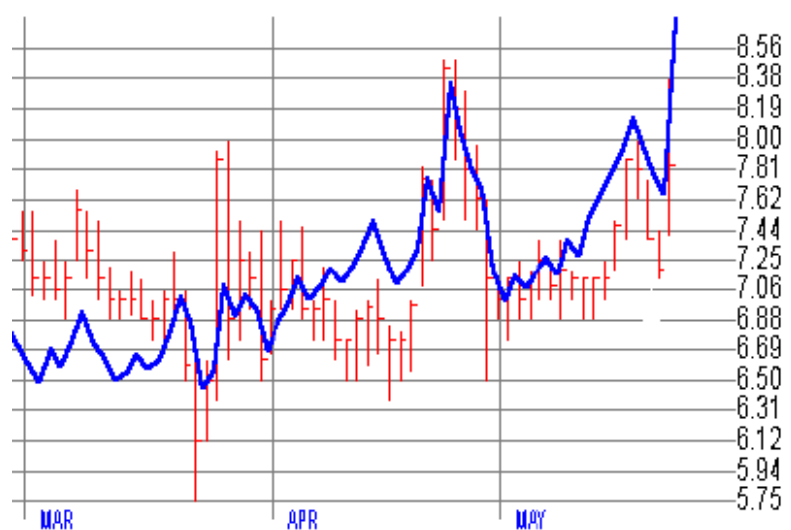
Point: "Smart money" must deal with the general public for this all to work, since the smart money needs someone to buy from and sell to in order to make its profits. That someone is us.

It matters not what makes smart money smart, or who the smart money investors are. All that's important is their money-moves ultimately determine the price. OBV is a method to reveal these moves.

Lets look at a positive example of OBV, where it flagged a change in price before the fact. The chart below shows OBV plotted on the price chart for VLNC, a good roller. Notice how the price trend was down at the end of March through mid-April. However, the OBV told us the volume was

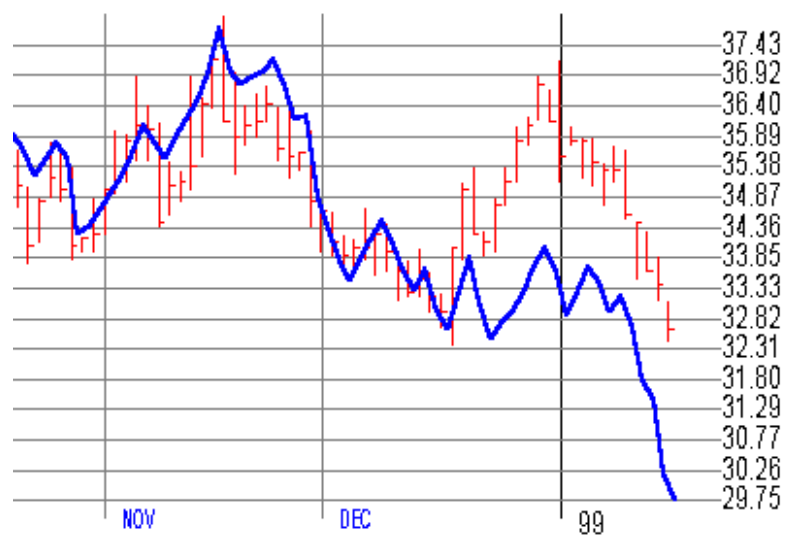
accumulating (more buying pressure). Price finally got the message the last half of April with a significant up-tick. Careful observation of the OBV gave us a great heads-up on where the price was likely to go.

VLNC Price Chart with OBV



Another trading example (OKE) shows the opposite signal, where in mid-December the price was rising without volume support. The trend of the OBV was doubtful with the rising price. The volume won!

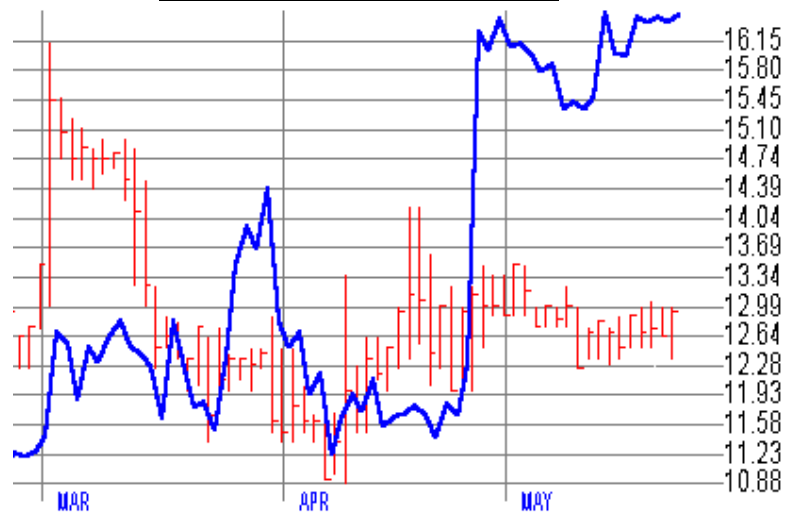
OKE Price Chart with OBV



The next chart (CCCG) illustrates the importance of OBV direction vs. magnitude. The OBV had bottomed out toward the middle of April, forming what is called a "doubtful trend," not really knowing which way it was going. Then came a dramatic one-day spike in positive volume, followed by turn down in volume.

Point: While the steep rise in OBV may whisper "something big is going on," there was no evidence of sustained accumulation (buying) to move price higher. The down-trend following the spike in OBV was reflected in the subsequent price pattern. It was "doubtful" again.

CCCG Price chart with OBV



A final thought in this chapter regarding the OBV: This method allows us to take advantage of "insider trading" without inside information. We simply "listen to" market data. While there is profound value in this indicator, keep in mind we used a few examples to make our point but every chart will not send us a message. Most charts will simply show price following volume. That's not bad! We just need to be aware of opportunity when it shows up.

Point: We must keep the all the indicators we've studied in perspective. None of them is perfect. We will find value in using them together, looking for confirmation where two, three or even four send us the same message. When that occurs, it is likely a winner.

5.8 Technical Summary

The following tables summarize the work we have done in this section on technical analysis. This is one opinion, that of the Provident Investor, based on a study of this segment of the market. That is, rolling stocks with a short-term traders hat on. We have chosen this arena because of the merits of the activity and the ability to see chips fly. We have not covered hundreds of other indicators available, but find these sufficient for a base entry into trading.

Master Overbought/Oversold Indicator Summary

Indicator Summary - A		Trending Markets			Divergences - breakouts
How well do the indicators work?	Trading Market (sideways)	Bull (up)	Bear (down)		
	Stochastic	Valid crossovers for Overbought & Oversold	Crossovers from Oversold are valid	Crossovers from Overbought are valid	Fair
T L	OB/OS indicator				
r e	OB above 80				
e a	OS below 20				
n d	RSI	OB & OS indication	Skewed to OB	Skewed to OS	Good
d i	OB/OS indicator				
n	OB above 70	excellent			
g	OS below 30				
	ROC	Rate of change can be used on price or any of the indicators. This will help define the momentum or strength of the action, be it an up or down trend.			

Indicator Summary - B		Trending Markets			Divergences - breakouts
How well do the indicators work?	Trading Market (sideways)	Bull (up)	Bear (down)		
T L	MA's	Many false breakouts	Oversold are trends.	Work well on trends.	Slow
r a	Watch for Price/MA crossovers.	& whipsaws.	Valid breakouts	Valid breakouts	
e g	MACD	Most effective in wide swinging trading markets.	Many false signals.	Many false signals.	Good
n g					
d i					
n					
g					
Volume Ind.	OBV	Good indicator of accumulation	Good supporting indicator	Slower to respond	Good
Trading Bands	Bollinger Bands	Bands serve to identify resistance and support levels.			
	Envelopes	Helpful when choosing buy and sell points.			

SECTION VI - Trading Strategies

6.1. Thoughts

Our attempt in the previous material has been to provide an understanding of market activity sufficient to take the next steps and to begin trading.

Lets see if we can make that simpler: To begin trading, we need three things:

1. A way to *value* stocks we may spend money on.
{Fundamental analysis points the way}
2. A method to find *when's a good time* to spend that money.
{Technical analysis points the way}
3. An understanding of market dynamics and investor behavior in the face of those dynamics.
{Market risk and all it entails}

We have just opened the door to this vast world of market activity, but each investor/trader must step through and engage in the battle. This section provides important first steps in the hopes that each participant will find his/her own niche for profitable returns. All gurus in this arena agree that success comes to those who find and magnify *their own* style, whatever that turns out to be.

In what follows, we will consider different trading strategies, methods and techniques. Some may fit a trader's personality while others may not. As we have noted, one size does not

fit all. But it is tough to know if a pair of pants will fit without trying them on. This will be an opportunity to try on a few of these trading strategies.

This book is a companion to our Web site, www.Pro-fundity.com, where we have published a list of “rolling stock” tickers each week since its inception in 1998. We have looked at a lot of tickers. We have learned a lot about stock patterns and market dynamics through both the bull and the bear. What follows reflects many of the lessons learned and some of the different directions that might be taken.

We begin with a study of *Rolling Stocks*, a term coined by Wade B. Cook in “The Wall Street Money Machine.” We start here since it is a simple and easy trading strategy to understand.

6.2. Rolling Stocks

Some stocks will roll back and forth within a channel, between a high and a low price. The low price is termed its *support*, while the high price is termed its *resistance*. Once a stock like this is identified it should be easy to buy low and to sell high.

"Buy low, sell high!"

That is always good advice for any would-be investor. It is also quite useless since we never know where the highs or the lows will be.

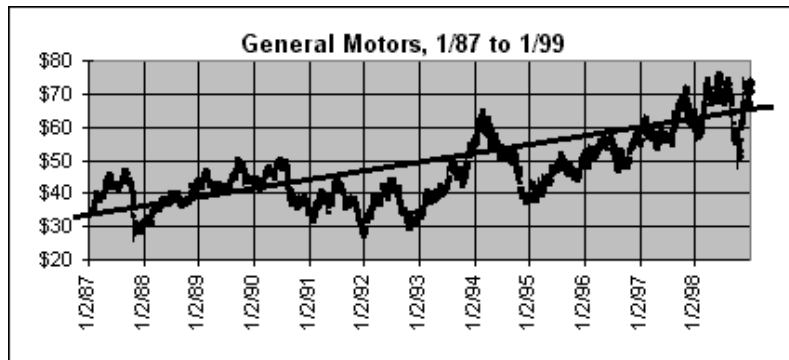
However, with the computer tools available today, it is easier to reduce the risk and to anticipate potential stock price moves. Armed with this information, stocks that roll between predictable channels can fatten our bank account.

Suppose we had invested \$1,000 in General Motors in 1987:

Case 1. Buy & forget about it until we sell in 1998
(11 years later):

Buy	1/2/87	@	\$33.45	Invested	\$1000	Growth	82.4%
Sell	1/2/98	@	\$61.00	Increase	\$787	APR	7.5%

That's nothing to write home about.



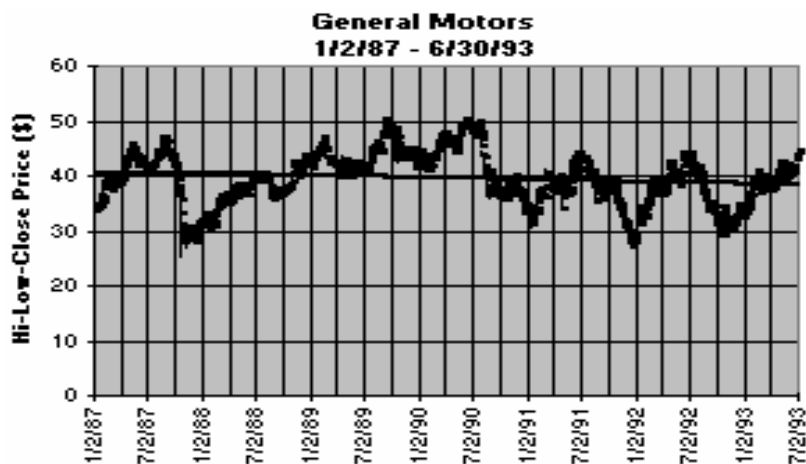
Case 2. Instruct the broker, "Buy at \$30.00, sell at \$65.00," then check back in 11 years:

Buy	1/2/87	@	\$30.00	Invest	\$1,000	Growth	143%
Sell	7/2/93	@	\$65.00	Increase	\$1,430	APR	13%

A little better.

Case 3. Work only that portion of the stock chart where it appears to move sideways (1/2/87 to 7/2/93):

Buy	@	\$33.45	Invest	\$1,000	Growth	275.0%
Sell	@	\$41.50	Increase	\$2,750	APR	25.0%



The trend line for this last example shows virtually no growth over the time period, yet working the variation, we can get almost twice the return in 2/3's the time.

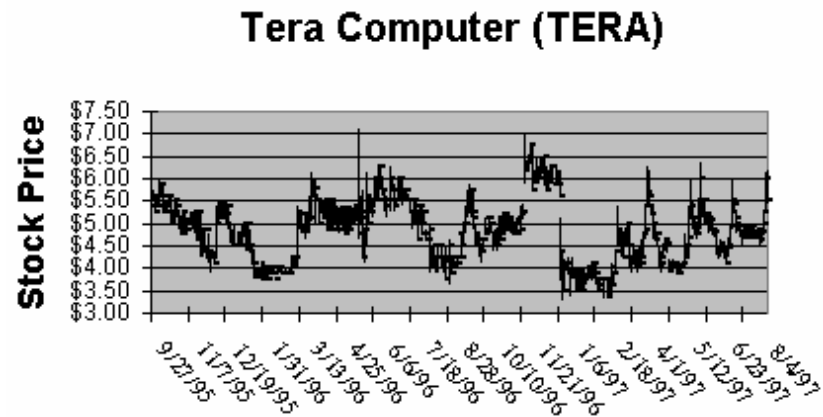
Of course, if we knew where the stock was going we could make such brilliant calls. Hind-sight is 20-20. The purpose of this example is to show the ***potential*** for higher returns on stock purchases by working the "rolling" nature of some stocks.

We will examine in this section how to take advantage of this rolling stock strategy?

6.2a Rolling Analysis

Let's climb a mountain together! Consider this concept.
Don't let the numbers trouble you, just capture the concept.

Look at the chart below of a rolling stock.



1. Consider where to put buy and sell signals to get the best return. How about:
 - a. Wait for the stock to hit the very bottom of its downswing, then buy.
 - b. Next, wait for the stock to hit its top, then sell.

In your dreams!

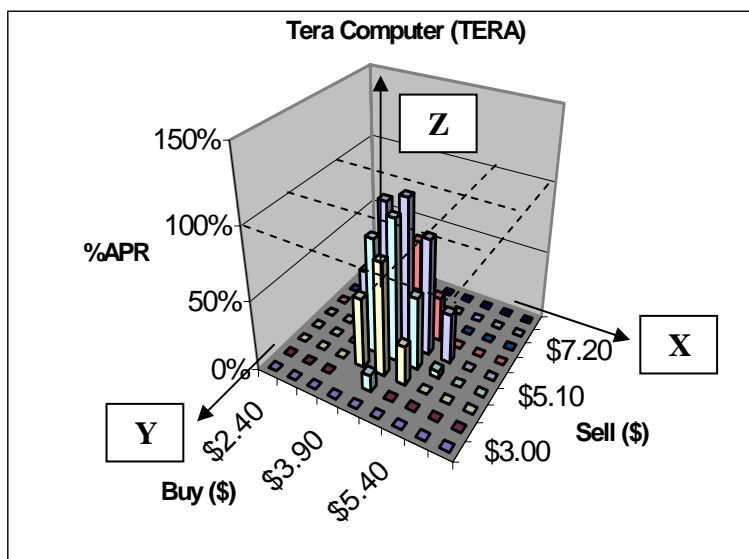
2. Let's take another approach – ROLLING ANALYSIS

(a "what if" scenario):

- a. First, pick a roller with a chart like the one above (one with no noticeable trend, just trading sideways)
 - b. Secondly, pick fixed buy and sell levels and analyze the stock over the time it rolls.
 - c. When it goes down to the buy signal, **buy**
 - d. When it goes up to your predetermined sell signal, **sell**
 - e. Repeat the process through the designated time period
 - f. Your return is the sum of "sells" minus the sum of "buys" less commission.
3. But where do we put our buy and sell levels? There are virtually hundreds of combinations we can try. **Let the computer do the walking!** A spreadsheet of the analysis of the chart shown above for Tera Computer would have returned 106% APR with a buy point at \$4.22 and a \$5.23 sell. (In all of our examples, we include a commission cost of \$20 each time we buy or sell, with an initial \$1,000 investment.)
4. You can see the "**what if**" nature of this exercise. **IF** we had bought and sold consistently over that time period at these buy/sell levels, **THEN** we would have returned 106% APR.
5. What does the analysis say if the buy/sell signals had been \$3.95 and \$5.38? Or \$4.14 and \$5.18? This is where our mountain comes in. Look at the 3-D chart below showing a range for the buy/sell signals in the x

and y-axis and the resulting yield (APR%) in the third or vertical axis.

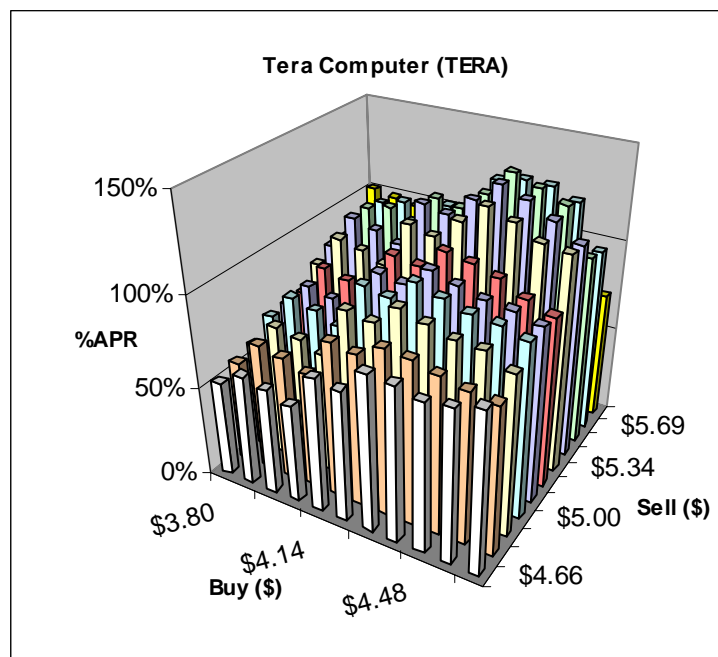
6. For example, if you look at a buy signal of \$5.90, there is no sell signal to give you more than 0% return (the floor of the chart). You must select buy/sell signals that will place you within our mountain of bars.



7. This 3-dimensional chart shows us three things:
 - a. There are specific buy/sell combinations that produce over 100% APR
 - b. There is a range of buy/sell signals where the return is over a handsome 40%.

c. The 106% APR stated in 4 above is actually in the middle of the mountain.

8. To get a better look at our mountain of profits, we can change the scale to show only the range of buy/sell signals that produce adequate returns; A set of "Success Combinations!"



9. Now we see how broad the signals are that will provide high returns. Any combination of buy signals between \$3.80 and \$4.60 with sell signals between \$4.66 and \$5.70 will produce returns no less than 52% APR.

10. Think about what we have done. This mountain of profits is a somewhat irregular surface. However we can get high returns if we stay away from the edges of this plateau. To borrow a page from Japanese industrialist Genichi Taguchi, a "robust" process is one that does not change when expected variation takes place. The operating point is positioned away from the boundaries. In selecting our buy and sell signals, we do not simply pick the combination with the highest yield. Rather, we select signals that place our default position in the center of the "*Success Combinations*."
11. Our most robust investment scheme will be one where our plateau is:
 - a. Flat (Yields are nearly the same over the plateau)
 - b. Wide (Buy range is large, bigger is better)
 - c. Deep (Sell range is large, bigger is better)

The degree to which these three criteria are satisfied would be a measure of the quality Q of our selected stock. In our analysis, Q is designed so that "bigger is better."

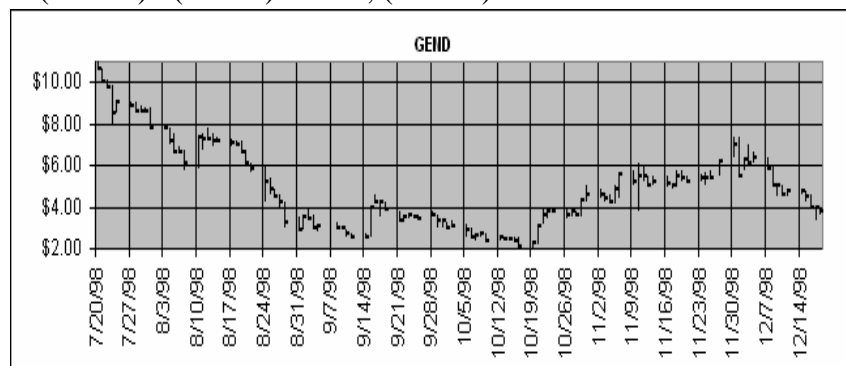
12. A Quality factor for a rolling stock would incorporate these three criteria. However, due to the volatility of the market, a "Q" factor for a stock would be a volatile measure. The purpose for even bringing it up at this point is to help understand the "flavor" of a roller, how much leeway there is in the selection of buy & sell levels. The entry & exit strategies outlined later are far

more important to success here than in finding magic buy/sell combinations based on historical data. The returns on TERA in this example are dramatic, but this is looking in the rear view mirror. Brilliance with hindsight. Going forward we will find a major challenge. However, we understand in some way the opportunities that are ours.

It is important to utilize the *statistical* nature of market variation. Remember, Peter Lynch favored stocks with a formation he called “the EKG of a rock. ...never changing.” We differ with Peter where he says that when we “...guess right, the stock goes north and when we guess wrong, it goes sideways.” *To exercise rollers, we hope it continues sideways!*

6.2b Rolling Analysis - A Lesson

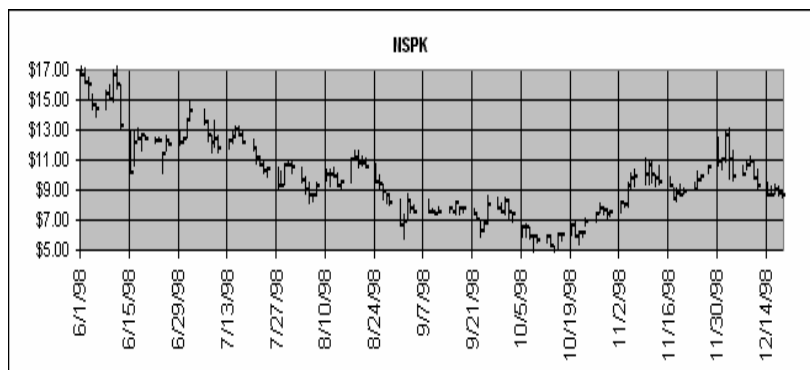
The rolling analysis spreadsheet lets us do some interesting things with historical data. Let’s consider some lessons learned from the rolling stock analysis. We will look at three rollers to appreciate the importance of this lesson: (DNCC) (GEND) (NSPK). First, (GEND):



If we want to show the value of (GEND) as a rolling stock, where should we put the buy/sell channel?

1. First case, choose the time frame between 8/31/98 and 10/26/98 with a channel \$2.60 to \$3.80. We get two rolls and an APR return of 620%! Our rolling analysis selects buy/sell at \$2.90/\$3.51 for the greatest return.
2. Lets take advantage of the larger price rise and select a time frame of 9/28/98 to 12/7/98 with a price channel of \$2.50 to \$6.50. In this case the optimum buy/sell is \$3.50 and \$5.51 with only one roll and a return of 369%, about half that returned with the more narrow channel!

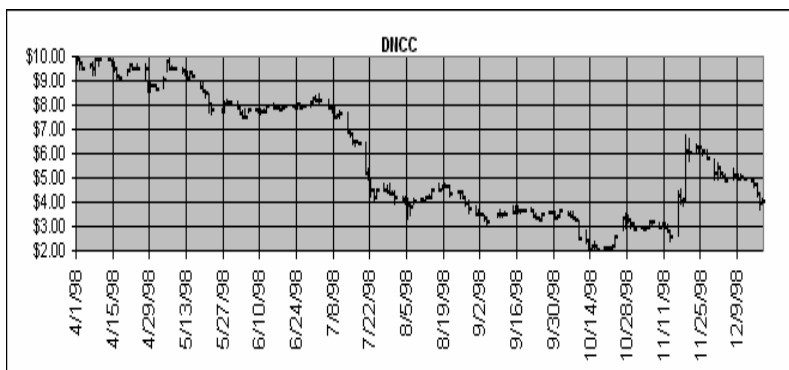
Second, (NSPK):



In this case we have stronger rolls in November with anemic activity in September and October. However:

1. First case, choose the time frame between 8/31/98 and 11/09/98 with a channel \$6.70 to \$8.00. We get three rolls and an APR return of 472%! Our rolling analysis selects buy/sell at \$7.00/\$7.66 for the greatest return.
2. Next take the time frame between 10/05/98 and 11/30/98 to get more of the November increase with a price channel of \$6.00 to \$10.00. Now the optimum buy/sell is \$7.00 and \$9.01 with only one roll and a return of 316%, about 30% less!

Thirdly, (DNCC):



DNCC had a dramatic rise in November. How does that impact our rolling analysis?

1. For the first example on this chart we will choose a time frame between 9/2/98 and 11/18/98 giving us two rolls in a price channel of \$2.55/\$3.50. This returns 392% APR at \$2.79 buy \$3.27 sell.

2. Next take the time frame between 9/02/98 and 11/25/98 to get the big jump in November with a price channel of \$2.00 to \$6.00. The optimum buy/sell is now \$3.00 and \$5.00 with only one roll and a return of 597%!

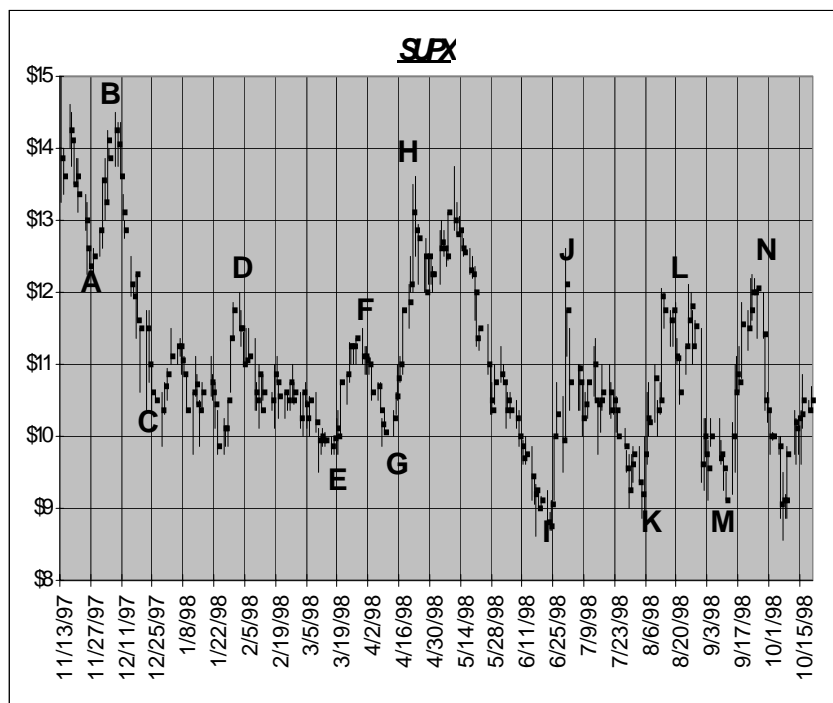
So What? If you have stayed with this so far, now is the time to ask what is the value of all this. Let's summarize:

1. We found in the first two examples a greater return when we pursued a modest path, the smaller channel with more rolls. The last example had a dramatic price increase that brought a greater return than with a smaller channel.
 2. The last example helps us understand how the volatility in the market can thwart the best-intended strategies. It takes uncommon discipline and diligence on our part to define our own set of rules, and to then stick by them.
 3. In any case, what we have observed with these three examples is a play on history. It is easy to look at what has happened and predict with hindsight what would have been best. It is up to us to find comfort in a set of entry and exit rules for playing rolling stocks, then adhere to our principles! Follow our rules!
-

6.2c Rolling Paper Trades

Paper trading can be a rewarding and educating experience. It simply means we simulate a trade by actually investing paper money, writing down the details of each transaction. We outlined an approach with a Paper Trade Worksheet back on pages 54 and 55. Noted market players have said paper trading just isn't the real thing. That lessons are learned only when you have your money on the line with the emotion involved. Nonsense! Should a track star who pole vaults not practice on the field because it isn't the same as when he is in the track meet? Should an accountant not practice his skill because it is not the same as during an audit? Of course it is different with your own money invested. But how about being comfortable with backup plans you have developed for different scenarios, *when* they happen. It is always better to have a fall-back position in mind when going to battle. Paper trading can help us develop those.

- a) Paper trades: Let's take a price chart on an example roller and try, as though we didn't know what lay ahead, to buy and sell for maximum return.
- b) Definition: A rolling stock is one where the price pattern rises and falls at least 10% of its value, several times during a one-year period (several could be anything from 3 up).
- c) Look at a good example on the price chart on (SUPX) below from November 97 to October 98.



d) Observations:

Seven distinct rolls exist in the 11 months – It is a roller!

A to B: 14.1%	This identifies the percentage gain for each of the 7 rolls. The table below identifies the final result of having played all the rolls with the maximum return possible. This is for different combinations of dollars invested and commission costs.
C to D: 13.3%	
E to F: 15.2%	
G to H: 30.4%	
I to J: 38.6%	
K to L: 29.9%	
M to N: 32.2%	

We calculate the total return over these eleven months as if we were perfect and caught the very top and the very bottom of each roll. These results are shown in the following table calculated with several combinations of dollars invested and commission costs. We want illustrate two important points with this example.

1. **Spend the cash** **Commission**

		\$8	\$12	\$20	\$45
Invest	\$500	147%	134%	107%	23%
	\$1,000	160%	154%	140%	98%
	\$5,000	171%	170%	167%	159%
	\$10,000	172%	172%	170%	166%

2. **Let \$ compound** **Commission**

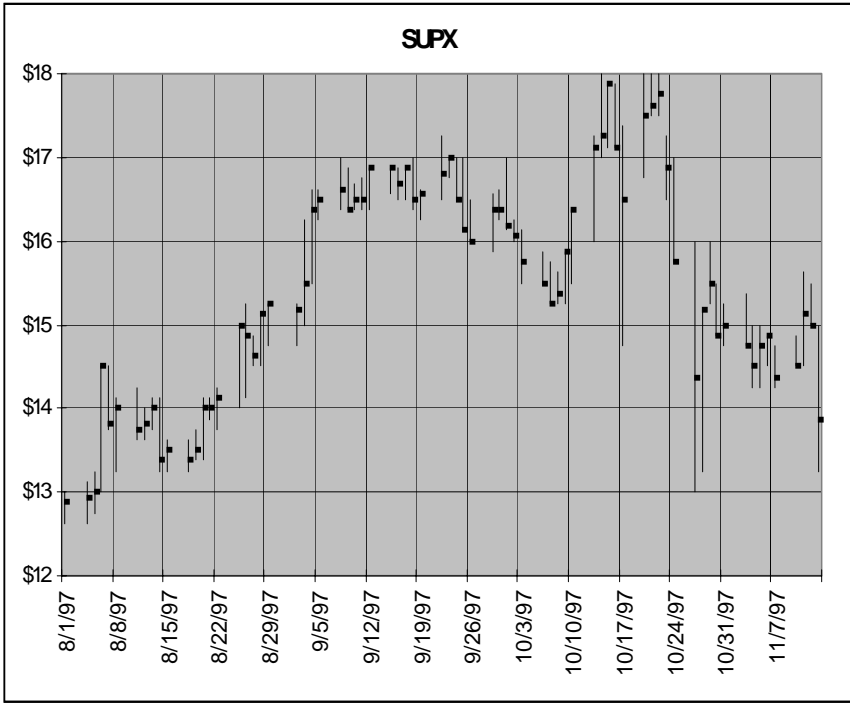
		\$8	\$12	\$20	\$45
Invest	\$500	291%	262%	205%	26%
	\$1,000	320%	305%	277%	187%
	\$5,000	342%	340%	334%	316%
	\$10,000	345%	344%	341%	332%

1. In the first case, we use the increase to pay bills or go to a movie, investing only the initial amount on each subsequent roll. The second case, all of the return is reinvested in the next roll, letting the increase compound over the eleven months. This result should encourage us to let our money roll, to keep it working. Re-invest the profits.
-

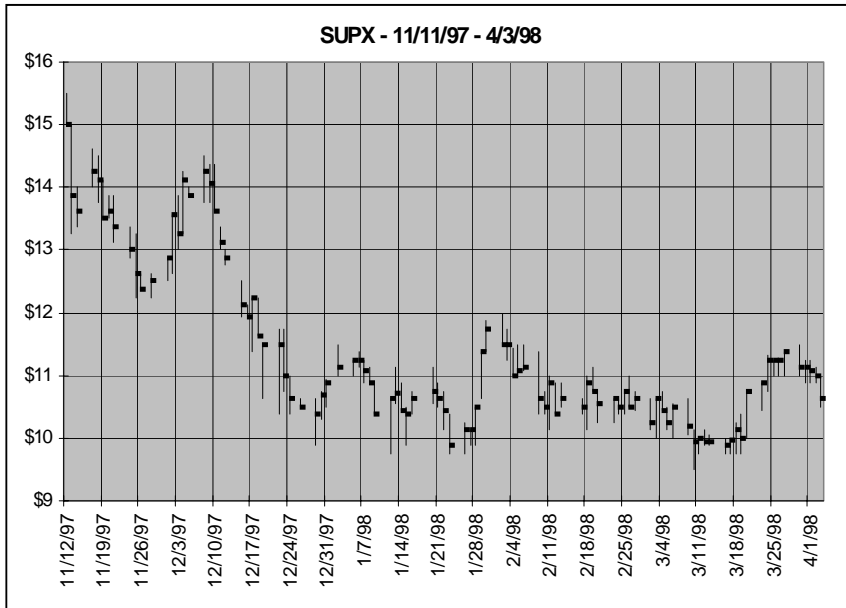
2. Notice the bold cells in the tables, showing poor performance. It is much more difficult to make a profit while investing small amounts or paying high commissions.

We will use this stock to simulate a trading record, that is, execute a paper trade as though we didn't know what was going to happen the next day. This is called "back-trading" because we can use what *has* happened to develop trading skills going forward. Let's go back into the price chart and try our hand simulating a real set of trades with historical data.

Having found a roller we are now ready to play: (SUPX), has shown some wild swings in the past and meets our selection criteria. It is November 13, 1997 and we have watched the price decline the past three weeks and are waiting to buy in.



So, lets watch the next developments with SUPX:



The actual data for the next three weeks is shown here to help make the important decisions:

	Date	High	Low	Close	Volume
SUPX	11/13/97	15	13.25	13.875	57500
SUPX	11/14/97	14	13.375	13.625	19100
SUPX	11/17/97	14.625	14	14.25	27100
SUPX	11/18/97	14.5	13.75	14.125	21800
SUPX	11/19/97	14.125	13.5	13.5	25100
SUPX	11/20/97	13.875	13.5	13.625	35300
SUPX	11/21/97	13.875	13.125	13.375	33600
SUPX	11/24/97	13.375	12.875	13	33500

SUPX	11/25/97	13.25	12.25	12.625	30600
SUPX	11/26/97	12.625	12.375	12.375	39900
SUPX	11/28/97	12.625	12.25	12.5	5800
SUPX	12/1/97	12.875	12.5	12.875	21300
SUPX	12/2/97	13.5625	12.625	13.5625	16600

We had a false up-tick on 11/17, but got two in a row on 12/1 with the price at \$12.88. A buy-stop at 2% above this price equals \$13.14. That is the order we place to continue our strategy. It fills the next day so we are in the market at something near \$13.14. Remember, this is a market order so we are not sure of the execution price.

What follows refers to the Paper Trade Worksheet

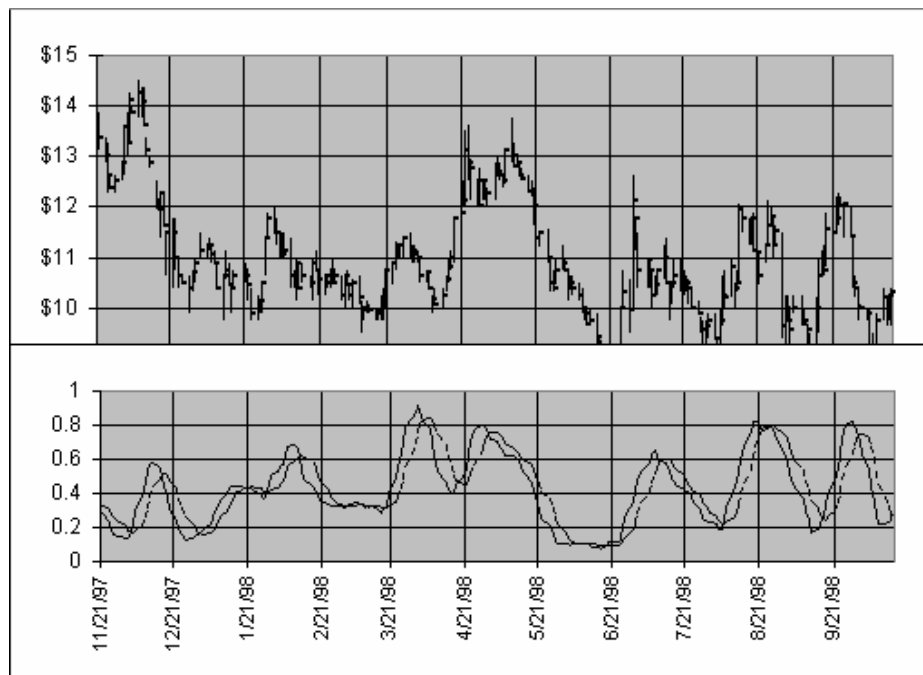
shown on pages 54 and 55: We put this value in column B, with the date 12/2/97 in column A. We use \$2,000 for paper trades to keep commission a small percentage of the action. However, we always include the commission figure under heading N at the rate with our current broker. So, \$2,000 goes in column C and we calculate the shares purchased for column D: $[\$2000 - \$8]/\$13.14 = 151$ shares (with an \$8 commission cost that is placed under heading N).

Next calculate what the break-even sell price must be as a reference to keep honest. The sell price must be high enough to cover two commission charges, one to buy and one to sell. Therefore, break-even = $[2,000 + 8]/151 = \$13.30$ (remember, the \$2,000 already includes one commission since we bought stock with only \$1,992).

We also like to have in mind what we expect to get out of this type trade. If our target is 10%, the price must reach $[2000 \times (1 + 0.1) + 8] / 151 = \14.62 . That does not mean we will sell when it reaches this level, it just provides a guide as we move forward.

Take these ideas and continue the paper trade on SUPX. See how close you can come to the ideal returns shown in the earlier tables. If we get 50% of those results we are in excellent shape.

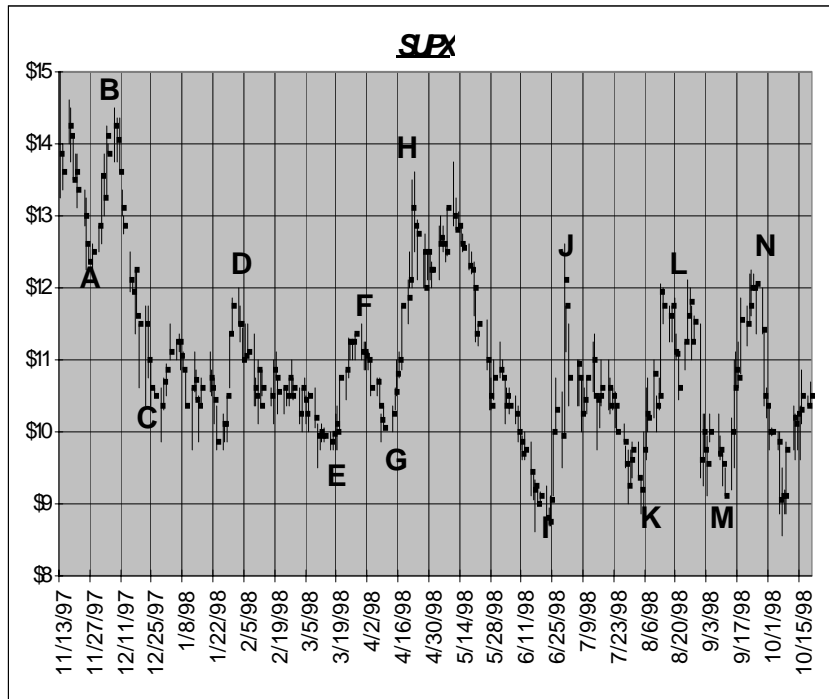
As a help to picking entry and exit points, the Stochastics technical indicator is a good predictor for rolling stocks. To see how this indicator might help, we have included it below with the chart repeated for SUPX. Include this as you continue your study of this ticker with your paper trades.



6.2d Rolling Stock Strategies

Let's pick up where we left off last chapter, doing a paper trade on (SUPX) to see how much of the potential gain we can pull out of a strategy.

Looking again at the price chart from 11/13/97 to 10/1/98, we see the seven major rolls as identified earlier:



Seven distinct rolls

A to B:	14.1%	These figures represent “bottom-to-top” gains, termed “ideal.”
C to D:	13.3%	
E to F:	15.2%	
G to H:	30.4%	
I to J:	38.6%	
K to L:	29.9%	
M to N:	32.2%	

Let’s see how realistic these yields really are.

1. Rolling Stock Strategy #1

Before we begin a paper trade on this roller, lets re-examine the strategy outlined earlier. This strategy requires monitoring a stock each day to watch for signals that tell us when to buy and when to sell. In this we buy the stock when:

- a) It appears to bottom.
- b) Then has successive up-ticks.
- c) Then reaches a price some set value above the close on the last up-tick.

[This reduces our risk of buying a stock near its bottom, then watching it continue down]

We then sell the stock when:

- a) It appears to reach a top.
- b) Then has successive down-ticks.

c) Then reaches a price at some set value below the close on the last down-tick.

[This reduces our risk of selling a stock near its top, then watching it climb further into the sky. That is, we have put no arbitrary limit on how high the stock can go. We let the stock tell us when to get out.]

We are asking for confirmation on both the buy and the sell that the stock is indeed moving in the right direction. If we only place a trailing stop somewhere below the current price, we can be whipsawed by momentary spikes that would execute the sell-stop before its time.

Will it always work? Certainly not. Will it work often enough to justify its use? The only way we will know that is by having market experience. Paper trading can give us that experience for only the cost of our effort. Experience will equal success.

2. (SUPX) Rolling Performance

Lets return to our consideration of the (SUPX) price chart at the beginning. Working each of the seven rolls in the chart using Strategy #1, the following returns are achieved (Buy: 1 up-tick plus 1% buy-stop, Sell: 1 down-tick minus 1% sell-stop):

Roll:	Buy	Sells	Return	Ideal
A-B	\$12.63	\$13.92	9.9%	14.1%
C-D	\$10.79	\$11.14		
	\$10.37	\$10.52		
	\$10.61	\$11.39	2.8%	13.1%
E-F	\$10.07	\$11.01	9.0%	15.2%
G-H	\$10.35	\$12.75		
	\$10.86	\$10.64	22.7%	30.4%
I-J	\$9.15	\$12.25	26.7%	38.6%
K-L	\$9.72	\$9.28		
	\$9.85	\$11.63	6.4%	29.9%
M-N	\$10.10	\$11.29	11.4%	32.2%
	Simple Total Return		88.9%	185%
	Compounded Return		227%	434%

Notice, on the C-D roll-up we had three buys and sells, not all profitable. Similarly two each for G-H and K-L. We said earlier if we were able to get half of the ideal we were in excellent shape. (SUPX) was a good roller for this strategy.

Observations: There is a give-and-take as we set parameters for trading. If we increase the number of up-ticks required or % above buy-limit before we buy, we will eliminate a lot of the noise that results from the normal volatility of this type stock. That means we won't buy stocks going no-where as often. However, if we use too many signals, we lose some of the value in the trade. That is, by the time a stock has risen two or three up-ticks, the buy is so close to the sell we don't get much return. We can virtually eliminate any whipsawing, but miss some good trading opportunities. Whether we use one, two or more depends upon how fast the

price increases or decreases! If the rise is a two or three-day spike, two up-ticks will miss it. If the rise takes a couple of weeks, three or four is not unreasonable. This is where the experience of the market provides insights working with different stock price patterns. *Market insight!*

3. Rolling Stock Strategy #2

Look at the price chart for (SUPX) again at the first of the section. If we bought the stock near its bottom at point A, we could simply ask ourselves what would be a good return and set that as a target on the upside. We could do this if we had confidence in the company's fundamentals and were certain it was going to survive. In this case, 10% above a price of say \$12.60 would be \$13.86. We can place a sell-limit at that level and simply let nature take its course.

In this example, this order would fill on 12/3/97 and we have our 10%. If a stock is rolling consistently within a channel where the top & bottom are reasonably predictable, we can buy the stock in the same way. This would be a little tough with (SUPX) in this time frame but look to the right in the areas between I and N. The support and resistance levels here are pretty well defined.

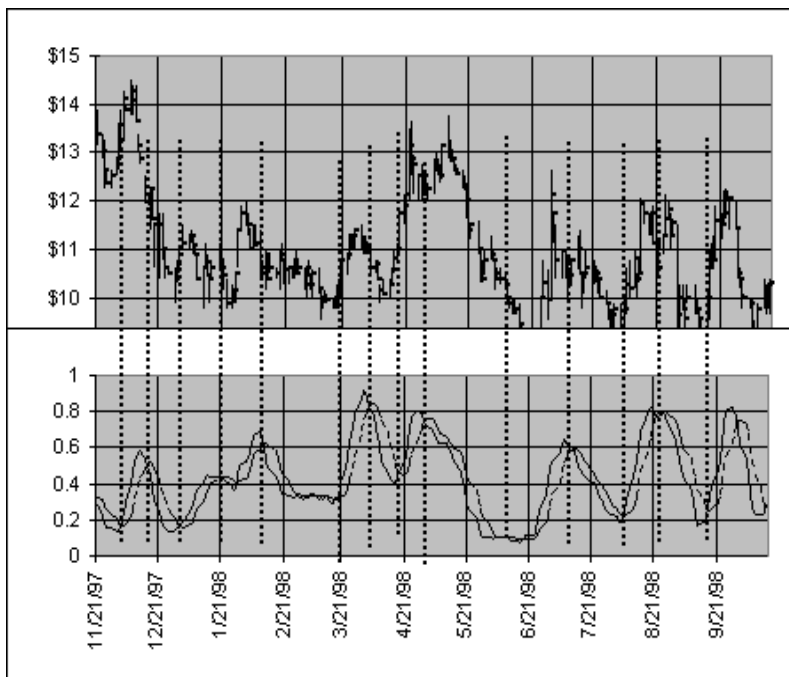
Had we sold the stock near J, we could put in a buy-limit order at something over \$9 using the prices around I as a guide. Let's pick \$9.20 for a little cushion, and wait for the order to fill at K, which it does on 8/4/97. Next, place a sell-limit at a reasonable increase. 10% would bring it up to \$10.12, but that is only half the distance to the previous

resistance level at J. Be aggressive and set the next sell limit at \$11.25 and wait! This fills on 8/13/97, and on it goes. See how much fun it can be to take aggressive positions doing paper trades!

4. Stochastics for Buy-Sell signals, Strategy #3

Refer to the price chart with the Stochastics indicator below. We learned earlier how this indicator is a measure of when the stock is over-bought or over-sold. A good rolling stock can use this indicator to predict buy and sell signals.

The critical signals are where the stochastic curve crosses

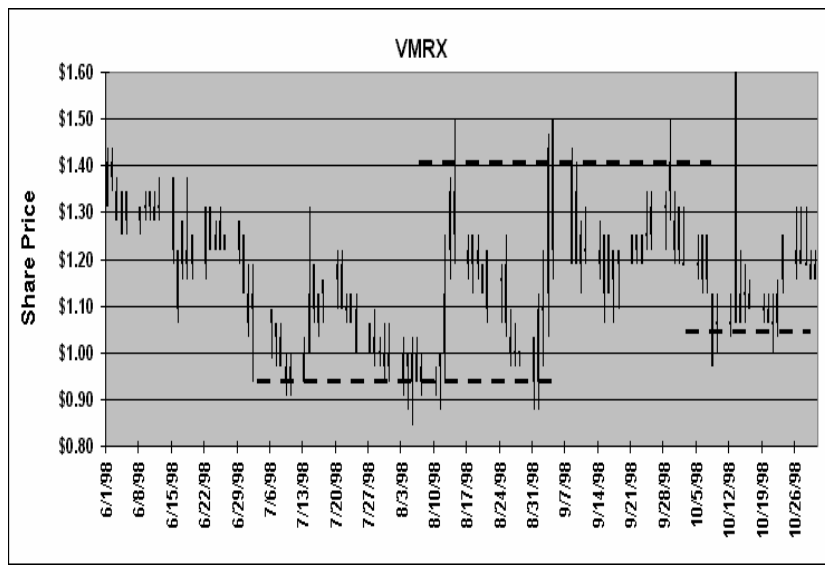


its moving average, sell at the top, buy at the bottom. The dashed lines help identify these points. Take time to examine this tool while working with rolling stocks. It can be very helpful with smooth rollers having a lot of volume. The statistical nature of the indicator thrives on volume. It is less reliable with low volume stocks with erratic price patterns.

6.2e Timing

Now let's consider the importance of timing to bring this in for a landing - how to maximize returns by the appropriate use of time.

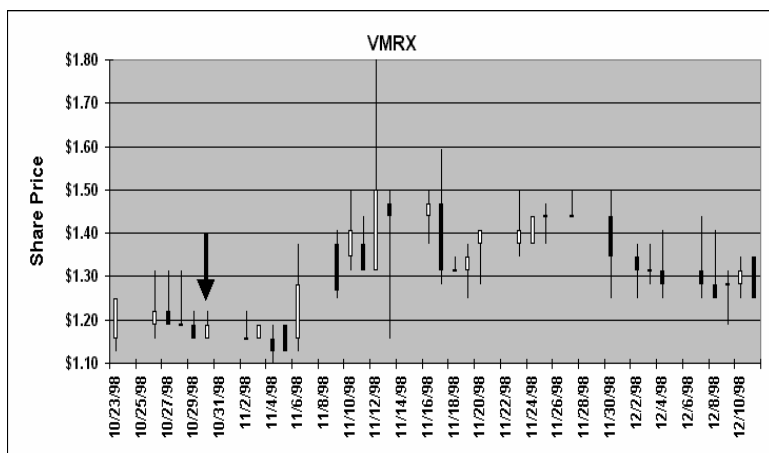
1. Consider the price chart on a roller (VMRX). What you see is the rolling pattern in about a 40 cent channel centered at \$1.20. This stock had tested a support level at \$0.95 three times in a couple of months, then drifted upward, maintaining a resistance level at \$1.40. It seemed to then suggest a new support about 10 cents above the previous level. It closed at \$1.19 on Friday October 30th, the day we are now ready for action.



2. To our point on timing, what would have been a good target sell if we chose to buy at that level? What is our entry and our exit? We've been taught to select conservative preliminary Buy and Sell signals and estimate a rate of return. In our case the closing price on that Friday for (VMRX) was \$1.19. A conservative Sell level would be between \$1.30 and \$1.40, returning 8.5% to 17.6%. Let's split the difference and shoot for \$1.35 which would return 13.4%.
3. We can enter the buy order as a "market" or a "limit." On a "market" order we agree to buy the stock at the current market price, whatever that is. A "limit" allows us to specify what we will pay for the stock. If we place the order in the evening waiting for it to be filled the next morning when the market opens, a market order may surprise us. The "open" price is not always what the "close" was the day before and we may pay more than planned (or less). But, a limit order may not get filled and will usually cost us a little more as well.
4. The market maker sets the price where he will sell (where we buy, the "ask") or where he will buy (where we sell, the "bid"). A quotation lists the stock trade price, the higher (ask) price where we buy or the lower (bid) price where we sell. The difference is how the market maker earns his money. He is buying low, selling high!
5. Brokers usually do not make money on limit orders, where we specify that we want to buy (or sell) a stock

only at a certain price or better. That's why many online brokers charge extra for limit orders and why it may cost us to guarantee that we buy (VMRX) at \$1.19 above. Many on-line brokers charge an additional \$5 for a limit. (Shop around, some don't charge the limit premium)

6. For our upside exit, we would execute a GTC (good 'til cancelled) limit sell order at \$1.35. This way, the broker's computer will sell the stock at that price if it reaches that level.
7. Next, what is our exit on the downside? If the stock just starts going down, where do we bail out? For this example let's use 30% (\$0.83) as the downside exit. This level must be one we are comfortable with. We must decide what that is before entering the arena. We now know what we are going to do regardless of which way the market turns.
8. All that behind us, lets see how we did. The next chart shows price performance from our buy-date (10/30/98) to the second week in December (the arrow identifies our entrance). This is a "Candlestick" chart showing the open, high, low, and closing prices in a way to show the relation between the open and the close. The body of the candle shows the difference between the open and close price for the day, white if the close was higher than the open, black if the stock lost during the day. The whiskers on the top & bottom (called the upper and lower shadow) represent the high and low during the session.



9. We see from this chart that the price closed above our \$1.35 price on November 10. Our return, letting the broker execute at our chosen limit, would have been 13%. Had we sold the stock for the closing price of \$1.41, our return would be \$0.22 or 18%, excluding commission (a \$1000 investment with \$12 commission twice would still return 16%). That means we would have had to watch the ticker closely to catch that peak.

10. Looking back, our choice of a \$1.35 may have been too conservative. We might have observed that the higher support level should have pointed us to a higher resistance level as well. Had we chosen \$1.45 as a sell it would have occurred on November 12th with a close of

\$1.50 giving us 23% after commission; ($23 * 365/13 = 646\%$ APR).

11. Not a bad return in 11 days. But “not bad” compared to what?
12. First convert this return into an Annual Percentage Rate (APR):

$$13\% * 365/11 = 430\% \text{ APR.}$$

APR does not mean it must roll for the entire year but it gives us a valuable benchmark for reference.

Time plays a critical role! To achieve an actual 430% APR at the end of the year we would have to repeat this experience on (VMRX) 33 times.

13. The point on timing lies in our ability to do three things:
 - a) Select buy/sell channels that will provide the greatest number of buys and sells during the roll of the stock. We can wait for the home run or we can beat out a lot of one and two base hits.
 - b) Keep our money working for us, that is, when we've sold a stock and have money waiting to invest, have alternate rollers we can dump the money into while we wait for the one to roll down to a buy level. We call this staggering and it allows us to keep several rollers in play most of the time.
 - c) Let the computer do the walking with GTC orders where we define our sell points and not have to

keep glued to the computer screen 8 hours a day.
That frees up our time for more profitable activities.

- d) Since we cannot have two active special orders at the same time on the same stock, we can't have an upside sell order *and* a stop-loss on the downside. We have to be involved, watching one or the other. If we have a sell-limit at a 10% gain, the only safety net to protect our capital is our own actions.

6.2f Rolling Stock Tips:

1. Play inexpensive stocks. A \$1 increase on a \$50 stock is only a 2% gain. That same \$1 increase on a \$5 stock returns a whopping 20%. Understand the value of leverage with lower priced stocks. Additionally, lower priced stocks roll more frequently than expensive stocks.
2. Select stocks from a price bar-chart that show a pattern of roll's within some channel, between a low price (bottom of the channel, called *Support*) and high price (top of the channel, called *Resistance*).
3. Select preliminary Buy and Sell signals at conservative points and estimate a rate of return:

$$\text{Return(\%)} = (\text{Sell Price} - \text{Buy Price}) / (\text{Buy Price}) \times 100$$

If the calculated return is less than about 10%, don't waste your time.

4. When a stock price is decreasing to its support level, don't buy just because it reaches your predetermined "buy" point. Wait for the price to touch that support level and start back up. Never put a *Good til Canceled* (GTC) order to buy the stock as it decreases. (Too many rollers just keep going down after buying when the price has dropped to a buy point)
5. A GTC order is okay as the stock is rising toward its sell signal. In fact, this is a good way to maintain the upside exit rule. In addition, a GTC on the upside can help us catch a momentary blip that we would miss unless we sat at the computer all day watching the stock movement. Not a very pleasing prospect.
6. Confirm the value of a rolling stock with fundamental and technical analysis before jumping in. Don't buy just because it's low-priced and appears to be on the down cycle.
 - a. If a stock looks strong as it moves up to our sell point, we can chose to cancel our sell order and hold the stock as it moves beyond its resistance level. The Stochastics technical indicator can assist us in making that decision.
 - b. We can also let our better senses tell us to sell a stock if it looks weak before reaching our chosen "sell" point.

- c. Since we know that rolling stocks will go back down, we must strive to sell the stock before that occurs. Our entry & exit rules, that is, our strategy for dealing with rollers, makes it clear we bought the stock to sell at a profit.
- d. Use the Stochastics to help make buy and sell decisions on good rollers.
- e. Rolling stocks are not eternal. Each identified rolling stock has a shelf life and will stop rolling. We cannot set our buy & sell signals with the computer and then go sit on the porch. Rather, it takes a lot of work, daily review of the status and then decisive action as we *follow the rules* for our strategy.

7. Caveats:

- a. A trending stock pattern, one moving sideways, is usually a period of indecision in a stock's history. That is, it will likely move away from its channel up or down. In the trend-less (sideways) pattern, rollers may only roll two or three times before making their move. Five rolls is about the max.
- b. Rolling stocks are difficult to identify because by the time they expose themselves, they have often stopped rolling (at least in the same channel).

- c. To play rollers effectively, we must understand this is a trading strategy, not an investment strategy. Be buy to sell, not to hold.
- d. Paper trading can help us develop both skills and market insight. There are no silver scientific bullets to do our thinking for us. This is both an art and a science.
- e. Remember from the chapter on Risk, news overrides everything else, fundamental, technical, or any other analysis. Check for current news on a stock before taking a position.

6.2g Conclusions

1. We observed the application of rolling stock strategies on a rolling stock, (SUPX). This was on a single stock and we will surely modify the strategy we select as we develop market insight through a lot of paper trades. A very important point here is that successful trading involves a lot of intellectual input on our part. That is, we can't simply develop a routine, put it on auto-pilot and go sit on the porch.
2. We have discussed three different strategies for playing rolling stocks. They can be used independently or in concert, looking for agreement to strengthen our position.

3. Strategy #1 uses alternative buy-stop and sell-stop orders to get the most from a roller. Since most internet brokers will allow only one active order on a stock at a time, the use of a sell-stop precludes the use of another sell-stop placed as a safety net or “stop-loss.” It is okay to use this order as a trailing stop, moving it higher as the price moves up, protecting our paper gains as it moves. We cannot be careless and wait for the price to increase before putting in this sell-stop. We must protect our down-side at all times with some level below the purchase price where we’re not willing to lose more. If we must, keep a “mental” stop-loss mindset, ever ready to act when appropriate. Remember, the key is not in always making correct picks, it is in cutting our losses quickly on those that do not follow the script, to lose as little as possible when we are wrong.
4. Chart reading can be a rewarding and enjoyable task. We have only talked about the stochastics indicator to predict buy and sell triggers. There are others we will discuss in future chapters. There is a wealth of information available free on the internet. For the serious mind, charting services will pay for themselves easily as they become a default exercise in picking and working rolling stocks. We use TC2000 as a critical tool in selecting our selections. Serious and detailed study of the Investors Business Daily is another important tool.
5. There is a light at the end of the tunnel! While this may seem overwhelming at first, a routine can evolve which takes a minimum of effort. It does not require sitting at a

computer terminal throughout the trading session. Day-trading is a difficult and seldom rewarding activity. The focus of this book is to develop principles we can use in the evening for maybe 30 minutes each day. By setting alternative orders with our brokers, we come as close to auto-pilot as possible.

6.3 Beyond Rollers

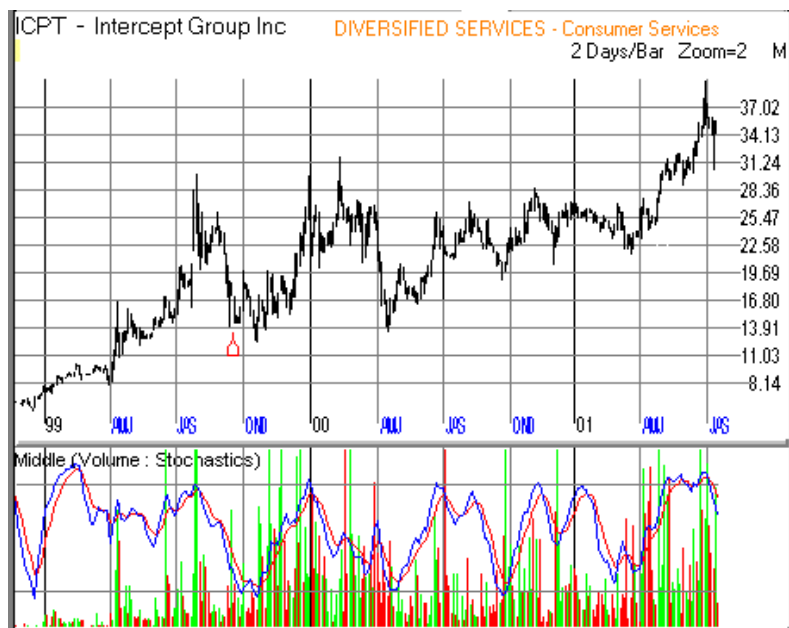
When we began making weekly picks several years ago, as an offering for our web page, we studied charts diligently finding stocks that had rolled and would hopefully continue to roll. We found moderate success applying the rules and methods outlined in previous chapters. However, certain patterns kept recurring that seemed to say, “There might be a better way!” Let’s consider some of those patterns as we detail the evolution of our trading strategy.

The chart below was selected in September of 1999. The small figure just below the price bars marks the date of the pick. Now consider what we could see then; Only what *had* happened up to that time.

Before we continue with *this* discussion, lets step back and revisit a point made earlier in the Rolling section. We said that rollers were hard to find because:

- a) They typically roll two to five times before moving up or down to a new channel.
- b) By the time they reveal themselves, they are ready to move out of that channel.

That means we are often making a rolling stock pick on the basis of a single promising roll. Such was the case in the chart below.

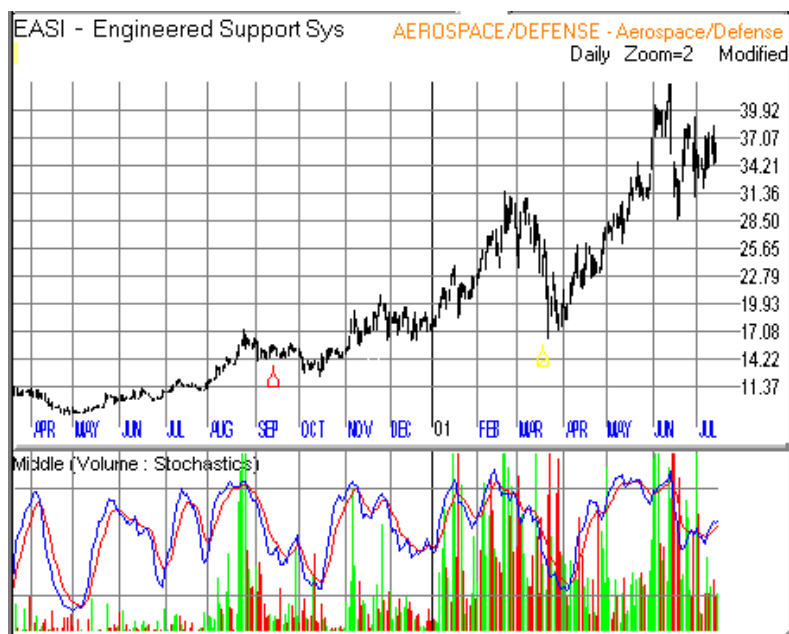


ICPT Rolling Pick – 9/17/99

In this example, we got a couple of rolls within a dandy \$10 channel before it moved on and up in the middle of 2000. If we expanded the chart we would see some interesting shorter rolls in October and November of '99. But whichever channel we pick, we see the short duration of the rolling pattern. Questions: Would we be smart enough to capture a decent part of the price moves? Would we be happy to walk

away from the subsequent price increases in the first half of 2001, because it wasn't then a roller?

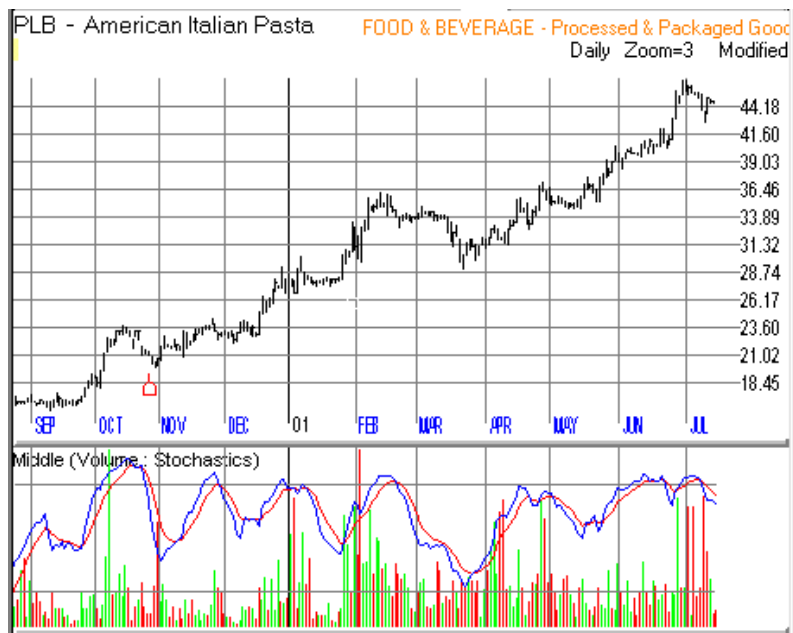
A year later, 9/15/00, EASI was selected among our weekly picks seeing the potential for a good roll. Remember, all we could see was the price action up to that date. What we did see was about a \$2 channel forming on a \$14 stock. That fit our criteria for at least a 10% possible return.



EASI Rolling Pick – 9/15/00

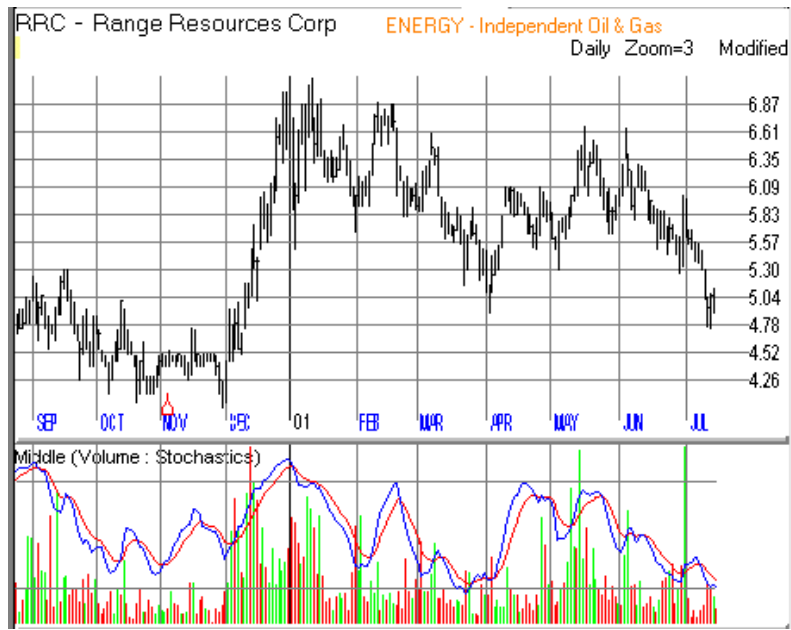
We got about one good roll, but look where the price went!
Questions: Could we have captured some of the subsequent gain? Which rolling stock technique contains the answer?

A month later, we bump into the same questions.



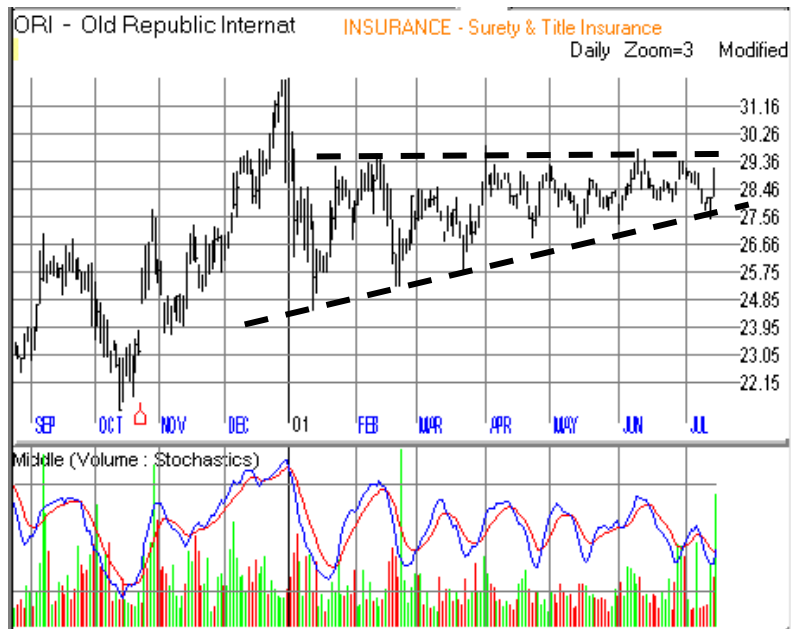
PLB Rolling Pick – 10/27/00

And in another month, we see the same dilemma. It seems our rolling picks keep leaving money on the table. **Note: We have chosen these examples to illustrate the point. During these weeks our picks had both good and bad rollers to work with.**



RRC Rolling Pick – 11/3/00

Let's look at one more chart to make another point about rolling stock patterns. In the selection below, the pick was made and brought a good return on the first roll. If we waited for the stock to go down to its support level to buy back in, we missed an opportunity. More dilemma! But the important point this chart makes is the pattern after the first of January. Notice how the rolls become less pronounced as time progresses. This is called a descending triangle and spells the death of a good roller.



ORI Rolling Pick – 10/20/00

As we struggled with the dilemmas posed by examples like this we made an executive decision and added a new category to our Web site offering – ***Breakouts!*** These were tickers we felt ready to move up and out of any channel they had been in. We weren't expecting a nice roll but a marked increase in price in the near-term. We were saying that some ticker behavior justified a riskier approach and we expected a higher return on those that met our expectations.

Let's review a one-week performance in 2001 to illustrate the principle. Of Friday, April 6, 2001, the following ten

rolling picks were published, along with the five breakout picks shown:

WatchList Tracking						
Report						
Symbol	Company Name	Date Added	Entry	Close	% Change	# Days In
UOCR	Urocor Inc	04/06/2001	8.88	16.90	+90.32%	101
MTH	Meritage Corp	04/06/2001	26.60	50.60	+90.23%	101
DFXI	Direct Focus Inc	04/06/2001	26.25	48.05	+83.05%	101
EASI	Engineered Support...	04/06/2001	21.88	36.54	+67.00%	101
BEV	Beverly Enterprises I...	04/06/2001	6.33	10.20	+61.14%	101
ABFS	Arkansas Best Corp	04/06/2001	15.31	24.34	+58.98%	101
SP-500	Standard & Poors 500	04/06/2001	1128.43	1202.45	+6.56%	101
DBRN	Dress Barn Inc	04/06/2001	24.00	22.50	-6.25%	101
SYMM	Symmetricom Inc	04/06/2001	14.50	12.51	-13.72%	101
FST	Forest Oil Corp	04/06/2001	29.54	24.98	-15.44%	101
XTO	Xto Energy Inc	04/06/2001	25.30	13.55	-46.44%	101
					+34.13%	101

Rolling Picks

WatchList Tracking						
Report						
Symbol	Company Name	Date Added	Entry	Close	% Change	# Days In
MDVI	Movie Gallery Inc	04/06/2001	7.44	22.25	+199.06%	101
KMX	Circuit City/Carmax ...	04/06/2001	7.70	15.88	+106.23%	101
EDO	Edo Corp	04/06/2001	13.70	20.50	+49.64%	101
DYII	Dynacq Internationa...	04/06/2001	17.13	17.90	+4.50%	101
BPT	Bp Prudhoe Bay Ro...	04/06/2001	16.54	15.24	-7.86%	101
					+70.31%	101

Breakout Picks

The data in these two watch lists was compiled on July 16, 2001. That means it had been 110 days since the picks were made on 4/6/2001. The Entry and Close prices show what has happened to the price during those 110 days. The

%Change for each is what a Buy & Hold investor would have seen during this time, with no short term trading taking place.

The S&P 500 index is included to show what the market did during that time period. It is that index we hope to beat as we perfect our trading strategies. Six of our rolling picks did beat the S&P, with four coming in below.

The average return of all ten picks was a respectable 34%, without any short-term trades in between.

On the Breakout side, three were well ahead of the S&P, with only one negative, for an average return of 70%. That is the higher return we expect from the Breakouts.

It will be instructive to look at several of the charts in this group to highlight the added returns possible as we trade the rollers and breakouts. However, we need to step out of the picture and look back at how these picks are chosen. The data-base from which these tickers are selected has a great deal to do with the returns achieved.

6.4 The “Pick” Data-Base

Certain fundamental and technical criteria must be satisfied before a company will be considered as a candidate for our weekly offering. The following outlines the steps taken to build the data-base from which the tickers are chosen.

1. A list of tickers is assembled, having all passed tight screens with regards to *fundamental analysis* (they are solid companies with good prospects for future growth). The criteria considered in this screen include EPS, Relative Strength, ROE, Volume-history, Accumulation/Distribution rating, and Growth Rate. The *Investors Business Daily* provides current ratings for most criteria, from 1 to 99. (For instance, a stock with an EPS rating of 85 has a better performance record than 85% of all other traded stocks). Candidates for the weekly list must be rated above 80 to make the cut.
2. A “News” screen must signal *no current bad news* in the press regarding that stock. This is an issue that can cause the best of stocks to take a tumble for seemingly no reason. A quiet “downgrade” by a mutual fund analyst can spell big trouble. The news is checked on the day the picks are published.
3. Part of this “News” screen is a review of the sector or group a stock is in and how that group is doing against the rest of the market. Again, the IDB provides the resource. Most market pundits agree

that about 70% of a stocks price movement is tied to the market itself. That is, if the market is up, individual stocks follow the lead and generally do well. That also applies to the *sector* a stock is in. If a few of the generals in a market sector, such as “Energy” or “Transportation,” are on the uptake, they will pull a lot of the lesser stocks along with them. Sector rotation is the result where the institutions move their money around from sector to sector, over months or even years time frame. It important to know what a stock’s sector is doing before spending money. I may have a great company identified with all the fundamental and technical data leaning my way, but realize it has a “Group Relative Strength” of 14. That means 86% of the sectors in the market are doing better. It would have to be a *very* strong story for me to buck the heavy traffic and go ahead with my selection.

Will it always work? Of course not. But this is part of the effort to reduce overall risk and to increase the likelihood of success in our trading efforts. We are moving more chips to our side of the table.

4. After the picks make the *fundamentals* cut, they go through detailed *technical analysis* screens, seeing if the timing is right. Are they *near-term* buy prospects?

These four steps outline the criteria for our data-base from which all of our picks are taken.

This is not meant to be a commercial for the web site. Rather, as we have said repeatedly through this work, *one size does not fit all*. Why can one trader make money on a strategy the next trader has trouble with? Emotion plays a large role. We don't react to stressful situations in the same manner. And we will encounter stress along the way with our own hard-earned money on the line.

But another equally important factor is the kind of stocks we choose. That is why we need to see how the stocks are picked for the strategies outlined in this book. There are many different categories of stocks. What fits the classic "Buy & Hold" investor will not be the same companies a "Day-trader" will select. Between these two extremes lie the selections each of us will make.

The intent of the Provident Investor is to reduce risk wherever possible. This is one way we do that. The database from which the tickers are chosen has a *positive* bias. Stocks are less likely to go down, say after they stop rolling. We've been asked why we spend so much time and effort on the fundamentals side when all we are doing is short-term trading? Great question. It is our way of providing a slight edge to the work. Stocks do not stay where they are. They will ultimately trend up or down. Wouldn't you rather have a bias in the price movement that moves up and not down?

With this kind of effort going into the selection of tickers each week, what's our success rate? What percent were successful? If all you wanted was consistent, reliable rollers to put on auto-pilot, with automatic buy and sell signals, so

you could go sit on the porch, not many. Again, Rolling-stocks do not continue to roll. Rollers have moved into a "trading range," which is usually a period of indecision, not knowing which way to go. This period may last only two rolls, but rarely more than say five. They will often move to a new price level and roll a bit more. But their nature is continually changing.

So why do we deal in Rollers? To make money. Sure, money can be made buying low and selling high, which is all rolling stocks is about. But lets expand our vision and accept the dynamics of the market. An important dynamic is the fact that in the balance, stocks with good fundamentals are more likely to increase in price than a company on the rocks. Our data-base of good fundamental stocks provides the bias for increase. We let the rolling nature of selected tickers ride on that positive bias. Companies selected in this manner are much less likely to "roll down and out of our channel!"

Another dynamic of market-action is there will be winners and there will be losers. Anyone who has had any success in trading accepts this as fact. All of our picks won't work out. So how do we make money? As the market adage goes, "We cut losses short and let our profits run." That is, we make a lot of money on the winners and lose little on the losers. Think about this carefully. If we set up a strategy to sell with say a 10% profit, and maintain a stop-loss to protect our capital at 10% of our purchase price, what percentage of our picks must succeed for us to make money? If half our picks are winners, we will have half losers. The 10% gain will equal the 10% loss and our return will be a wash. That may be one of the most important reality-shocks in this book.

We must take advantage of every opportunity to *increase* our chances. The market is a tough task-master with large measures of uncertainty. Certainty is a play on history. Certainty is in the past. It is essential to have a profound reverence for the market since it can make dramatic moves with no rational motive. Rolling stocks are no exception. This is why we take these detailed steps to heighten our chances for success.

I have never known a truly successful trader who rode in on someone's coat tails. Market success comes not from finding the silver bullet, the perfect system, the Holy Grail of investing. Rather, each trader brings his/her own risk tolerance, expectations, intuition, training and a host of other issues. All these, taken together, make each of us very unique and different. As we've said, what works for one will not work for all. Each individual, in their quest for the system that for them works best, must encounter many different options. Experience must be gained in the good, bad, and ugly of as many as possible. The difference between success and failure in the market is razor thin. That balance is tipped predominantly to those that learn as much about themselves as the market.

What a great combination to master them both. Those interested in making a reasonable profit with the challenge of being involved with charts, ready to pull the trigger when opportunity rears its attractive head, this may be the ticket. However, it cannot be done successfully without spending

some time and effort. The Pro-fundity picks are made to help this effort. Paper trades can provide experience at minimal cost. On our part, we go out into the acres and acres of used auto lots (thousands of companies), line up fifteen stocks of what we consider great prospects, give you the keys to test drive (via paper trades), look under the hood, kick the tires, and eventually pick one (or more) to do your own thing on. But no one will pull the trigger for you. It is ultimately your decision. These picks are not recommendations with canned buy-sell targets.

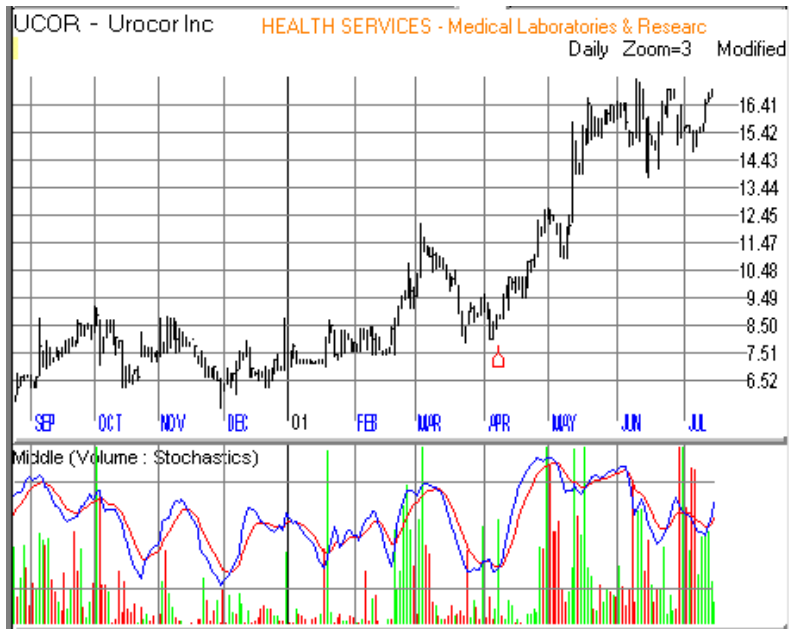
6.5 Trading strategies

Back to our picks in Section 6.3:

Looking at our watchlists on page 188, with what you now know about the way these tickers were picked, it is not such a surprise they did so well during this time frame. They were sound and healthy companies. But did we do any better than the Buy & Hold as we exercised our “trading craft?” Let’s look at some trading methods first.

6.5a “Sell with a 10% Target”

Let’s look first at the best ticker (UCOR) in our weekly ten of 4/6/01 and the worst (XTO).



UCOR Rolling Pick – 4/6/01

From the date of the pick, shown by the small marker, we got the roll as expected, about \$2 on a \$9 stock. That is a healthy roll. But it peaked at around \$16. Let’s examine two strategies for this selection.

The first approach is to use some fixed target price increase and to sell whenever that price is reached. This is simple and follows the Rolling adage, *“Don’t get greedy!”* We are happy with a small and simple increase. However, what is the best figure to use? 10% has been suggested but for this particular stock during this particular time frame, **IS** there a

“*best Target?*” Using the “*Pro-fundity TradeScape*” spreadsheet we can use the historical data to find what *would have* happened under many options. Here is the result:

PTS	Commission	\$8	Stop	8%	Target	"X"	Invest	\$1,000			
1	Stock Buy	Buy	Sell	Sell	\$	\$	Price	\$ (%)	Dys	%	
"X"	Ticker	Price	Date	Price	Date	Out	In	Gain	Gain	In	APR
10%	UCOR	\$8.88	06-Apr-01	\$10.20	12-Apr-01	\$1,000	\$1,132	14.9%	13.2%	6	572%
15%	UCOR	\$8.88	06-Apr-01	\$10.25	17-Apr-01	\$1,000	\$1,138	15.5%	13.8%	11	325%
20%	UCOR	\$8.88	06-Apr-01	\$10.75	23-Apr-01	\$1,000	\$1,194	21.1%	19.4%	17	296%
25%	UCOR	\$8.88	06-Apr-01	\$11.85	26-Apr-01	\$1,000	\$1,317	33.5%	31.7%	20	411%
30%	UCOR	\$8.88	06-Apr-01	\$11.85	26-Apr-01	\$1,000	\$1,317	33.5%	31.7%	20	411%
35%	UCOR	\$8.88	06-Apr-01	\$12.62	30-Apr-01	\$1,000	\$1,403	42.2%	40.3%	24	436%
40%	UCOR	\$8.88	06-Apr-01	\$12.62	30-Apr-01	\$1,000	\$1,403	42.2%	40.3%	24	436%
45%	UCOR	\$8.88	06-Apr-01	\$15.39	11-May-01	\$1,000	\$1,712	73.4%	71.2%	35	529%
50%	UCOR	\$8.88	06-Apr-01	\$15.39	11-May-01	\$1,000	\$1,712	73.4%	71.2%	35	529%
55%	UCOR	\$8.88	06-Apr-01	\$15.39	11-May-01	\$1,000	\$1,712	73.4%	71.2%	35	529%

Pro-fundity TradeScape I (PTS-I)

Study this table carefully. It shows us what the \$-Gain is for the several Target %'s. We buy the stock on the same date in each case at \$8.88 per share. We invest \$1,000 with an \$8 commission, and the spread-sheet calculates the return for each Target. What did we learn? For this stock which was on a sharp ramp-up, our greatest return was for the higher target percentages. The best return was 71% in 35 days with a 50% target increase.

Is that too good to be true? Not if we knew beforehand what the price was going to do. Unfortunately, such is not the case. We will find many other examples where the stock

won't reach such heights and we will wait forever for the price to reach some high target. We will have to limit our target to a more reasonable level. Let's consider another strategy.

6.5b “Sell with a fixed Trailing Stop”

Consider the market adage, “**Cut your losses short and let your profits run!**” The reason this is sound thinking is that if we are going to have losses among our picks (a market fact! The best in the business have losses and consider part of the cost of play the game), we should exit quickly and gracefully when a price turns south. Okay. But to make up for those expected losses, we need to make a greater profit on our winners than we lost on the losers. “**Let our profits run!**” This runs counter to what we have learned about rollers, being happy with small gains. That would be sound advice if we didn't have to make up for the small losses we must encounter. Let's not put a cap on our potential gains. Lets allow the price to increase when it will.

We do this by placing a “Trailing loss” sell point at some level below the current price. That means, for example, a 10% trailing loss would kick us out of a position whenever the price falls below 10% of yesterday's close. Or maybe we want to try 5%, or 20%. Anyway, the sell point increases with the price and we are literally letting our profits run. We sell when the price starts to turn down and not before.

So where do we put the trailing loss? We go to Pro-fundity TradeScape 2 for experience with such decisions.

The table below is the result with the same ticker as the previous analysis on PTS-1, showing ten different trailing-loss values.

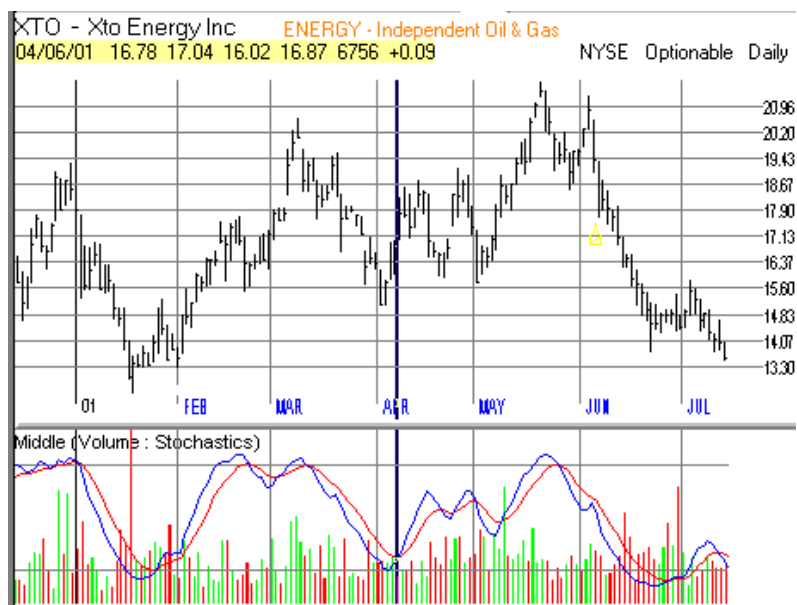
PTS	Commiss	\$8	Trailing Stop		"Y"	Invest	\$1,000				
2	Stock	Buy	Buy	Sell	Sell	\$	\$	Price	\$ (%)	Days	%
"Y"	Ticke	Price	Date	Price	Date	Out	In	Gain	Gain	In	APR
4%	UCOR	\$8.88	06-Apr-01	\$9.31	12-Apr-01	\$1,000	\$1,033	4.9%	3.3%	6	142%
6%	UCOR	\$8.88	06-Apr-01	\$9.12	12-Apr-01	\$1,000	\$1,011	2.7%	1.1%	6	48%
8%	UCOR	\$8.88	06-Apr-01	\$11.04	7-May-01	\$1,000	\$1,226	24.4%	22.6%	31	190%
10%	UCOR	\$8.88	06-Apr-01	\$15.29	12-Jun-01	\$1,000	\$1,701	72.3%	70.1%	67	272%
12%	UCOR	\$8.88	06-Apr-01	\$14.08	14-Jun-01	\$1,000	\$1,566	58.6%	56.6%	69	213%
14%	UCOR	\$8.88	06-Apr-01	\$17.36	19-Jul-01	\$1,000	\$1,661	95.6%	66.1%	104	165%
16%	UCOR	\$8.88	06-Apr-01	\$17.36	19-Jul-01	\$1,000	\$1,622	95.6%	62.2%	104	155%
18%	UCOR	\$8.88	06-Apr-01	\$17.36	19-Jul-01	\$1,000	\$1,583	95.6%	58.3%	104	146%
20%	UCOR	\$8.88	06-Apr-01	\$17.36	19-Jul-01	\$1,000	\$1,544	95.6%	54.4%	104	136%
22%	UCOR	\$8.88	06-Apr-01	\$17.36	19-Jul-01	\$1,000	\$1,506	95.6%	50.6%	104	126%

Pro-fundity TradeScape II (PTS-2)

For this example, a 10% trailing loss gave us the best return, 70% in 67 days. Sound like a winner? For this stock during this time frame! An important caveat here, though. We must still have a stop-loss in place to protect our capital. For instance, if we do not want to lose more than say 10% of our investment if the price goes south, we need to have that order in place. Either as a special order with the broker or with a disciplined mental stop. You see, if we have a trailing-stop at 10% below yesterdays close, the price could drop slowly, at say 5% a day and our trailing stop would never catch it.

Let's work another ticker from our watch-list on page 188, the worst performer for our Buy & Hold returns, XTO. Can we beat the negative B&H return with our trading strategies?

We bought the stock on April 6th (the vertical line), with a couple of small rolls in that month (only about \$1.00 to \$1.50 roll). The price did increase to \$21 + before starting down. Did our strategies catch any of the increase?



XTO Rolling Pick - 4/6/01

PTS-1 found a target price of 25% brought the greatest return. In fact, all targets below the 25% brought greater returns than the B&H which was negative.

PTS	Commission	\$0	Stop	0%	Target	"X"	Invest	\$1,000			
1	Stock	Buy	Buy	Sell	Sell	\$	\$	Price	\$ (%)	Dys	%
"X"	Ticker	Price	Date	Price	Date	Out	In	Gain	Gain	In	APR
5%	XTO	\$16.87	06-Apr-01	\$17.80	9-Apr-01	\$1,000	\$1,039	5.5%	3.9%	3	337%
10%	XTO	\$16.87	06-Apr-01	\$18.67	27-Apr-01	\$1,000	\$1,090	10.7%	9.0%	21	112%
15%	XTO	\$16.87	06-Apr-01	\$19.80	15-May-01	\$1,000	\$1,157	17.4%	15.7%	39	104%
20%	XTO	\$16.87	06-Apr-01	\$20.50	17-May-01	\$1,000	\$1,198	21.5%	19.8%	41	125%
25%	XTO	\$16.87	06-Apr-01	\$21.45	21-May-01	\$1,000	\$1,254	27.2%	25.4%	45	147%
30%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$1,034	5.1%	3.4%	67	13%
40%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$1,034	5.1%	3.4%	67	13%
50%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$1,034	5.1%	3.4%	67	13%
60%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$1,034	5.1%	3.4%	67	13%
80%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$1,034	5.1%	3.4%	67	13%

Pro-fundity TradeScape I (PTS-1)

PTS-2 found a trailing loss of 4% brought the highest return, although this was only 4.7%. That still beat the B&H return.

PTS	Commission	\$8	Trailing Stop	"Y"		Invest	\$1,000				
2	Stock	Buy	Buy	Sell	Sell	\$	\$	Price	\$ (%)	Dys	%
"Y"	Ticker	Price	Date	Price	Date	Out	In	Gain	Gain	In	APR
4%	XTO	\$16.87	06-Apr-01	\$17.66	18-Apr-01	\$1,000	\$1,031	4.7%	3.1%	12	67%
6%	XTO	\$16.87	06-Apr-01	\$17.30	18-Apr-01	\$1,000	\$1,009	2.5%	0.9%	12	20%
8%	XTO	\$16.87	06-Apr-01	\$16.93	18-Apr-01	\$1,000	\$988	0.4%	-1.2%	12	-27%
10%	XTO	\$16.87	06-Apr-01	\$16.56	18-Apr-01	\$1,000	\$966	-1.8%	-3.4%	12	-74%
12%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$909	5.1%	-9.1%	67	-35%
14%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$888	5.1%	-11.2%	67	-43%
16%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$867	5.1%	-13.3%	67	-51%
18%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$847	5.1%	-15.3%	67	-60%
20%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$826	5.1%	-17.4%	67	-68%
22%	XTO	\$16.87	06-Apr-01	\$17.72	12-Jun-01	\$1,000	\$805	5.1%	-19.5%	67	-76%

Pro-fundity TradeScape II (PTS-2)

6.5c “Buy with up-ticks, Sell with down-ticks.”

In an earlier chapter on rolling stocks strategies we introduced the idea of up and down-ticks as an action guide. Lets revisit that technique and add a “volume” element to give it substance.

The idea was to never buy with the stock on the way down or to sell with the stock on the way up. Rather, we looked for some evidence that the stock had actually started back up as a buy-signal. We suggested a series of up-ticks after the stock price bottoms as an indication of strength. A series of down-ticks would signal a turn-around on the upside. This methodology is quite weak for two reasons. First, the random nature of price moves will give us a series of ticks in the same direction, either up or down, without a real change of character. Therefore, we get a lot of false signals. Secondly, if we get a real signal for a change in trend, we lose much of the change waiting for a specific number of ticks.

Since volume plays such an important role in price action, we can accompany our tick strategy with changes in volume. For example, a signal of strength might be:

Two upticks with an increase in volume of 20% over its 90 day average.

Or,

Three upticks with an increase in volume of 10% over the last 30 day average.

You get the idea. Using the spreadsheet analysis tool a number of scenarios can be played out, finding a particular combination that will work well for a stock category. This technique provides much more solid direction than the up/down tick by itself.

A final thought regarding strategies, methods and techniques to guide our market activity:

I believe there can be no mechanical system that will work on all stocks all the time. Human judgment will always be required in the face of market dynamics. It is possible to have mechanical exits, say a stop-loss for a safety net to protect our capital. Remember, the brightest minds in the field have been looking for the holy grail since market action began. Without success. What then is the value of the study, the analysis of price patterns and our attempt to find better ways? Just that. Without a system we are rudderless, adrift in a sea of chaos. It's a matter of degree, we can be better than we are, we can find easier and better ways to ply the trade. We can't find perfection! **But that does not mean we shouldn't improve.** Abraham Maslow once said we will either move forward into growth, or backwards into safety. We opt for growth.

SECTION VII - Options

7.1 Basics

No one should ever invest in a market they do not understand (Options, Commodities, Real Estate). Before investing a penny in any market, it is essential we understand the risks, opportunities, rules and terms. Only then are we able to make the kinds of informed judgements necessary for success, and success in any market is all about judgement.

That said, let's consider the "O" word, Options.

While trading in a stock market has been around since recorded history, *options* have only been traded on a formal exchange since 1973 when the Chicago Board of Options Exchange (CBOE) was organized. With some exceptions, we do not have parents who were long time options investors, teaching us the ins and outs of the discipline. The "terms" used in these transactions are not familiar to many small investors. I mean the inexperienced investor trying to increase his net worth in \$100 to \$5000 increments. Not to exclude those fat cats with a lot more, but this "smaller" group has been neglected and is missing some fruitful opportunities.

There will always be an edge of caution with the unknown. The result is a mystique, fueled by horror stories about money lost and how risky the options market is. The option market *is* risky, as is the stock market. The key to either success is knowledge, understanding what the risks are and

in tilting the playing field in our direction. For instance, when I buy a stock, I don't *know* the price will go up. But if I buy when the price trend is favorable, the technicals suggest strong upward support, the fundamentals of the company convince me it isn't going into bankruptcy soon, and the real driver of market opinion "News" has no clouds on the horizon, I will have improved my odds of a good return. That is not gambling, it's smart business!

That does not mean I will always be right. It means I will be right more times than I am wrong.

Here is an example of what the term "option" mean; I purchased a home many years ago. Initially, I leased the home for x.\$ per month with wording added to the contract, "the option to purchase the home anytime before the end of the lease for a y.\$ price." I had an option to buy the home at a specific price before the end of the contract. It is a "right" secured by a legal piece of paper, in this case the lease/option contract. I then "owned" the right to exercise that option. If I chose to exercise the option, I would have to come up with the price agreed upon to purchase the home. If I chose not to exercise the option, upon expiration of the contract, it would expire worthless. I had paid for the right to "buy" the property for a y.\$ price for the term of the lease, the cost being included in the lease payments.

During the time of the lease, if property values skyrocket up or drift down, I could still buy the home for the agreed-upon fixed option price.

Terms:

6. Option
 - c) Call
 - d) Put
7. Strike (Exercise) Price
8. Write a Call
9. Contract Size
10. Premium
11. Optionable Stock
12. Called Out
13. Covered
14. Naked
15. Derivative

1. **Option:** “A contract permitting its owner to buy or to sell an asset at a fixed price until a specified date.”

The option is the contract, the piece of paper, giving the owner the “right” to buy or sell, for a certain amount of time. In the property example above, I could arrange in the contract the right to sell that option if I could find an interested buyer, and receive some commission or reward for finding the buyer. That is, I could treat the option as a commodity to sell for whatever the market would allow.

- 1a. **Call:** “An option permitting the holder the right to buy a specific asset at a pre-determined price until a certain date.”

In the property example above I would be holding a “call” option since I had secured the right to buy the

property. In the stock market, I can pay for the right to purchase a particular stock by buying a “call” option, giving me the right, for a certain time, to pay a specified price to buy the stock.

1b. **Put:** “An option permitting the holder the right to sell a specific asset at a pre-determined price until a certain date.

(Calls and Puts are distinct from each other, buying and selling of one has nothing to do with the other)

2. **Strike (Exercise) Price:** “The price at which the owner of an option can purchase or sell the underlying stock.”
3. **Write a Call:** “Sell a call option. The term write is synonymous with sell in options parlance. The seller then becomes the writer.”
4. **Contract Size:** “Options are only purchased in contracts, each contract representing 100 shares of the stock.”
5. **Premium:** “The price paid to the writer (the person who owns the stock) for the rights of the option. It is entirely a nonrefundable payment in full and not a down-payment on the stock.”
6. **Optionable Stock:** “All stocks are not optionable. Very simply, if the options market is buying and selling options on the stock, then that stock is optionable. To find if a stock is optionable, go to the Home Page of CBOE (Chicago Board Options Exchange)

www.cboe.com, select Delayed Quotes from DIRECT LINKS, enter a ticker for the stock and hit Submit. This will give you a delayed quote and list of options for the stock if the stock is optionable. If the stock we select is not optionable, we will get a SIGNAL NOT FOUND message.”

7. **Called Out:** “If the buyer of a call exercises the option, the writer is said to be Called Out. He must sell the call to fulfill his obligation.”
8. **Covered:** “If the writer of a Call owns the stock, he is said to be covered and the option is termed a Covered Call.”
9. **Naked:** “If the writer of a Call does not own the stock, he is said to be Naked, and the option would be a Naked Call.” This is the highest risk option play.
10. **Derivative:** “An asset that derives its value from another asset.”

Now why are we doing all this?

We would only buy a “call” to purchase a stock sometime in the future if we were convinced its price would go up in the meantime. That is, if we could pay for the right to purchase a stock for \$12.00 a share within two months when we felt it was going up to \$15.00 in that time, that would be a good investment. If the stock did go to \$15.00, we could buy it for \$12.00, sell it on the market for \$15.00 and pocket \$3.00.

The price of purchasing a “call” in this example may be in the \$1 to \$2 range. We have controlled a large amount of the stock with a small amount of money. We are able to trade more expensive stocks investing a fraction of the price. Sound good? What is the down-side?

Because an option is a fixed-time investment, we lose whatever we paid for the call if it is not exercised by its expiration date. What if the stock does not go up as anticipated? Oops! What if the stock drops in price? Double oops. However, all one loses is the price of the option call.

A call option on a stock is a derivative security that obtains its value from the shares of the stock purchased with the call option. All options are derivative securities. The market value of an option is affected by changes in the value of the underlying asset. What this means is the value of the option changes along with the value of the stock. The importance for us here is understanding that a change in stock price is magnified in the price of the option. A small change in the price of IBM can cause a large price change in a call option on the security. It is this “leveraging” feature that makes options trading such an attractive way to invest money.

Definitions:

- 1: An option is always quoted** at a time and a price.
- 2: Strike Price** – The price at which the owner of a call option can purchase the underlying stock. Strike

(exercise) prices are standardized into intervals, starting at \$5, increasing at \$2.50 increments until \$25, then increasing at \$5 increments until \$200, then at \$10 beyond \$200.

3: All option contracts expire at the close of trading on the third Friday of a month. That is, a February option would expire at 4:30pm EST on 2/15/02.

4: Contract – Options are only purchased in “contracts,” each contract representing 100 shares of the stock. “c” in the IDB version represents a “call option.” The \$17.50 January call option traded 111 contracts (11100 shares) at price of \$2.25 on the day before.

An option price depends on two important factors, value and time. For example, Fore Systems Inc. (FORE) closed at \$19.25. A January call option for the stock at \$20 was quoted at 5/8 (\$0.63). A February call option at the same price of \$20 was quoted at 1 15/16 (\$1.94). What do these different prices mean?

Quotes on FORE in the newspaper would look like this:

The Wall Street Journal: - Call - - Put -

Option/Strike	Exp	Vol.	Last	Vol.	Last
ForeSys	20 Jan	3845	5/8	40	1 1/4
19 1/4	20 Apr	690	3 1/8
19 1/4	25 Apr	423	1 3/4

This lists three options available, three Calls and one Put. The last traded price on the stock was 19 ¼ (\$19.25). The first call is for a \$20 strike price which will expire the third Friday in January. The last premium paid for this option was 5/8 (\$0.63). That means you could buy one contract (100 shares) for \$63 and own the right to buy 100 shares of FORE for \$20 per share until the third Friday in January. If the price of the stock goes up to \$25 in the meantime, that will be a good deal. If it does not reach the strike price, you lose \$63 (unless you can sell the Call option to someone else).

This is how the same data would be shown in the IDB:

Investor's Business Daily:

Call

(c)

Put (p)	Strike Price	Last Vol.	Last Price	Last Vol.	Last Price	Last Vol.	Last Price
------------	-----------------	--------------	---------------	--------------	---------------	--------------	---------------

Jan

Feb

ForeSysms					Close 19 1/4	Apr
c	17 ½	111	2 ¼	13	3 5/8	25 4 1/2
c	20	3845	5/8	147	1 15/16	690 3 1/8
c	22 ½	30	¼	163	1 1/8	21 2 1/2

We see in the IDB example above the three strike prices shown are \$17.50, \$20.00, and \$22.50 as mentioned in Definition 2. We cannot buy a \$21.00 option.

The volume number listed tells us what the interest is in that particular option.

To summarize:

- a) An option is a derivative of an underlying stock, it derives its value from the stock.
- b) The price of an option changes as the price of the underlying stock changes.
- c) This price change is a magnified version of the change in stock price. Small change in stock price create large percentage change in the option price. This is the good news.
- d) We can invest in high-flier big-ticket stocks with a small amount of money (the Intel's, the Microsoft's). This is more good news.
- e) The "call" is the right to buy, or to call away a stock at a pre-arranged price within some fixed time.
- f) An option is a fixed time investment, that is, it expires! This is the bad news.
- g) The cost of purchasing a call is always lost.

How all this comes together in a coherent trading strategy will be the focus of the next three chapters. Remember, our objective is to reduce risk. There are some clever ways to do this with options.

7.2 Options – What Makes it Work?

Last chapter we introduced the basics of options trading, how we might leverage a small investment to control a large amount of stock.

We will spend our time this chapter and next discussing the conservative strategy of "selling" call options on stocks we own (writing covered calls). This is the safest play with options and *one that should be mastered first!*

Example:

You own a stock (the seller of the option). I (the buyer of the option) pay you for the **RIGHT** to buy the underlying stock at a fixed price anytime until some fixed date in the future. I have paid my money for this right, but I am not obligated to exercise the option.

In this example the option is an agreement between two parties, a seller and a buyer. The seller agrees, for a price, to let the buyer exercise some action on an asset if the buyer chooses.

You have taken my money, you **MUST** sell me the stock if I exercise my right, anytime before the fixed date. You are obligated.

	<u>Seller (writer)</u>	<u>Buyer</u>
<u>Reward</u>	Receive an immediate premium for giving up temporary control of the stock. He still owns the stock, up to the time if and when the option is exercised (as owner of the stock he will continue to receive any dividends paid).	Buy the stock at a premium price if the price increases above the "Strike Price." He has an enormous profit potential if the stock price rises above this value (strike price).
<u>Risk</u>	The stock price may go above the strike price. He would sacrifice what might have been gained by selling at the new higher price.	The stock price may stay the same or go down in price. In which case there would be no value in the option. He would lose all the money paid to the seller for the option.

The seller's risk is limited to unrealized potential gains as the stock price rises above the strike. If the option is exercised, he will still get the profit selling the stock at the strike price. If the option is not exercised, he will still own the stock for further action. In either case he will pocket the premium paid for the call on the front end.

Why it Works!

We saw the Reward/Risk comparisons between the buyer and seller of the Call option. In our example above, the seller owned, had possession of, the stock on which he “wrote” the option.

We have talked about two parties in an options contract, the seller (writer) and the buyer. If I want to buy an option on say Intel (INTC), a very popular optionable stock, it may be difficult to find someone who owns the stock willing to sell the option. Enter the third party, the Options Clearing Corporation (OCC). This is a clearing house created in 1973 by the options exchanges through which all options transactions are cleared.

So, rather than try to find a seller, I submit a request, through a broker, to the OCC where market-makers risk their own capital to bring us together making the options market an easy way to trade. I will get a current quote on a selected stock for a particular option, as with (FORE), which will include bid and ask values, set by the market-makers based on supply and demand, and if we agree, I will buy the option. I will never know from whom I bought the option, only that someone at this point in time offered to sell. The market-maker is the backbone of this trading system, a great example of a free-market enterprise at work.

How Do We Make Money?

There is another high-leverage way a Call can be sold, with certain agreements with a broker, that is, selling a Call without owning the stock, a naked call. What that means is that I might write a call and then only buy the stock if I get called out, that is, if the option is exercised. This is a high-leverage play since I might receive the premium for the call with no outlay (if not called out). My return would be dramatic! Money in, no money out! “Might” is the operative word in this scenario. The risk for the seller goes up dramatically, however. He will have to pay market price for the stock to honor the call. Market price could be above the strike price. If called out he is obligated to sell at the strike price.

Our focus then is on writing covered calls as a way to reduce risk as we magnify our returns.

Which risk would you rather have, that of the seller or the buyer? Consider how you feel about this question as we go through the mechanics of the next chapter. One can be a buyer or a seller as an options trader. Your own temperament plays a dominant role in the answer to that question.

7.3 Option Premiums

In this chapter we will demonstrate why many find Options trading so interesting. We will then review the risks and finally learn how option premiums are determined as we begin writing covered calls, the least risky options strategy.

We saw in previous pages an actual Options quote on Fore Systems Inc., FORE. This showed the role “time” plays in the premiums paid for the options.

In the following, we repeat a portion of the previous quote and a more recent quote, 13 days later from the Investors Business Daily. This shows graphically why options are fascinating.

The summary point C in chapter 6.1 (good news/bad news) reads:

***Changes in the stock price are magnified
in the price of the option!***

Investor's Business Daily: 1/7/99

Call
(c)

Put	Strike	Last	Last	Last
(p)	Price	Vol. Price	Vol. Price	Vol. Price
		Jan	Feb	Apr
Fore Sysms			Close 19 1/4	
c	17 1/2	111 2 1/4	13 3 5/8	25 4 1/2
c	20	3845 5/8	147 1 15/16	690 3 1/8
c	22 1/2	30 1/4	163 1 1/8	21 2 1/2

Investor's Business Daily: 1/20/99

Call
(c)

Put	Strike	Last	Last	Last
(p)	Price	Vol. Price	Vol. Price	Vol. Price
		Feb	Mar	Apr
Fore Sysms			Close 21 1/16	
c	17 1/2	207 4 1/2	no tr	20 5 5/8
c	20	552 2 11/16	no tr	no tr
c	22 1/2	1018 1 5/8	58 2 3/16	no tr

Date	\$22.5 Feb C	Close
1/20/99	\$1.63 (1 5/8)	\$21.06
1/7/99	\$1.13 (1 1/8)	\$19.25
Difference	\$0.50 (44%)	\$ 1.81 (9%)

Dealing strictly with options, had we bought a \$22.50 February Call (naked) on 1/7/99 and sold it thirteen days later we would have realized a 44% gain (1235% APR)! If that isn't exciting you need oxygen.

But what's the down side? The manic nature of the market, particularly where severe volatility is the norm, heightens the risk. That kind of an upward swing has its counterpart in the opposite direction. Look at the next figure, showing two similar stock quotes for the Borders Group (BRG).

<i>Investor's Business Daily:</i>		12/30/98					
Call							
(c)							
Put	Strike	Last	Last	Last	Last	Last	
(p)	Price	Vol.	Price	Vol.	Price	Vol.	Price
		Jan	Feb	Feb	Feb	Feb	May
Borders Gp			Close	25 1/8			
c	20	238	5 1/8	22	5 1/2	20	7

<i>Investor's Business Daily:</i>		1/20/99					
Call							
(c)							
Put	Strike	Last	Last	Last	Last	Last	
(p)	Price	Vol.	Price	Vol.	Price	Vol.	Price
		Feb	Mar	Mar	Mar	Mar	May
Borders Gp			Close	18 9/16			
c	20	385	3/4	no tr		75	2 3/8

Date	\$20 Feb Call	Close
12/30/98	\$5.50	\$25.13
1/20/99	\$0.75	\$18.56
Difference	-\$4.75 (-86%)	-\$ 6.57 (-26%)

So it goes both ways. This is a great example of the Risk/Reward ratio, how they go up or down together. We will take advantage of the leveraging feature of options (Reward) with a calculated uncertainty (Risk) and try to tilt the Risk/Reward ratio in our favor. But first, let's understand how option prices are determined.

We said earlier that the option premiums were based on value and time. Since an option is a fixed-time investment, the time portion of the price decreases as the expiration date approaches. The value portion depends on what the stock price is doing.

The important issue is where the stock price is relative to the strike price.

We have three possibilities (and three names) for a *call* option:

- | | <u>Name</u> |
|------------------------------------------|-------------------------|
| 1. The stock price equals strike price. | At-the-Money |
| 2. Stock price is above the strike price | In-the-Money |
| 3. Stock price is below the strike price | Out-of-the-Money |

For example:

If the call option *strike price* is \$22.50, we have for the *stock price*:

- \$23.25 In-the-Money (any price above \$22.50)
- \$22.50 At-the-Money
- \$19.85 Out-of-the-Money (any price below \$22.50)

Case 1

Regarding our covered call strategy: If we bought 100 shares (1 contract) of FORE when the price was \$19.25 (\$1925) on 1/7/99, we could turn right around and sell a call on the stock we now own. A \$22.50 Call for February would have brought the premium into our account (the very next day) $100 \times 1 \frac{1}{8} = \112 . That's cash we can spend or put to work! It cost us control over the stock we just purchased until the 3rd Friday in February. If the stock moves above the strike price we will be called out at \$22.50 realizing \$437 profit in 6 weeks ($\$2250 - \$1925 + \$112$, less commissions). That's about a 22% return (190% APR). If we aren't called out, we regain control of the stock and may choose to sell another call. (Our example shows a one-contract transaction. Commission costs will be less for larger volume but must be considered in finding actual return)

Case 2

Let's change our sequence a bit by buying the stock as before but waiting for the stock price to increase before selling the call. In the quotes on FORE above, the price for the call on 1/20/99 was $1 \frac{5}{8}$ (\$1.63). Had we waited two weeks while the stock price strengthened, our return would have been \$51 higher ($\$163 - \112), with the return of 25%. This may not seem a lot but it is this level of detail that spells the difference between home runs and ho-hums.

Now let's look at an example of option prices as the stock price moves up.

Look at three quotes, taken from the IDB on three dates, for Iomega (IOM). This shows the **option premium**, the **stock price**, and the **time left** to expiration on each date for an In-the-money call option. Also shown is the **open interest** on each date, how many contracts were traded. Take a minute and study this table to find these.

<i>IOMEGA</i>		Table 1				
Date	<u>12/24/98</u>	Open	<u>1/7/99</u>	Open	<u>1/15/99</u>	Open
January	Call	Interest	Call	Interest	Call	Interest
Call	Premium	(Contracts)	Premium	(Contracts)	Premium	(Contracts)
\$7.50	\$0.94	511	\$1.13	3699	\$1.50	451
Stock Price	\$8.00		\$7.94		\$9.00	
Weeks til Exp.	3		1		0	

Now consider the two elements of the option premium:

$$\text{Premium} = \text{Time} + \text{Value}$$

Value = difference between Stock Price and Strike Price

Strike	\$7.50		\$7.50		\$7.50	
Stock	\$8.00		\$7.94		\$9.00	
Value (Diff)	\$0.50		\$0.44		\$1.50	
Premium	\$0.94		\$1.13		\$1.50	
Time	\$0.44		\$0.69		\$0.00	

In this example we can see how the premium changes as time approaches expiration. Initially, the premium has both time and value content. In this, an **In-the-money** call, the

premium has intrinsic value because the stock price is already above the strike price.

But the option premium is larger than this intrinsic value, because of the added time value. As time approaches expiration, the time value goes to zero and the premium is all intrinsic value its intrinsic value increasing with increasing stock price.

Take another look at Iomega with an Out-of-the-money call for the same time period:

\$10 January Call

<i>IOMEGA</i>		Table 2				
Date	<i>12/24/98</i>	Open	<i>1/7/99</i>	Open	<i>1/15/99</i>	Open
January	Call	Interest	Call	Interest	Call	Interest
Call	Premium	(Contracts)	Premium	(Contracts)	Premium	(Contracts)
\$10.00	\$0.19	394	\$0.19	2630	\$0.13	94
Stock Price	\$8.00		\$7.94		\$9.00	
Weeks til Exp.	3		1		0	

Premium = Time + Value

Value = difference between Stock Price and Strike Price

Strike	\$10.00		\$10.00		\$10.00	
Stock	\$8.00		\$7.94		\$9.00	
Value (Diff)	-\$2.00		-\$2.06		-\$1.00	
Premium	\$0.19		\$0.19		\$0.13	
Time	\$2.19		\$2.25		\$1.13	

In this case, the premium is not so easily defined. There is no intrinsic value and the premium is much less, primarily

only time value. Expiration day was the 15th of February, the third Friday. The reason the premium has any value at all in Table 2 is the newspaper date was 1/15/99, but it reported Thursdays prices on the 14th. The premium would be worthless on Friday without a dramatic rise in stock price that day.

To further lock these ideas in, look at the February calls for Iomega during the same time frame showing both the \$7.50 C and \$10.00 C in the table below.

<i>IOMEGA</i>		Table 3					
Date	<u>12/24/98</u>	Open	<u>1/7/99</u>	Open	<u>1/15/99</u>	Open	
February	Call	Interest	Call	Interest	Call	Interest	
Calls	Premium	(Contracts)	Premium	(Contracts)	Premium	(Contracts)	
\$7.50	\$1.44	465	\$1.56	2019	\$2.00	321	
\$10.00	\$0.50	892	\$0.63	3483	\$0.81	1371	
Stock Price	\$8.00		\$7.94		\$9.00		
Weeks til Exp.	7		5		4		

Notice how the premiums compare to the January calls. In each case they are higher for the February calls. Everything else is equal, only the time to expiration is longer. There is more time for the stock to react in the way we want it to. There is more time value.

In next chapter we will put all this information into a stock play to make it clear why we're spending this much time on the preliminaries.

Summary:

1. Understanding how options are priced will increase our confidence in venturing into the options market.
2. An option premium is basically made up of two parts:
 - a) Intrinsic value – the portion of the premium equal to the degree that it is In-the-money. If I own a \$15.00 February Call and the stock price is \$16.50, I can exercise the option for \$15.00, sell it on the market and pocket \$1.50. The option has an intrinsic value of \$1.50.
 - b) Time value – related to the “hope” that the stock will react in the right way for us. The more time to expiration, the more chance of this taking place. Therefore, time value decreases to zero at expiration date.
3. Several factors contribute to the exact time value. Three important factors are:
 - a) Stock price – Options on a high dollar stock will have greater time value than a low priced one.
 - b) Volatility – The greater the movement of stock price, the higher the time-premium.
 - c) Supply & Demand – The more people trying to buy, the higher the price.
4. Because the price of an option will increase tick for tick with the stock after it becomes In-the-money, the leverage of option trades is its most attractive feature.

We can control expensive stocks with a relatively small investment.

5. The leverage requires a stock to react in the way we want. If we buy a call, the stock must increase for us to benefit.
6. The attendant risk of buying a call is that the stock may not increase, or even go down. We will lose all of our investment because the option is a fixed time vehicle. It not only has to go in the right direction, but it must do so within a specific amount of time.
7. If we own a stock, we can write (sell) a call for a premium and agree to sell it if it reaches a specified price, called the strike price, anytime before a specified expiration date. We limit our risk in this case because if the stock does not move in the way we want, we still own the stock and can keep the premium received for selling the call. Our risk is in not being able to capture all the profits, beyond the strike price, if the stock move dramatically upward.

7.4 Writing Covered Calls

In this chapter we will continue with options, moving through a review with some added detail on options pricing, including one way to find candidates for this strategy. Some brief comments on when to write covered calls, then an actual transaction.

Options in general increase the inherent risk in investing because they are *fixed-time* investments. An option does expire! With a stock, if the price goes down we can just wait it out. We don't lose money until we sell. Such is not the case with an option.

That said, why are we spending time delving into the world of speculation when our objective has been to reduce risk, to seek ways to improve returns without biting our nails to the bone? Simply, by selling call options on stocks we own, that is, "Writing covered calls," we meet our objectives. Let's try to understand with a brief review of some option definitions.

Covered option writing is misunderstood. Unfortunately, it has been confused with speculative option buying, where the losses can be significant. On the other hand, covered option writing (calls) may be as conservative as buy & hold investing.

Options: "We can buy or sell the right to buy or sell a stock at a predetermined price within a specified time frame."

How's that for double-talk. Actually it is more than double, since it includes six different conditions. Let's make it easier:

1. We can buy a call (Call = the right to buy)
We can sell a call
 2. Either covered (Covered = we own the stock)
 3. Or naked (Naked = we don't own the stock)
-
4. We can buy a put (Put = the right to sell)
We can sell a put
 5. Either covered (Covered = we own the stock)
 6. Or naked (Naked = we don't own the stock)

BUY A CALL

1. We can **buy** (pay for) the right (but not be obligated) to buy a stock at some specified price in the future. We are not obligated because **we** have paid the money. We are in control and can choose to buy the stock or not. We do this hoping the stock price moves higher than the specified (strike) price. We can then pay for it at the lower strike price then sell it immediately at the new (higher) market price for a profit. This right for which we have paid is termed the "Call."

SELL A CALL

2. We can **sell** a call for some specified price at a future date. We obligate ourselves by accepting someone's money and must comply if the buyer

exercises the option. We do this to generate immediate income, setting the strike price where we are willing to sell the stock. We accept the loss of control over the stock until the option expires, when we are either “called out,” that is forced to sell the stock at the strike price, or when the option expires worthless.

COVERED

- a) Sell the call on a stock we own. These are stocks in our portfolio at a strike price we feel good about. If we have stocks that seems to be going nowhere, we may be happy to unload them at some price. The “some price” becomes near the strike price and we receive income as we wait to be called out. If called out we get both option income and capital gain (or loss, if the price is less than we paid for it). We can also buy a stock intending to write a call either at the same time we purchase the stock, or later if the stock price moves up to garner a higher option premium.

NAKED

- b) In the options market we are allowed to sell the right to buy a stock that we do not own. That means if we get called out, if the buyer of the call exercises the option and wants to buy the stock from us, we must buy the stock at market prices to fulfill our obligation. This is a risky play and the broker will usually require sufficient collateral in securities or cash before letting us sell a naked call.

Conditions 4-6 designated above deal with Puts, which are the right to sell a stock, to “put” it to someone, at some strike price before expiration. We will not cover Puts in this book.

1. Writing covered calls

When we sell a call on a stock we own, the only thing that can go wrong is *with the stock* itself. The stock can go down. But we already have that risk. Selling a call does not increase the risk on the stock. It does tie up the stock however, for the duration of the call. There is NO risk on the call itself. We receive the premium into our account the next day when the call is sold. That cannot be taken from us.

A covered call can be written three ways:

1. Buy the stock and sell the call at the same time.
2. Buy the stock and sell the call at a later time.
3. Sell the call on stock we already own.

2. Option Premiums

We previously considered the important factors that help determine options premiums, what they cost. If an option is a promise to act in a certain way, given a specified set of circumstances, what is that promise worth?

We found the following:

1. The price of an option has two basic parts:
 - a) Time
 - b) Value
2. Time relates to hope and/or expectation. This portion of the price is set by market makers based on several factors, including:
 - a) The amount of time left before the option expires
 - b) The price of the stock
 - c) The volatility, the expected movement or fluctuation of the stock price. (The greater the volatility, the higher the time-premium).
 - d) The interest in the option (the more investors trying to buy, the higher the time value, supply/demand). This relates to volume with securities.
3. Value depends on where the stock price is relative to the strike price. If the stock price is above the strike, the option has intrinsic value. When the price of the stock is below the strike price, the premium has only time value. Three conditions are so named:
 - a) In the money – the stock price is above the strike price
 - b) At the money – stock price equals strike price
 - c) Out of the money – stock price is below the strike price

[A \$10 call on ABTX, currently priced at

\$8.13, is \$1.87 out-of-the-money. The same stock is \$0.63 in-the-money on a \$7.5 call.]

Option premiums are proportional to the relationship between the stock price and the strike price. We will pay more for an in-the-money call than for one out-of-the-money. However, when we “write” a covered call, on a stock we own, *we* are selling the call. The buyer is paying us and will therefore pay a higher premium if it is in-the-money.

The further the stock is in-the-money, that is above the strike price, the less its time value. The greatest time value occurs **at-the-money** because the stock price is the same as the strike price. As a seller we want the most time value, therefore we should sell “at the money.”

As an option **buyer**, the conservative play is to always buy in-the-money, paying less for smoke & mirrors (time value is fleeting, it decays to zero).

3. When should we write a covered call?

Covered calls make sense when:

1. We have a stock in our portfolio that we are neutral or mildly bullish about and would be happy to sell it at a near-market price. In such a case we pick a strike price that we are comfortable with and pick up immediate cash as we wait for the expiration date. If we are called

out, we keep the option premium and pick up some capital gain on the sale of the stock.

2. When we are willing to forego possible gains on the up-side to put some cash in our account now.
3. When we want to be paid for accepting the obligation to sell a particular stock at some specified price on or before some date in the future.

When covered calls don't make sense:

1. When we expect a stock to strongly move higher. We do not want to limit our potential return by tying up a stock.
2. When we do not want to tie up the stock, that is, when we write the call we can only wait for expiration. That may be a "nail-biter" for some. There is the possibility of "buying back" the call to wipe the slate clean and then deal with the stock as we choose. However, there is a cash penalty for that action.

4. How do we find stocks to write covered calls on?

We need to get into a "selling" frame of mind as we start dealing with covered calls. That is, we are looking to get out of the position in a relatively short time, rather than "buy & hold."

To do this, we need to set some ground rules.

1. Find optionable stocks in the \$5 to \$20 range. This is to limit the outlay in cash necessary to get started. If we have big bucks we can find great plays in the more expensive stocks.
2. When possible, select stocks we expect to move higher or sideways in the short term (3 to 8 weeks).
3. Select stocks from this data-base that have option premiums that are at least 10% of the stock price. That means if we buy the stock for \$16 and turn around and sell the call for \$1.60 or more, we have a 10% return in the time to expiration. On a margin play that could be doubled. This return is whether or not we get called out with the attendant capital gain.
4. If the stock is in a positive trend upward, we may wait before selling the call to gain a higher premium on the call. They don't have to occur simultaneously.
5. Sell the call near the money to garner the best premium.
6. Choose an expiration date that is relatively close, usually the next month out. We need at least 3 weeks but not longer than about 8. Risk increases with longer expiration dates.

An excellent exercise to locate candidates for writing calls is to go to either the Wall Street Journal or the Investors Business Daily and scan the most active options listed. This week's scan in both papers found 302 listed options in WSJ

and 794 in the IDB. Checking into the Investors Tools in the www.cboe.com which is where it all started, there are 2759 listed options.

The scan proceeds in this way:

1. Find the page in the paper with listed options quotations.
2. Note with a pen or highlighter those that meet the price criteria (I scanned only five columns on the top left side of the page in IDB for this example, covering 122 stocks, finding 24 in the \$5 to \$20 range)
3. Now look in those you have marked for an option premium to stock price ratio above 10%. I found eight candidates (looking at only 15% of the listed options in this paper):

<u>Name</u>	<u>Price</u>	<u>Option</u>	<u>%</u>	<u>Strike</u>
Able Telcom	\$10.50	\$5.50	52	\$5
Acclaim Ent	\$9.25	\$1.63	18	\$7.5
Agribiotech	\$8.13	\$1.06	13	\$7.5
Andrea Elec.	\$8.88	\$1.38	16	\$7.5
Applied Magn	\$5.00	\$0.56	11	\$5
Collagn Asth	\$13.00	\$4.63	20	\$15
Columb Labs	\$5.00	\$0.50	10	\$5
ComptrLnCt	\$5.13	\$0.63	12	\$5

4. Are any of these good candidates? I don't know. This is where we begin our study of fundamentals, technicals, and a search of the news. But we have a good place to start.

5. An example

The following example is a \$15 covered call written on 10/16/98 on FORE, called out 40 days later on 11/20/98. I put up \$2000, buying 300 shares on margin, obtaining these shares at 12 11/16. The net return as shown was 36.9% in 40 days after all commissions and expenses.

The stock price did rise above the strike and I was called out. That provided a nice capital gain as shown. Had I not been called out, I would have been free to sell a call for another month. In either case I was able to keep the option premium which netted 8.8% of the return. You will find that most option are never exercised. That is, they expire worthless. When exercised, they are usually called just before the expiration date.

Trade						
Date						
Debit						
Credit						
Bal						
10/16	Bought 300 FORE @ 12 11/16 (Margin)			\$3,806		-\$3,806
10/16		Fee		\$63		-\$3,869
10/16		Sold Call - Fee		\$31		-\$3,900
10/16	Premium received on Call				\$206	-\$3,694
10/16	Collateral (out of pocket)				\$2,000	-\$1,694
11/20	Sold (Called Out) @ \$15				\$4,500	\$2,806
11/20		Fee		\$69		\$2,737
11/20	October Interest			\$5		\$2,732
11/20	November Interest			\$5		\$2,726
	Less Collateral			\$2,000		\$726
				\$5,980	\$6,706	\$726
Time for transaction = 35 days						
Return in 35 days = $(726)/(2000+63+31+5.22+5.43-206) = 36.9\%$						
APR = $36.9\% / 35 * 365 = 385\%$						

SECTION VIII - Summary

We have highlighted reasons to invest in common stocks as we charge into the 21st century. In this work we have studied five primary concepts, including two relatively low-risk strategies, to generate income from these efforts:

- a) Fundamental analysis (how are stocks valued)
- b) Technical analysis (when is the timing right for both entries and exits?)
- c) Rolling stocks (a simple “buy low, sell high” strategy)
- d) Trading strategies (techniques to improve moves in and out of the market)
- e) Writing covered calls (a conservative, low risk method to trade in stock derivatives)

This is more a trading than an investment effort since we buy stocks with the intent of a near-term sale. However, nothing in this work in any way downplays the value of a strong portfolio of growth stocks for a long-term asset base. Trading stocks and writing covered calls is a way to gain the resources to enjoy such an investment style.

To obtain maximum benefit from these strategies we have outlined a four-tiered process for selection:

- Identify stocks with strong fundamentals.
- Screen these stocks with technical analysis tools to find those that provide strong support for an increase.

- Select those tickers that suggest a near-term uptick.
- Check the news! Always review the latest news items on any stock before purchase.

Control your own destiny! Study stock patterns and do paper-trades until you feel good about your own strategy. Select a few rollers to play together. It is possible to play rolling stocks together. That is, when one is going down, have your money in one that is moving up.

Take advantage of a good charting service. There are abundant free services on the web but the price of a good service pays for itself. We use and recommend highly Telechart 2000 (TC2000) as a boost toward success. The charts are the best way to flag buy and sell signals which will fluctuate with news, the economy, and the whims of institutional investors.

Review the options quotes in a newspaper regularly to keep potential covered calls on deck, ready to move on when all the important indicators are in place.

Remember, certainty is a play on history. Certainty is in the past. It is essential to have a profound reverence for the market. It can take dramatic moves with no rational motive.

A rolling stock knows no season nor economic patterns. When a stock rolls it is up to us to take advantage of it. All rolling stocks have a finite shelf life. That is, they will stop rolling. It is the nature of variation, the principle of supply and demand, and the fickle/non-efficient marketplace

that guarantees stocks will roll. It is our role to take advantage of this phenomena. We must remain flexible and ready to change direction at a moments notice. We do this by carefully watching volatile stocks. By following the principles outlined in this book, we can stack the cards in our favor, obtain that "edge" that spells the difference between failure and success.

Review the pages of this book consistently until the principles are just a part of your makeup.

IX Index

3-D chart	150	collateral	38, 40
analysts.....	16, 20	commission.....	35, 175
analyze	150	commodity.....	206
annual	19, 82, 83	comparison	84
annual earnings	19	competitive	17
APR.....	17, 176	component	11
ask	36, 157, 173, 215	concept	7, 149
assets	20, 83	contract.....	205, 206, 207, 210, 215, 221
assignable	11, 12	covered calls.....	213, 217, 233
at-the-money	232	credit.....	35
auction.....	15	crossover.....	120
average	5, 18, 120	current earnings	19
Balance Sheet.....	83, 85	debt.....	19, 85
Beardstown Ladies	18	decline	38, 119
beta.....	21	decrease	83, 86
bid	15, 173, 215	decreasing.....	178
bond.....	16	default.....	153
book value	20, 21	derivative	209, 212
boundaries	153	discipline	157, 204
Business Wire	86	disclosure.....	83, 84
buy & hold	3, 227, 233	discount	18, 20
buy a call	226, 228	dividends	17, 19, 214
buy a put.....	228	double-talk.....	228
buy point	178	down cycle.....	178
buying power.....	38	downside.....	36, 174
called out.....	216, 229, 234, 236	dreams	149
cash value.....	39	earnings	16, 17, 18, 20, 86
causal.....	12	efficient.....	13, 15, 16, 22
cause.....	11, 14, 85	EKG	12, 154
causes	11	emotion.....	14
CBOE.....	207	entry.....	153, 157, 173, 179
Charles Schwab.....	8	environment.....	14
charts	238		

EPS.....	17	interest rates.....	16
E-Trade.....	8	intermittent	11
exchange.....	204	internet.....	3, 39
exit.....	157, 173, 174, 178, 238	in-the-money	232
expenses	16, 33, 236	intrinsic.....	15, 223, 225, 231
expiration	205, 223, 226, 236	intrinsic value	223
financial ratio	20	Investorama	238
financial reports.....	86	irrational	10, 16
fixed-time	209, 220, 227	knowledge	204
flavor	153	labyrinth	5
floor.....	151	learning.....	11
footnotes.....	85	lease.....	205
FORE	210, 221, 236	leeway.....	153
forecast	16, 17	leverage .36, 177, 213, 225, 226	
free-market	215	leveraging	209, 220
fundamental.....	15, 17	limit	173, 174, 175
fundamentals	11, 235	limit orders	173
future earnings.....	19	magnified.....	209, 212, 217
GAAP.....	86	management performance	20
gain.....	41, 229, 233, 236	margin..36, 37, 38, 39, 234, 236	
General Motors	146	margin account	36
global.....	16	margin call.....	37, 38, 41
growing	15, 19	market maker	173, 231
growth	18, 19	market-makers	215
growth rate	18	methods	12
growth stock.....	6, 9, 15	momentum	10
GTC.....	174, 176, 178	mountain.....	149, 150, 151, 152, 153
handicaps.....	34	moving average	120
historical.....	16, 19, 154	multiple.....	17
income.....	17, 229	naked	218, 228, 229
inconsistencies	84	national	16
increasing	20, 210, 223	negative	18, 21
inefficient	22	net income	19
institutional.....	7, 238	noise	11, 85
institutional ownership.....	21	obligation.....	208, 229, 233
insurance	21	OCC.....	215
INTC	215	on-line.....	39, 174
Intel	39, 212, 215		

open interest222
 operating.....153
 opportunity8, 10, 12, 13
 optimism.....14
 optionable.....207, 215, 234
 Options Clearing Corporation
 215
 order173, 174, 178
 oscillates.....119
 out-of-the-money.....232
 P&L.....83
 P/E.....17, 18, 19
 paper trades35
 patterns7, 22, 237
 perfect5
 pessimism.....14
 Peter Tanous.....10, 12, 22
 portfolio.....7, 9, 229, 232
 positive18, 84, 234
 predict13, 157
 predictive.....121
 price bar-chart177
 principle12, 13, 153, 238
 principles.....4, 13, 20, 157
 profits16, 152, 153, 226
Provident.....3
 psychology15
 put36, 149, 178, 230, 236
 quality153
Quant.....15
 quarterly82, 83
random.....10, 11, 13, 85
 ratio17, 19, 85, 235
 rational14, 16, 238
 resistance.....172, 175, 178
 risk capital3
 risk/reward5
 robust.....153
 ROE.....19, 20
 saw-tooth121
 SEC.....37, 83
 sector18
 selections22
 sell a call.....221, 228, 230, 236
 sell a put228
 sell point176, 178
 shareholder19
sideways .12, 13, 147, 150, 154,
 234
 significance.....85
 speculation.....227
 statistical.....12, 121, 154
 stochastics....119, 120, 121, 178
 stockholders.....17, 20
 strength16
 strike price ..211, 216, 226, 229,
 231, 232
 supply/demand.....231
 support.....175, 178, 205
 Taguchi.....153
 takeover20
 taxes.....16, 19
 technical15, 120, 121, 178
 technicals205, 235
theory.....11, 13, 16, 22
 ticker.....175, 208
 time value225, 231
 timing172, 173, 176
 trend 11, 12, 119, 120, 147, 150,
 205, 234
 understanding4, 14, 204, 209
 upside174, 178
variation11, 12, 147, 154
 vertical151
 volatility ..6, 10, 12, 18, 21, 231
 volume221

Wall Street Journal 210, 234
what if 82, 149, 150

wholesale 20

Fraction / Decimal Conversions

1/64	0.0156	1/32	0.0313	1/16	0.0625	1/8	0.125
3/64	0.0469	3/32	0.0938	3/16	0.1875	3/8	0.375
5/64	0.0781	5/32	0.1563	5/16	0.3125	5/8	0.625
7/64	0.1094	7/32	0.2188	7/16	0.4375	7/8	0.875
9/64	0.1406	9/32	0.2813	9/16	0.5625		
11/64	0.1719	11/32	0.3438	11/16	0.6875	1/4	0.25
13/64	0.2031	13/32	0.4063	13/16	0.8125	3/4	0.75
15/64	0.2344	15/32	0.4688	15/16	0.9375		
17/64	0.2656	17/32	0.5313			1/2	0.50
19/64	0.2969	19/32	0.5938				
21/64	0.3281	21/32	0.6563				
23/64	0.3594	23/32	0.7188				
25/64	0.3906	25/32	0.7813				
27/64	0.4219	27/32	0.8438				
29/64	0.4531	29/32	0.9063				
31/64	0.4844	31/32	0.9688				
33/64	0.5156						
35/64	0.5469	45/64	0.7031	55/64	0.8594		
37/64	0.5781	47/64	0.7344	57/64	0.8906		
39/64	0.6094	49/64	0.7656	59/64	0.9219		
41/64	0.6406	51/64	0.7969	61/64	0.9531		
43/64	0.6719	53/64	0.8281	63/64	0.9844		

The author: A career educator, author, and industrial consultant. He has applied technical, fundamental and statistical expertise in many disciplines and has found these applications beneficial when used in the market.