Part V
The Part of Tens

The 5th Wave By Rich Tennant

"I read about investing in a company called Unihandle Ohio, but I'm uneasy about a stock that's listed on the NASDAQ as UhOh."

In this part . . .

If you're looking for some easy-to-digest general information about candlestick charting, look no further than Part V. This part is the Part of Tens, where you find two helpful chapters on the myths of charting, trading, and candlesticks, and then ten things to remember about technical analysis.

Chapter 16

Ten Myths about Charting, Trading, and Candlesticks

In This Chapter

- Getting the facts on trading and candlestick misconceptions
- Discovering some trading tips

Throughout this book I reveal how charting techniques — especially candlestick charts — are a path to making money in the markets. But my views on the subject aren't unanimous among those interested in the markets. Many folks are critical of technical analysis in general. Also, some say there's no benefit in keeping an eye out for candlestick patterns. (I know, unthinkable!) Many of you who've attended business school have heard the arguments from professors (not professional investors or traders) that the markets are efficient and nothing can be done long term to outperform this efficiency. But rest assured that the reverse is true. I've worked with some very smart people who've done just what these professors say can't be done, and they've done it well.

In this chapter, I dispel ten common myths and misconceptions about trading and candlestick charts to set your mind at ease and help keep you confident in your trading pursuits.

There's No Difference between Candlesticks and Bar Charts

If you've already read some of the material in this book, hopefully, you roll your eyes when you see this myth. Candlestick charts are far superior to ordinary bar charts, for a whole host of reasons:

- Candlestick charts are aesthetically appealing.
- They also feature patterns that can be easily discerned and used as the basis for profitable trading decisions.
- Although the exact same price action shows up on bar charts, the dull presentation makes it difficult for you to pick up on the intricacies of the price movement.
- There aren't any exotic names for bar chart patterns. After you're used to *marubozus* and *dojis* and *haramis,* how can you go back?

Market Efficiency Makes It Impossible to Beat the Market over the Long Run

They drilled this into my head in college and did it again in graduate school. Why, oh why was I trying to get a degree in finance to get into the investment field if it was impossible for me to make any money at it? Why were all these classes full of people wanting to move on to careers picking stocks, making investments, or trading securities? Because some people do make good money as investors and traders. And because everyone believes that America is the land of opportunity, and with hard work, you can achieve some level of success.

Market efficiency is the belief that all investors have access to the same information and are making informed investing decisions. Some say that because these decisions are well informed and rational, current market prices reflect the proper value of a stock or commodity. But that simply isn't true. Traders make impulse purchases, and prices are always moving. Prices do get out of line, and it's possible to profit from the results.

Only a Full-time Professional Can Make Money in the Markets

Plenty of professionals make money as traders or full-time investors. If this game is truly made up of winners taking money from losers, how can a part-time amateur with a small account and limited time for analysis be expected to profit? It's easy: focus.

One of the most successful traders I know is a person in the state of Arkansas who does nothing but focus on trading stocks in a specific retail stock. I won't say which one, but it's very, very large. He knows the company inside and out, and trades nothing but options and stock on this particular big box store, where you can get anything and everything. He's been doing this for years and doing well at it. As a side note, he doesn't work for the company — he just happens to live where it's based, and he's watched it emerge as one of the largest companies in the world.

If you work in a particular industry, focus on the stocks in that industry. You already have a leg up on the competition because you have a fundamental knowledge of the industry through experience, which is something that many traders will never gain. For instance, if you work for a regional bank, find a handful of similar banks to focus on, or if you work for a construction company, focus on the companies that supply to builders. By narrowing your focus, you may just find a small niche where you can profit while professionals are spreading themselves too thin looking at multiple stocks and industries.

Technical Analysis Is Nothing More Than Reading Tea Leaves

This one gets me every time, probably because I just love it when charting is compared to psychic or supernatural activities. It's ludicrous! There's quite a bit of upper level math that goes into various methods of charting and trading. Also, when back testing is conducted on technical trading methods, the statistical measures used are similar to those used to check for errors in other hard sciences.

Not convinced of the seriousness of technical analysis? Tell that to the members of the Market Technicians Association (MTA). The MTA is a professional society with a professional designation called a Chartered Market Technician (CMT) that requires hours of study and the successful completion of three levels of tests to obtain. There are loads of extremely smart people that make a living using technical analysis who belong to this organization, and they all argue vehemently against the idea that technical analysis isn't a hard science. And you'd be hard pressed to find a tarot card or crystal ball owner anywhere in the group. For more information on the organization and the designation, you can visit its Web site at `www.mta.org`.

Charting Is for Short-Term Traders Only

Charts are wonderful for short-term trading. They depict the emotion behind what the market is doing and allow more rational traders to pick points to buy and sell. I can't imagine trading over the short term without them. However, long-term charts are also very useful, despite what you may hear from naysayers.

Those of you with full-time jobs outside of trading probably don't have the time to trade full time. If you still want to get involved with trading, one solution would be to trade by using longer holding periods. You simply need to work with longer time periods on your charts (use weekly instead of daily charts, for instance) and just plan on holding your trades for a bit longer.

One of the more successful technical traders is William O'Neil, the publisher of *Investor's Business Daily.* O'Neil has a longer term charting methodology that he highlights in his newspaper and through his charting service. If you're interested in longer term trading, seek more info on his strategies at `www.investors.com`.

You Must Be Rich to Start Trading

Don't get me wrong: No one should be speculating with money he or she can't afford to lose. If you're interested in day trading stocks, you must open an account with at least $25,000, which is more than most people can lose without suffering major repercussions. You shouldn't take out a second mortgage or bet the kids' college fund on a trading strategy, regardless of how confident you are in your abilities. Trading is stressful enough without worrying about the potentially devastating impacts of losing money if you don't have the appropriate means.

That said, you can also open a small account with a discount broker by using just a few thousand dollars, and trade lower priced stocks or futures contracts. In order to trade futures with a small account, you should concentrate on futures contracts that aren't terribly volatile or use some sort of strategy that employs stops to limit losses. You can get started with a small account, but you should be prepared to either expect limited returns or use very tight stops.

Trading Is an Easy Way to Get Rich Quick

Trading isn't easy. I can't emphasize that enough. Imagine working on something for a while, and then instead of reaping monetary rewards for your hard work, you end up losing money. If trading was easy, we'd all do it for an hour a day and live a life of luxury. Becoming consistently profitable requires quite a bit of hard work.

It took me a few years of working on systems (and losing some money) before I became consistently profitable trading for myself. My beautiful wife will attest to the amount of work I have and continue to put into my personal trading endeavor, which is almost like a second full-time job. However, I've noticed a direct correlation between how much time I devote to trading preparations and how well I'm doing. Hard work does pay off in trading, but don't expect to strike it rich with a half-hearted or lackadaisical effort.

Candlestick Charts Require More Data and Are More Difficult to Create

Okay, if you're drawing your charts by hand then yes, candlesticks are tougher to create. But with very few exceptions, candlestick charts are widely available and can be created by using the same information that's used to make bar charts. For more info on all the electronic resources you can tap into to view and build candlestick charts, flip back to Chapter 4.

The Trading Game Is Stacked against the Small Trader

This myth may have been true years ago, when almost all trading went through a trading pit or floor specialist. Now that the Internet has transformed trading into a mostly electronic medium, there aren't professionals standing between you and the execution of a trade. Technology has leveled the playing field.

Also, professionals used to pay much lower commissions than individual traders, but this too is in the past. There are several discount brokers that charge individuals the same low rates that institutions and large traders pay to trade. Small traders now have many versatile tools at their disposal and can more than fend for themselves in most markets.

Selling Short Is for Professional Traders Only

Selling short can be a difficult and nerve-racking business, especially when working with stocks. There may be extra fees involved, and if your broker is unable to borrow a particular stock, you may not even be able to put on the desired short position. And keep in mind that the overall long-term trend of the stock market is for prices to move higher, so you're always trying to buck the long-term trend when selling a stock short. Finally, in theory, the potential loss on a short is unlimited, while buying a stock limits your losses to the sum of your initial investment.

Despite all the downsides associated with shorting, I can honestly say that it's silly to assert that selling short is for professionals only. Not many individuals consider shorting, so there's ample opportunity to make money at it.

TIP

If you're interested in trying your hand at shorting, consider selling futures contracts short as an initial effort. The barriers for shorting futures contracts aren't quite as high as those involved with shorting stocks. Plus there's never a futures contract that needs to be borrowed — you just short and wait for a price drop to buy back.

Chapter 17

Ten Tips to Remember about Technical Analysis

In This Chapter

- Getting some sound advice on technical analysis
- Finding the right balance in your data
- Remembering to always back up your data

A debate continues to rage about the validity and usefulness of technical analysis in security trading. I'm a firm believer that, when used correctly, technical analysis is an outstanding trading and investing tool. There are also other methods of investing and trading, but for my purposes, technical analysis combined with candlestick charting has worked quite well. As you begin or continue your trading efforts, you almost certainly encounter differing opinions on technical analysis, and I use this chapter to set out ten points on the topic that you should remember as you cut through all the discussions and get down to the business of trading.

Charts Can Give False Signals

I am the first to admit that sometimes — in some cases up to 50 percent of the time — signals can be wrong. If all signals were reliable, then you could just see A and do B time after time, and you (and all your trading peers) would rake in the profits.

But the reality is that charts do give false signals, and it's up to you to use proper money management to limit the losses that can occur when good signals go bad. Always use wise stops when you put on a trade, and remember that when a signal fails, you must get out and move on.

People Will Give You a Hard Time

Some people regard charting and trading as nothing more than glorified gambling or guessing at the future. Let them talk. Just smile and bite your tongue, and think about the profit you just earned after closing out a winning position. Remember, people tend to make fun of things they don't understand.

Plenty of successful traders make a comfortable living using technical analysis as a primary trading tool. One of them even owns a professional baseball team. Who's gonna try to ridicule you when you're buying a sports franchise? Okay, your trading goals may not be that lofty, but you see my point.

There's No Definite Right or Wrong Opinion of a Chart

Because charting combines many factors and approaches, two traders or analysts can view a chart and have two completely different opinions about whether the chart is bullish or bearish. The reason for the differing points of view may be as simple as the time frame that each trader has in mind for a trade, or it can be something as unusual as one of the traders holding a bias about a particular stock or market depicted on a chart. Regardless of the reasons, both opinions have some measure of validity. Also, keep in mind it takes a buyer and seller to make a market, so when you make a trade, the other side of that trade has a differing opinion than you.

Try to remember that wrong opinions don't exist, just those that don't pan out in a specific scenario. You want people to at least be open-minded about your use of charts for trading and investing, right? So, you should offer others the same level of respect and consideration. After all, differing opinions are a crucial component of an active market!

A Single Chart Doesn't Tell a Whole Story

Multiple factors affect the prices of securities, from the health of the overall economy to industry-specific concerns to individual company events. And a multitude of individuals trade specific stocks daily, all with a variety of goals and time frames.

One solitary chart can't provide insight into what all the various players and influences are hoping to accomplish as they buy and trade a security over a period of time. Keep this in mind as you develop your trading strategy, and be sure to look at charts with time frames that don't necessarily match up exactly with the time line you use for your trades.

For example, you may be looking for a trade that lasts two or three days — a pretty short time frame. It certainly doesn't hurt to look at charts with a longer time frame as you search for a good environment for your trade. It may be a little confidence booster if you believe some traders with a longer time horizon are going to be on the same side as you! It's well worth the small amount of extra time and effort you spend to retrieve and study the additional chart.

Charting Is Part Science, Part Art

Although higher math is crucial for technical analysis, there's also what I like to refer to as the art component. Some people seem to have a knack for looking at charts and getting an instant (and profitable) feel for how the future trading action will develop with a stock or market. I think these few talented individuals just have a sixth sense, much like traditional artists have natural talents. These abilities are rare, but I've seen them in action. Unfortunately, it wasn't when I was looking in the mirror.

That said, I have been able to take the natural talents I do have for analyzing charts and enhance them with study and practice. You can do the same! Keep reading up on your patterns and maintain a watchful eye on your charts, and you can develop the ability to analyze and trade quickly and efficiently, too.

You Can Overdo It

I stated earlier in this chapter that you should consider varying time frames when putting together your trading ideas, but make sure you don't overdo it!

How can you overdo it? You can look at so many time frames and indicators that you end up seeing both bullish and bearish features on every security you analyze. You can end up with so much information influencing your opinion in both directions that you develop analysis paralysis, and you can't make a decision.

Don't overcomplicate your trades. Look at a few charts, draw your conclusions, and make a reasonable move. And don't forget to place your stops wisely! (For more information on stops, see the chapters with examples of trades starting with Chapter 7 and running through Chapter 15.)

Develop a Backup System

Whatever system you choose for your charting and data needs — whether it's a high-end system that charges hundreds of dollars a month or a free Web site — make sure to have a backup plan. No matter how costly or clever, systems do go down, and problems usually strike just when you need the systems the most. Make sure that you have a backup that you can rely on when you're faced with a system failure.

You should also have a backup system that you can use for confirmation when something just doesn't look right on a particular chart, or when it looks too good to be true. Data errors are a part of the game, and using a backup system for checking on what seems like a sure thing can save you some heartache and losses.

For more information on how to choose a primary and backup system for your data and trading needs, flip back to Chapter 4.

Error-Free Data Doesn't Exist

I can't emphasize the fact enough that error-free data isn't possible. If you start to back test your trading theories with historical data, keep in mind that there are errors in almost all data. Personally, I use two sources of data and compare them before performing tests, but I have the luxury of some programming knowledge and access to several data sources.

If you're on a limited budget, compare charts from two sources or use free data from two sources and make sure everything matches up. If you spot discrepancies, find a third data source and see which of your first two is correct!

No System Is Silly As Long As It Works

The world is filled with outrageous money-making theories, and the markets are no exception. However, if you have an idea of what works in the market, and you can properly test it and execute it to make consistent profits, your idea is worth incorporating in your strategy. I don't care if you say, "When it rains on Wall Street on a Friday it's time to short the DIA ETF" — if it works consistently, don't discount it, no matter how ridiculous it may seem. If something works historically for you in real money situations, keep an open mind when you're considering whether to keep doing it.

Past Results Don't Always Predict Future Performance

Sometimes the best laid trading plans just don't work. You can come up with a logical plan that's worked in the past and execute it while following all the right rules, and you can still fail to make money (or even lose it).

The market environment can change in erratic ways, and predicting what your trading peers will do all the time is very difficult. If you trade long enough, you're bound to get knocked down in situations where you expected to leap ahead. What's the best thing to do when that happens? Dust yourself off, chalk it up to experience, and begin looking for your next promising trade.