The *TREND*advisor Guide to Breakthrough Profits

A Proven System for Building Wealth in the Financial Markets

CHUCK DUKAS with
T. Parker Gallagher

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Contents

Foreword

The history of technical analysis in the United States dates back to the late 1800s; it was Charles H. Dow who expressed his thoughts about the activity of the stock market and the sentiment of investors. His belief in the primary, secondary, and minor movements of price set the stage for what we all know and accept as technical analysis. In fact, he went further by describing the emotions of fear and greed evidenced in the activity of investors and traders alike; his writings on sentiment were the forerunners of what university professors now call behavioral finance. He and many other writers have contributed to our understanding of the basic forces that dominate the marketplace today: supply and demand.

The latest adaptation of these basic principles is found in Chuck Dukas' book *The* TREND*advisor Guide to Breakthrough Profits: A Proven System for Building Wealth in the Stock Market*. Early on, this author talks about the need for methodology and the understanding of who is doing either the trading or the investing. Knowing the difference between the two, he feels, will help in creating the discipline and the knowledge we must all have to best analyze trends and use them in trading and investing. Like Dow, Dukas states that there is a clear distinction between price movements; and, with the advantage of modern-day tools, he has created a combination of technical indicators that form his TREND*advisor* Diamond.

The buy side and sell side of the Diamond highlight the technical traits found when demand dominates the action of buyers and conversely when the characteristics of supply overwhelm and the sellers take control of the action. By establishing specific criteria that define each phase, the book breaks trends into separate components. Each phase describes a distinct price movement. This book explains how the indicators are created and distinguishes how they behave in each separate phase, aiding the reader in learning how to interpret them. Each chapter describes how the forces of buyers and sellers play out in the charts, making it easier for the reader to understand the dynamics of supply and demand. The author writes about the need to include analysis in a methodology and plan. The detailed analysis of the sell side covers an important topic that many people overlook of how to take profits, and also offers a useful explanation of short selling.

Thorough, detailed, and useful technical analysis like what is offered in this book continues a trend of wider acceptance of technical analysis. The release date of this book follows shortly after the most important event to ever happen to technical analysis since Charles Dow's first articles of price activity appeared in the *Wall Street Journal*. It came in the form of the Securities and Exchange Commission (SEC)'s recognition of technical analysis. In March 2005, the SEC amended Rule #344. It now reads: "There are officially two analysts in Wall Street; a fundamental analyst follows companies and a technical analyst follows stocks." This watershed event has placed technical analysis on a par with fundamental analysis. Never in its history has this subject been so recognized and accepted by the establishment. The organization that gets the credit for this historic achievement is the Market Technicians Association (MTA). Many hardworking members of the MTA helped raise the standard for this deserving subject.

And it is authors like Chuck Dukas who continue to raise the bar for all of us when he writes that technical indicators will act differently during the six stages of his Diamond. He wants his readers to understand that we should all approach the market with a trading plan and the discipline to carry out that plan. Enjoy Chuck's book—I certainly did.

—Ralph Acampora

Acknowledgments

I dedicate this book to those individuals who have contributed emotionally, physically, spiritually, and professionally to this undertaking. With their support the dream became a reality.

First, to my wife Judy for your willingness *always* to support my efforts and to assist in bringing this vision into focus without distraction.

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To T. Parker Gallagher, my colleague who assisted me with taking my intellectual property and putting it into words.

Introduction

This is a book about teaching you how to approach making money in the markets. How can you make money by trading or investing in the financial markets? Our answer is by having a methodology, consistently applying it, controlling risk to preserve capital, and taking profits. What we will do for you in this book is help you to develop a methodology so you can determine whether a stock, mutual fund, commodity, or any other financial instrument is something you want to own—either as an investment or as a trade. What we are going to teach you is how to analyze any financial instrument to determine whether it is a candidate for your investment or trading dollars. There is a variety of ways to make money in the markets. You can be an investor or a trader. In our world, investors tend to have longer time horizons; traders tend to be shorter term oriented. The common objective of both is making money in the markets.

For all market participants, there are two important decisions to make—when to get in and when to get out, or when to enter and when to exit. Where the exit is relative to the entry dictates the outcome of the trade or investment—profit or loss. What you use to determine your entry and your exit is your methodology. This book is about how to create your own methodology for trading or investing in financial instruments.

Your methodology for entries and exits is not the only important decision you must make. You also have to decide how many positions or trades you will carry, at a maximum, and how much capital you will devote to any single position. You will need to decide how much risk you will take in any single position by defining where your stop loss will be placed. Your stop is the amount of capital that will be forever gone from your account when it is triggered. It is one of two possible exits from your trade or investment. The other is your profit target—the area where you will be starting to liquidate your winning investment or trade. Most traders have no set methodology for harvesting profits. We encourage a different approach of having a defined methodology that helps set a target and harvesting part of your profits when it is achieved.

You will make more decisions when you select what you will be investing or trading. Stocks? Futures? Indexes (including exchange traded funds)? Commodities? Foreign exchange? Mutual funds? What timeframe will you be using—are your trades or investments going to be held for a few days or a week? Months? Years? What are your objectives? How much capital are you going to devote to reaching them?

The answers to these various questions are all part of a trading plan—an organized approach to how you will be doing your trading or investing. Trading or investing is like any business or economically motivated endeavor in that success is much more likely to come from a defined methodology, consistently applied, with good risk control—in short, a well organized plan—than by chance or random selections. In Chapter 10 we will guide you into creating a trading or investing plan of your own. As you read this book, please keep in mind that you are learning what you need to know to create a trading plan for yourself.

An example of a simple methodology that many mutual fund owners, who have subscribed to the "buy and hold" approach, use is to own funds in their retirement accounts. They buy mutual funds, often periodically with every paycheck, and hold them until retirement. As the market goes up and down, they sit through the gyrations. They sell, or exit, on retirement day or when they need the money during retirement. There is a methodology in this—a defined strategy for buying, holding (under the theory that time will make you money), and selling—only when the money is needed in retirement.

The managers of those mutual funds, the folks who invest that money, also have some kind of methodology. Frequently it is to analyze a number of companies across industries, and find ones that their spreadsheet model says will grow in a manner that their calculations say they can now buy at a discount based on their predictions of future value. They then wait for the company to grow and the stock price to go up to reflect the value of that growth. They sell when the stock price is higher than the discounted future value calculation says it should be.

However, this is only theory. The reality is that the Investment Company Institute calculates the average turnover in mutual funds is 100 percent per year. This means that, on average, fund managers are buying and selling every stock in their portfolio once a year, which hardly qualifies as long term investing. This tells us that there is a tremendous amount of trading going on in mutual funds. This, combined with the fact that most mutual funds underperform the indexes, suggests that those investing methodologies do not translate successfully into profitable trading strategies.

The point is this: Everyone needs a methodology. Few have one that they consistently apply. If you are actively managing financial assets of any kind—stocks, mutual funds, or commodities—your methodology should include the criteria for how and why you are buying what you are buying, and the criteria for how and why you are selling what you are selling.

Our approach has a simple underlying rationale: buy and own only stocks or instruments that meet the criteria of an uptrend. For those who have the sophistication and for whom it is appropriate, sell or sell short stocks or financial instruments that meet the criteria of a downtrend. The definitions of uptrend and downtrend come from how the prices of these instruments are behaving. This puts us in the world of technical analysis. There is no fundamental analysis in our methodology—no discounted cash flow models, earnings estimates, industry predictions, or present value calculations.

When you enter your position, your outcome is going to be a function of what the other market participants are doing. If you trade with them, you will profit. If you trade against them, you probably will not. Therefore, you should have an understanding of who the players are, their methodology for decision making, and how they are paid (which is a proxy for motivation). You will find your job of making money in the markets easier if you understand the dynamics of how these players make their decisions and use that information in your own decision-making.

Why do stocks and other financial instruments go up and down? The price at which a stock/instrument trades at any moment in time is the balance of supply and demand for that stock/instrument at that time. Different participants have different determinations of what something is worth at any point in time. If something is rallying, going up, there may be a large-volume trader who decides it is time to take a profit and sell. This will cause the price to stop going up or to go down. Likewise, if something is going down, a large investor may have a model that says, at this price it is worth buying. This will cause the price to stop declining or go up.

Who are these other market participants you are trading with or against? They are the sum of all market participants, but we can categorize them into three distinct groups. The first is mutual funds and other professional investors (money managers). Next come hedge funds. Some hedge funds are investor oriented, but there are many that are trading oriented. The third group includes the trading desks of the major Wall Street brokerage firms and other professional traders (which can include trading oriented hedge funds).

Mutual funds are run by a fund manager or managers. One becomes a mutual fund portfolio manager by having been a good analyst. The path to becoming an analyst is: first, graduate from an excellent college, then work at an investment bank or mutual fund for two or three years, building spreadsheet models of companies' income and expenses and predicting how the income and expenses will play out under various circumstances. Then go to a top business school (two more years), build more spreadsheet models, after which get a job as an analyst at a mutual fund or brokerage firm. If the analyst is good and makes good recommendations to the portfolio managers, after three to five years she may be offered a portfolio to run. Mutual fund managers are graded by beating the benchmark, by how much they outperform the index their fund is compared to. Note that this does not mean they have to make money—in a down market, all they have to do is be down less than the market to earn their bonus—and bonuses are the greater part of their pay. They beat their benchmark frequently by looking at all the industries and companies in the benchmark, deciding what is likely to underperform, and buying everything else. Or, they will load up on (overweight) what they think will outperform and underweight everything else. Like professional money managers, they have to wait to get their profits—usually for quarters and years, because it takes time for the companies they are buying to experience the growth they are forecasting. Their decision inputs include what the analysts are discovering and advising (both buy side and sell side analysts), and what the companies tell them. It is estimated that the total investment amount of mutual funds is about one trillion dollars.

Hedge funds come in all shapes and sizes. Like mutual funds, they are pools of money put up by their investors. However, they differ from mutual funds in several aspects. First, hedge fund managers are paid a percentage of the profits the fund earns. This gives them a huge incentive—they are paid on actual profits earned, not by beating some benchmark. This is called absolute performance as opposed to relative performance. Second, not only can they buy stocks, they can also short them; see the next paragraph for a description of short selling. Because these managers can short, they can make money in markets, stocks, or instruments that are going down. Finally, hedge funds can use leverage—they can borrow money to increase the amount they invest. This magnifies the fund's returns (and also its losses!). Hedge funds are incredibly lucrative. Pay scales there are vastly higher than at mutual funds. This means that the best portfolio managers and analysts frequently leave mutual funds to set up their own hedge funds. For the fundamentally oriented funds, the manager's decision inputs include what the analysts are discovering and advising (both buy side and sell side analysts), and what the companies tell them. Because they are paid on what they make, they will frequently trade in and out of positions, taking advantage of market moves to generate profits. Many use sophisticated algorithms—mathematical models—to make their buy and sell decisions. It is estimated that hedge funds' total investment is about one trillion dollars. Note that this makes them about the same size as the mutual fund industry—they just have different tactics and objectives.

Short selling is a tactic employed by sophisticated traders to profit from things that are going down, not up, in price. To conceptualize this, let's use a fictional story. Pretend that your analysis suggests that a company's stock is about to decline from its current price of $50 and you would like to profit from that decline. You call your friendly broker and tell him you would like to short 100 shares of the stock. He goes into his book of clients and finds a fellow who owns a bunch of this stock. He calls the fellow up and asks if the fellow would "lend" some of the stock and be paid some interest for lending it. The fellow says, "Let me see if I understand you. You would like to borrow some of my shares of stock. I will still own them. And you will pay me interest for lending them to you. Is that correct?" "Yes," replies the broker. "Okay." So the fellow lends the 100 shares to you. You take the borrowed 100 shares, sell them in the market for $50 and collect the proceeds ($5,000 less commissions, which you keep in your brokerage account). The stock falls to $40. The fellow calls the broker: "Remember the shares I lent you? I want them back now because I want to sell the stock." The broker calls you. "The lender wants his shares back." "No problem," you say. "Take some of the money in my account and buy 100 shares of stock at the current price of $40. Then return the 100 shares to the lender." Your broker does this. You had sold the borrowed 100 shares at $50, collecting $5,000. You bought back those sold shares at $40, for $4,000. The stock has gone down 10 points and you have made $1,000.

Please note there are a number of substantial risks in shorting stocks, including, but not limited to, the company getting taken over and the stock price soaring. If the stock price goes up when you are short, you will have losses because you have to buy back the stock at a higher price than you sold it for.

Because of these risks, short selling is only for sophisticated traders. However, it is widely used by hedge funds, which are extremely sophisticated, and the big Wall Street trading desks. It is estimated that hedge funds control almost $1 trillion dollars, which is about the size of all mutual funds combined. Because of this, selling pressure in markets is not just from folks who own something selling it. Selling pressure in markets also includes short sellers. Short sellers are one of the significant reasons downtrends show pronounced selling.

Who do mutual fund players and hedge funds sell to and buy from? The trading desks of the largest Wall Street firms. These trading desks are very short term oriented; they will be in and out of positions in hours or days. Their inputs include sophisticated mathematical models that help determine the price to pay. Interestingly, we calculate that the total capital the largest Wall Street trading desks have to deploy in the market is about one trillion dollars. This means they are as well funded as the mutual funds and the hedge funds.

How do these three, equally well-capitalized players who each control about a trillion dollars, interact on any given day? The hedge funds who trade the indexes have sophisticated mathematical models that determine whether they should be buying or selling. The other professional traders (including the trading desks) react to these waves of buying and selling. Mutual fund managers are buying and selling based on updated information from the analysts and companies. In earnings seasons, those four times per year when companies report their quarterly earnings, the mutual fund managers will be quite active, updating their positions based on how the companies are performing. They sell out of, and buy into their positions, with the trading desks. Because they are longer-term investors (in theory), and they make their decisions based on the flow of information that impacts their spreadsheet models, they are not very sensitive to the price they pay or sell at. When it is time to buy, they buy; when time to sell, they sell. They buy and sell from the sophisticated traders who are only in those positions for a short period of time, and for whom price is everything—thus, they set the price in the short term. The mutual fund investors are less active at times outside of earnings season because there is less information on which to make decisions. This means the trading models have much more influence in how the market and stocks behave outside of earnings season.

Commodities have their own sets of players. If one thinks of agricultural commodities, there are producers (corn farmers), the users of those commodities (Kellogg's, who buys corn for cereals), and traders who are simply trying to make a profit. The longer-term price trends in commodities are a result of the underlying drivers of the supply and demand for that commodity. For example, a drought will kill off the corn crop, reducing supply. Prices rise—this is good for farmers who have corn, but bad for the consumers of corn.

To summarize, in the short term, the market is influenced by the professional traders; in the longer term, it is influenced by investors. Align your decision making and trade selection with the underlying dynamics of the demand and supply of the instruments you are trading. In short, trade with the trend! We will now explore how you can effectively analyze for trend.

CHAPTER 1

The Ins and Outs of Trends with a Toolkit for Analysis

Years ago *Fortune* magazine ran a powerful campaign about its media power under the slogan, “There is nothing more powerful than a trend.” In reality, there is something even more powerful than a trend, and that is being able to perceive the beginnings and ends of trends. To be able to do that is to be able to take full advantage of knowing when to be in and when to be out. As Shakespeare said, “There is a tide in the affairs of men, which, taken at the flood, leads on to fortune.”

Trading and investing is the art of deploying capital as prices change over time. When we analyze market behavior we are looking at two interactions: how price is changing (or not changing) over time; and whether or not the current price is behaving in a manner that indicates an action.

Our goal as investors and traders is to overcome fear and greed by trading what we *see*, not what we think or feel. Conceptually, trading and investing is putting capital at risk over time, and profits (or losses) are the outcome when we exit our trades. Trading is easiest when our capital produces profits quickly. Quick profits in short time frames are possible if we are trading in an instrument that is strongly trending. Then we should be continuously harvesting profits.

We define an uptrend as higher highs and higher lows over time. The faster prices rise in a shorter time frame indicates the strength of that uptrend, or shows how quickly higher highs can be achieved over time. Conversely, lower lows and lower highs are what characterize downtrends. The faster prices fall in shorter time frames allows us to calculate the strength of the downtrend. (A tool used for precise calculations, the 60 period high/low channel, will be described later.)

Our job as an investor or trader, therefore, is to recognize a trend and to identify when that trend is ending. If an uptrend is a series of highs, what does the end of that trend look like? Most traders would say it looks like a series of lows. However, more accurately, the end of an uptrend can just be an absence of further highs.

From either a trading or investing perspective, when our financial instrument breaks out into a series of new highs, we usually have our quickest, greatest profits in short time frames. Likewise, when we are short and it breaks down into lower lows, we frequently have our quickest, largest profits in short periods of time. We define a new series of highs as an emerging uptrend and a new series of lows as an emerging downtrend. Additionally, when there is an absence of new highs over time, that uptrend has potentially ended and likewise, on the down side, when there are no further new lows over time that downtrend has potentially ended.

60 PERIOD HIGH/LOW CHANNEL

We can track highs by using an indicator that draws the value of what the highest high has been for the last 60 periods. We then can see where the current price is relative to whatever the highest high has been for the last 60 periods. When price starts to exceed this line, the market is now producing the higher highs that define an uptrend. We use 60 periods because that is three months of trading data, one calendar quarter in the annual earnings cycle. (See Figure 1.1.)

If price has been going sideways for some time, there will be no new higher highs and the 60 period highest high indicator will go flat, indicating a potential end of trend.

We can also track lows by using an indicator that draws the value of what the lowest low has been for the last 60 periods. We then can see where the current price is relative to whatever the lowest low has been for the last 60 periods. When price starts to fall through this line, the market is now producing the lower lows that define a downtrend (see Figure 1.2).

If price has been going sideways for some time, there will be no new lower lows and the 60 period lowest low indicator will go flat, indicating a potential end of the downtrend.

We now have an indicator that tracks highs and an indicator that tracks lows. These help us to see the trend as it unfolds. We add to these two indicators a third: the 50 percent retracement indicator. This simple indicator shows the middle of the channel created by the 60 period high/low channel. It is calculated by summing the value of the high and low channels, then dividing by two. As you will see later, the 50 percent retracement line can be useful in making trading decisions in the trend (see Figure 1.3).

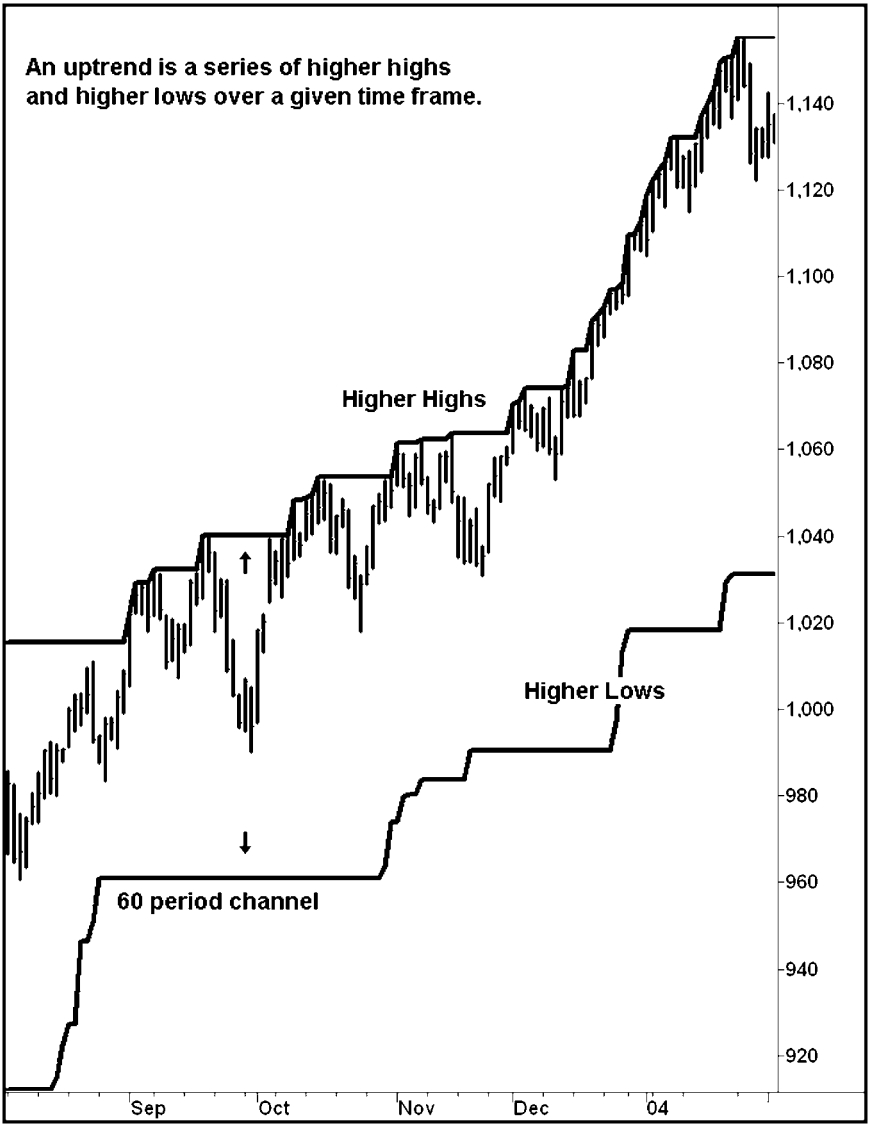

FIGURE 1.1 Uptrend with 60 Period High/Low Channel
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