BOOK REPORT (7/13/09)

SHORT TERM TRADING STRATEGIES THAT WORK

By

Larry Connors
Cesar Alvarez

In trading, do the opposite of your instincts.

I. Buy pullbacks, not breakouts

a. Buy at 10-day lows; sell when price crosses above 10 period moving average. Buy markets which pull back (10 day low is a superior strategy).

b. Lock in gains when markets make new highs

c. As markets are making new highs, odds are increasing a pullback or short-term reversal are near; as markets make new highs, lock in your gains

d. Don't get caught up in hype when markets make highs. Things may be great, but prices already reflect this, and vice versa

e. When everyone is thinking the same way, they're usually wrong; think differently

II. Buy market after it's dropped, not after it's risen

a. Hypers and bashers are only repeating what the market already knows

b. Market has already factored in much of the news

c. Don't buy a stock after it's risen a number of days or vice versa

d. From 1995-2007, after S&P 500 index has dropped three days in a row, it has risen more than four times its weekly gain over the next five trading days

e. After S&P 500 has risen three days in a row, it has on average lost money over the next five trading days

III. Buy stocks above their 200-day moving average, not below

a. Many people look for stocks that have been beaten down over a long period of time. People "bottom fish" stocks as they fall below their 200-day MA (kiss of death is when "growth stock" is referred to as a "good value"). Better to be buying stocks in a longer term uptrend than longer term downtrend

b. Reviewing 8 million trades of stocks from 1995-2007, they looked at 5-day behavior of stocks above and below 200-day MA

    i. Average 5-day gain above 200-day: 0.25%

    ii. Average 5-day gain below 200-day: 0.18%

c. Most cataclysmic individual stock drops over past century have occurred when stock was under 200-day MA

d. Not foolproof. Many good stocks represent real value below 200-day MA, but it's easier and less stressful when buying when longer term trend is up

IV. Use the VIX to your advantage; buy the fear, sell the greed

a. Extreme market sell-offs are associated with extremely high VIX readings (reflects fear in marketplace). These identify good times to enter on opposite side of emotion and go long

b. Opposite end is when market rises and complacency (and greed) take hold. Reflected by lower than average VIX readings. Time to lock in gains or short market

c. Proper way to use VIX is to look at where it is today relative to 10-day simple MA. The higher above 10-day MA, the greater likelihood market is oversold and a rally is near. Conversely, the lower it is below 10-day MA, the more the market is overbought and likely to move sideways to down in the near future

d. <u>VIX 5% Rule</u>: Be careful buying stocks anytime VIX is 5% below its MA. Since 1995, S&P 500 has lost money on a net basis 5 days following the times the VIX has been 5% below its 10-day MA. Since 1995, whenever VIX has been 5% or more above its 10-day MA, the S&P 500 has achieved returns which are better than 2-1 compared to the average weekly returns of all weeks

e. Edge lies in buying when VIX is at least 5% above its 10-day MA, and locking in gains (and not buying) when VIX is 5% or more below its 10-day MA. When fear is great and VIX is high, we want to be buying. When greed is prevalent and VIX is low, we want to be locking in gains and/or shorting the market

V. Stops Hurt

a. In 2005, they ran tests to identify optimal stop levels to use. They ran hundreds of variations of stops tests and all came to the same conclusion: stops hurt [see tables pp. 32-33]. The tighter the stop, the worse the performance.

b. Market makers, specialists and professional traders know stops are sitting there and often they are gunning for them

c. Stock will drop, stop gets hit and stock reverses and proceeds to rally. Happens frequently enough to lessen returns

d. Stops are a psychological comfort zone; if that's the case for you, use them

e. Tests not run on options, futures or forex

VI. It pays to hold positions overnight

a. Even though many market landmines occurred after markets closed, over last 13 years, SPY points gained were 171.40 if you held overnight and (70) if you held during day and sold on close. For QQQQ, 99.44 points gained overnight vs. (58.33) gained if sold on close

b. Successful trading often involves doing the opposite of what everyone else is thinking and doing. If it's logical and everyone is thinking the same way, it's not likely going to make money

c. Edges lie in looking at the obvious and often looking to do the opposite

VII. Trading with Intraday Drop, making edges even bigger

a. Longer time frames make for more efficient markets

b. Short timeframes, more chaos

c. Greater chaos means more opportunity for stocks to be mis-priced

d. <u>Fear and Irrational Behavior</u>. A stock drops dramatically and people start looking for a fundamental reason why. Like a self-fulfilling prophesy, selling causes more panic selling, until reaching an extremely oversold condition before it snaps back (usually intraday). Buyers step in, shorts scramble to cover and stock jumps up, without a single fundamental event occurring. This is called "reversion to the mean" or pullback trading.

e. When stocks are jumping up and financial news is hyping them, blind greed urges you to jump in. Best choice may be to short stock.

f. If you see people on CNBC wearing party hats, you may want to start aggressively hitting bids

g. You want to see stocks become even more overbought or oversold. Buy the fear, sell the greed

h. Greater the intraday momentum to the upside, the worse the performance has been over the next 5 trading days. They don't have positive edges. They are overbought and most reverse within 5 days. [p. 44]

i. Stocks accompanied by concerns and heavy selling closed at 10-day lows and then sold off further intraday:

    i. Rules: Stock closes at 10-period low and is above 200-day MA (a pullback within a longer term uptrend); average volume over past 100 days is at least 250,000 per day; price greater than $5 per share; buy on close; exit on close 5 trading days later [p. 46]. Best results: above rules and buying next day @ 10% less (4.4% avg gain), 7% less (3.0% avg gain), 5% (2.0% avg gain). Correct 54% of the time.

    ii. Greater intraday sell-off, the better the performance

VIII. The 2-Period Relative Strength Index (RSI): The Trader's Holy Grail

a. There is no edge to using the 14-period RSI. More robust and consistent results are obtained using 2-period RSI

b. RSI: Compares magnitude of a stock's recent gains to magnitude of its recent losses. Gauges overbought and oversold conditions. Accuracy: 84%, avg hold ≤ 3 days:

    i. Higher RSI the more overbought and vice versa [p.56]

    ii. Over 90: overbought; Under 10: oversold

    iii. The lower the RSI, the greater the performance and vice versa

    iv. Stocks with 2-period RSI above 90 should be avoided short-term or use short strategies; greater than 98 = short.

    v. On average, stocks with RSI below 10 show a positive return over one week. RSI < 1 (.49% gain), <2 (.62% gain), <5 (.79% gain), <10 (.93% return).

    vi. Returns can be improved by buying the low RSI stocks the next day on further pullback and selling in one week

c. Rules (for SPY; 84% accurate in direction):

   i. SPY above 200-day MA

   ii. 2-period RSI closes below 5

   iii. Buy S&P on the close

   iv. Exit when S&P closes above its 5-period MA

d. From 1995-2007, no. of signals: 49; percent correct: 83.6%; average hold: 3 trading days

e. Cumulative RSI Strategy: (Holy Grail of oscillators; 88% accurate, avg hold ≤ 4 days:

   i. A running day total of 2-period RSI readings (add up past number of days of 2-period RSI readings)

   ii. Stock trading above its 200-day MA

   iii. 2-period RSI

   iv. Take past X days of 2-period RSI and add them up

   v. Buy if the Cumulative RSI is below 35, 40 or 50 (you decide)

   vi. Exit when 2-period RSI closes above 65

   vii. They looked at stocks from 1995 which had cumulative RSI readings below 10 and average daily volume of 250,000 and stock price above $5. There were 77,068 trades, of which 69% were profitable exiting above a 2-period RSI of 65. Average gain nearly 4 times greater than gains for all stocks for same holding period

IX. Double 7's Strategy (85% accurate, in market 20% of time; consistent results buying SPY, ETFs or indicies. Stocks have added risk vs SPY, ETFs and indicies.

a. Three Rules:

   i. SPY is above its 200-day MA

   ii. If it closes at 7-day low, buy

   iii. If it closes at 7-day high, sell

b. Strategy picked up 100% of the gains and more in the SPY since 1993; in market 25% of the time, avg .85% profit / trade, 80% accurate

c. Can also be applied to Double 5's, Double 6's through Double 10's

d. Can also be applied to FXI (China ETF) and WEZ (Brazil)

X. End of Month Strategy

a. Stocks show an upward bias at end of month

i. Money managers pile into stocks at month end in anticipation of 401k and retirement account money coming in

ii. Looked at trades from 1/95 through 12/07, breaking them down to the day of the month, asking "if we bought every stock today, how would we have done over next 5 trading days?" with stocks above 200-day MA with trading volume at least 250,000 [See chart p. 84]

iii. Days 23-30 had best gains; day 25 best of month. Next best days of month (in declining order): 24, 27, 26, 29, 28, 30, 1 (ie, not 31).

iv. Worst days of month (in declining order): 4, 6, 5, 7, 17, 12, 8.

v. On average, stocks have lost money for 6 consecutive trading days from 3rd through 8th day. Money was spent by money managers near the end of the previous month

vi. Gains even better if stock drops previous day or two.

XI. Strategies to Time the Market

a. VIX Stretches Strategy:

i. Markets tend to behave differently when the VIX is above its 10-period moving average vs. below. The longer it stays above and the more stretched it is above, the higher the likelihood that the market will rally soon.

1. Strategy (85% accurate, avg hold: ≤5 days):

a. SPY above its 200-day MA

b. VIX is stretched 5% or more above its 10-day MA for 3 or more days. If so, buy the market on close

c. Exit when SPY closes above a 2-period RSI reading of 65 or more

b. VIX RSI Strategy (79% accurate, avg hold: ≤5 days):

i. Rules:

1. SPY above 200-period RSI

2. 2-period RSI of VIX above 90. VIX is overstretched (fear and panic have entered the market) and likely due to reverse

3. Today's VIX open is greater than yesterday's close, signifying further panic

4. 2-period RSI of the SPY is below 30, saying stock price weak and market oversold

5. Buy on close

6. Exit when 2-period RSI of SPY closes above 65

c. TRIN = (Advancing Issues / Declining Issues) / (Advancing Volume / Advancing Volume):

i. TRIN point of equilibrium is 1.0. Readings above 1.0 occur when markets decline; readings below 1.0 occur when markets rise. Readings above 1.0 lead to oversold markets and readings below lead to overbought, which are likely to reverse

1. Strategy (76% accurate, avg hold: ≤4 days):

   a. SPY above 200-day MA

   b. 2-period RSI of market is below 50, signifying a little oversold

   c. TRIN closes above 1.0 for 3 consecutive days

   d. When these 3 rules are met, buy on close

   e. Exit on close when 2-period RSI of SPY is above 65

2. Don't use TRIN daily as a standalone indicator. Trade with trend and wait for persistent high TRIN

d. Cumulative RSIs Market Timing Strategy (79% accurate, avg hold: ≤5 days):

i. Multiple days of low RSI readings, especially above 200-day, indicates markets that are potentially washed out

1. Rules:

    a. SPY closes above 200-day MA

    b. If sum of past 2 days' 3-period RSI is below 45, buy on the close

    c. Exit when 2-period RSI closes above 65

e. S&P Short Strategy (79% accurate, avg hold: $\leq$5 days). Be long above 200-day MA and short below:

    i. Rules:

        1. SPY below 200-day MA

        2. Market closes up 4 or more days in a row

        3. Sell on close

        4. Cover short when SPY closes under its 5-period MA

XII. Exit Strategies

a. Fixed Time Exit Strategy: When a certain amount of time has passed. Not really recommended

b. First Up Close Exit Strategy: Exit after first up close vs. previous day

c. New High Exit Strategy: Sell after it closes above a new high

d. Close above MA Exit Strategy: Exit after close above simple MA. 5-day and 10-day MAs. 5-day is favorite

e. 2-Period RSI Exit Strategy: Exit on close above 65 RSI

f. Few, if any, stop strategies improved results

g. Interview (Q&A) with Navy Seal

SUMMARY of 16 Short Term Trading Strategies That Work

1. Buy pullbacks, not breakouts! The statistics overwhelmingly prove that out.

2. Buy the stock market after it has dropped multiple days in a row, not after it has risen

3. Buy stocks above their 200-day moving average

4. Buy stocks when the VIX is 5% or more above it's 10-period moving average. Lock in gains (or short stocks) when the VIX is 5% or more below it's10-period moving average.

5. As you saw, stops are potentially an expensive form of insurance

6. Hold positions overnight in times of concern. One has been amply rewarded doing so.

7. Buy stocks on intra-day pullbacks in order to increase the edges even more

8. Apply the 2-period RSI to all of your trading. It's as close to the Holy Grail of indicators that's available.

9. Buy the market and stocks when the 2-period RSI is below 5.

10. Trade with cumulative RSIs. The lower the Cumulative RSI the better,

11. Trade Double 7's on US and world indicies and ETFs.

12. Time the market using the TRIN, the VIX the 2-period RSI and price as described in the Market Timing chapter.

13. Buy stocks at the end of the month, especially those that have dropped 1-2 days in a row.

14. There are many good exit strategies. The key in to make sure the ones you choose are dynamic. The best are the close above the 5-period moving average and the RSI exits.

15. Have a plan in place to deal with the many realities of daily trading. Professional trading requires professional preparation.

16. The most important strategy begins with your mind. You mind will dictate your success. The more focused you are on your targets, the more successful and profitable you will be.

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