Serving a trading apprenticeship

The Wyckoff method of trading stocks part 13

by Jack K. Hutson

Anyone studying the stock market intends to remove themselves from the ranks of the public that dabbles with luck as their foremost rule of operation. A true student of the market doesn't graduate into actual trading before completing a self-imposed apprenticeship where experience becomes the teacher.

Experience hones practical skills such as the timing of trades and also builds the mental attitude that allows a trader or investor to think clearly and follow an analysis to its conclusion. If you, as a student of the Wyckoff Method, were embarking into an apprenticeship alone, experience could be a hard and painful lesson. But Wyckoff offers a comprehensive package of detours around the common pitfalls that so often sidetrack beginning technical analysts into frustration.

Here, we'll discuss how to approach practical skills and later examine the mental and emotional attributes a technical analyst should encourage.

Paper trading

Medical students don't begin with heart transplants and stock market students don't jump right into trading with their hard-earned capital. Trading on paper is the inexpensive way to gain experience and test abilities.

Although paper profits aren't as thrilling as cold cash profits, early success on paper should bring a thrill in achievement and in knowing that you never again have to take chances or suffer disastrous losses.

Paper trading should continue until you learn what and when to buy or sell—anywhere from 50 to 100 transactions. Use stop orders and keep records just as if you were working with a broker. Figure commissions and taxes; calculate net profit and loss.

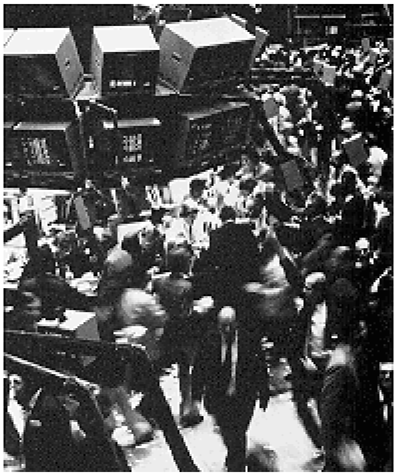
Be certain of your judgment before you venture a dollar in the market and don't let anyone entice you into hastily committing real money. In the beginning, knowledge of stock market technique is far more valuable than capital.

Actual trading

When you feel confident to trade with money, start with 10- or 15-share lots no matter how large your capital. You're still in training, so don't try to make money at this stage by over-trading and straining your judgment with extra nervous energy.

Operating with actual money is more of a test of your ability than paper trading, because, says Wyckoff "when your money is at stake you will be more or less at the mercy of the two devils of stock market followers—hope and fear."

Diversify into three, five, 10 or 20 of your best selections depending on your capital and ability to watch each commitment. Resist the temptation to put all your faith in 100 shares of one stock vs. 20 shares of five issues. Out of five issues, one may fail, one may not turn out as well as expected, but the other three should more than compensate for the others. "The man does not live who can make a profit on every transaction," Wyckoff points out.



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All commitments need not be made at once, of course, but Wyckoff does advise that trades be in the same number of shares (equal lots) of each stock. Loading up on low-priced stocks, the most speculative and riskiest, would mean that losing trades most often occur in the largest lots, while profits come in small amounts from higher-priced stocks.

If you're investing for intermediate and major swings, you also could divide your capital by investing the same number of dollars in each issue—provided you stick to the higher-grade stocks and do not put an undue percentage of funds into low-priced stocks.

Any profits made at the start should be used to build up your capital for dealing later in larger lots. If you spread your capital too thin in the beginning you may be handicapped and discouraged by early experience. If actual results aren't as good as your paper trading results, go back to paper.

Work and study habits

Find a quiet spot away from interruptions to study your paper and actual transactions. Whether it's your home den, your office after hours or a privately leased office, find someplace far from brokers, gossip, questions and rumors that will confuse judgment.

Devote at least one hour each day to studying the market. You can obtain the comparatively few facts needed to compile your own records from an evening newspaper's stock pages. As Wyckoff explains: "The best results I ever had in judging the market and trading were when I could devote only one hour a day to study of the market, planning my campaigns and giving instructions, and so busily engaged in other affairs that it prevented my studying the (ticker) tape throughout the session."

In Wyckoff's view, it is much better to make one commitment a month that realizes a profit than to trade every day and show a net loss.

Concentrate on determining the position of the market, defining its trend, anticipating turning points and selecting stocks that should make the most profit in the shortest time. The study should become almost like comparing successive snapshots of a moving object, much like time lapse photography.

Learn to sell short

Selling short is not as easy for most people as trading on the long side. But the biggest and quickest money is on the short side.

Trade on paper until you can sell short as easily as go long. "A trader who can only operate on one side of the market is only half a trader," says Wyckoff. "He sees everything through the eyes of a bull. He thinks everything is always going up. He never can see money on the short side. The truth is, a chronic bear has a better chance of making money than a chronic bull."

Time your actions carefully

Don't jump in too soon and tie up money waiting for a stock to move up or down. Wait for the period of preparation to end and let other people play with the stock until then.

Go with stock that should move soonest, farthest and fastest. You want immediate action for your money and it is bad practice to hold a position for many days or weeks without getting anything out of it.

Limit losses and let profits run

This is a fundamental Wall Street principle that the public notoriously practices in reverse because the public forgets that it's not what you make, but what your keep, that counts.

Decide in advance how much risk is in a trade. Profits should be at least several times the amount of risk before it's considered worthwhile and a stop order should always be used to limit losses. It's no sin to be wrong, but disastrous to let a small loss run into big figures.

Know every minute why you are starting a trade, why you're holding it and why you should close out. If your stops are caught too frequently, use more discrimination in starting trades. Refuse all but the best opportunities and wait for them.

Placing orders

In nearly every case, whether long or short, it's best to place your orders "at the market." If you specify a price, a broker may not be able to get the stock at that exact price and you may miss an entire move.

Limited orders (the office stop and buy stop, where a new trade is to begin at a specific price) can be useful if you are experienced enough to anticipate an action. For example: if you clearly anticipate a slight dip in price that would be an advantageous buying position before a stock continues advancing.

Don't "straddle" the market (being long in one stock and short in another) unless you are so proficient and so controlled that nothing will rattle you.

Work in harmony with the indicated market trends and wait for the best openings, don't try to jump into every turn. If the market indicates a decline, go short. When the decline runs its course, cover and watch for signs of an important reversal. Then go long, and when that important rally has topped out, read the market for signs of a continuing decline to switch back to short selling.

Wyckoff also advises against timing a long or short trade according to the ex-dividend date (the date dividends are declared) simply to obtain the dividend payment. The allure of this practice in a bull market is that the amount of the dividend frequently will be recovered in the stock's price within a day or two following the ex-dividend date. Likewise, in a bear market, the stock price may sag off by the amount of the dividend and lose several more points due to offerings from those who held the stock just for dividends. Yet, in both cases, this is gambling for a gain that is absorbed in the long run by the average trend.

Pyramiding

This technique of adding shares of stock to a position for each point the stock moves in your favor is comparatively safe only under certain conditions. The ideal time for pyramiding on the short side is when pressure is so heavy and support so light that it signals a sudden and drastic decline. On the long side, it is when sudden and insistent demand creates such an irresistible lifting power that the stock seems about to be driven suddenly and strongly upward.

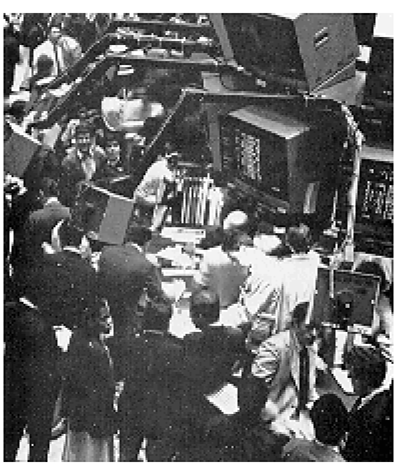
Wyckoff advises that pyramiding isn't justified without the potential for a 10-15 point move, and that orders to buy or sell additional lots should be limit orders so the broker executes the commitments automatically.

One way to pyramid is to make the initial commitment, say of 300 shares, with a stop order three points or less from the price. For each point the market moves in your favor, add a certain number of shares, in this case 100, with a 3-point-or-less stop order. Move the stop on the initial commitment (lower if short, higher if long), for each point the stock moves favorably. Move the stops on the smaller, subsequent lots so that none of them surpasses the initial stop.

Averaging

Never increase your line if a trade goes against you. Letting a stock run against you more than a few points is bad practice, but "letting it run" to where it seems more desirable to buy or sell more in order to average the cost is worse.

A losing stock proves wrong judgment and a stop order should get you out with a small loss. Why abandon the stop and persist in using wrong judgment?

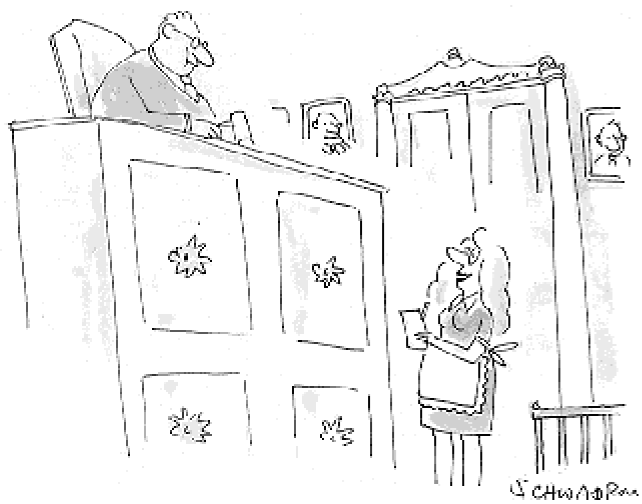


Closing trades

There should be as good a reason for closing a trade as there is for beginning it in the first place, and both should be based on your chart or ticker tape analysis. If you begin a trade based on chart indications, finish the trade based on the chart. Likewise, a trade begun with a tape indication should be closed based on the tape.

If analysis says to be "neutral," close your commitment whether there is a profit or loss in it and stand aside until there are definite indications of a move up or down.

How well you're able to follow Wyckoff's practical advice is greatly influenced by the mental attitude you cultivate. Complete self control unhindered by emotion is the stock trader's perfect mental state and how to approach that type of intellectual calm is the subject of our next installment.



"Two eggs over light, coffee, toast and marmalade. Will there be any other orders in the court?"

