SHARE TRADING ESSENTIALS
YOUR INTRODUCTORY GUIDE

Learn how to manage your portfolio, automate the process and trade like a professional.

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My intention in writing this introductory guide is to share my experiences in the hope they may help newcomers understand some of the challenges traders face and endeavour to smooth out the learning curve. This guide contains the key ingredients to becoming a successful trader, with plenty of sound information gained from real life experience.

I will cover the importance of understanding financials, charts and risk management as well as some of my experiences. I do not claim to be an expert, I have made my fair share of mistakes along the way, but the important thing is that I have learned from my mistakes and have become a better trader.

For the past twenty years I have been trading and have had a very active interest in the markets and am happy to say that I still love the challenge and the excitement. I have also spent the last ten years of my life working in the retail stock market software and education industry which has put me in constant contact with everyday investors looking to improve their knowledge and earn some extra income from the markets.

It was during this time that I gained a solid understanding of what sort of tools people need in order to be successful. I learned about the common pitfalls and hurdles people encounter while trading the markets, and studied the techniques used by different players and noticed which worked, and which did not. I have met and worked with industry professionals and gained a broad understanding of how the big players operate, and how they move funds in and out of the market. Trading is fun, rewarding and exciting, but there are risks. The more you read and learn from others the better prepared you will be.

It was in 1988 that I first got involved in the share market buying and selling shares using a full service broker. At the time I was working in the ANZ Bank in Melbourne. I didn't know a lot about trading at the time, but had always been interested and enjoyed a challenge, and I was fascinated by what drove the markets, and what made a stock climb and fall. I was also very interested in how to become financially independent from the market, and after some overseas travel, decided to enrol with the Securities Institute to study the financial markets, and in particular stockbroking.

I knew that I needed to learn as much as I could about the stock market and trading. After all we never learned anything about investing when I was at school. We had Chemistry, Physics and Maths, but no one ever taught us the importance of managing our money. It is amazing how one of life's most crucial lessons can be ignored, leaving us little choice than to teach ourselves.

One of the reasons many of my friends avoided the share market was for this very reason. People are afraid of things they don't understand. It's a shame, because trading shares is a lot less complex than most people think. Investing and trading in the stock market has some risk, as do all asset classes that offer good long term returns, however, risks can be minimised and returns can be magnified with the right strategy. The old saying goes "we must speculate to accumulate" and, in my opinion, there is no better investment vehicle than the stock market. Anyone can buy and sell shares; it is how we choose these shares and then how we manage our position that dictates how successful we will be.

What are shares?

When you buy a share you are essentially becoming a part owner in that company. If the company is well managed and returns a profit your shares will most likely increase in price, and more than likely you will receive a share of the profit in the form of a dividend; as earnings increase, so will your return.

There are other benefits like shareholder discount cards, "bonus issues" and from time to time "rights issues" where you can buy more stock at a discounted price. Investing in the stock market can also have tax advantages, for example imputation credits. The stock market is very liquid, especially the top 300, so it is easy to move in and out of stocks relatively cheaply and easily.

At any given time, there are plenty of opportunities in the share market. There are some excellent quality companies that are growing and out performing their competitors right now.
The trick is finding them. How do we find stocks that are giving shareholders huge returns? The answer is by identifying the best quality and most undervalued stocks at the right time in the cycle. We will talk about how to identify undervalued stocks in a moment, and also how we can use the charts to time our placement in the cycle.

We must make an effort to stay away from "tips" and rumours. Logically, the tips are there to excite investors with a "Pot of Gold at the end of the rainbow," but generally the smart money is selling into this rumour, catching unwary investors out.

In the early days, I would receive my recommendations by fax, and after reading them, and consulting with my broker; I would make my selections.

I was lucky; my broker was well regarded in the industry and had my best interests at heart. Despite this, I had limited success. For every good trade, I had two bad ones. My problem was that I sold my winning trades too early, and held onto the losing trades too long.

Friends thought I was crazy. Why was I risking my hard earned money in the market without any guarantee of a return?

In many ways they were right. I was taking a risk, there was no guarantee of returns, but the alternative was to do nothing, and that meant never really getting ahead. I had my doubts when some of the stocks my broker had recommended went against me. I often changed these losing positions from short term trades into long term investments, hoping for a miracle. It's funny how human nature often gets it wrong. We act so impatiently with the stocks that are moving in the right direction by selling them straight away, yet we reward the falling stocks with endless patience. It's human nature to sell profitable stocks too early so we can feel good about our decisions.

In this guide I try and highlight these common pitfalls and explore some simple steps that will put the odds in your favour and share some of the lessons I have learned over the years. I believe the best way of getting ahead is to work hard, save, invest and make my money work for me. Ironically, most people are too busy working for their money; they don't have the time to make their money work for them.

Buying and Selling Shares.

These days there are a number of ways to buy and sell shares. We can use a discount (Internet) broker, a CFD provider or a full service broker. In the late eighties and early nineties, the only way of trading shares was through a full service broker, as online brokers and the internet were not widely available. I used to pay 2% brokerage in and 2% out, which meant I needed to make 4% before breaking even; brokerage rates are now much more affordable.

Discount brokers have a fixed fee to buy and sell shares and all transactions are done via your computer. You can place a trade for as little as $20 for transactions generally under $10,000 in value.

With the introduction of CFD's (contracts for difference), the cost of trading has reduced even further and the numbers of instruments available to trade have increased dramatically. A CFD is one way of using a small amount of money to gain exposure to large share holdings. CFD's allow you to take, for example, a $100,000 position in BHP, while only using $10,000 or less of your own money, therefore borrowing the balance and paying interest for the privilege. CFD's can be a great trading instrument, but you need to be cautious. With access to high leverage, it is easy to get carried away trading with someone else's money.

Full service brokers still charge a higher rate than internet brokers, but seldom as high as 2%. This extra expense normally allows you to speak to your own individual broker and often gives you access to additional research material.

Successful traders talk about eliminating the "noise." We are bombarded with magazines, experts on every corner, dedicated financial TV stations, web forums and the list goes on. One expert says buy and the next expert says sell, by the time we make a decision, it is often too late. On the positive side, the price of brokerage and data services have fallen, and with the introduction of web based platforms it is much easier to trade the market.

I became more involved in researching companies and trading stocks on-line during the 1990's and changed to using an internet broker rather than a full service broker, I then started working in the industry.

I sometimes look back at the old days and think about how much simpler it seemed. For all the advancements in technology the market itself hasn't changed much. It is still driven by the same two opposing forces, fear and greed. There will always be share market booms and busts, but the share market has consistently out preformed most other investment classes.

These moves affect the various market participants in different ways, but one thing is true, the worst affected are those who are randomly speculating without a sound trading system or the right tools. By following some simple tried and tested conventions, we can learn to protect our capital and improve our overall investment returns.

Getting Started.

I believe that every investor or trader can greatly improve their experience in the market with the correct software, education and understanding of money management. These days there are some excellent resources available to assist traders to generate an income and improve their skills from home.

Here is a link to an interesting test that tells you what kind of trader you are:

www.tharptradertest.com

This link is a great way to research all things related to trading:

http://www.investopedia.com/

Here are a couple of books I really enjoyed reading and found useful:

Reminiscences of a stock operator by Edwin Le Ferve

How I made $2,000,000 in the stock market by Nicolas Darvas

The right trading tools do not necessarily have to be overly technical or expensive. My mission, when I started MetastockAustralia.com.au was to supply the best, most cost effective and user friendly software, education and data services, coupled with plenty of ongoing support. This meant the average person could enjoy trading the market without getting too bogged down in the technical stuff.

These days everything is available off the shelf, we have self installing files and automatic one click access to stock market data. It's now easy for the average person to start trading without the need for a technical degree.
You will benefit from other peoples experiences, you will also save time and money by attending the right training courses. A good teacher and the right software package is a powerful combination that can set you on the right path from the beginning.

There are numerous options available to customers when it comes to choosing an analysis program, the prices can vary greatly as can the results you achieve. The two standard disciplines are Fundamental Analysis (the study of financial data) used for good stock selection or finding “undervalued” shares, and Technical Analysis (the study of charts) mainly used for analysing trends and timing trades, then of course there is a combination of both.

For fundamental analysis, we have created our own product called Oraclescan. It is best described as a search engine that allows users to create scans based on company financials so you can cherry pick the best value stocks that are available on the exchange. When working with my programmers to create Oraclescan, I had many objectives, chief among them, was that Oraclescan had to be easy to use. I wanted a search engine that every client could master, regardless of their computer skills, I also wanted the highest quality data and some pre-written example searches to make the task of stock selection fast and easy.

For a top quality charting package, we recommend MetaStock; it has a large customer base and an excellent reputation in the industry. I like MetaStock because it has all the tools a chartist could ever wish for and the ability to easily develop your own trading systems. It also allows users to import and apply trading systems from various experts around the globe. Many trading books and websites also include trading systems written in MetaStock format that are free to copy and paste or type into your version.

For a long time you had to decide which camp you belonged to, were you a fundamental analyst or a technical analyst. It was almost like you had to pledge your allegiance to one method of analysis. I never understood why the study of technical analysis seemed to be at war with fundamental analysis; after all, both methods have their strengths and weaknesses.

I have seen fundamentally sound companies with good earnings get hammered during a market selloff. The fact that they have sound fundamentals and are good value is only half of the picture. They need to be in demand by the market, otherwise they won’t have the momentum to move higher. As a general rule, buying quality companies that are in an up-trend is the way to go.

Fundamentally sound companies are often the first ones to recover and lead the market higher. Knowing that your portfolio consists of quality companies also helps to remove some of the anxiety people feel, especially if you are new to the share market.

Combining fundamental and technical analysis together increases our chances of success. Why not have the best of both worlds, it works and now access to this type of information is so easily accessible and affordable.

A good friend and well respected author and share market educator, Jim Berg teaches his students to use a weight of evidence model for stock selection based on good fundamentals, coupled with technical analysis and good money management. Jim’s proven model which incorporates both disciplines has returned outstanding results for his students over many years. In fact Jim applied all disciplines together to win the 2002, personal investor trading competition.

Jim is now a great advocate for Oraclescan and has commented that it is the best fundamental package he has ever used and recommends it to clients of his newsletter.

Understanding financials.

As I mentioned at the beginning of this guide book, buying a share means that you are essentially becoming a part owner of a company. Financials or fundamentals are basically the foundations that underpin a company. Bearing this in mind, we need to make sure we are buying into a worthwhile company at a fair price at the right time in the cycle. This can only be done by looking at both financial data and a chart. That doesn't mean you have to spend endless hours studying each company's balance sheets, or learning the ins and outs of every financial ratio. Much of the information shown on a company's balance sheet is not really relevant to most of us; the important ratios are the ones that can have a major impact on a company's value now and into the future.

The simplest and probably best known financial ratio is the Price / Earnings Ratio.

The PE ratio formula is simply the shares price / earnings per share.

For example, imagine a company has earnings of $10 on its balance sheet; if that company has 100 shares on issue, then each share has earnings of 10c.

For this example the PE ratio would be 10.

If those shares were trading at $1 per share, the 10c in earnings is pretty good, but imagine the share was trading at $2.00; for each share, the earnings of 10c is not as attractive. It would have a PE ratio of 20.

Theoretically, even if the company was to pay each share holder the full 10c per share as a dividend, it would take twenty years to be re-paid the $2 per share you invested.

The PE is a useful ratio to compare like companies in the same industry to gain a sense of value. As a guide, an average PE ratio is usually somewhere between about 15 and 20, but this can vary depending on the industry group the company belongs to.

As an investor it is unwise to ignore fundamentals, especially when the world's most successful investor Warren Buffet has proven just how important and powerful fundamental analysis can be.

Warren Buffet said "For it is through PE's that one can instantly identify where mob madness is at work and, conversely, where the oversights of Ignorance are neglecting sound shares". Buffet seeks to buy shares for no more than two thirds of a company's net asset backing and is dismayed that other people don't jump at it too "it is extraordinary to me that the idea of buying dollar bills for 60 cents either takes immediately with people or it doesn't take at all. It's like an inoculation. If it doesn't grab them right away, they don't ever seem to be able to grasp the concept".

Many fundamental investors also pay a lot of attention to key ratios such as Return on Equity, Investment and Assets, the former measures how much profit the company is generating from money entrusted to it from shareholders. We look at these values with a view to figuring out what a share is really worth.

One of the most difficult questions investors face when contemplating taking a trade is "How much is this stock worth"? In other words what is a relatively fair estimation of a stock's value? Many fundamental analysts will tell you that one of the most important factors that influence a stock's price are its earnings, both current and projected. It is also important to ensure debt levels are managed and minimised.

Learning about these key ratios is important, but here's the good news. There are a multitude of professional analysts that have already done most of this work for us; they have already spent the time figuring out what a company is worth. The Oraclescan program compiles this data in an easy to understand format. It compares the analysts target prices against a shares current share price and highlights which stocks are most likely to be considered undervalued. So with just a basic understanding of company financials and access to the Oraclescan program, you can generate a list of potentially undervalued stocks with a couple of mouse clicks.

Remember; just because a stock looks undervalued, doesn’t mean it’s the right time in the cycle to buy it. As I mentioned earlier, this is really only half the picture. The next step is to have a look at the chart.

Understanding charts.

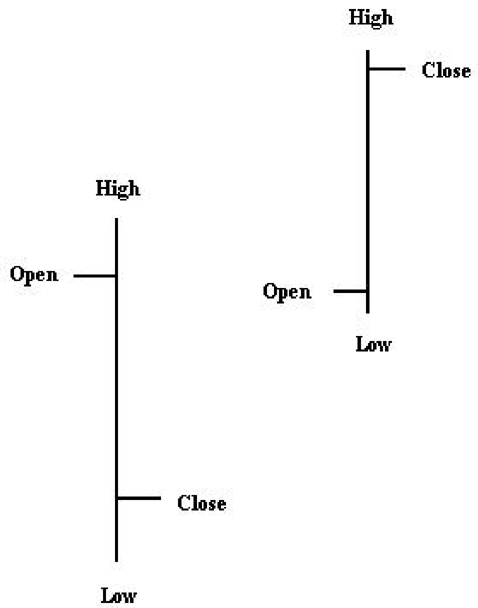
When we hear a share price being quoted on radio or television, it is generally only the day’s closing price. This doesn’t give us a complete picture of what happened during the course of the trading day.

To gain a better insight into how a share is performing, you need to know what happened during the course of each trading day. For example; what was the high for the day in relation to the close? Was the volume abnormally high or low? These important factors are captured on the charts and give you the entire picture.

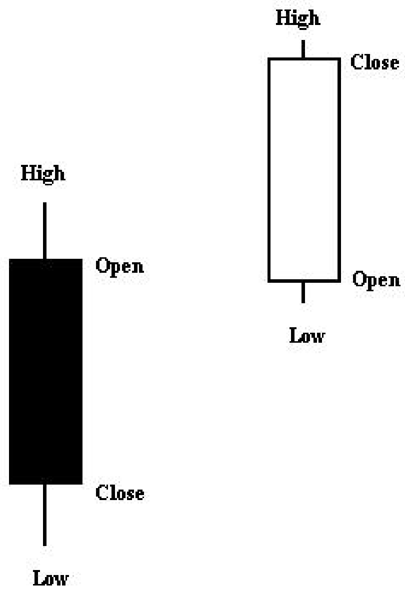
The two most commonly used charting styles are “bar charts” and “candlestick” charts.
Both of these charting styles tell us the same thing, they display the price of the stock’s open, high, low and close. Below are two examples of how they look. These charts give us a visual guide to what happened to the stock during the course of a period of trade, the same visual image applies to all time periods (hourly charts, daily charts, weekly charts etc).

In the example picture below, both the bars and candles are showing identical data, however displaying this data in their own style. The bar chart shows the open on the left of the bar and the close on the right.

The black (or solid) candlestick is a down day, where the stock closed lower than it opened. The white (or hollow) candle denotes a positive day, where the stock closed higher than it opened.



Bar Chart



Candlestick Chart

There are many chart patterns and trade set ups that are worth knowing about. Learning how to interpret these charts is essential. For a complete understanding of how to read charts I recommend the book “Technical Analysis from A-Z” by Steven Achelis.

I once heard someone compare the stock market to the ocean, it sounded corny at first, but he went on to explain, the stock market like the ocean is a very powerful force that moves in waves and tides. It will do what it’s going to do, regardless of the individual, like the market, it doesn’t take our plans or feelings into account. Trying to fight the market is much like trying to hold back the ocean; however, if you learn to read the waves and go with the trends, you can take advantage of them. That’s the mentality you need to use.

Charts are commonly used for viewing individual shares, sectors, industry groups and indices. Unlike an individual share which has an underlying value an index is just a figure derived from the average performance of a number of shares. The share market is made up of many indices which give us a guide of market sentiment. The most common Australian index we hear about is the All Ordinaries. This is derived from the performance of the top 500 largest companies using a complex weighting system to arrive at a value.

The All Ordinaries index gives us an idea of market sentiment; however, it is worth pointing out that it only takes into account the top 500 stocks and ignores the rest of the market. To gain a more complete perspective of the overall picture of the entire market, an alternative is to view the “advance decline line,” The advance decline line displays a ratio of stocks that have advanced for the day in comparison to the amount of stocks that have declined for the day, this data is displayed as a simple line chart and is available from most data vendors.

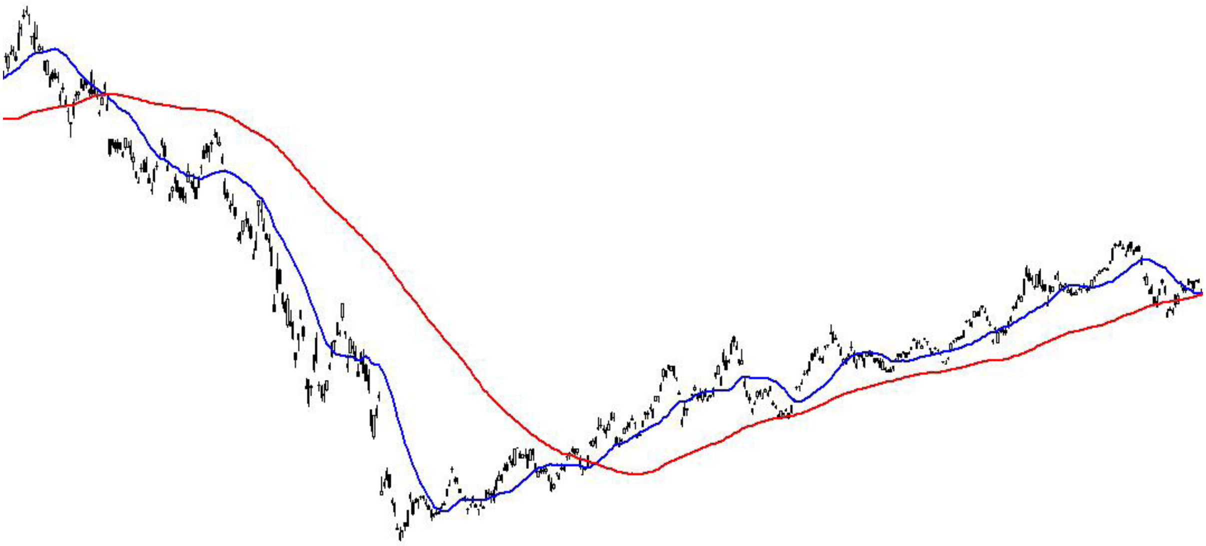
We hear about bull and bear markets, these are broad terms used to indicate the major direction of the market; bull markets indicate a higher market and bear markets lower. Common sense tells us that if the major indices are trending down, we need to think of the Ocean example mentioned above and move into a position that allows us to profit from the overall trend.

Every chart tells us a story about supply and demand. When buyers outweigh sellers, the result is that stocks climb higher. Technical analysis is the study of charts and patterns. With practice, it’s not hard to see accumulation and strength appear on a chart. It’s not essential to understand what’s driving a stock’s price, what matters is that you are on the right side of that trend.

It’s common to see a stock rally without any news being disclosed to the market, then fall as soon as good news is announced. Watching news and announcements doesn’t automatically lead to profits. It’s usually too late when you hear the reason a stock has moved higher once the good news has been announced, the speculation ends, there is a well known saying “Buy the Rumour , Sell the News.”

The charts usually give us a signal that buyers are accumulating shares long before anything is revealed to the market. The characteristics of a stocks normal trading pattern show us what’s going on, as long as we know what to look for.

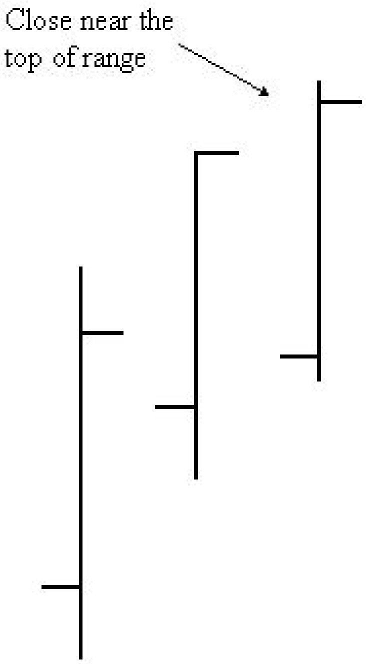
A really basic but effective way of judging how a stock is performing in relation to its normal trend is by applying two moving averages to a chart, a short term moving average and a long term moving average.



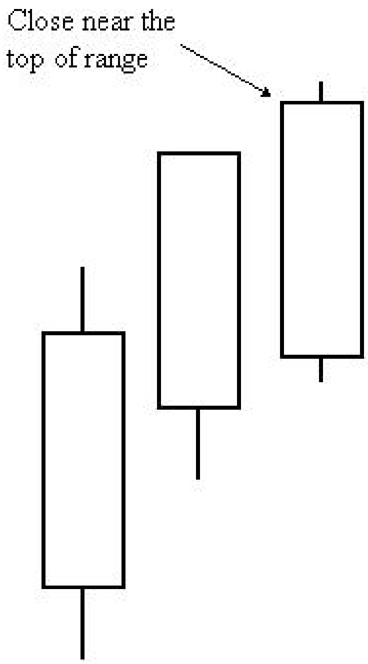
A moving average is a basic tool; it simply works out what the stock's average price has been over a given period of time. The moving average indicator is perhaps the most widely used technical indicator in the world. It is easy to interpret and is extremely effective. Two commonly used moving averages are a 21 period (short term) and a 100 period long term average. If the short term average crosses above the long term average, this indicates that the trend is accelerating and the stock is going higher. The opposite moving average scenario indicates selling pressure and lower prices or weakness.

As the forces of supply and demand play out, a picture begins to emerge on the chart. I noticed the smaller the chart time frame was, the harder it was to get consistent returns, or gauge where that stock was going. Looking at 5 minute bars, or hourly bars, it is difficult to see any form of trend arise. It is almost like standing too close to a painting, it's only when you stand back that you get a real perspective and are able to see the whole picture. Sometimes even a daily chart is patchy and unpredictable, whereas if you are looking at a monthly chart, the trend becomes a lot clearer. A monthly chart combines all the daily bars for the entire month to simply display a summary of where the stock started, where it finished and its range for the entire month. This removes a lot of the excess information and clutter and allows us to gain a much clearer picture.

I like to look at daily, weekly, monthly and quarterly bar charts. If a stock closes in the upper range of a monthly bar, (say in the top 25% of the range) this is a sign of underlying strength, it shows us that the buyers were able to push the prices higher or that the sellers are dwindling. The more time we add to our charts, the more powerful these signs of strength are. This means that a strong close on a quarterly bar is a more powerful indicator than a strong close on a monthly bar because the quarterly bar contains three months of data combined into one bar.



Bar Chart



Candlestick Chart

I like to find stocks that have made a new high and closed in a position of strength. This method goes against our natural processes as we are always looking for a bargain, but buying strength or buying stocks that are moving higher works. I also like to see charts where the pull backs are making higher lows. Stocks will almost always pull back for a period before continuing higher, or resuming their trend. A common tool used to gauge these pull backs is the Fibonacci retracement indicator. This is a popular tool among technical traders and is based on key numbers identified by mathematician Leonardo Fibonacci. A stock making consistently higher highs and higher lows displays signs of accumulation and tells us that overall demand is out weighing supply.

It's no secret that the "big players" are the ones who actually move the market. They have the resources to really affect a share price, and if they want a stock, they will buy it. However, an institution won't just place a buy order for millions of shares on market at one time; generally they would acquire the stock discreetly and not declare their intentions to everybody. Instead, they may construct a campaign which sets out a plan to purchase a given number of shares over a number of weeks or months. Supply will be quietly mopped up by demand without there being any overly obvious rallies; after all it is in the funds best interest to keep prices as low as possible until they have accumulated all the stock they require.

These stocks will have waves up and down, but will show a consistent up trend. If you can identify these trends and buy stocks on these smaller pull backs, it can be a great way of aligning yourself with the big players, and taking advantage of their appetite for the stock.

When these pullbacks make a succession of higher lows, it gives us a pretty clear indication of accumulation. Once a stock is accumulated to the point that all the sellers are gone at certain price levels, the stock price must trade higher, as buyers must pay a higher price if they wish to buy the stock.

I have “MetaStock” set up to scan the market and find these chart patterns. It’s too difficult and time consuming to find these patterns manually, so you need to have some sort of software program that can do the ground work for you. MetaStock has been around for over 25 years and is sold in over 90 countries. MetaStock is highly regarded worldwide as the industry leader, and has won the Stocks and Commodities readers’ choice award for the past eighteen years.

One key reason MetaStock has become so popular is “the explorer” feature. This is a powerful search engine that scans the market for the chart patterns and set ups traders are looking for. To save our member’s time building their own searches, we developed Oracle 7, which contains seven powerful scans. These scans are based mainly on strength; stocks that are gaining momentum or showing signs that a trend is beginning to emerge. We have scans to find stocks that have retraced off their highs and stocks that are showing good signs of accumulation on daily, weekly and monthly timeframes. Adding Oracle7 to Metastock gives you the ability to explore and analyse stocks that are showing potential technically based on various criteria.

Regardless of the patterns you prefer, you can set up your charting software to find them. It is enormously satisfying to buy a stock using your own resources and make a profit. Then after the trade has been closed, you read a positive news announcement which explained what had been driving the technical rally. It is only by using charts that we are able to find these opportunities.

New opportunities appear in different stocks and different sectors as funds move in and out of the market. It’s important to keep track of where the next opportunity is coming from. The Explorer feature in MetaStock is a great way of searching and finding trading opportunities as they arise. We can start our search by identifying the better performing sectors of the market.

Sometimes the financial sector is outperforming, sometimes it’s the resources sector and so on. If we trade the better performing stocks in the leading sectors, we are giving ourselves a higher probability of success. Stocks that are “Cheap” are generally cheap for good reason. Trying to buy stocks that look cheap, based on historical prices can be very dangerous. Regardless of whether you use Fundamental or Technical data to select your stocks, one thing I believe you cannot do without is a good “Money Management” plan. If there is such a thing as a Holy Grail, Money Management is it.

Money management.

It is extremely important to protect your capital, and to have a good money management plan, a good understanding of position sizing and exit rules, if you have these you are well on the way to making trading a success. Did you know that even if you have more losing trades than winning trades, you can still make considerable profits in the markets as long as you are implementing a sound money management strategy? For example, if your minimum profit is 25% and your maximum loss is 10%, you only require 3 winning trades out of 10 to make money. Anyone who has traded the market long enough will tell you that you need to limit your losses and allow your profits to run. This sounds simple, but if you can master this one skill, you will have a massive head start over the average investor.

Everyone, regardless of experience or background has the potential to be successful in the stock market. The rules are pretty basic. Stock selection, timing, and money management are the keys. The hard part is following these rules; having the discipline to stick to the plan, and the patience to implement the strategy consistently. I guarantee there will be times when you could have broken the rules and achieved a better result, but over time, breaking the rules will only hurt your bank balance.

Many years ago I heard a “fantastic” stock tip from a friend of mine. I bought a large parcel of the stock and bought the company options too. The stock’s price started to fall, so I bought more in order to lower my average buy price. My friend (who had the best of intentions) told me more about the rumour and I allowed this to cloud my judgment. When the stock finally delisted, during the tech bust, I realised some valuable and expensive lessons.

- If it sounds too good to be true, it probably is.
- Don’t average down; it’s like throwing good money after bad.
- Follow your rules, wishful thinking and prayer probably won’t drive it higher.
- Never fall in love with a stock or a “Tip”, be careful, it happens to almost everyone.
- Accept that sometimes things don’t go according to plan and move on.

No matter how good you are at picking shares, you are bound to end up with some that will disappoint, it happens to everyone. There is nothing wrong with cutting your losses; you are far better off having that money in other shares that are making you money. Taking a small loss on a stock allows you to free up your capital to take the next trade, there is no point having all your money tied up in losing trades. A loss on the market should be seen as a cost of running your business, much like leasing an office or paying for your telephone. If I had used a stop loss, I would never have held the “fantastic” tip as long as I did. It hurt losing the money, but it hurt my ego more that I was wrong.

I now understand the importance of a risk versus reward ratio, and I examine each chart with this in mind. There is a great saying “plan a trade and trade a plan.” Risk and Reward need to be evaluated prior to taking a trade. We need to be able to place our stop loss at or just below a support level and still be within our 10% stop loss range. This is not always possible and some trades are just not meant to be. The most successful Investors and Traders possess patience and discipline; there will be another opportunity just around the corner.

Before you buy a share, look at the chart to see if it has a strong resistance level (glass ceiling). If the share is trading close to that resistance level, it may have limited upside potential. Therefore you will probably find that your stop loss position is bigger than your potential gain. You are better off waiting to see a break of the upper resistance level to confirm it has the legs to carry it higher. Once a stock is trading at a new or all time high, it has a lot less selling pressure to absorb, as all holders of the stock are now in profit. This can be a very rewarding time as stocks trading at new highs often have powerful moves to the upside.

When entering into a trade you need to have an exit strategy in mind. Let’s use a $1 stock as an example. Before you buy the stock you need to know what to do when the stock begins to move. There are three possible scenarios; the stock goes down, moves sideways or it goes up.

I always start by planning what to do if the stock starts to fall. I set a price level at which point I will take a loss and exit the trade. I can use the charts historical trading range to gauge where this level is. On occasion we can place our stop a few cents below a major support level and only risk a few percentage points on that trade. If there are no obvious support levels available, I look at the stock’s average price fluctuation. If a stock moves an average of 5% per week, I would suggest a stop loss of 10%, twice the average range to give us some room to move. The easiest way of calculating a stock’s average price fluctuation is to use a technical indicator called the “average true range” set to 5 periods. The ATR is a commonly used indicator and is available in most charting programs including Metastock.

If a stock moves sideways for a long period of time, it may be better to break even and use your money elsewhere. This is a judgment call, I am more patient than most, and tend to wait for something to happen either way within reason.

When stocks rally, they often keep going for quite some time. As long as a stock is trending in our favour we need to take advantage of the move by having a strategy in place that will capitalise on the trend. Setting a fixed profit target where you simply sell all of your stock may be cheating yourself out of upside potential. One method is to take partial profits when the stock reaches the 25% level, for example, selling a portion of our holding, or we may use that 25% profit target as our new stop loss level. By moving our stop to this new level we are locking in profit while still having exposure to any additional potential gains. The trick is to repeat this as the stock climbs by moving our stop loss higher. Try not to place your stop too close to the last price and allow for general market fluctuations. There are plenty of examples of stocks that have trended higher for many months on end. Only those using a trailing stop will capture the majority of these larger trends.

There is a saying that “you can’t go broke by taking a profit”, however, it’s little comfort to look back at a stock where you made a 25% profit, but could have made 50 or 150 %. Using a trailing stop will ensure this doesn’t happen to you.

Position management.

Position sizing is a very important part of your overall trading plan. You need to be comfortable with your position; after all you need to be able to sleep at night. Once you have identified a stock as a possible trading opportunity, it can be tempting to buy a large parcel in order to maximise profits. Long term it pays to be cautious and take a measured approach when deciding how many shares to buy. As with all aspects of trading, there needs to be a set plan of action to help us calculate how many units to purchase.

If we continue with the $1 example, our support level might be set at 94c. This way we have a 6c window or buffer zone to allow the stock some leeway and only need to risk 6% if it goes against us. It is important to note that, in this example, the 6% at risk is not 6% of our portfolio, but 6% of the allocated or divided capital allocated for this trade. This simply means that if your initial capital is $20,000, you would probably break this up into say 8 trades of $2,500 each, thus the total amount at risk, in this example, would be 6% of $2,500 or $150. Diversification is another way to spread risk across our portfolio of stocks. Having 8 individual trades is a sound idea to spread your risk, but not if all these stocks are in the banking sector. An index fund is also an option to spread our risk, we almost eliminate individual stock risk and gain exposure to a group of stocks that mirror the index, an example is the SFY 50 fund or the STW 200 fund.

If we assume the worst scenario and are stopped out of our trade, taking a 10% loss, we need to be able to take this loss without it having any major adverse effects on our overall trading plan. No-one likes losses, but they will happen and we must plan for them and calculate our position size accordingly. Everyone has different amounts of money available and different attitudes toward risk, so position sizing is a very individual thing. For example if we buy $5,000 worth of a stock and have set our stop at 10% of this, worst case, we are risking $500 on this trade if we get stopped out. We need to make sure we are comfortable with the amount being risked; this allows us to remain in the trade as the price fluctuates.

For your own peace of mind, you need to consider what sort of risk profile you have. Remember you are in charge of your own destiny. Trading is supposed to be fun, so avoid putting yourself in a stressful position; a slow and steady approach often wins the race.

Re-cap 6 steps.

No 1. Look at the prevailing trend:

> Gain a sense of the overall market trend by looking at the indices, sectors and the advance decline line. Remember the ocean example and stay on the right side of the market, the trend is definitely your friend.

No 2. Find a trade:

> Run your scans to identify possible trading opportunities. If you have a number of possible trades, narrow them down. Look for sound fundamentals, check for liquidity, check for the glass ceiling. Open the charts and visually assess the risk versus reward potential.

No 3. Position sizing and divided capital:

> Always protect your trading capital and only risk a small amount at any one time. Make certain that you are comfortable with the amount of money at risk if you get stopped out of the trade. Divide your trading account up into about 6-8 trades of similar size, never put all your capital into one or two stocks.

No 4. Calculate your stop loss and profit target:

> You must decide on a money management plan by setting an exit level if the trade moves against you, and also your initial profit target. Use the chart to decide where these levels are set. Don’t take the trade unless the potential profit is at least twice the potential loss.

We can often enter a trade and place our stop loss just below a support level and only risk 5%.

No5. Manage the trade:

Each day, monitor your positions by reviewing your charts. Remember to move your stop or sell some of your position when you reach your initial profit target.
Take an active interest in your trading and follow the rules.

No 6. Treat trading like a business:

You don’t need luck; you don’t need to spend hours every night. Follow the steps, stick to the plan. The goal of trading is to make money. It can be very rewarding and great fun, but it’s very important to follow a few “common sense,” simple rules to ensure your overall experience is a much happier one.

Conclusion.

In conclusion this guide explains how financials are the foundations that underpin a company. Buying sound profitable stocks is the best place to start. This guide also explains how charts offer us an untainted view of real supply and demand. The more confident you become reading charts the less you allow external sources to interfere with your own analysis. Eventually you start to ignore the finance television channel and you stop listening to the “experts.” You begin to have an independent opinion that comes from an un-biased source. Success will come when you start to trust your own judgment and leave behind all the conflicting noise.

This independence frees you from relying on others for advice and gives you a real insight into what’s going on. You will move beyond those who rely on tips or allow others to invest money on their behalf. Remember: Nobody will look after your money with as much care as you do.

When you become proficient as a trader, you possess a skill that can be used anywhere in the world. When you understand Fundamental Analysis, Technical Analysis and Risk Management, you can trade any market with confidence. It is up to you whether you choose to trade for a living or as a hobby to generate a secondary income.

My experience has taught me that the simpler strategies often give the best results; you do not need complicated systems to become a successfully trader, there is no substitute for your own common sense. Never under estimate your own judgment; the charts do not lie.

Trading opens up many opportunities, all you need is the desire to take the next step, one final quote “You cannot reach new horizons unless you have the courage to leave the shore.”

I wish you all the best with your trading endeavours and hope this 20 minute guide has provided you with some insight into the fascinating world of trading.

Regards
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