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### Beyond Set-ups

## Take Your Trading to the Next Level! Take the Time to Develop the Skills You Need to Be Successful

By Steve Palmquist  
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Steve Palmquist, a full-time trader with nearly 20 years of experience, is the founder of [www.daisydogger.com](http://www.daisydogger.com), which provides free market analysis, trading tips, and educational material. Steve is also publisher of the Timely Trades Letter available through the web site. He is a featured speaker at AIQ Seminars.



STEVE PALMQUIST

They will continue to lose money until they realize there is more to trading than just set-ups.

Some traders will use very tight stops trying to "minimize risk." When they lose most of their money they are convinced trading is just luck. Some traders use only a single system they learned from an "expert," and when they start losing

**T**rading, like most professions, requires a number of different skills in order to be successful. It takes time to develop these skills—two to five years. And there are few shortcuts if you try to do it alone.

Many traders will read about a system and then use it until they have a number of consecutive losses; then they will switch to another system in a constant search for something that "works all the time."

with that system they stop trading and wonder why the system doesn't work any more.

***"The school of hard knocks has taught me that there are several aspects to trading beyond set-ups that successful traders must master...It takes time to develop these skills--two to five years."***

The school of hard knocks has taught me that there are several aspects to trading beyond set-ups that successful traders must master.

- Trading with the market
- Exit strategies.
- Developing multiple strategies
- Learning from your mistakes and those of others
- Focus

### Trading With The Market

Learning to read the market and trading with it is one of the keys to

***“Successful trading isn’t about predicting exactly what the market is going to do, but about knowing how to react to whatever it does...watch the trendlines and bases, and trade moves off these key areas.”***

success. Many traders read a few books, open an account, then start reading the Yacht brochures. In late 1999 that was about all it took. Almost any system worked, and it wasn’t unusual to make \$10,000

several days a week in relatively small accounts.

When the market turned in 2000, many traders found out that understanding the market is one of the key skills needed for success. Be guided by the market, not the opinions or hopes of others. No system works all the time so it is critical to identify the type of market conditions and knowing which conditions are favorable to each system you use.

I monitor the NASDAQ for market guidance because it generally leads the other indices on both the up and down moves. The market has three types of behavior: trending up, trending down, and basing. Trendlines are key tools for determining what the market is up

to. As long as the market is above an ascending trendline, focus on trading long set-ups. When the market eventually breaks below the ascending trendline it enters a period of uncertainty; it may base for a while or enter a new downtrend.

During periods of uncertainty risk increases, so reduce position sizes and use the short-term techniques in your trading toolbox.

If the market makes a clear lower low after breaking an ascending trendline then a new descending trendline should be drawn and traders should focus on short set-ups until the descending trendline is broken to the upside. If the market enters a basing period, the trader’s actions should depend on the width of the base. Narrow bases, ones where the market moves from top to bottom in less than four days, are a

great time to head to the beach. The market needs to move for more than a few days before reversing in order for swing trades to have time to work.

If the base is large enough that it takes more than four days to swing between the top and bottom of the range, then traders can focus on entering long trades when the market is bouncing off the bottom of the base and exiting them as the market approaches the top. They can also enter short trades when the market bounces off the top of the base and close them as it approaches the bottom of the range. Remember—narrow bases just build your vocabulary; wide bases build your bank account.

Too many traders try to predict the market’s direction. This is not only difficult to do on a consistent basis, but hazardous to your account balance. Successful trading isn’t about predicting exactly what the market is going to do, but about knowing how to react to whatever it does. If you develop a bullish or bearish view there is a strong tendency to find reasons to justify it, and you are likely to get hurt. Just watch the trendlines and bases, and trade moves off these key areas.

***“The market has three types of behavior: trending up, trending down, and basing. Trendlines are key tools for determining what the market is up to.”***

If you would like to see my current outlook on the market along with the trading set-ups I’m watching, email me at [market@daisydogger.com](mailto:market@daisydogger.com).

### Exit strategies

It is interesting that there are a number of books and articles on how and when to enter trades, but relatively few on when to exit them.

### AIQ Opening Bell Newsletter

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While the information in this newsletter is believed to be reliable, accuracy cannot be guaranteed. Past performance does not guarantee future results.

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Remember that you do not have a profit until you are back in cash. The whole point of entering a trade is to exit it with a profit. If you don't know what would trigger an exit for your position, then don't enter it.

***“Inexperienced traders often place very tight stops to “reduce risk” and end up taking losses as the market noise stops them out. Stops should be placed based on the technical patterns and not some arbitrary price point.”***

There are books that advise entering a stop seven or eight percent below your entry point. If you follow this advice you will likely think it is great when the market is in a strong uptrend, and get a lot of practice exercising stops when it isn't. Most of the time, stops should relate to the entry pattern, not some random percentage of the entry price. In most cases, a protective stop just under the low of the set-up pattern is a good bet.

If you set a protective stop and wait for it to get hit you will lose money every time. The protective stop is just to guard against large losses on failed patterns. Traders also need an exit strategy and, like most things in trading, the exit strategy depends on the market conditions.

Inexperienced traders often place very tight stops to “reduce risk” and end up taking losses as the market noise stops them out. Stops should be placed based on the technical patterns and not some arbitrary price point.

Make sure the stops are set based on what would constitute a pattern failure, not some random number; then adjust your position size to control risk. You cannot control risk with inappropriately placed stops.

When the market is in a strong trend, positions can be held for longer periods than when the market is basing. Consider taking profits when the stock breaks a trendline, or the market breaks its own trendline.

Watch for climax runs. When the stock moves very rapidly on strong volume and becomes extended, consider taking at least some profit. If the stock starts moving (up for longs or down for shorts) on declining volume, consider closing the position. Volume generally measures interest; if your stock is going up on declining interest you don't want to be the last one out.

When the market is not strongly trending, a time stop (i.e. sell after x days) rather than a price target tends to work well as an exit strategy. A number of back tests on several different systems have shown that it is hard to beat a two or three-day time stop in these conditions. The reason is that when the market is not strongly trending most breakouts and triggers tend to move for two or three days then pull back and retest the breakout point. A time stop captures this first breakout move and allows you to move on to another set-up while the stock is retracing.

Be aware of how far stocks are typically running in the current market conditions, and after yours moves that far consider selling. If you are unsure about what to do then SELL. Remember, nobody goes broke taking profits.

## **Develop Multiple Strategies**

If you hire a contractor to work on your house he usually shows up with a large toolbox full of different tools. If he came to the door with just a screwdriver you would likely fire him. Given this, it is amazing how many traders show up at the trading desk armed with a single trading system. I have yet to see one trading system that works well in all market environments, or one tool that does everything a contractor needs. Develop a trading toolbox with several different trading systems in it.

The market favors different setups at different times. Sometimes base breakouts work well, other times most fail. Sometimes the market likes pullbacks, sometimes flags. At a minimum, traders should have four well-tested systems, two for longs and two for shorts. Well-tested means that you should clearly understand how they perform in different markets with different filters and with different holding periods.

***“At a minimum, traders should have four well-tested systems, two for longs and two for shorts. “Well-tested” means that you should clearly understand how they perform in different markets with different filters and with different holding periods.”***

This is what AIQ's Expert Design Studio (EDS) was designed for. Don't use a system just because a friend of a friend of Uncle Billy thought it was great; thoroughly test and understand the systems prior to using them.

Trading systems should be simple. If it takes five pages of EDS code to describe a system you are going to have a hard time understanding it, let alone trusting it to

work well in the future. You should be able to describe a trading system to a teenager during an elevator ride. If not, it's too complex.

Develop a set of tools for your trading toolbox that are based on different ideas, not variations of a theme. Consider pullback systems, basing systems, flags, other patterns, etc. If you are not sure where to start, email me at [market@daisydogger.com](mailto:market@daisydogger.com) and I'll send you a couple of EDS files to get you started.

### Learning From Mistakes

Mistakes are part of the tuition you pay to learn about trading. It's best to learn from someone else's mistakes; it's usually cheaper than making them yourself. Attend a trading seminar at least once a year. You will not only learn from the presentation but also have a great opportunity to meet other traders and learn from them. Traders are like eagles, they don't flock. The best time to meet and learn from several is at a well-done seminar.

Get in contact with someone who has experience and learn from

When you learn to fly a plane there are two approaches you can take. You can read all the books and memorize the material then jump in a plane by yourself and take off, or you can read the material then fly with an instructor who will help you understand how to apply what you have read. The fatality rate for the first approach is high; most people taking the second approach do fine. Before you jump in the trading cockpit, work with someone to be sure you know how to read the market and select the appropriate tools.

Review your trades and learn from your mistakes. This is really the only way to get better in any business. Was it a strong set-up? How was the volume behaving in the set-up? Did you enter correctly or did you chase the stock past the entry point? What was your price target? For price targets consider measured moves, the upper Bollinger Band, or chart pattern resistance.

What was your stop strategy? Consider selecting stops just under the low of the set-up pattern or in some cases the previous day's low. Consider exiting the trade if it shows a large

volume down bar, or the market bounces off resistance. In any case, have an exit plan. How was the market behaving when you took the trade? Where was NASDAQ support and resistance? Did the trade have "room to run?" Were you trading with the market?

You don't have a profit until

you're back in cash. Too many traders watch a set-up trigger and then start counting their money as they hope it will keep going up, only to see the breakout reverse and the position turn into a loss. The exit strategies outlined above come from experience and are intended to

***"Trading systems should be simple... You should be able to describe a trading system to a teenager during an elevator ride. If not, it's too complex."***

minimize this problem. There are many profit taking approaches that work; just be sure you have one and are not hanging on indefinitely.

### Focus

Focus on the market. Successful trading is about knowing the best type of trading techniques for the current market conditions, and having the correct set of tools to use for them. Focus on tools you know and trading when the market conditions are favorable. You don't need to trade every day; let the set-ups come to you and take the best ones.

Trading weak or low volume set-ups may simply give you practice exercising stops. When the market is moving there are lots of good quality set-ups to choose from. If there are only a few set-ups and they tend to be failing, listen to the market's message and wait for better times.

Focus on the process. One of the online brokerage companies has a TV ad showing the trader as a warrior going forth to do battle with the market every day. If your focus is on being at war with the market and being "right" about each trade, you may need a lot of Kleenex at the trading desk.

Trading is a business about probabilities. You don't have a winning trade because you did

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that person, especially in regards to learning to read the market. Learning to trade is like learning to fly; there are a lot of things to master that are not hard to learn, but they must be fully integrated and understood in relationship to the current situation in order to have the right picture.

everything right—the trade was profitable because you carefully researched the trading tools and you know that a certain percentage of trades will be profitable and that some will lose money. Winning traders focus on understanding their systems and reading the market. No matter how any individual trade turns out, they just take the next set-up and follow the process.

Focus on understanding and using your tools. Trading is not a discussion. Stay away from chat rooms, analyst recommendations, TV talk shows, and the like. Most of these are recommending things based on reasons that do not have your best interests at heart. Be guided by the market not the opinions or hopes of others. Trade the charts, not CNBC or analyst recommendations.

Focus on profits. The idea of trading is to make money, not just to practice clicking the mouse. Keep an eye on your account balance; it won't go straight up so review trades during periods when it is declining to see if you are following all your rules.

#### S&P 500 Changes

##### Changes to the S&P 500 Index and Industry Groups:

Coventry Health Care (CVH) replaces May Department Stores (MAY). CVH is added to Health Care-Managed Care (HEALTHMC).

Public Storage (PSA) replaces Delta Air Lines (DAL). PSA is added to Real Estate Investment Trusts (REITRUST).

Murphy Oil (MUR) replaces Nextel Communications (NXTL). MUR is added to Integrated Oil & Gas (OILINTER).

Vornado Realty Trust (VNO) replaces Sunguard Data Systems (SDS). VNO is added to Real Estate Investment Trusts (REITRUST).

Tyson Foods (TSN) replaces Unocal (UCL). TSN is added to Packaged Goods (FOODCOMP).

When you start telling others how good you are doing, it's time to think about scaling out. The market rarely moves straight up or down; when you have seen a good run then start to think about taking some of the profits.

#### Summary

I spent a lot of time on "tuition"—learning the importance of trading with the market, on exit strategies, developing multiple strategies, learning from others' mistakes, and focus. Time spent developing your skills in these areas can take your trading to the next level. It won't happen overnight, but it is well worth the effort.

*You may contact Steve Palmquist at [market@daisydogger.com](mailto:market@daisydogger.com).*

#### MARKET REVIEW

**S**o much for the "dull" summer. Stocks had a good run in July, but were volatile and faded in August. In August the S&P 500 fell 1% and the Nasdaq Composite dropped 1.5%. These results were worse before the market rose by 1% last day of the month.

Energy stocks have been the market leaders for many months. Then came Hurricane Katrina, the damage from which won't be known for weeks or months. This further boosted the Energy sector, which leaped 8% in August. Due to high oil prices, Transportation was the worst performing sector, falling 6%.

## A few seats still open! AIQ's popular Lake Tahoe Seminar

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per person, which includes AIQ-hosted breakfasts, lunches, and a catered reception. AIQ and Harveys have made special guest room arrangements for attendees. Call Harveys at 1-800-427-8397. Group code for booking rooms is S10AIQ.

**Plus, sharing insights** into their own AIQ-based trading systems are guest speakers:

- Steve Palmquist, Founder Daisydogger.com
- Henry Brookins, Founder BrookinsBuys.com
- Steve Wheeler and David Johnson, Founders NaviTrader
- David Vomund, AIQ's chief analyst
- Stephen Hill, CEO AIQ Systems
- Jim Crimmins, CEO Traders Accounting, with helpful advice on record keeping and taxes.

**You can still reserve your seat - but do it soon! Call AIQ 1-800-332-2999**

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*Testing Your Systems in the 'Real World'*

# How Much Money Would a System Make? AIQ's Portfolio Simulator Tells You

By David Vomund

**L**ast month we reviewed several trading systems that were developed for the *Opening Bell*. An Expert Design Studio (EDS) backtest showed that these models continued to perform well even after they were developed.

The EDS backtests gave important statistics such as the return per trade and average holding period. They didn't, however, tell how much money would have been made using the trading systems. For that, use AIQ's Portfolio Simulator.

After creating a trading system, the most important question is "does the system work?" EDS answers that question by comparing the return on each stock trade to an

equivalent trade in the general market. If the average stock trade outperforms an equivalent trade in the market, then the system has value.

The next important question then becomes "how much money would I have made trading this system?" That's where the Portfolio Simulator comes in.

Unlike an EDS backtest, the Portfolio Simulator requires capitalization rules. An EDS backtest simply looks at all qualifying stock trades and makes inferences based on the average return and holding period. In other words, it assumes every trade is acted on. That's impossible in the real world. Eventually, a portfolio is fully invested.

Using the Portfolio Simulator, users can specify how much money is placed in each stock trade and new positions cannot be purchased unless there is sufficient cash in the portfolio. A test using the Portfolio Simulator closely reflects real trading conditions.

In order to perform a Portfolio Simulation, you first need an EDS screening model. You can either create your own model, or use one of those that we covered in last month's issue. For this article, we'll use the Citizen Kane model, which was created and published in our April 2000 issue of the *Opening Bell*.

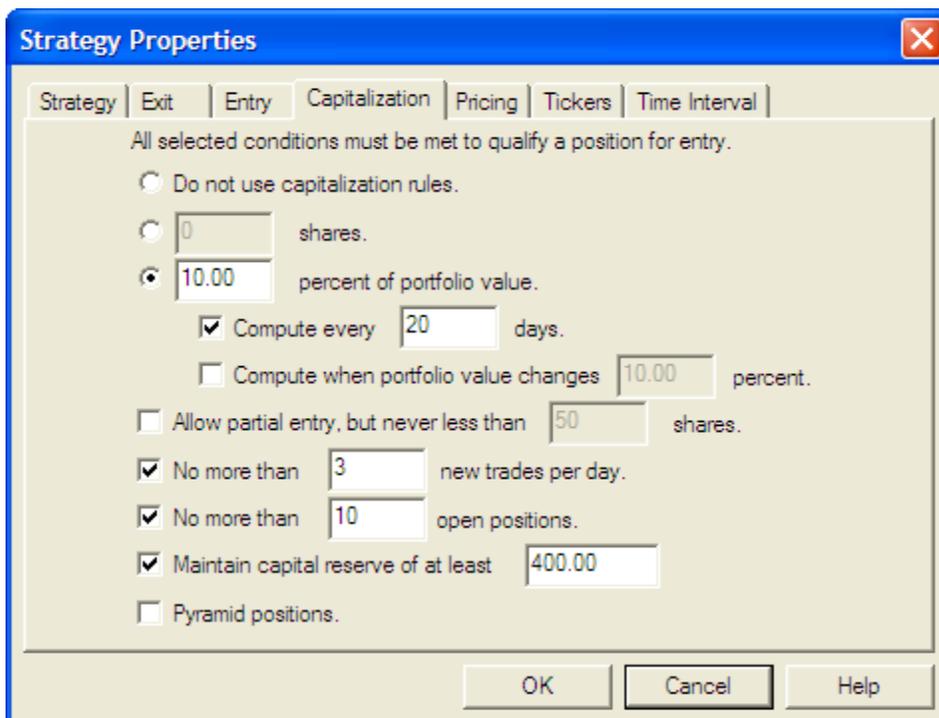
Once you have decided on an EDS model, you are ready to set up the backtest. Open TradingExpert's Quick Launch Menu and select the *Portfolio Manager*. In Portfolio Manager, click the *New Simulation* icon (the fourth icon from the left). In the first box on the Portfolio Simulation screen, enter a name for the simulation test.

If you wish, use the *Description* and *Comments* boxes to enter additional information. Select a broker from the pull-down menu. Commission rates are determined by the broker you select.

Under the Strategy box click *New*. The Strategy screen that appears is where you select the EDS



DAVID VOMUND



**Figure 1.** Strategy Properties function (accessed by selecting *New Simulation* in AIQ Portfolio Manager) displays Capitalization rules specified for simulation of Citizen Kane trading strategy.

file that contains the entry rules and any other statements that you will need to implement the strategy. In the Strategy Name box, input a name that identifies the strategy. The name should include a description of the strategy's stock entry criteria.

To select the EDS file that you want to use, click the button with the three dots (...). Then use the Open box to find and highlight the file name. Then click *Open*. When the Strategy box reappears, click *Next*.

The next few screens are used to specify exit and entry rules and capitalization criteria. The capitalization screen is shown in **Figure 1**.

For our test, we stated that each stock position should represent 10% of the portfolio value at the time of purchase. This implies that a fully invested portfolio contains 10 stocks. In addition, we specified that portfolio value is to be recomputed every 20 days and that no more than three new trades can be placed per day.

After clicking *OK*, the Portfolio Simulation screen reappears. Enter the starting cash balance, the start date of the backtest, the end date of the backtest, and an index to compare results to (see **Figure 2**). To run the simulation click *Run*.

*Editors Note:* a more detailed description on this process is found in TradingExpert's *User Reference Manual* beginning on page 469. A detailed step-by-step procedure is found on page 480.

The simulation statistics are

***“Using the Portfolio Simulator, users can specify how much money is placed in each stock trade and new positions cannot be purchased unless there is sufficient cash in the portfolio. A test using the Portfolio Simulator closely reflects real trading conditions.”***

**Figure 2.** Before simulation is run, final entries are made on the Portfolio Simulation screen. These include starting cash, test start and end dates, and the RS Ticker.

found in **Figure 3** (next page), and the results are pretty good. During a time when the S&P 500 lost about 3.3% per year, this system had an annualized return of 11.7%.

The Portfolio Manager also shows a trade-by-trade statistics on this model. By clicking a column header, the program will sort on that column. You can also get a

graph showing the portfolio's internal rate of return.

Our focus in this article has been on the use of AIQ's Portfolio Simulator because it gives a more accurate picture of a system's results compared to an Expert Design Studio backtest. That doesn't imply that the backtesting functions in the Expert Design Studio should be ignored. Because it looks at the activity of every stock that passes the screening, the Expert Design Studio's backtesting function is often a better choice when creating a model.

Once a model is created, then it should be tested using the Portfolio

Simulator. It will tell you how the model would have performed during the time period selected.

Be careful not to tweak models too much based on Portfolio Simulator results. Since the simulator only buys stocks when cash is available, its test will have fewer trades than a test in the Expert Design Studio and it is easy to over-optimize a strategy, leading to poor future results.

David Vomund publishes VIS Alert, a weekly investment newsletter. For a sample copy, go to [www.visalert.com](http://www.visalert.com).

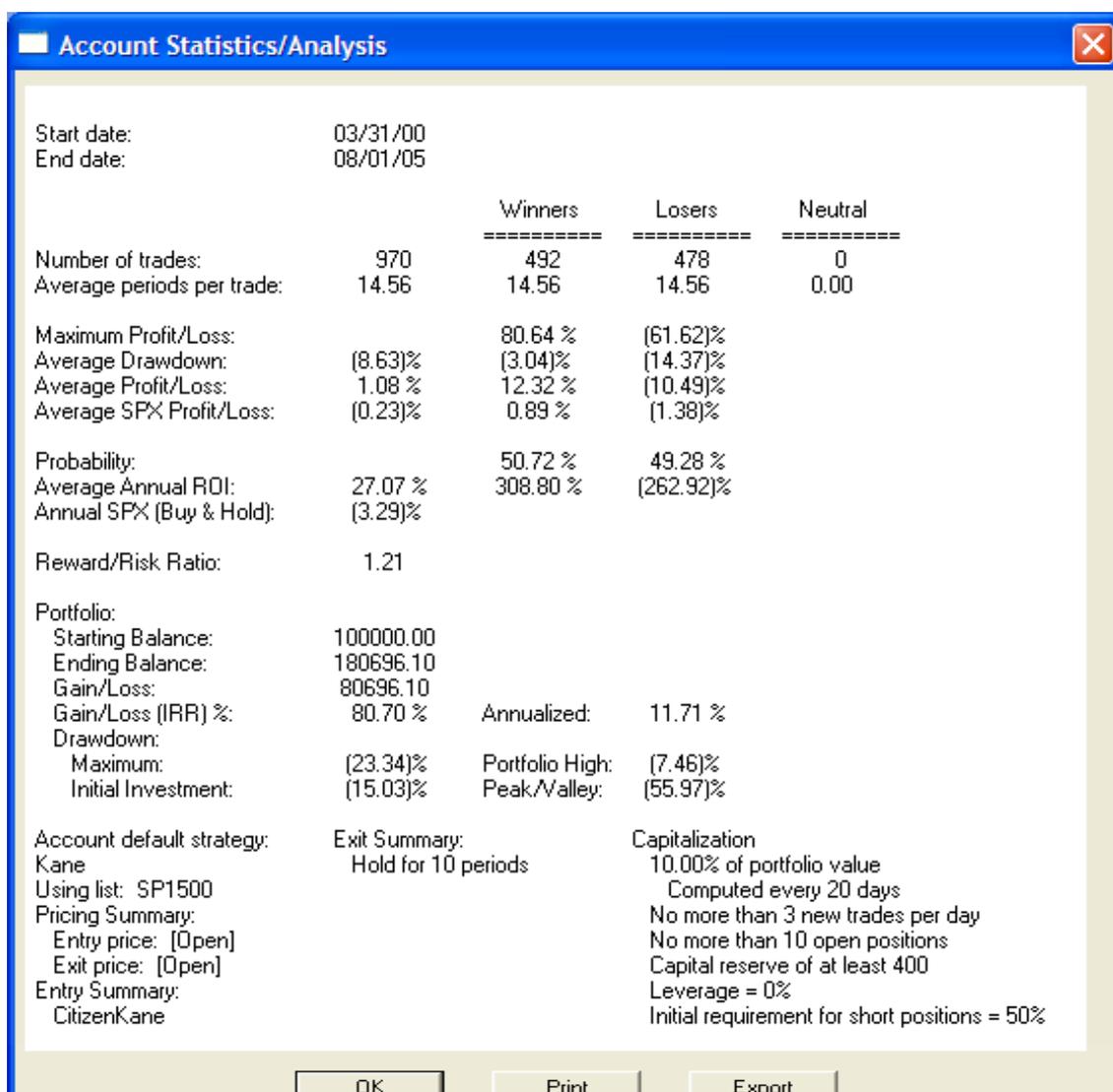


Figure 3. Account Statistics/Analysis screen with results from simulation run of the Citizen Kane trading strategy.

#### STOCK DATA MAINTENANCE

The following table shows stock splits and other changes:

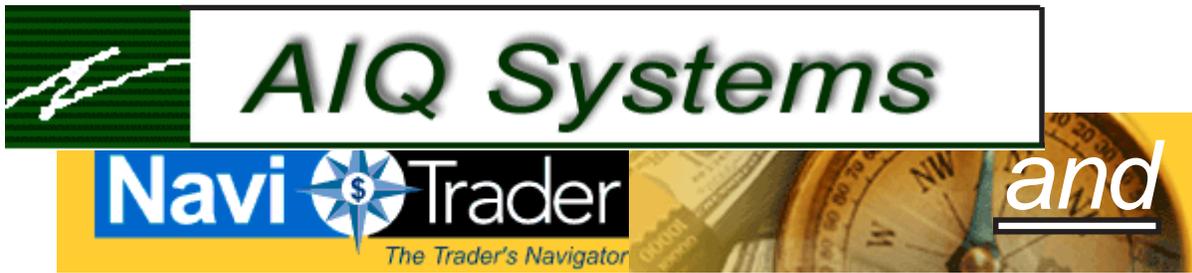
Stock	Ticker	Split	Approx. Date	Stock	Ticker	Split	Approx. Date
BJ Services	BJS	2:1	09/02/05	Brightpoint Inc.	CELL	3:2	09/16/05
Pulte Homes	PHM	2:1	09/02/05	Sigan Holdings	SLGN	2:1	09/16/05
Meridian Bioscience	VIVO	3:2	09/06/05	Urban Outfitters	URBN	2:1	09/26/05
Precision Castparts	PCP	2:1	09/09/05	Valspar Corp.	VAL	2:1	09/26/05
Fording Canadian Coal	FDG	3:1	09/12/05	Texas Roadhouse	TXRH	2:1	09/26/05
Noble Energy	NBL	2:1	09/15/05	Stage Stores	STGS	3:2	09/28/05
Alliance Resource	ARLP	2:1	09/16/05	Hibbett Sporting Gds	HIBB	3:2	09/28/05

#### Trading Suspended:

Ask Jeeves (ASKJ), Epimmune Inc. (EPMN), HIS Inc. (HIS), Modine Manuf. (MOD), Titan Corp (TTN), ToysRUs (TOY)

#### Name Changes:

Carlisle Holdings (CLHL) to BB Holdings Ltd (BBHL), Century Business Services (CBIZ) to CBIZ Inc. (CBIZ), Sprint Corp (FON) to Sprint Nextel (S)



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Steven Wheeler,  
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David Johnson,  
Co-Founder, Navitrader

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