A Wiley Finance Edition

CAMPAIGN TRADING

TACTICS AND STRATEGIES TO EXPLOIT THE MARKETS

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Campaign Trading

Tactics and Strategies to Exploit the Markets

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JOHN WILEY & SONS, INC.

New York • Chichester • Brisbane • Toronto • Singapore

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Library of Congress Cataloging-in-Publication Data:

Sweeney, John.
Campaign trading : tactics & strategies to exploit the markets / by John Sweeney.
p. cm.—(Wiley finance editions)
Includes index.
ISBN 0-471-14150-X (alk. paper)
1. Program trading (Securities) 2. Investment analysis. 3. Stock exchanges—Data processing. 4. Commodity exchanges—Data processing. I. Title. II. Series.
HG4515.5.S93 1996
332.6'0285—dc20 96-7807

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

CAMPAIGN TRADING

This book is dedicated to the folks who provided the education I didn't get in business school: Jack Hutson, Jake Bernstein, Bruce Babcock, Cliff Sherry, John Ehlers, Larry MacMillan, Martin Pring, Ned Davis, and Thom Hartle. Each provided some practical piece of the market puzzle. Thanks!

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Introduction

Up until now, you didn't really know where to put your stops. You didn't know when to get out or to reverse. You might have had some gut feeling for it, perhaps some support or resistance levels on the chart, or perhaps a money management stop or a parabolic being crossed, or maybe you just got a signal in the other direction, but aside from reversing, these were and are vague.

What sense did it make to put your stop at the level every other trader was watching? Where did that dollar limit or percentage of capital limit on losses come from, truly? If you investigated, you found that the foundations of these practices—if you could find any—were weak. Nevertheless, the trading maxim was "Cut your losses!" How to do it?

STOPS

Here are some answers:

1. If you look at the market's price behavior from the point of entry of your trading rules, there should be some regularity.
2. One of those points of regularity is that good trades don't go very far against you. Measured properly, the difference be-

tween good trades and bad trades tells you where to put your stops.

3. Knowing where to put your stops quantifies your loss levels, which in turn gives you the amount of capital you need to trade according to the rules you're considering.
4. Knowing the losses you should be taking, you have rules against which to measure your performance. If you're managing other traders, you have standards for their performance.

MORE MARKETS, MORE TRADES

Furthermore, this technique works not just for trend trades but also for trades in all phases of the market: trades into a range, trades against the trend, and trades reversing other trades. In other words, the technique makes it possible to trade no matter what the market is doing.

Trading all the time is a new ball game. You may have several types of trades at the same time. The number of contracts or blocks of stock may vary by type of trade. The instruments themselves may vary as options or other derivatives are used. Perhaps you're trading more than one market, and each market has its own set of effective rules and loss levels. In other words, you're running a complex but necessarily coordinated trading campaign.

PREPARING TO CAMPAIGN

Running a trading campaign is not like executing a single trading rule over and over, and this book doesn't describe running a campaign. Instead, this book shows by example how to build the base for campaigning: the measurement techniques to use, how to test trading rules for effectiveness, and how to pick the types of trades you will use in future campaigns. Think of this book as an example of preparing a campaign of trading.

INNOVATION

I believe the unique argument[1] here is that we should try to capture our experience in the market with observational statistics (not *parametric statistics*).[2] *We are still in the observational stage of developing* a theory of market behavior, but that doesn't stop us from using our observations to quantify old saws like "cut your losses short," "let your profits run," and so forth. If nothing else, our computer power allows the efficient gathering of data in volumes unimaginable even a decade ago. That's experience in digital format. What we make of this experience depends on our analytical constructs. I believe I can show at least one method of analysis of our experience in the markets that gives us quantitative guides to our future conduct.

The counterargument is that markets don't behave consistently, and therefore, our experience of markets cannot be consistent. In this view, the multitude of random events stimulating the market makes its behavior unpredictable. If it's unpredictable, how is it possible to characterize it and, hopefully, exploit that characterization?

I don't argue that I can predict tomorrow's market (and I don't deny it either!), only that given my view of the market (or your view or any other consistent view—even, perhaps, a random view), it may be possible to describe the market's behavior characteristically and, for practical purposes, exploit the most likely behavior, allowing always for being wrong.

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[1] Unique in 1982. Although there hasn't been much response to my articles in *Stocks and Commodities* magazine, good analysts started to publish work along this line in 1994 and 1995. Also, it could be argued that Art Merrill's work estimating the value of indicators at different confidence levels is in this line of thought. Ed Gotthelf's 1950s observations on how far trades carry is also experiential.

[2] *Nonparametric* statistics are used to describe phenomena that do not have normal relative frequency distributions. *Parametric* statistics are used to describe phenomena whose characteristics can be described with normal distributions (among other assumptions). These descriptions can use formulae filled with parameters, values that determine the shape of the distributions.

NINETY-NINE PERCENT PERSPIRATION

In 1982, seeking to deal with losses, I first hit on the differing behavior of winning and losing trades. I published that material in 1985 and again in 1991 and 1992. In the era of "rocket science," my down-in-the-mud techniques didn't give me much pride, but I gradually gained respect for their practicality. These days, the growth of arcane technique is unbridled, and I commend the exploration. Sooner or later, though, it all must actually work in a market where pricing is determined instant by instant by, in some cases, two people screaming at each other. This perspective reminds us that fear and greed, possessed by every investor, every trader, and every speculator, still drive the prices we seek to predict and drive them episodically, not randomly. Lots can go wrong. A certain caution, a certain humility, and a certain respect for the difficult job of exploiting changes in price is in order.

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INTRODUCTION

This is a book for speculative traders, retail or commercial, not niche traders or arbitrageurs. Speculative traders may be trading from an intensive knowledge of their market or merely from the action. Their horizon is usually short, but in some industries (copper comes to mind) may extend to four or five years. Speculative traders aim to profit from price fluctuation, not hedging. It follows that the more fluctuation they may exploit, the better their chances.

In the trading books of the early part of the century, writers would grandly refer to a campaign of trading, a series of battles and skirmishes to accumulate and eventually distribute a position, long or short. Today, while large operators still assemble and disassemble large outright positions, grand campaigning may be hindered by the capacity of the markets. Many, if not most, money managers are locked into quarterly comparisons of performance that prevent a longer view and focus on managing many issues. The field of play for the smaller speculator therefore is not often occupied by predatory competitors seeking to destroy him.

Smaller *speculative* traders can use their advantage on execution to fully exploit market swings. They can nimbly add positions on the way up or down, bail out at the peak or bottom, reverse or go into trading range mode until another trend is established. Moreover, they can add positions on pullbacks, as well as fade the trend *during excesses of the advance or decline—times when you must be* particularly nimble. The result is more profit opportunities that arise from more comprehensively exploiting market movement.

That said, it's not possible to constantly be right on a moving market. Most objective trading schemes are tied to one mode: trending behavior. That's because the most spectacular gains appear to come from catching a big ride. Surely, you must sit through a lot of small moves that don't turn into trends, but you plan to be there when the big one shows up. You hope that the move will be big enough to cover all the losses and indecisive trades.

To take full advantage of the market's movements, to extract all the *energy available in the tide of the price cycle* (ultimately the business cycle), we need to employ the tactics of today and the next three weeks while keeping in mind the strategy for the next six months to a year and the grand swing over the next four or five years. This book emphasizes that task up to about six months.

The key to this is determining which mode we're in and employing an objective trading strategy for that mode. Being objective means we know for each tactic in each strategy what winning trades or losing trades look like, and therefore how much capital to use and where to cut our losses. Oddly, just about any trading rule that objectively specifies an entry and exit serves our purpose.

Once we have objective means of defining trade modes, taking trades, and managing losses, we should trade all the time, not just on a single trading rule. A strong set of rules should allow us to be active in all market phases. I refer to this continuous activity as a campaign, a concerted effort to build capital.

Finally, I hope to keep things simple. This isn't the book for exotic definitions of trend or piles of theoretical mathematics, because the state of the art doesn't support such approaches. I hope most traders will be able to follow my argument by first looking at the pictures, then reading the text. Footnotes will lead to other references, sources, and products. I'll achieve my purpose here if I show a comprehensive view of recording and exploiting market behavior.

THE BIG PICTURE

What if we could extract from the market every bit of profit that its fluctuations allow? We'd be pretty excited, right? Even if we could get to half of it, we'd be pumped up. After all, the market is constantly moving somewhere, but we all know how difficult it is to be there and be right. Few of us have the agility or the market sense to constantly and consistently ride the waves and wavelets in the right direction.

Yet what we ask isn't crazy. We *should* be working toward that goal, even if we can't make it.[1] Instead, what typically happens is that we lock into a single mode of trading or a single trading "system," typically a trend-following mechanism. If there's no trending or the trend we seek isn't behaving the way our system likes to see things, we're in for trouble. If we do get headed in the right direction and at the right time, we don't have a way to fully exploit the advance or decline we're riding. How do we know when to add positions and when to take them off?

Then, when we reach the end of the trend—what to do? Most systems (all the ones I've seen) just bail out and wait for another setup like the one they are programmed to see. There's no thought of reversing into the countertrend, no plan to exploit a hiatus at a new level. Most so-called trading systems are one-note affairs.

This single-minded approach may have some virtue, but it limits us when we most need to make hay—when things are going right. We know we're going to have the numerous small losses—we need to make a ton when there are fish in the water. A one-note trading rule doesn't do it no matter how many setups, triggers, and filters we tack onto it. That's just going for the perfect entry, the unreachable Valhalla of retail traders.

Instead, see the whole picture (see Figure 1.1), not just the uptrend. Look at the basing, the trend, the reversal, and the ranging, which are not, as we know, the only possible sequence. Instead of a

[1] To get a taste of this, check the "perfect indicator" in MetaStock for Windows and DOS by Equis International. The indicator is used as a reference, not a trading signal.

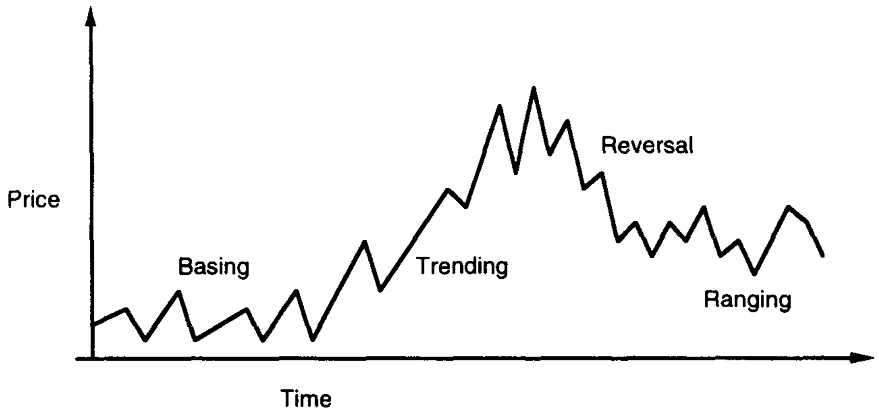

FIGURE 1.1 THE WHOLE CAMPAIGN. Instead of looking just for trends, plan for an entire campaign of trades, some exploiting ranging and some exploiting trending.

single tactical fight over a single entry and exit on the trend, consider a whole campaign of tactical conflicts beginning with quiet skirmishing during a basing period, skirmishing that builds and builds until it erupts in a breakout and we commit greater and greater amounts of capital. Even within this battle—uptrend or downtrend—there are entries and exits and more skirmishes, until we sense, through heavy contact and diminishing advances, that the trend is ending.

Our campaign strategy shifts to exiting the positions we've accumulated, not in a spasmodic ejection, but carefully, conceding ground while considering the possibility of a complete reversal of trend—and our position. Or perhaps ground gained will be held and we can go into defensive positions, hacking back and forth around support and resistance, holding a ridgeline, in combat terms, with aggressive patrolling and probing assaults.

The combat terminology isn't meant to indicate that we analyze or think in these terms but only to suggest the overall picture. Obviously, there's plenty of colorful but unquantifiable verbiage we could use to describe these concepts. I want you to campaign using objective, *quantifiable* tools. This book will illustrate how to campaign using New York Light Crude as an example.

BASICS

A young basketball player is fascinated with The Shot. He doesn't think about the footwork he needs to get to the shot. He's not aware of position on the court or even body position in the constant tactical encounters at each end of the court. These fundamentals can make for easy buckets or, alternatively, the continual need to pull a great shot out of nowhere time after time. (As a trader, which mode would you prefer?)

Neither is the young player aware of the substitution pattern, game pace, or matchups except as he faces them momentarily on the court or while sitting on the bench. The game plan is completely subordinate to hitting the shot and not getting beaten to the hoop.

It is the same in trading: There are some basics and there are tactical engagements within the endless campaign. To start with the basics, let's talk about time and loss.

Time Horizon

This clumsy term refers to the period of time you consider when trading, time past (for analysis) and the future (for projections). You need to know if your horizon is thirty seconds, thirty days, or thirty months. Many analytical techniques need to be given the number of days (or minutes or months) they should include in their calculations. Charts inevitably select a certain time period. Is it just the past ten days that are relevant to tomorrow's price, or the past six weeks or ten years? Technical analysts argue that the market in some sense remembers past prices, that past prices have an impact on today's price and tomorrow's. Well, then, what's the relevant memory span?

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