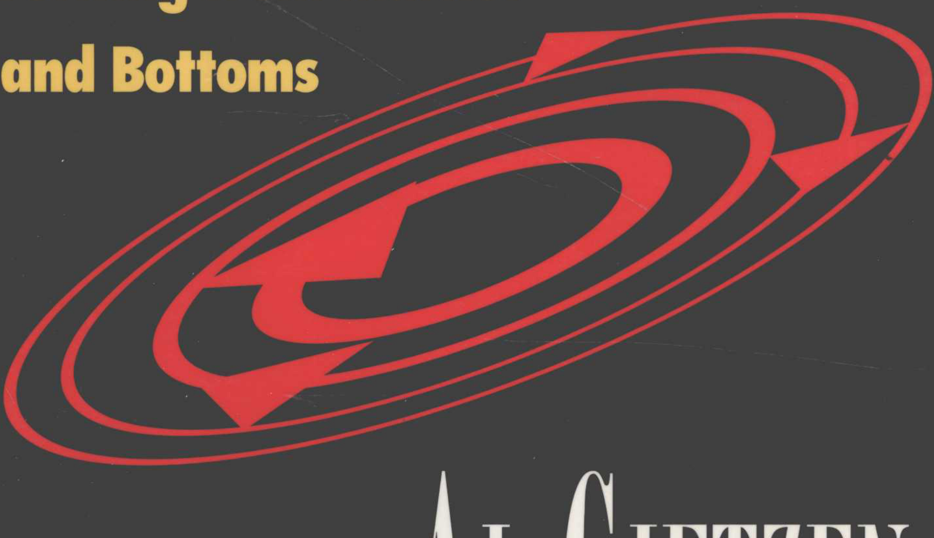
ADVANCED CYCLE TRADING

Cutting Edge Techniques for Profiting from Market Tops and Bottoms



AL GIETZEN

ADVANCED CYCLE TRADING

Cutting Edge Techniques for Profiting from Market Tops and Bottoms

AL GIETZEN

IRWIN
Professional Publishing®
Burr Ridge, Illinois
New York, New York

© 1995, Al Gietzen

Originally published as *Real-Time Futures Trading* © 1992

ALL RIGHTS RESERVED. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the publisher and the author.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the author and the publisher are not engaged in rendering legal, accounting, or other professional service.

ISBN 1-55738-881-1

Printed in the United States of America

BB

1 2 3 4 5 6 7 8 9 0

Foreword

The task which confronts today's investor is monumental. Never before has there been so much unrest in the world of finance and so much volatility in the markets. Effective timing is a strong prerequisite to survival and profit in the investment world. But the task with which the speculator is faced is still more weighty than that of the investor.

Short-term traders must have the ability to implement precise timing. And in this battle against the markets and emotions, only those who are able to achieve effective timing and iron discipline will emerge victorious. The low success rate, which is well known throughout the futures industry, is a strong testimonial to the fact that futures trading is a risky business. While it is generally believed that stock trading is less risky than futures trading, I feel strongly, based on my more than 20 years of experience in both fields, that the majority is wrong in most cases and at most times in both the futures and the stock markets. And this leads to the question, "Why?"

Several lengthy books could be written in response. Even then the answers would prove insufficient. Reality is being interpreted by human beings who perceive events against an internal backdrop shaped by a myriad of factors from heredity, early childhood experiences and life circumstance. The behaviors prompted in different individuals by the same events are often diametrically opposed. News which confirms a bullish predisposition to one trader validates a bearish stance to another.

We trade the way we think. For traders who are able to maintain an objective view of the markets, of their abilities, and of their performance, the lack of an operational and objective trading system may pose no problem. But for the overwhelming majority of the traders, the "seat of the pants" approach (which is commonplace) leads only to losses, frustration and anguish. It is the rare trader indeed who can be successful without objective technical tools as a guide to self-control. And this is the essence of trading systems, timing methods, indicators, charts, computer programs, seasonal analysis cycles, and so on. It is to this end that Al Gietzen offers the book that you are about to read.

In my view, the purpose of any good book about trading is threefold: first, to offer ideas about market timing; second, to illustrate how these ideas are applied in real time; and third, to stimulate thought for additional research. Al has achieved all three goals admirably.

If you expect to come away from reading this book with final answers to cyclical riddles that have plagued traders for many years, then you've set unrealistic goals. But if you're looking for a practical, tradable, workable, and above all, an understandable way of using cycles to your advantage, then you've come to the right place. Within these pages, you will find important answers to the perennial issues of timing in conjunction with cycles. And you'll learn how to apply them in a consistent and objective fashion which will take much of the guesswork out of cyclical timing.

I only wish that I had known these indicators back in 1982 when I wrote the *Handbook of Commodity Cycles—A Window on Time* (Wiley & Sons, publishers). Al has gone well beyond my original work in providing specific timing indicators and analytical methods which will unlock the power of cycles. And in doing so, his techniques will help you overcome the chief enemy of the trader—emotion.

Jake Bernstein
Northbrook, IL

试读结束，需要全本PDF请购买 www.ertongbook.com

Preface

But as I see it now, as I feel it, I want my visions to come out of my own juices, by my own effort—the hard, ancient way.

I mistrust visions come by in the easy way. . . . the real insight does not come from this.

Lame Deer
Sioux Medicine Man

The trading of commodity futures carries with it the reputation of high risk. But the flip-side of risk is reward. The key is to understand the risk and take appropriate measures to control it. After all, most things in life involve risk; it is only when we act like we're **not** taking a risk that it is dangerous.

This book is an outgrowth of my personal struggle to understand the markets and to develop and adapt technical methods which could outperform all that I was able to find in the literature. But as I used and refined the methods it became evident that the successful trading method was only one piece of what is essentially a three-piece puzzle. A sound methodology must be accompanied by a sound money management system; and there must be an understanding of, and solutions to, some of the key psychological problems that inhibit overall trading success.

As a guide to profitable trading, the book necessarily became more comprehensive and covers all three areas. The combination of the three main ingredients—methodology, psychology and money management—can bring the risks of speculative trading into line with those of other entrepreneurial activities. And with the reduction of risk in this high-leverage business, substantial profits can be made.

The intent is to provide a succinct and thorough approach in each area to give useful and workable solutions. Thus the serious novice can use it as a complete guide to successful trading. The new approach presented, as well as the presentation of the technical foundations of both new and old indicators, can be useful to the professional seeking better methodology. The original analytical approach to limiting losses as part of the money management system can be used by all traders, regardless of methods used.

The trading methodology presented utilizes a new technical indicator that I call "Market Reactivity." It is an analytical indicator that goes beyond the typical use of price behavior alone. It incorporates changes in trading volume and volatility to give a more complete indication of market behavior; and it is then used in conjunction with the inherent cyclical content of each specific market, making it a powerful tool. It has broad applicability to stock and commodity markets and adapts to possible changes in the inherent behaviors of these markets over time.

The calculations required for the indicators, and for the identification of the approximate cycle content, require the use of a computer. The method is adapted for use with standard spreadsheet software so no special software or equipment is required.

For those wishing to use the method without spending the time and aggravation of doing the programming can simply purchase a spreadsheet "template" from the author for specific commodities (see order form at back of book). These are in Lotus 1-2-3 or Excel format for IBM-compatible computers and include all necessary equations and graphics.

I found existing literature on money management in trading limited and even more contradictory than information on trading systems. Besides answering such questions as where to trade, how much capital is needed, how much of an account balance should be used as margin, and when to add to a position, Chapter 4 makes a valuable addition to risk management by providing an analytical approach to determining stop-loss points. It limits risk based on the market behavior (price movement and volatility) rather than arbitrary comfort level or fractions of a guessed potential reward.

A complete demonstration and explanation of trading over a 90-day period of actual data for five different commodities is given. This period was not chosen because the system happened to work well: an arbitrary period was selected, and the same period used for the demonstration of all five commodities. It is in this section where the reader can get information on an application of the method specific to a given market.

The importance of psychological factors is usually the last area appreciated by an aspiring trader. Prior to presenting the technical methods, the importance of these factors is highlighted and some key character traits for successful trading are discussed. The last chapter then returns to the psychological aspects and discusses the key components of trading stress, the common pitfalls experienced by traders, and some suggested ways of dealing with these psychological traps.

The book is of most benefit to those who have at least some familiarity with the futures market, the use of a computer, and an interest in the technical analysis of the markets. The concepts are stated in a concise manner; that is, things are explained only once, so it needs reading in an atmosphere conducive to concentration. Of particular interest to the more inexperienced trader, Appendix A presents an introduction to the futures markets, how they work and who uses them.

It is a complete guide to commodity trading and provides a method that has shown the ability to generate substantial return. Here is an opportunity to examine all the details of a technical trading system and its application before you spend hard-earned money on specialized trading software.

ACKNOWLEDGMENTS

Trading commodities and writing a book are both solitary activities. With no built-in support group in these activities, the support and encouragement of friends and family is paramount, and for their support I am grateful. In particular, thanks to Elaine Blackburn, Roger Kinnischtzke, Jan Winn and Lynn Thompson Winn. Special thanks to my cousin, the psychologist Rose Turner, for her review of the trader psychology, and to Wil Price for his penetrating technical review and expertise as author of many books.

Al Gietzen

Introduction

To fly as fast as thought, to anywhere that is, . . . you must begin by knowing that you already have arrived.

Chiang's advice to
Jonathan Livingston Seagull

Even those who invest and trade in stocks will try to convince you that commodity prices are too volatile and the risks too great. But look at the stock market in recent years. It has been extremely volatile and risky. The principal difference in the risk factor between stocks and commodities is the degree of leverage that is allowed. The cash needed as margin in trading commodities is a small fraction of the value of the commodity that you actually control with the contract. This greater leverage, while adding to the risk, also equates to greater opportunity.

Taking advantage of the greater leverage and making greater profits by speculating in commodity futures requires at least three ingredients: a sound methodology, sound money management, and proper trading psychology. Diligent application of sound principals in these areas can bring the risk of commodity-trading into line with other kinds of investment or income producing activities.

If we're going to be taking risks, we must be sure that we understand what we're doing, act like we're taking a risk, and take the steps necessary to control it. In essence, that is what this book is about. It presents the complete development of a technical market trading system, a sound approach to money management, and discusses some of the key psychological factors that affect the outcome of a trading program.

Development of methodologies for speculating in the commodity markets generally is divided along the lines of "fundamental" versus "technical." Fundamental analysis looks at all those factors in the marketplace that affect the supply and demand, and therefore the price, of the commodity. These are many and complex, and often it is difficult to interpret the net effect on the market.

This book deals with technical analysis. Technical analysis attempts to bypass some of the uncertainty in the interpretation by concentrating on how the market is actually reacting. This is based on the assumption that the net effect of all the fundamentals, as they are being interpreted at large, is what causes the current market behavior. So it is necessary to extract some underlying behavior characteristics that can then indicate what is expected in price movement.

The manner in which fundamental factors affect market prices in the short term is largely because of trader and investor sentiment. Sentiment changes, as well as some of the fundamental factors, are not entirely random. Like so many other things in nature, the price behavior tends to vary in a way that can be described as a complex combination of cyclical patterns. By doing an approximate unraveling of the cycles inherent in the market behavior, and constructing a trading system in harmony with it, we can make timely trades. As is the case with "chaos theory," we are finding the non-randomness in the market behavior and exploiting it.

You don't have to believe that the markets are governed by some inherent cycles in nature. All that is relevant is that the observed behavior can be suitably described in this way, and that we can use this description to better know when to buy or sell to make profits.

A new measure of market behavior called the "market reactivity" indicator is introduced in this book. It is an indicator that combines analysis of the price, the trading volume, the price range (volatility) and the inherent cycle content into one powerful tool. The reactivity indicator, along with its associated "critical ranges," is the principal tool of the trading method developed.

The problem with most technical trading systems is that they lag too far, especially for short-term trades. By the time you get in too late and out too late, you haven't made any money. The system developed around the "market reactivity" concept cuts the "lagging" problem by teaming the indicator with the inherent cyclical patterns in the particular market. This allows immediate identification of short-term trend change and is key to timely entry and exit.

A new, logical and mathematical approach is also developed for determining "stop-loss" points. We know that no indicator system is foolproof. A major challenge of the trader is the effective limiting of losses. The method gives stop-loss points, providing minimum risk consistent with current market behavior. This gives the trader the backup of always knowing the point at which to exit a trade if the price moves against the position. Besides minimizing risk, this alleviates the stress of uncertainty for the trader.

By exploiting the intrinsic characteristics of any given market, the method is not market specific. It can be applied to many different commodity futures, stock indices or to individual stocks. You can trade directly in the stocks, or futures contracts, or their respective option contracts. Nor is the method specific to a given period of time. It is an adaptive technique, i.e., possible changes in market behavior are handled by adjustments in the analysis.

The approach presented both encourages and requires study. Although a relatively simple set of rules defines the use of the indicators, it requires some practice to get good at using the techniques because at times some judgment is required. And, although there may be some black-box computer programs that you can buy which will produce some profit by a purely "mechanical" approach, the belief here is that the added use of our human judgment and flexibility can result in significantly better trading results.

In a basic way, the adaptive nature of the method and the judgment and flexibility factors are consistent with another topic *du jour* in technical analysis, "neural networks." I believe the ultimate neural network is the human brain.

In addition to developing a sound methodology for trading, it must also be recognized that a significant part of successful trading has to do with psychology. In our cultural setting, the concepts of money and winning have as much to do with emotions as with the intellect. The major psychological aspects that determine our ability to make substantial profits are presented as they relate to our trading success.

The methods presented are intended for use with standard spreadsheet computer software. No expensive specialized software is needed.

试读结束，需要全本PDF请购买 www.ertongbook.com

Yes, the use of a computer is necessary. Anything less rigorous would be bypassing a major tool and would probably not put you into serious contention with the traders who use them.

It is assumed that the reader has a basic understanding of the markets, has perhaps attempted trading, or is, in any case, serious about its pursuit. The minimum level of knowledge required can be obtained by studying the free brochures you can get from your local stock and commodity brokerage house. Some computer savvy is needed for application of the methods, but, of course, you can start learning that right now. The experienced trader can also benefit from application of the techniques presented to improve trading results.

Emphasis is given to the explanation of the foundations upon which the technical system is built. The mathematical formulations are generally straightforward for someone with at least some algebra background. The belief here is that the most successful application of the methods can be made with a good understanding of the methods. The presentation of the foundation of some other "commonly" used technical indicators is also given, along with examples of how some of these are used incorrectly because the original derivation is overlooked.

Even if algebraic equations are a foreign language to you, don't be intimidated. You can simply buy the spreadsheet file for Lotus 1-2-3 (or compatible) with the equations and graphics already built in (see order form in back of book). But challenge yourself to try and understand the approach to whatever extent you can, and then concern yourself with the end result: profitable trading. In return for some effort to understand, and the willingness to use some judgment, you will gain a good understanding of how the markets work and how to trade them profitably.

I have studied many books on technical trading methods where the examples of the method being applied always work well. Authors have a tendency to select data which shows things working out well. Perhaps when *you* try to apply the system to current data, it doesn't work. There is always that disclaimer that says past performance is not necessarily indicative of future results.!

In Chapter 5, you will find a demonstration of the application of the methods for different commodities for a specific 90-day period. This period was arbitrarily chosen and the same period is used for all five of the commodities which will be discussed as examples. There's no picking and choosing of the times when things worked best. Nevertheless, you will learn how profits were made, and how and why the trades were made even though in some cases things got a little messy. (Of course, that disclaimer about future results applies here as well.)

There is a common argument that if a system worked, everybody would use it and the markets would change so that it would no longer work. Not to worry. If there were only a handful of traders and they all read this book, perhaps that would be true. But there are many thousands of traders, and most will already have a system that they prefer. Only a relative handful will ever read this book, and then only a small fraction will follow through and actually use the system. The widespread application of the computer has changed market character, and changes in global communication can change the market; but making this system available will have negligible effect on the markets. It will only affect the profitability of an individual reader's trading program. Go for it!

Contents

List of Figures

试读结束，需要全本PDF请购买 www.ertongbook.com