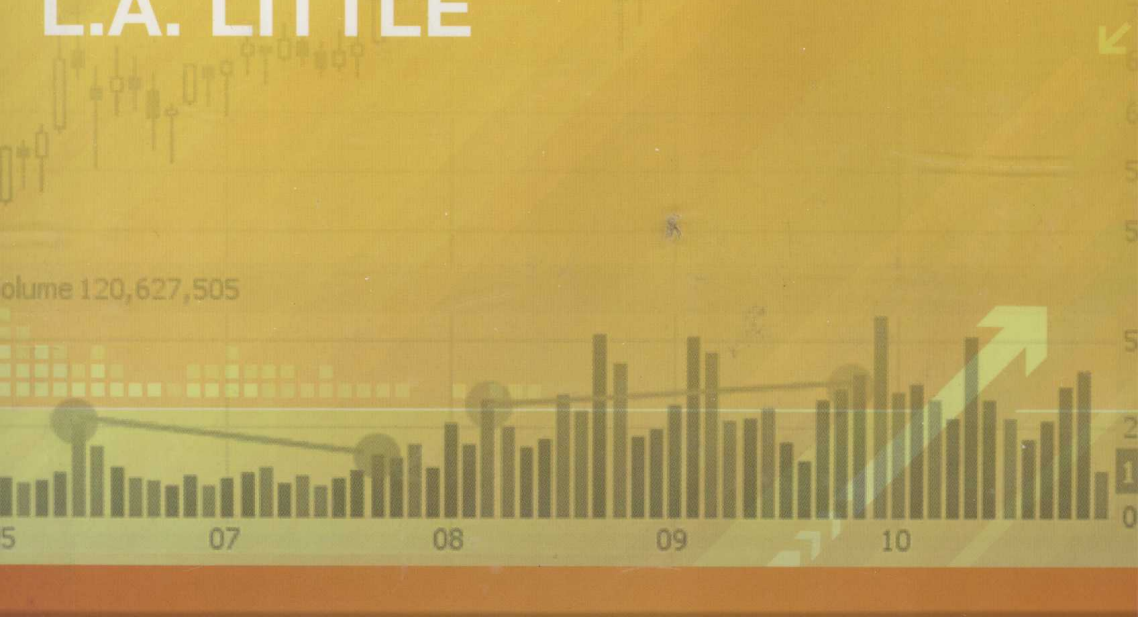




TREND QUALIFICATION & TRADING

Techniques *to* Identify
the Best Trends *to* Trade

L.A. LITTLE



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Trend Qualification and Trading

*Techniques to Identify the
Best Trends to Trade*

L.A.



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Foreword

The essence of all successful investing and trading is trend following. Trend following is not just a style or an approach to the market; it is the heart and soul of all profits. There is no way to escape the fact that you must embrace an uptrend of some sort if you hope to eventually recognize a gain.

Even the most long-term dedicated value investors, who focuses on fundamentals and buys out of favor stocks, needs to have his or her insight eventually validated by a positive trend. At the other extreme, the aggressive day trader needs a trend of some sort even if lasts for just for a few minutes. Market success and trend following are inescapably connected.

Despite the essential nature of trend following to the investment process, the literature on the topic is woefully lacking. Platitudes such as “the trend is your friend,” “buy low, sell high,” and “cut losers and let winners run” constitute much of the discussion about riding a trend.

In many ways trend following is like the famous dicta uttered by Supreme Court Justice Potter Stewart in regards to pornography: “I know it when I see it.” Trends are always easy to see in retrospect. They are almost always painfully obvious when we look at charts, but defining them and exploiting them for profit is a daunting task.

Many market players, including me, like to think that our success in identifying and riding trends is some intuitive skill that is akin to artistic talent. We like to believe that trend trading is an art form that can’t be easily taught or communicated. L.A. Little crushes that conceit with his systematic approach to trend trading. He uncovers and dissects the many nuances and subtle issues that make trend trading so powerful.

Trend trading isn’t just about holding a stock through a series of higher highs and higher lows. That is the easy part. Anyone can hold a stock that goes up endlessly, but, unfortunately, that doesn’t happen that much in the real world. We have news events, shifting sentiments, and a host of factors that toss stocks around at random. Only the best stocks will continue to exhibit relative strength and reward us if we stick with them. Knowing

when to hold and when to abandon ship is what this book addresses like no other that I have ever read.

The easiest part of the investment or trading process is the buy point. It is not that hard to find a stock that has a positive technical pattern. The hard part is the sell decision and that is what L.A. Little addresses with great precision. He integrates the concepts of volume, swing points, and anchor bars into the analysis, which greatly aids in determining the health of a trend.

In my experience, the most common mistake among active traders is that they don't stick with trends long enough. They simply don't have a good framework for deciding whether a trend will continue and, as the old adage goes, "no one ever went broke" taking a profit. However it can be quite disheartening to look back at how costly premature sales have been.

The great difficulty in trend trading is trying to determine when a trend has ended and it is time to move on versus what is just a healthy correction within a trend. I've heard countless tales about how someone bought a stock like Apple Computers at \$7 in 2003 and then sold it for \$10.50 and a big fat 50% profit a few months later. That sounds pretty darn good until you look at the current price of Apple Computers at around \$340.

There is nothing more valuable in this excellent book than the disciplined structure and set of rules it sets forth for staying with a trend and not selling prematurely. There will be times when the trend is suspect or ambivalent, but L.A. Little develops a clear approach to dealing with those times so that you can stay with the trend and reap the big payoff.

It is obvious to every logical thinker that trend trading is the key to market success. It is the qualification of trends and the execution of the investor that is the key to success. You will not find a better framework for trend trading than that set forth by L.A. Little in this very valuable book.

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Professionally I extend special thanks to my publisher for all the wonderful work and opportunities they have provided.

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Finally, to the countless technicians, both contemporary and historical, whose writings inspired and embellished my trading methods, I thank you all.

L.A. LITTLE

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Introduction

Unlike men, not all trends are created equal. That simple premise, when fully understood, forever changes how you look at a chart. Trend, as it applies to securities trading, is loosely defined as the proclivity for prices to move in a general direction over a period of time.

Trend direction, although generally understood as a series of higher highs and higher lows (uptrend) or lower lows and lower highs (downtrend), is largely left to the practitioner to identify and interpret, without any system of uniformity and codification. This is a problem.

A more subtle but detrimental problem is the widespread practice of treating all trends as equals. Rarely does one see any discussion or even the recognition that some trends are “better” than others. This monolithic approach to trend combined with a blindness toward quality necessarily results in inferior trading results. To believe that all trends are equal in importance is to ignore reality. They are not.

It is sometimes said that successful traders have a knack for picking the “right” stocks. Although there is a lot more to successful trading than the choice of what to trade, successful traders tend to trade “stronger” trends; their skill, however, is probably based more on intuition than consciously practiced.

Trends are the primary technical tool of almost all traders, trading indicators, and trading systems. As such, the concept of trend is embedded in almost all technical trading literature, thought, and practice. “The trend is your friend” is an often-repeated aphorism. The desire to both identify and follow trend is practiced with an almost religious zealotry.

There exists a hodgepodge of technical tools designed specifically to recognize the creation and termination of trends. The use of moving averages is probably the oldest and most widely followed method to capture trend. Although a lagging indicator, the use of moving averages is widespread not only as a stand-alone tool (20-, 50-, and 200-period simple, weighted, and exponential moving averages are widely available and found in all charting packages) but also as the underlying trigger in a host of technical tools. For example, moving average convergence divergence

(MACD) is based solely on moving averages.¹ Bollinger bands are nothing more than \pm standard deviation bands arising from underlying moving averages.² The list goes on and on.

Equally widespread is the use of trend lines. A trend line is nothing more than a line drawn across three or more price point highs or lows on a chart. Once drawn, a trend line has a rising, horizontal, or declining slope, and the slope of the line is interpreted as the direction of the trend. Trend lines are used repeatedly as a visual aid in the recognition of trend. They appear throughout technical analysis literature and are commonplace in practice. The vast majority of the technical patterns a technician examines are based upon trend lines—even though few technicians are aware of this. For example, the neckline of a head and shoulders pattern or the upper or lower boundaries of a rectangle are both trend lines.³ The entire concept of support and resistance is based on trend lines as well. A support or resistance line is nothing more than a trend line consisting of upward, downward, or horizontal slope.

The concept of momentum, another formidable technical crutch for technicians, is also rooted in the idea of trend. Momentum indicators attempt to address the “proclivity for prices to move in a general direction” part of the definition of trend. They are widely used by traders who follow a trend when trading and also by those attempting to anticipate a trend’s demise. In the latter case, by measuring the rate of change inherent in a trend, momentum indicators attempt to predict an imminent trend change.

Finally, many of the most popular trading systems, both past and present, are based primarily on the concept of trend. The term trading systems refers to any systems approach to trading that is codified in some set of rules of when to enter and exit a position. They can be manually implemented or automatically traded (commonly referred to as program trading).

A famous and widely popularized manual trading system based solely on the concept of trend was the “Turtle Trading” trading system. Turtle Trading came about as an experiment conceived of and implemented by the legendary futures trader Richard Dennis⁴ in 1983–1984. Dennis recruited and trained 23 individuals from all walks of life on the principles of trend based trading—principles that allowed many of the recruits to become successful traders in their own right.

Program trading systems (though the components of these systems are almost always proprietary and thus hidden from public view) are thought to universally have trend following as their key trigger for position entry and exit. Although each automated system varies to some degree, with respect to other factors such as reward-to-risk and drawdowns, the key component remains that of trend following.⁵

Given the importance of trend, one would think that this fundamental technical concept had been refined to perfection, with all ambiguities long since resolved. The reality is that trend is still not completely understood. Thus, this book focuses on a redefinition of trend through qualification, explores the implications of trend qualification, and examines the practical applications that flow from it. Trend qualification, like everything in technical analysis, offers no guarantees for predicting the future, as predictions are always fraught with error. Refining the definition of trend does, however, increase the probabilities of realizing an expected outcome.

Given its undeniable importance to all traders and its pervasive use in most trading tools, literature, and trading systems, the precision with which we define trend is critical to increased trading success. This statement rings true regardless of whether you are trading soybean futures in Chicago or a solar energy company in China. It holds true in South America, Asia, Europe, and the United States. Whether we look to currency, stock, futures, or even bond markets, trend is everywhere and so fundamental to technical analysis that the two are virtually inseparable. Sure, there are other components, but when you build a house, you don't start with the roof—you build from the foundation up.

It is for this reason that we embark on a redefinition of trend with the goal of solidifying our technical foundation. Our quest is for the treasure of increased predictive accuracy, and it is with the knowledge of trend qualification that we find a more perfect model: a methodology for evaluating the past and present in order to more accurately predict the future.

Trend Theory

Most literature on the subject of technical analysis focuses on application—how to apply some tool set to the market to magically make money. Very little of the available literature digs deeper into the mysteries of trading markets, asking the more philosophical and theoretical questions regarding what really makes the market do what it does.

Step back and consider the approach used in scientific inquiries. The common practice is to develop a hypothesis that attempts to explain the observed phenomenon. Next, studies are devised to test the hypothesis. After testing, the hypothesis is revised as needed, retested, and, as a result of this process, eventually a theory is created that explains most aspects of the phenomenon. Once understood, the theory can be utilized to create a simplified model of the reality.

In the field of study commonly referred to as technical analysis, the concept of trend is arguably the most fundamental of all technical building blocks. Without an accurate understanding of what trend is and how it can be reliably identified, technical analysis is crippled, at best.

Given the unquestioned importance of trend, there is an unparalleled need to create a theory of trend that utilizes the circular process of proposing and testing a hypothesis. In practice, this approach builds a solid foundation, a lasting foundation that isn't subject to the whims of the day.

The early work of Charles Dow and Thomas Hamilton is the most defining work on trend, and their trend model is studied intently. From that material, the objectives, inputs, definitions, and relationships of the currently practiced model of trend are exposed and analyzed. The Dow/Hamilton

model can be referred to as the classical model of trend, given its groundbreaking work and application.

Although an excellent model, the Dow/Hamilton model's focus was rather narrow. Later practitioners, rather than extending the model in order to properly apply it to other phenomenon, chose to take the simple way out. Rather than do the legwork required to formulate a new theory and resultant model, these modern-day practitioners chose to simply distort and stretch the classical model to fit their needs. Such an approach is problematic.

Thus, Part I addresses theory and model. It begins with a presentation of the classical model of trend followed by the proposed neoclassical model. Both are presented in depth with an eye toward their objectives, internal assumptions, inputs, definitions, and the relationships among those moving parts.

The neoclassical model is comprehensively documented and its far-reaching implications are analyzed. Starting from a set of objectives that seek to explain how all trends are created, persist, and eventually meet their demise, observable phenomenon (market behavior) is utilized to validate the model. As such, the neoclassical model is essentially a replacement for the classical model, extending its scope and applicability—but it doesn't stop there.

The neoclassical model introduces another equally important, if not more important, concept. The model proposes that not all trends are equal in terms of their quality; that some trends are better than others. Initially that may not sound groundbreaking, but the implications are huge. If a trader can discern one trend as having an increased likelihood of continuance as compared to another, then naturally the trader would gravitate their efforts into trading the trend that had the most promise. The resulting yields should increase, and thus the model provides a valuable application in the "real world" of trading.

To summarize, not all trends are created equal and the neoclassical model provides the theoretical foundation for both the identification and qualification of trends. The model that springs forth yields abundant opportunities for practitioners in a very practical sense. In all human endeavors, applications without theories and resultant models typically end up on the trash heap of failed ideas. The currently practiced trend model is a failure not because of the model itself, but because the model has and is being applied in a manner it wasn't designed for. There is a better way. Through a painstaking examination of the existing model followed by the creation and exposition of a new, more comprehensive one, future generations of traders shall have the benefit of a theory that more closely matches the reality and objectives that they are most interested in.

Redefining Trend

Trend, as it applies to securities trading, is loosely defined as the proclivity of prices to move in a general direction for some period of time. This definition appears to be a reasonable description, given the references made to *trend* throughout the technical literature. Note, however, that this definition neither indicates the direction of movement nor precisely defines the concept of time. Instead we are offered a broad picture of the inertia of prices moving along in one direction or another and continuing to do so for some unspecified period of time.

When you look for definitions of *trend* in the body of technical analysis work that has formed over the past century, there are few to be found. A general definition is contained in what has become known as the defining work for classical technical analysis, *Technical Analysis of Stock Trends* by Robert D. Edwards and John Magee.¹ Edwards and Magee explain how Charles Dow is believed to be the first person to make a thorough effort to express the notion of a general trend. Dow's research led to a series of editorials published in the *Wall Street Journal*. After Dow's death, the succeeding editor at the *Journal*, William P. Hamilton, continued to write about the market averages and trends. Eventually, Hamilton took Dow's work and organized it into a set of principles that later came to be known as the Dow Theory. That theory is heavily premised on the principle of identifying the general market trend.

Probably the most influential work on the Dow Theory is provided by Robert Rhea, who in 1932 published a book by the same title, *The Dow Theory*. Rhea recounts the work of Hamilton and provides what is probably

the most complete literary definition of trend, described in the context of bull and bear markets.²

Successive rallies penetrating preceding high points, with ensuing declines terminating above preceding low points, offer a bullish indication. Conversely, failure of the rallies to penetrate previous high points, with ensuing declines carrying below former low points, is bearish.

Outside of Hamilton's definition, *trend* is heavily referred to yet almost universally lacking a definition. The notion of trend is widely accepted, but other than in the early works of Dow and Hamilton, the absence of a definitive definition is deafening.

Open almost any book on trading and you will see references to *trend*. It doesn't matter if the subject matter addresses tape reading,³ the psychological aspects of trading,⁴ or something as unique as explaining the market through chaos theory;⁵ almost every trading book makes references to *trend*, yet provides no definition. It's as if the definition is so widely known that it need not be repeated. Clearly all these technicians view *trend* as important—certainly important enough to take the time and trouble to use the concept in their books and to utilize that concept to explain their trading systems and insights.

Given that *trend* is such a fundamental concept to the study of technical analysis, this absence of a precise definition is, in a word, baffling. Few would argue about the definition of a price-to-earnings ratio (PE). There is little disagreement in the world of finance about such concepts as PEG ratios, profit margins, return on assets (ROA), or a whole host of financial criteria used to evaluate a company's financial health. In fact, the less-than-rigorous nature of technical analysis is what frustrates so many traders. It is why fundamental traders (those who analyze the fundamentals of a company and use that analysis to make investment decisions) mockingly refer to technical traders as voodoo traders or worse. How can you use the conclusions of a field of study when a most basic concept is—shall we say—fuzzy?

The most complete definition of *trend* (as popularized by Rhea) has held sway for more than a century now and has been used liberally by all who have followed. It is based on the concept of price and direction and was originally provided in the context of the general market trend, a trend that is measured in years—not months, weeks, or, heaven forbid, days. Over the years, though, the notion of trend has increasingly been applied to price movements within shorter and shorter time frames. Given the criticality of the concept of trend to all technical traders and to technical trading in general, it is necessary to ask if this definition,