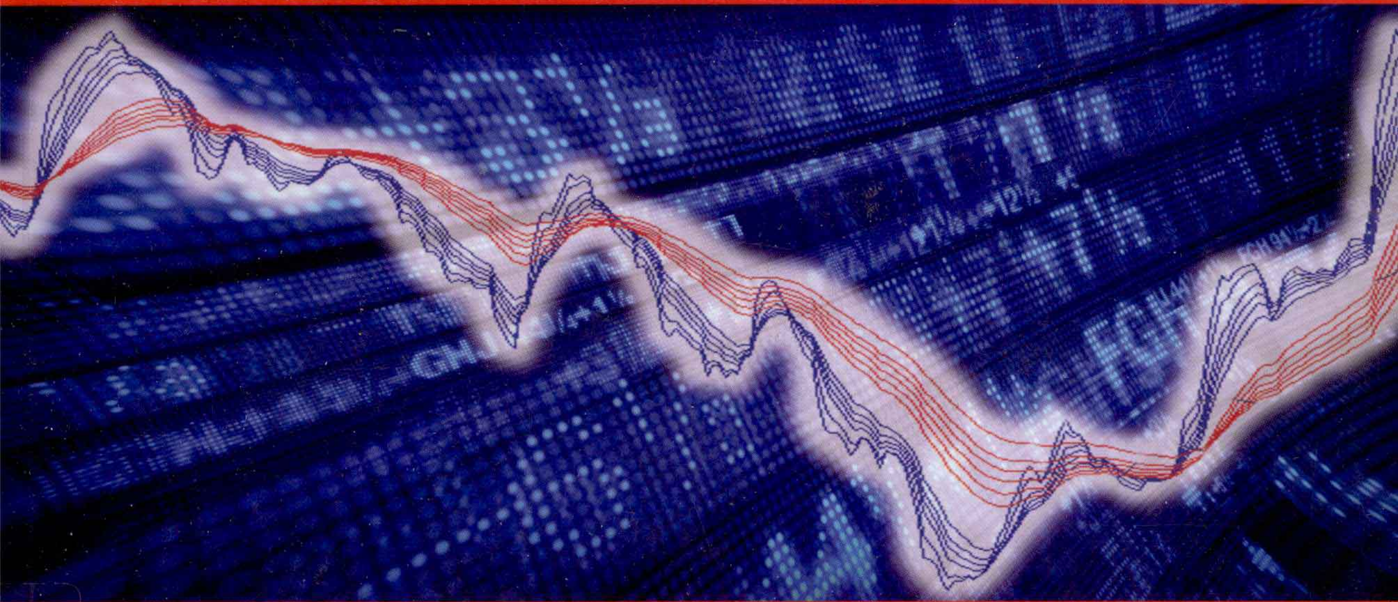
Essential Methods for Modern Trading

GUPPY TRADING



DARYL GUPPY

Best-selling author of *Share Trading*, *Chart Trading* and *Trend Trading*

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'Daryl Guppy is a technical analyst who sits in Australia looking both to the east and to the west for his ideas. I can't think of a better perspective for a book on using technical analysis in today's global markets.'

John Bollinger, CFA, CMT
www.BollingerBands.com

'*Guppy Trading* is a "best of Daryl Guppy" that summarises the most enduring and important chapters of all his previous books. In addition to his time-tested ideas Daryl has introduced new methods he has developed in recent years to take advantage of the increase in market volatility. Having been actively involved with traders and markets in 17 countries over the last 22 years Daryl occupies a unique position in the world of active trading—a unique position that has not only benefited himself but also his many followers who have enjoyed reading and learning his ideas. Once again this accomplished wordsmith has written another easy to read, thoughtful and enjoyable trading book that takes a fresh look at the changing financial landscape. A trading book I'm sure will enjoy great success. If you haven't read Daryl Guppy you haven't read an intelligent trading book.'

Brent Penfold, trader and author of *The Universal Principles of Successful Trading*

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Share Trading, 10th anniversary edition
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Trend Trading Master (Chinese)
Market Investment 36 Strategies (Chinese)
Chart Trading (Chinese)
Market Trading Methods (Chinese)
Lo specialista del Trading (Italian)

Introduction

What does it take to get you excited in the market? There was a time when an overnight 2% fall in the Dow Jones Index was enough to make people check the windows were locked in tall buildings. In modern markets this level of volatility is considered normal and the windows remain open. Now a 4% overnight plunge is unusual but not unnerving. Modern markets have changed and they cannot be analysed and managed with techniques and understandings developed in the middle section of the last century. Traders use many of the same fundamentals of trading, but the design and application must be different if success is desired in the modern market. The primitive wheel is no substitute for the advanced low-profile, high-performance automobile wheel, but the purpose remains the same. In this book we discuss some of the upgrades necessary to move indicator analysis into the 21st century after the 2008 Global Financial Crisis.

I have been trading markets since 1989 and have been an invited speaker in more than 17 countries. I actively trade and follow multiple markets, providing regular analysis for CNBC SquawkBox in Asia, Europe, India and for Chinese media. This experience has confirmed my fundamental belief about markets—they are driven by human behaviour. The trading methods we develop and use are focused on understanding human behaviour and the way this interacts with price and creates price behaviour. The price goes up not because the company is fundamentally good, but because traders *believe* the company has a good future. Tracking and understanding the behaviour of market participants is the foundation philosophy of my approach to the market.

The analysis foundations of the Guppy trading method are:

- Guppy Multiple Moving Average (GMMA) and enhancements, for market behaviour and trend volatility using the GMMA Trend Volatility Line
- count back line (CBL), for understanding price volatility, combined with traders Average True Range (ATR)
- chart pattern recognition based on trend lines and support and carefully defined chart patterns
- Darvas boxes.

These are the core analysis foundations, and they are teamed with a collection of specialist trading techniques, including:

- a genuine understanding and application of risk management suitable for your trading size
- Guppy parabolic trends for momentum
- modern tape reading of order line activity
- early warning system strategies for identifying informed and insider trading
- news event trading methods.

These foundations rest on analysis of markets and market behaviour. One of the lessons from the 2008 Global Financial Crisis was the increase in the interdependence of global markets. This is no longer an esoteric area. The ripples from China send a tsunami to Australia. The jitters in New York crash on the shores of Europe and reverberate throughout Asia. Impacts that once took days to be felt now land in our markets within minutes thanks to the internet, CNBC, derivatives that provide instant access to world markets, and the tight web of international credit markets. We are frightened, or excited, in real time, and our reactions are transmitted to markets in a fraction of a second. Ignorance is not an affliction. It is a choice you make when you choose to turn off the news or CNBC and switch to Korean or American soap.

Here are essential Guppy trading methods in 23 completely revised and updated chapters and 10 entirely new chapters, with analysis methods and trading techniques we find essential for survival in modern markets. We selected these chapters based on feedback from our newsletter readers, training-class students and seminar participants. These are answers to the questions most frequently asked about trading in the training classes and workshops I present internationally. The questions come from novices, from experienced traders and from professional traders. My son Ryan has joined Guppytraders and he also identified some of the chapters from my previous books he found most useful in learning to trade. The revised chapters include extract summaries from the original chapter mixed with new charts and updates. Readers who want to explore these concepts in more detail can browse the original chapters.

This book is written for independent traders. You have the most significant advantages in the market but most people squander them. In this book I want to show you some of the methods we use to maximise the advantages we have as independent traders. These advantages allow independent traders with small amounts of capital to outperform the market and many institutional traders and fund managers. After the terrible year of 2008 we completed a 14-month exercise with real trades showing newsletter readers how traders can still grow $6000 into $21 000, as discussed in my first book *Share Trading*. In the 21st century the millionaire next door with cash in the bank—not a mortgage—has very often accumulated his wealth by trading the market.

Shortcuts

The new trader wants to jump straight into the 'guts' of the book. He looks for new systems, new indicators, exact buy and sell steps, and trawls the pages for the search formula that will bring up opportunities in the market week after week.

The market doesn't work like this. The savage market collapse of 2008 shows there are no shortcuts to market survival. Trading success depends on a collection of soft skills that continue to defy computer programming, flash trading and algorithms. Trading success starts with the individual and his honest assessment of his location in the financial markets, and his personal strength and weaknesses in terms of personality. The new trader thinks this is psycho-babble. The experienced trader and the veteran know this is where the real market battle begins and ends. The bit in the middle—the trade—is just part of the process.

It has taken me a lifetime to develop my habits and I am unlikely to change these habits quickly. Our attitudes to risk, to greed, to having money or losing money are formed by countless individual experiences. This means we can all take the same system, use the same information and start with the same amount of money and end up with very different results. A handful will have success, but most will lose because they are stuck with habits of thinking and action that effectively allow others to take money from them. It's not a nice thought, so most of us move on to less confronting analysis—and continue to lose money.

Trading is more often than not an exercise in harm minimisation. I cannot easily change my habits, so I want to develop strategies to help minimise the harm they do to my trading. The first chapters examine these psychological factors that stand in the way of trading success. New traders should feel free to skip over them now. Save them for reading later when you have more experience of losing money in the market. Veterans will skim these chapters, using them as a ready reminder of lessons learnt and lessons which continue to need reinforcement every trading day.

The first of the five parts contains an overview of the market changes following the 2008 Global Financial Crisis. From this foundation we look at changes in analysis methods and the impact on managing risk. Then we move on to a collection of detailed trading methods, and conclude with a final section examining the way globalisation of markets provides a wider range of opportunities that are readily understood using the information in the first four parts of the book.

Modern trading world

The world has changed too quickly for our thinking and our regulators to be able to catch up. Investment theories based on work done in the 1930s and updated in the 1970s are still applied to modern markets, which are vastly different in character and behaviour. Modern Portfolio Theory taught in universities is built on work dating from the decades after the 1950s. The 2008 Global Financial Crisis suggested this required a more substantial updating than just an incremental tweaking around the edges. The first part of the book examines what has changed and what has remained unchanged. It's a guide to the new world, and suggests which attitudes and approaches remain appropriate. It offers a quick revision of the timeless losing behaviours that every trader must overcome on the pathway to success. The section ends with the essential rules traders live by in the market.

Analysis

Do you want to be a mechanic or a driver? One set of skills does not automatically transfer to the other. Yet many traders believe they can take the mechanics of analysis and turn these into successful trades. Mastery of analysis is essential for trading, but mastery of analysis does not turn you into a successful trader.

This section brings together the analysis toolkit underpinning our understanding of the market. We use this to develop a stock pool of potential trading opportunities. This is the application of strategic thinking and it reflects our beliefs about the market and its driving forces. Some of these lead naturally to trading, and we discuss the details of the methods in this section.

One of the foundations of our understanding of the market is observed in the Guppy Multiple Moving Average, and this section shows how it is integrated in analysis and trading. This includes updates on the application in fast-moving index, currency and derivative markets where trading evolves from intraday to end-of-day trade management.

Traders must have analysis skills, and these are more than just knowing how to program a market search in your favourite software. Analysis skill includes knowing which type of analysis tools to use and being able to interpret the results. Trading skills are different again. They start, not with identifying opportunity, but by managing risk.

Managing risk

Despite all the wailing to the contrary, the world of risk has not changed. True, markets have become more volatile, both in terms of daily price ranges and in terms of the speed of trend development and collapse. This has created more risk for those whose risk management techniques were always suspect. Snails cannot survive on a race track, and some of the major financial institutions have been very slow to realise this. The methods for calculating and managing risk remain largely unchanged. Understanding risk management is the absolute bedrock of trading survival. It is ignored by many people, which is one of the reasons why the failure rate among private traders is so high.

Risk comes before trading, not after it, and so too in the structure of this book.

We have been publishing a weekly trading newsletter since 1996. Called *Tutorials in Applied Technical Analysis*, the newsletter is designed to illustrate the methods and approaches relevant for current market conditions. It does not give stock picks, but it does provide ongoing trading education. Articles are written by myself, by staff writers and by other contributors, some of whom have gone on to become established authors. The case study portfolios start each financial year with a nominal $100 000 and each trade is around $20 000. Each of the case study examples uses strict risk control methods defined by the 2% rule. A significant number of the trade examples are personal trades. In every year of publication the newsletter case study portfolio has substantially outperformed the market, including the 2008 bear market period. The success comes from the strict application of risk management discipline.

The chapters in this part have been condensed, but they remain much the same as the original chapters because these trading foundations do not change. These foundations protected traders in the Global Financial Crisis while large institutions that told investors they knew better were going down in flames. These management methods protected traders against the damage from the foolish advice from many brokers and commentators who told investors to hold on in January and March 2008 because the market was 'irrational' and things would quickly return to normal. They said it was a bargain of the century and became a good example of the collective failure of established investment analysis. With notable exceptions, such as Bear Stearns and some other casualties of the Global Financial Crisis, these are the same people who tell us nothing significant has changed following the market rebound in 2009.

Risk does not have new fancy names. It remains unchanged. Modern markets have given traders some new tools and trade execution methods which help reduce the risk in trading, but they do not change the fundamental nature of trading risk.

Trading methods

Trading is more than just finding an opportunity. Successful trading includes a range of skills that revolve around specific trading situations. Traders use their knowledge of order flows and order systems to enhance the opportunity, to improve entry and exit prices and to implement modern tape reading tactics. In this section we look at nine specialist trading situations. They build on the analysis of markets, but these are the nuts and bolts of trading execution and activity. They bring together exact understanding of price volatility and match this with better trade execution to collect better profits from the underlying opportunity. We show how derivatives are used to maximise returns from short-lived, or otherwise small, opportunities. And we show how these trades are handled when things go wrong.

This is not technical analysis. We do not introduce advanced or complex technical indicators. We apply some very basic price chart analysis, but this section is about the skills of trading. It's based on the close observation of behaviour in the market and oddities or contradictions in behaviour that point the way to opportunity. This is information garnered from reading the tape—from understanding the messages delivered in the ebb and flow of buying and selling activity revealed in the order lines on the screen.

Beating the world

Australia is geographically a long way from anywhere, and this geographic isolation has affected Australian thinking. It's been easy to ignore the world despite the close relationship between the behaviour of the DOW and local indices. For decades these relationships existed in every market as the DOW lurched from rally to retreat. In the early years of the 21st century this relationship changed because of the growth of China. By and large Australians saw only one aspect of this relationship, which came from the positive impact of Chinese demand for resources. Like many other markets, we were slow to understand the full impact of the tremendous growth of the China market and the increasing internationalisation of market behaviour.

Investor protection became a much broader problem, moving beyond the boundaries of individual markets. New trading instruments and platforms brought the world within fingertip reach, and a new world of risk. Contracts for difference trading made it possible to pursue opportunities wherever they could be found. If your favourite trading style was a rally breakout based on volume leadership then why restrict yourself to the relatively small Australian market? It was just as easy to trade the same behaviour in European markets, or Asian markets, as it was to trade the limited pool of opportunity in Australia.

Traders who were not comfortable with direct exposure to overseas markets using a derivative were given a choice of a much more friendly-sounding derivative as exchange-traded funds (ETFs) bundled the world into a single instrument that was given the legitimacy of trading just like a stock on the traditional stock exchange. These investing products gave instant access to global diversity. Like most investment stories, if it sounds too good to be true, then it's probably not true. The ETF story hides the significant changes, and increases in risk, that have developed around these products. They have shifted from investment diversity into trading instruments, but most retail users have not come to grips with this change. Used effectively, ETFs give us a tool to beat the world, but used without caution they become a tool the world uses to beat us.

Behind the borders of China is a financial market already rivalling the size of the US markets in terms of turnover and number of listings. This is an entirely domestic market which does not yet have foreign company listings. It is closed to foreign traders and investors, apart from limited access through qualified foreign investment funds. The quota of shares they can buy, and their impact, is small. This market has behaviours and trading patterns specific to the China market. It is a very foreign market, made more difficult by language and writing barriers that make investors entirely reliant on the quality and timeliness of translation. Despite this, the foundation of market behaviour is tracked and analysed most effectively using the methods of technical analysis and charting to capture the thinking of market participants.

The independent markets of Shanghai and Hong Kong with co-listed stocks provide a real-time case study of the effectiveness and validity of technical analysis and the way price behaviour is determined more powerfully by investor and trader thinking than it is by the fundamentals of a company or organisation. This is important for understanding China market behaviour, but it also points the way to how traders and investors can manage their home market and international market risk with the tools discussed in earlier chapters.

International cooperation

This book is also an international cooperation project, coordinated from multiple locations in Australia, China, Singapore and elsewhere. My friend and colleague Chen Jing assisted with insights, and her analysis of China markets has influenced my thinking and analysis of markets outside of China. Writing this book would not have been possible without the support from my staff in Darwin—Alan Lim, Jenny Lin and Ryan Guppy—whose work makes my time available for this task. My wife Marion shows unending patience for the process of writing in addition to the demands of her job as a high school principal. Proofing is enhanced again by my mother Patricia, with a correction pen still endlessly supplied with red ink despite her decades-long retirement from teaching English.

I started trading in 1989 and the markets have changed a great deal since then. Some of the methods I use have stood the test of time, and they are discussed and updated here. Other methods became less useful as time and market conditions changed. Old tools have been re-sharpened to deal with new instruments, and new opportunities created by increased market transaction efficiency. New techniques have been added to profit from opportunities that did not exist in the last decade of the 20th century or the first years of the new century. This book brings together battle-tested methods and indicators. It summarises the most enduring and important chapters from my eight books—sixteen if you count editions re-written and modified for international and Chinese markets. It combines them with other methods developed in recent years to take advantage of new market conditions and processes. This is a combination that works for me. It is a combination I know from reader feedback that works for many others. This is not the only way to trade the market. It is not a masters guide to market success. It is a collection of methods and understandings which have helped me. You should take from this those elements which will help you to improve your current trading results.

Trade to the best of your ability.

Daryl Guppy
Darwin, Beijing, Singapore, 2011

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