

# THE SPECULATIVE STRATEGIST

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**High Returns From  
Controlled Risk Strategies  
in Stock and  
Futures Markets**

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**Will Slatyer**

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# Preface

I have written *The Speculative Strategist* for the individual speculator in futures and stocks who wishes to structure a sound, disciplined method of making money for themselves and their loved ones from the markets. Traders, from professional to novice, will gain a sense of the strategic qualities and resources needed to profit continually in fast-moving modern speculative markets. By many measures, the majority of today's markets are speculative.

The market novice will find the early chapters easy to read and understand but might find details of technical analysis later in the book slightly confusing. I make no apology for this. The principles I have outlined should enable novice trading to become profitable in a short time. However, those who have no prior knowledge of technical analysis will need to seek further education in this extremely important facet of financial analysis before they can formulate their own technical plans. Technical analysis requires some study before one can become proficient, but is well worth the effort. I hope that I have succeeded in encouraging this study.

Professional traders might find the pirate and privateer allegory somewhat colorful for a description of what are supposedly standard trading principles of fund management. They might even find some of their trading values questioned. This is necessary. Many traders concentrate almost completely on technologi-

cal toys, often at the expense of sound principle. I have tried to demonstrate principles that in recent years might have gone out of fashion, but which are still relevant. The professional technical analyst might also question my use of simple techniques, but they work. All the details are produced which allow independent testing of these techniques. Technological breakthroughs in recent years have produced more complicated instant computerized techniques, but do not appear to have produced the same quantum leap in profits of many managed funds. The systems which I have outlined in this book are admittedly simple in concept, but can be filtered through one's own values to produce a personal trading plan of the desired complexity.

I have been monitoring international futures, foreign exchange, and interest rate markets for more than thirty years, mainly from the point of view of a risk manager. Even the professional traders reading this book may have forgotten the principles of structured risk management, which seemed to fade around 1986, about the time when I commenced tracking international stock markets for inclusion in a conservative investment model. To my risk management principles I then added a rule that also may have been neglected in recent years: Hedge in adverse circumstances, but do not quit an investment until a better alternative has been established.

Principles provide a sound base for timely action in the markets, and sound techniques are needed for that action. In the 1960s I had become intrigued with one of the simplest forms of technical analysis—moving averages. The advent of software for the personal computer in the 1980s greatly increased the interest in various forms of technical analysis. Most professional traders moved on to new and exciting methods of trading that the computer made possible, and of which neural network programs are but the latest.

Rather than use each new technical tool that became available, I used the new computer technology to improve the simple moving-average technique which I had earlier developed by hand-held calculator. The system and software which I developed was able to provide risk management advice superior to that offered by many major institutions. I was surprised to learn that my international investment model, developed for the chairman of

one of my risk management clients, had, with 20% per annum noncumulative returns, proven more profitable than the methods of established European fund managers. Apart from a few personal, often ill-timed, bursts, I neglected short-term speculation.

I would like to credit the founder of Computrac, Tim Slater, with stimulating my serious examination of speculation and for planting the seeds for this book. In 1993, Tim invited me to make a presentation to TAG XV, the annual seminar of the Technical Analysis Group. This group was originally the driving force behind the world's first technical analysis personal computer software company, Computrac. Tim knew of my work in structured financial risk management, but told me that seminar delegates would be much more interested in speculative techniques.

My presentation to TAG XV was purposefully quite technical because, as an Australian without day-to-day contact with U.S. nonprofessionals, I believed that American traders were much more advanced than those "Down Under." I have since spoken to traders in New Zealand, England, Holland, and Japan as well as the United States, and now believe that no one corner of the globe has the edge in technical trading strategy. Tim's later comments that my ideas were maybe a little sophisticated for a seminar audience which included many novices led me to look for an allegory to describe the whole concept of speculation in a simpler form. The technical strategy which I presented in 1993 forms the basis of the Woodes Rogers strategy described in this book.

I was already working on a financial risk-management philosophy that followed many sound principles of war, and which will form the basis of coming books. Simply put, I believe that market capitalism of the twentieth century is merely a socially acceptable form of the warfare that humans have practiced for millennia, in which money flows instead of blood. Corporate capitalism was relatively organized, with its own rules of engagement, policy, strategy, and tactics. Speculation, even that of a corporate variety, was apparently considered too chaotic and fast moving to be subject to trading by war game principles.

Then, while researching historical money market principles, I discovered that the founder of the Bank of England, William Paterson, had been a buccaneer in his youth. A buccaneer—a free-booting pirate, similar to Long John Silver from Robert Louis

Stevenson's book *Treasure Island*. I am not quite old enough to have read the original 1883 book, but admit to having read a reprint more than once before I saw the 1950 Disney movie, following which Robert Newton, playing Long John Silver, also appeared in boys' nightmares. Having been involved in several litigation battles with banks as an expert witness, the idea of buccaneers progressing to bankers intrigued me. Further research led me to the speculative metaphor of privateers and pirates.

The idea of looking back into history for role models owes much to the comments of a famous U.S. lawyer and cynic, Clarence Darrow. At the dawn of the twentieth century, Darrow said, "History repeats itself. That's the trouble with history."

In fact the premise of historical repetition is not problematic at all to students of financial markets who have learned that profits can be made from identifying common patterns of market behavior. Traders who analyze the markets to discern patterns of the past are called technical analysts, to differentiate them from those dependent on fundamental analysis of supply and demand.

Technical analysts suggest that actions of all market participants from all over the world are combined to produce the crowd behavior responsible for price trends. Crowd behavior has changed little throughout the ages, so that the actions of the crowd can be forecast to some degree by using crowd psychology. The actions of the relatively uneducated crowd during the South Sea Bubble of 1720 were very similar to those of the more modern computerized crowd in the 1987 stock market mania. Technical analysis is the chart whereby the temperature of the crowd can be monitored to determine the start of likely fevers or frosts. History is repetitive, and by forecasting repetitive action, speculative profits can be made.

My concept that speculative activity is best approached with preformed policy and strategy, before applying technical tactics, also owes much to history, and in particular to a 2200-year-old Chinese book *The Art of War*. Like many executives, for many years I used the words "policy," "strategy," and "tactics" interchangeably in boardroom discussions. An English translation of Sun Tsu's *The Art of War*, which I picked up while in transit through Singapore many years ago, made the differences between the meanings of the three terms clear. Also known as *The Art of*

*Strategy*, the book has formed the basis of many business books in the last decade, so there are a number of translations available for further reading. Keen capitalist warriors might search for a little-known book of the same name by the fifteenth-century strategist Nicholo Machievelli, who is more famous for his book *The Prince*.

Finally, there are many hundreds of people whom I should thank for their influences on this book. My grasp of short-term technical analysis owes much to observations of many market participants, who won and lost in the daily skirmishes with the crowd, so I thank these soldiers who can remain unknown. To authors long dead, and to those very much alive, I express my thanks. In particular I would like to thank the still lively systems guru, Perry Kaufman, for his support.

*Will Slatyer*

# **The Speculative Strategist**

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# 1

# Speculative Philosophy: Privateer or Pirate

## **The Search for the Secret of Speculative Profits**

During my thirty years trading futures and financial markets as a broker and risk manager, I have encountered hundreds of speculators, but those who were consistently profitable could be counted in tens. I have met traders whose intelligence bordered on genius, but who consistently made fundamental errors. Professional traders with large capital and the latest in sophisticated computer programs have made a series of reasonable profits, and then been hit by a huge loss. Novice excitement seekers have always been profitable for commission merchants, because of the uncontrolled urge to always be in the market, trading constantly until their money ran out.

I have known some large losers. One very intelligent man lost a petroleum company because he refused to quit a bear position in a bull market. Another, an international sports hero, tragically took his own life following sharp reverses in the gold market, in which he had also traded clients' funds.

I have known fewer consistent winners. One battling farmer traded a few thousand dollars into the price of a large farming

property, and then quit the markets. A young man whom I introduced to the floor in his teens became a local floor trader and made so much money he became bored. He now takes long absences from the floor traveling the world, before again returning to the markets. A good friend, one of the best "gut feel" traders I have known, now is happy to scalp \$500–\$1000 per day without overnight positions, so that he can leave the floor early to spend time with his children.

A number of large winners have been eulogized in Jack Schwager's books on "market wizards." One must marvel at the success of these men, who appear to have the aptitude of time travelers. Collectively they appear to have the patience of a biblical Job, the policy grasp of Charlemagne, strategies of Merlin, discipline of Julius Caesar, and can operate the technology of NASA with a Midas touch. The ordinary speculator can be inspired by these Wizard winners, but might not be able to apply the examples to their own trading.

My search for the secrets of profitable speculation had to uncover methods which the average professional trader could use or that the dilettante could learn. I had to produce a system for mere mortals, which did not rely on superior natural skills.

The success of the "wizards" proved that speculation could be highly profitable, and I knew from my own risk management operation that systematic trading could be consistently profitable. So why did so many speculators continue to lose?

My conclusion, after much research, was that traders are concentrating their attention on the actual trade, entry and exit, and short-term movement while neglecting the long-term and strategic implications of their trading. Modern technology has allowed us to watch tick-by-tick movement of markets, and accompanying real-time information flows. It is natural that traders focus on the electronic output and use the adrenaline of market action to precipitate trading decisions.

*If I have been able to see further than other men, it was because I have stood on the shoulders of giants.*

SIR ISAAC NEWTON, 1642–1727

The secret which I might have discovered is that this concentration on the near-term activity has been at the expense of long-term planning. At a seminar where I presented technical analysis of the 1994 bond market, I displayed a monthly chart of T-Bonds and the evidence of a major top well before the market collapsed. One fund manager confessed that he had not looked at a monthly chart since he became an active trader. This manager of millions of dollars was so tied up in his short-term trading program that he had forgotten to look at the big picture. Publicized 1994 losses suggest that this man was not alone.

From my early days as a diver with the Royal Australian Navy, I was aware of the tremendous amount of planning and preparation that preceded a successful mission. Modern recreational scuba divers are taught an adage to reduce the incidence of accidents: "Plan your dive. Dive your plan."

Before my Navy team entered the water, we knew distances, tides, currents, targets, defenses, and support. We had trained extensively on the rebreathing diving equipment that left no visible sign of our approach, and which we could adjust automatically by touch in complete darkness. Each member of the team had a defined role, that was known by the other frogmen so that backup could be provided if necessary.

The actual diving of the plan was the exciting key to the overall success of the mission. Without the preparation, the dive might have been even more exciting, but might also have produced an unsuccessful mission. The adrenaline of action was a by-product of the mission, and in fact tended to be downplayed by the senior officers responsible for success.

Should not success be the main purpose of speculation? Should not the excitement of trading be secondary to success? Would this type of thinking from naval history produce a method of trading futures and financial markets which would provide consistent success?

In my mind some techniques of war could be readily applied to the markets. What is capitalism but a socially acceptable form of warfare in which money flows instead of blood? Speculation in financial markets is the riskiest form of capitalism, but no more risky than frogman or commando raids.

If I were to be able to teach this uncovered secret to traders

more interested in market action than analysis, I would need an allegory to convince traders to examine a different emphasis. When I studied the art of war looking for an allegory, I found that the thinking preceding a battle had changed little over the centuries. Technology has changed from the arrow to the guided missile, but strategic preparation today is much the same as it was in the days of Alexander the Great.

But my research into the policy of war and the strategy of battles failed to produce the examples I was seeking to demonstrate planning techniques for market speculation. There were examples for corporate activity. In military terms, financial risk management can follow the metaphor of embattled siege mentality, or maybe the planning of highly mobile defense forces trained to attack as well as defend. Investment can be defined as the advance of a well-armed convoy, in which the defense of objectives already captured is at least as important as the gains from fresh advances. And the winning of battles is most often a triumph of the organization of large forces, which could not be reproduced by an individual speculator. The policy and strategy that direct an army appeared to be unsuited to the resources available to the average speculator.

### **The Art of War**

*The Art of War* was written by a legendary Chinese general, Sun Tsu, somewhere between 551 B.C., the probable birth date of Confucius, and 223 B.C., when the first emperor of the Chin dynasty was proclaimed.

*The Art of War* can be translated into advice to market strategists:

Know your enemy, know yourself,  
and your victory shall not be threatened.  
Know the terrain, know the weather  
and your victory shall be complete.

## Financial Speculation

It next occurred to me that financial speculation might be the embodiment of guerrilla warfare, where highly mobile teams of skilled warriors attacked entrenched positions with the objective of rich rewards. Further study of the history of warfare disabused me of this notion. Guerrilla warfare is basically an ideological war of attrition, aimed at the collapse of a political system. The number of losses and atrocities far outweigh the heroic successes. Even when guerrilla warfare is successful in controlling government, the country has often been debilitated to such a degree that it regains stability only slowly, under leaders not particularly suited to sound governance. Speculation of the guerrilla type has been carried out without lasting success, such as in the attempt to corner the silver market by the Hunt brothers in 1979–1980.

Following further study, now of naval warfare, I finally formed the opinion that modern financial speculation might indeed have its origins in the seventeenth century with the growth of war at sea. Privateering and piracy is a great analogy for financial speculation. Why? Because financial speculation can be seen as a series of fluid attacks on financial markets, using well-financed modern vessels, which can avoid high risk by speed and daring, and can capture rich rewards.

A *successful* financial speculator in the twentieth century will have the best attributes of a *privateer* from the golden age of piracy in the seventeenth and eighteenth centuries. The *least* successful financial speculator will enjoy the excitement and brief rewards of a *pirate*, but will, more often than not, also experience the quick demise of most pirates.

## Privateers or Pirates

What is the difference between a privateer and pirate? This is a question that has been asked for millennia, since the introduction of sail to large vessels allowed wide-ranging trade by daring merchant adventurers from the Gulf of Oman. By the ninth century B.C., trading posts had been established in Java, Sumatra, and Siam, and voyages commenced to obtain Chinese silk from Canton.

Cargoes of spice, precious metals and jewels, ivory, and teak en route through Oman to Babylon attracted daring merchant adventurers who became known as "pirates."

The word *pirate* is derived from the Greek *peiran*, meaning "to attempt" or "to attack." The Assyrian king Sennacherib led a naval expedition against seagoing brigands in the seventh century B.C.

The word *privateer* does not appear in the records until the seventeenth century, but as early as 594 B.C. the Laws of Solon in Athens refer to authorized associations of pirates. The authorities of the Greek city-states could not afford a regular navy, so they employed bands of seagoing brigands to fight naval wars on *commissions*. Merchants were authorized to outfit vessels to take reprisals to the estimated value of earlier stolen cargoes.

The continual wars between the feuding nations of England, Spain, France, Portugal, and Holland encouraged monarchs short of cash to allow pirates to attack ships of other nations in the name of patriotism. The name *privateer* came to mean a privately owned and armed vessel *commissioned* by a belligerent state to attack enemy ships, usually vessels of commerce. Crews were not paid by the commissioning government but were entitled to cruise for profit, with crew members receiving portions of the value of any cargo or shipping prizes.

In 1630 Charles I of England licensed Captain Quail of the *Seahorse* to "make purchase in the Red Sea, as well as anywhere else, of any he can meet with that are not friends or allies of his Majesty." The profit from the plunder of the *Seahorse* was estimated at the equivalent of \$5 million U.S. dollars.

One of the earliest individual privateers to achieve fame was Francis Drake. In 1580, Queen Elizabeth I knighted him on the deck of the *Golden Hind*, calling him her "dear Pyrat." Drake's three-year voyage around the world attacking Spanish colonies paid dividends to his backers (suspected to include Elizabeth) at the rate of forty-seven to one. As is no doubt becoming clear to the reader, privateering, like funds management in the twentieth century, became an industry.

Elizabeth tried to regulate privateering during the seventeenth century by establishing "prize courts," through which seized