DAY TRADING SYSTEMS & METHODS

CHARLES LE BEAU
DAVID W. LUCAS
CONTENTS

1  COSTS OF DOING BUSINESS  1

2  THE 5-25 ENVELOPE METHOD  9

3  THE "HI MOM" SYSTEM  15

4  INTERMARKET DIVERGENCES, OHAMA'S 3-D TECHNIQUE  21

5  KANE'S %K HOOKS  27

6  ONE-MINUTE CHARTS WITH STOCHASTICS  35

7  PIVOT POINTS  41

8  PRICE GAPS ON OPENINGS  47

9  RSI DIVERGENCES  53

10  SIBBETS "KNIFE" SYSTEM  59

11  STOCHASTIC DIVERGENCES  65

12  SWING REVERSALS PLUS STOCHASTICS  71
COSTS OF DOING BUSINESS

The day trader enters and exits trades during the same market session, normally a period of only four to six hours from opening to close. The very short-term nature of day trading presents advantages and disadvantages to the trader. The major advantages are the lower margin requirements and the absence of overnight risk. The disadvantages are the bad odds, the time and effort required, the limited profit potential, and the burdensome costs of frequent transactions.

The transaction costs consist of commissions and slippage. The trader might have a mental image of trading at the prices shown on a computer screen, but in reality she must continuously buy at the offered price and sell at the bid price. The spread between the bid and offer becomes a substantial hidden cost of doing business. It is also unrealistic to expect stop orders to be filled at the stop price all of the time. The com-
missions are a large and much more obvious cost. In the meantime, to offset these unavoidable costs, the day trader is limited to only very small profits. Under even the most optimistic scenario, the day trader's potential profits are limited to only a portion of the price range occurring within one day of trading.

Let us assume that our day trader is paying $20 per trade in commission, and the spread between the bid and offer amounts to $10 buying and $10 selling. For the trader to complete a trade that nets $100, she must be smart enough to identify a move of $140 on the price screen that she watches. On the other hand, when her timing is wrong by only $140, she is going to lose $180. It doesn't take a Ph.D. in mathematics to figure this isn't an ideal business environment. In fact, even the professionals on the floors of the exchanges must be excellent, highly disciplined traders just to survive. The public does not realize how many of these professionals fail, in spite of the advantage of being on the floor and paying only minimal costs per trade. Imagine how small the odds for an off-the-floor be for an off-the-floor trader faced with the costs we have described.

To have any hope of success, the day trader must strive to maximize the profits on each trade so that he can overcome the tremendous disadvantage of the transaction costs. Unfortunately, the day trader has very little control of the potential profit to be obtained, because the price range during the day so severely limits the maximum profit to be realized on an average trade. No trader can reasonably expect to buy at exact bottoms or sell at exact tops. A very good trader might hope to be able to capture the middle third of an intraday price swing. This means that to make $180 the total price swing must be three times this amount, or $540. How many futures markets have a daily price range of $540 or more? Very few. How many futures markets can produce a $180 net loss? Almost any of them.

Don't forget, the trader who is smart enough to find markets with $540 price swings and then smart enough to trade them so correctly that he nets $180 is only going to break even unless he has more winners than losers. To make money in the long run, the day trader must have a percentage of winning trades that is far better than 50 percent or he must somehow figure out how to make more than $180 on a $540 price swing. (Or best of all, do both.) This also assumes that the trader is smart and disciplined enough to harness his instincts and emotions and carefully limit the size of the losses.

TOUGH ODDS

As you can see, a day trader is faced with an almost impossible task. We would venture a very educated guess that less than one out of a thousand day traders makes money over any sustained time. Our advice is to not even attempt it. Your time and energy will be much better spent perfecting your
longer-term trading skills. Even if you should succeed at day trading, it is difficult to reinvest the profits and continue to compound them. Day traders can only operate efficiently in small size, so don't expect to make your fortune at it—it's only a hard-earned living at best.

In spite of our sincere warning, we know many traders will attempt to beat the odds and become day traders for a while. Fortunately, the lessons learned can be applied to more serious and productive trading later on. We will do our best to teach you as much as we can about day trading and make the learning process less costly. Obviously, we don't have all the answers or we wouldn't have such a negative outlook on the probability of success. We have learned a great deal about this subject over many years of trading, and the fact that we have elected to no longer play this game simply demonstrates our personal preferences in the allocation of our productive time. We hope whatever hard-earned information we pass along proves helpful.

**SELECTION OF MARKETS FOR DAY TRADING**

As we pointed out earlier, very few markets have wide enough intraday price swings to make them suitable candidates for day trading. Day traders generally prefer to concentrate their efforts on only one or two markets. The prices must be watched closely, and there are very few markets that are suitable even if we had the capacity to follow lots of them.

Presently, day traders tend to favor the stock indexes, bonds, currencies, and energy markets. From time to time other markets may become candidates for day trading, because of temporary periods of high volatility.

We ran a test to see what percentage of the time various markets had a total daily range of $500 or more between the high of the day and the low. Here are some sample results over our most recent 1,000 days of data: S&P Index 69 percent, NY Composite 64 percent, British pounds 53 percent, T-bonds 50 percent, Swiss francs 50 percent, Japanese yen 38 percent, heating oil 37 percent, D-marks 35 percent, crude oil 31 percent, soybeans 28 percent, silver 23 percent, gold 21 percent, and sugar 13 percent. As you can see, only five markets had a $500 range 50 percent of the time.

**CONSIDER TICK SIZES**

In addition to looking for a wide daily range, the liquidity and the size of the minimum spread should also be factors to consider when selecting markets for day trading. Our example of costs included paying a spread of only $10 on each side of a trade. In the S&P market, a minimum spread would be $25 each side, while in the bond market a 1/32 spread is $31.25. If you are day trading bonds with $20 commissions, you must overcome total costs of $82.50 added to losses and subtracted from gains. Your average winning trade must run $165 farther than your average loss just to break even. This assumes a
one tick spread, which is the best case possible. The element of liquidity comes in to play in determining the number of ticks in the spread between bid and offer. A one tick spread is the best you can hope for, and most markets have a wider spread than that. You can usually assume that the higher the average daily volume, the tighter the spread. For that reason, you will want to concentrate your day trading in only those markets with very high volume. Otherwise, you can be making good timing decisions and still be assured of losing money.

**MAXIMIZING PROFITS**

Day traders are constantly faced with the problem of capturing as much profit as possible from a relatively small range of prices. This situation naturally leads traders into the strategy of buying dips and selling rallies, rather than attempting to follow trends. Most trend-following strategies tend to be too slow for day trading. Countertrend strategies offer the potential of extracting the greatest profit from a small range of prices. However, countertrend strategies tend to be less reliable than trend-following strategies, because quickly spotting turning points in prices is much more difficult than simply trading in the direction of a trend.

We have observed that the best day traders incorporate elements of both methods. Successful day traders try to buy dips within an uptrend and to sell rallies within a downtrend. The day trader who consistently makes money must be good at following trends and be good at finding short-term turning points. Most traders lose money because they are never very good at either task. As we look at some examples of possible day-trading strategies, keep these two steps in mind: First find the intermediate trend and then find the short-term turning points. Both steps need to be done quickly and accurately to produce a winning day.

**OUR DISCLAIMER**

The day-trading methods that follow are a few of the many methods that have been shared with us over the last few years. We seldom attempt to day trade, so we have very little firsthand experience with any of these methods. The various traders who shared these methods with us claimed success with them. We tried to select the ones that seemed most logical and the ones that seemed to hold up under a cursory examination over very limited data. The inclusion of these methods should not be considered an endorsement or recommendation. At best they should give the reader some food for thought—and a representative sample of the many methods and tools that can be used for day trading. Use them at your own risk.
THE 5-25 ENVELOPE METHOD

This day-trading method is based on a very unusual way of using a moving average envelope. Most envelope systems call for trading in the same direction as the envelope breakout. The 5-25 method does just the opposite.

We assume that the market will traverse back and forth between the extremes of the envelope. We treat the excursions beyond the boundaries as overbought or oversold levels. After a move outside the envelope, we expect the market to re-enter the envelope and traverse to the opposite side. Here are the rules:

1. Use 30-minute bars on the S&P futures.
2. Set up an envelope study for five periods, normal (no smoothing), and at a distance of 25/100 of 1 percent from the closes.
3. Look for trades only when the boundaries of the envelope are at least 150 points apart. When one of the 30-minute bars closes at least 5 points outside the envelope, look to initiate a trade in the opposite direction as soon as the next bar closes back inside the envelope.

4. Use an initial stop loss at the extreme high or low point just before your entry. After the market has moved 75 points in your favor, the stop loss should be changed to at least your break-even point.

5. Take profits when the market reaches the opposite side of the envelope. If you want to simplify the profit taking, use the boundary of the envelope at the time you enter the trade as the target, otherwise you might have to adjust your exit point every half hour. (See Exhibit 1.)

With some modifications to the envelope, this system can be used for regular trading instead of day trading. We used to have good results using it to trade soybeans.
De & P
30-Minute 5-Period Moving Average with 0.025 Envelope

[Graph with price levels and annotations: Enter, Enter, Enter]
THE "HI MOM SYSTEM

We call this day-trading strategy the "Hi MOM" system, because trades are signaled only when there is a high momentum reading. Here is how it works:

1. Use 9-minute bars on the S&P futures. We picked the 9-minute interval because the system must be sensitive to minor price patterns. The 9-minute bars also divide the trading day into 45 equal time periods. Ten-minute bars would probably work just as well; but we have a slight preference for the logic of having all bars represent an equal time period, rather than having an odd bar at the end of the day. The 9-minute bars also give us a head start on traders using the more common intervals of 10, 15, 20, and 30 minutes.
2. Directly underneath the 9-minute S&P bars, set up a six-bar momentum study. Scale the study so you can easily tell when the momentum reaches +/- 150.

3. Look for divergences between the MOM study and the S&P bar chart. The first spike of the particular divergences we are looking for will have to have penetrated the +/- 150 level on our MOM chart. The second or third divergence spike does not have to reach the 150 level.

4. After a Hi MOM divergence, enter the market as soon as possible after the hook that completes the divergence pattern. Place an initial stop loss 20 points beyond the recent high or low of the bar chart. (Point B of an AB divergence). Trail the stop using peaks and valleys on the bar chart as support and resistance levels.

5. Take profits when there is a divergence in the opposite direction, but do not reverse the trade. We want to only trade the first divergence of the day. The exception to the one trade per day rule is when the divergence sets up as an ABC divergence with three spikes instead of two. If we entered after the second peak and were unfortunate enough to get stopped out on the third spike, we will want to initiate a second trade in the same direction if the divergence continues. Close out any remaining open positions at the end of the day. (See Exhibit 2.)

The "Hi MOM" system is simple but very effective, because it combines the patience of waiting for volatile periods (indicated by the +/-150 MOM) with the excellent entry timing provided by divergences.
INTERMARKET DIVERGENCES,
OHAMA'S 3-D TECHNIQUE

One of our subscribers in the Los Angeles area, Gary Inouye, worked closely with Bill Ohama for several years prior to Bill's death in 1990.

Gary has been very successful in applying Bill's well-known "3-D" techniques to day trading. Here is an explanation:

1. Make a page of five-minute charts on two or three related commodities. For example, compare the five-minute charts of the S&P, the NY Composite, and the Major Market Index. You might also compare the T-bonds, the T-notes, and the muni bonds. There are other possible related groups, like currencies, energy futures, or the soybean complex, but the best day trades are usually in stock indexes or bonds.
2. Carefully compare the five-minute charts for divergences where one commodity makes a new high or low and where one or more of the other commodities in the group fails to confirm by also making a new high or low. (See Exhibit 3 & 4.)

3. When a divergence is spotted, the trade should be implemented in the most tradeable (most liquid) commodity in the group. For example, in the stock indexes you would trade the S&P, not the Major Market Index.

4. Once a trade has been entered, some method of trailing stops would be advisable. For example, a trailing stop of about 125 points in the S&P would be a starting point. It would be logical to use wider stops during volatile periods and tighter stops when the markets are quiet.

5. If you get a quick profit of $500 within a half hour, just take it. If the trade moves more slowly, hold on as long as it seems to be trending in the right direction. Gary does not wait for a signal to close out the trade but uses his judgment on when to take profits or losses.

This method is not a complete system, because of the lack of specific stops and the lack of a more specific exit strategy. Your results might be better or worse depending on your skill at exits. We like the entry method.