Digital day trading

Moving from One Winning Stock Position to the Next

Howard Abell
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The digital age of financial investment has arrived. Individual traders and investors can now bypass brokers and enter the formerly rarefied arena of the major Wall Street players with just a PC, strengthened by their own knowledge and trading ability. As one financial writer recently quipped, “Electronic day trading is really starting to click.” In fact, trading online is fast, redefining the entire concept of individual investing. As Dave Pettit, a Wall Street Journal editor, noted, “The rush to go online promises to dramatically change the nature of individual investing both for the investors themselves and the businesses that cater to them.” For individuals, online investing has meant a chance to take full responsibility for their finances; you execute your own trades without a broker to hold your hand. The Internet has also provided a radically cheaper way to invest.

One hundred years ago the French novelist Marcel Proust observed, “The more things change the more they remain the same.” This observation is also true as it relates to trading. Whether it is done digitally or conventionally, trading is the ultimate psychological chess game based on brains, guts, and timing. Trading profits are cultivated in the rich soil of market discipline, strict money management, and strategy.

No day trading system is perfect; however, the use of one is critical for trading success. To be successful, a day trading system must be profitable, consistent, and personal. In short, it must be guarded by an overriding and all-encompassing trad-
ing strategy that takes into account the real-time characteristics of dynamic markets: debilitating emotions and ambiguous technical indicators.

The key question then is, How does the trader create a real-time profitable day trading strategy that conforms to the unique psychological and methodological needs of the individual, given the special technical and psychological demands of the arena in which he is forced to perform? Historically, books on day trading stocks offer either a survey of systems and indicators that may be used for short-term trading or a compilation of specific techniques that are presented in the abstract, a hypothetical offering at best. When the psychology of trading is introduced into the discussion, it is typically mentioned in passing or as a theoretical construct rather than as an underlying and integral aspect of any winning market approach.

_Digital Day Trading: Moving from One Winning Stock Position to the Next_ addresses all of the above considerations in detail and goes beyond anything written to date on the subject of day trading. It presents everything you need to know to trade stocks electronically on a short-term basis, including specific charts and computer setups. It combines age-old insights about risk taking and risk management with the realization and knowledge of cutting-edge, state-of-the-art technology. It is based on my 25 years of personal day trading success, intimate knowledge of the psychology underlying profitable trading based on my previous publications (see “For Further Reading”), and my work training successful traders on and off the exchange floors as a principal of a clearing firm specializing in its own proprietary traders, as well as interviews with literally hundreds of successful short-term traders.

I believe _Digital Day Trading_ builds logically on the insights of my previous books and will provide an invaluable resource for market philosophy and strategy. It also offers specific technical and tactical methods bolstered by considerations of money and risk management, which will significantly strengthen a trader’s day trading performance.

Success in trading.

—Howard Abell
Many people’s contributions made writing *Digital Day Trading* a deeply rewarding experience. The success of this book is a testament to their outstanding talents and fertile minds. In particular, I wish to thank Bob Koppel, friend and business partner, whose market insights prove invaluable day in, day out. Bob is a living testament to the Innergame trading method.

I wish to thank Roslyn Kolin Abell, wife and friend, for her important insights into the systems portion of *Digital Day Trading* and for her strong support throughout the years.

Finally, I would like to thank Cynthia Zigmund and the entire staff at Dearborn Financial Publishing; their ongoing commitment to, and enthusiasm for, this project are gladly acknowledged.
“Don’t be misled into thinking that anyone can walk through our doors, sit down at a computer, click off some trades, and be profitable. Day trading is a serious business. It is a profession and like other professions it requires training and experience. Your success in day trading relies on your willingness to dedicate yourself and your abilities to learn the techniques required to be successful.”

—Mark Seleznev, “Electronic Day Trading and SOES Trading”
The Day Trader's Advantage

"Every trader knows that market truth and practice are visceral, not cerebral. Market wisdom, like Samurai truth, is practical truth that can only be utilized and realized in action. It can never reside on the level of mere theory."

— Robert Koppel, The Tao of Trading

I remember, as a young stockbroker 30 years ago, watching in awe as the New York Stock Exchange ticker struggled to complete the record volume day on Wall Street. It took 45 minutes after the close to record the final trades of the day. Dire warnings of electronic failure and uncleared trades abounded. We had just witnessed the first time in history that the daily volume on the New York Stock Exchange (NYSE) had exceeded 13 million shares.

Today, as I routinely walk into a modern day stockbroker’s board room, there is no “board” of stock or commodity prices from which the term is derived. There’s not even an electronic ticker crawling across the wall. Instead, there is row after row of computer stations with traders, young men and women, tapping urgently on their keyboards like Skinnerian pigeons seeking pellets. They stare into glass monitors filled with scrolling and flashing data from which they can enter into a world heretofore
unavailable to the general public. This is the contemporary world of the electronic day trader. He or she is someone who makes one or dozens of buys and sells in one or several stocks during the course of a day and rarely ends the day with any open position in the stocks that were traded. They end the day “flat,” as professionals say. This investment strategy is the polar opposite of that of the long-term investor, who will make a commitment to a stock or several stocks or a mutual fund for months or years at a time.

As in most things, there are many levels and gradations of short-term trading just as there is variation in time intervals in long-term investing. The current state of technology and reduced commission costs allow traders to buy and sell stocks for as little as the smallest trading increment, $\frac{1}{16}$ point. Short-term traders will execute trades many times in a day, building small profits into a large payday. This form of market activity is analogous to the trading activity of so-called scalpers in the pits of the Chicago and New York commodity exchanges, or of Nasdaq market makers, who spend their day bidding and offering, making a market in the smallest practical spread. It’s a trading method that requires discipline, nerve, and fast-paced response to a myriad of financial and political events as they unfold.

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Modes and Methods of Day Trading

Traders can choose from several short-term trading modes and methods to realize the trading objective consistent with their own personality and ability. Different trading methods may be categorized by the price increment objective that an individual trader focuses on. For example, each additional price increment to the smallest increment, $\frac{1}{16}$ point, however, presents different challenges and requires a different set of skills.

The practical increments above $\frac{1}{16}$ are $\frac{1}{4}$ to $\frac{1}{2}$, $\frac{1}{2}$ to 1 point, 1 point to 2 points, and 2 points and above.

The market, of course, is the final determinant of the end result, but traders must focus their energies and create a method that is consistent in its objective. Switching objectives, such as making a trade for $\frac{1}{2}$ point and trying to stretch it into a 2-point trade, is doomed for failure, in my opinion, over a series of trades. Worse yet is designing a risk management system for an objective of $\frac{1}{2}$ point and then changing it to attempt to stay the course for 2 or 3 points at a time. This is no different from executing a trade that starts out as a short-term swing trade and turns into a long-term investment because the trader refuses to accept the initial loss!

It is my goal in *Digital Day Trading* to introduce you to the new and exciting world of electronic short-term stock trading and to present many of the tried and true methods that successful traders routinely employ. Many of these methods don’t require you to sit in front of a computer screen every minute if you don’t choose to. The technology that has accommodated the increase of volume from that record 13-million-share day of 30 years ago to the present-day average on the NYSE in excess of 500 million shares also allows you, as a day trader, to compete with market professionals on a level technological playing field.

Until the 1970s, the securities industry was conducted in its own time-honored fashion. The brokerage houses controlled the flow of orders, made largely to the NYSE but to a lesser degree to the American Stock Exchange (AMEX) and the over-the-counter (OTC) market. Not only was the order flow controlled but the commissions charged to the general public were fixed. Price reporting was available at your broker’s office or in newspapers, and only professional securities traders or wealthy individuals had real-time access to price and volume information.

In 1971 the National Association of Securities Dealers created Nasdaq, an electronic market where members could display
their bids and offers to other members. On May 1, 1975, fixed commissions were terminated by Securities and Exchange Commission (SEC) decree, and a new era of competitive pricing and discount brokerage was born. The termination of fixed commissions, which was the culmination of a five-year phase-out and said at the time to be the death knell of the securities industry, actually turned out to be the main ingredient in the subsequent explosion of trading volume. An industry that had predicted brokerage house failures and the end of the industry saw a new breed of brokerage house called “discount brokers” provide an increased order flow at greatly reduced prices. Not only were discount brokers profitable, but they generated the explosion in trading volume by making the cost of buying and selling an insignificant factor.

Over the years and with some SEC rules changes, the Nasdaq system has evolved from a member-only, inside market to a quotation platform open to all. In 1985 the Small Order Execution System (SOES) was introduced to allow customers to buy on the offer and sell on the bid for up to one thousand shares at a time. After the 1987 crash, when market makers refused to answer phones or backed away from their quotes, Nasdaq instituted an automatic electronic execution system through SOES. Soon after, the SelectNet system, which allowed customers to see and trade with market maker bids and offers as well as other customers’ bids and offers, was created.

The final ingredient in the explosion in the securities industry was the technological advances that have occurred recently and are still occurring: online access to the markets that is readily available to all at a cheap cost with state-of-the-art quickness and precision. Today’s technology offers the buying and selling of stock via the Internet, completely bypassing a broker as well as securing inexpensive online systems. These online systems not only supply quotes and news but also allow the direct entry of orders through participation in the SelectNet system and in

the various electronic communications networks (ECNs) that present your bids and offers on an equal footing with other market professionals.

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**Online Trading**

To use the concepts, patterns, and ideas in *Digital Day Trading*, traders need to familiarize themselves with electronic trading. Because the focus of this book is the specific strategies and techniques that the day trader can use to enhance market performance, I won’t spend a great deal of space on the technology itself. *The Electronic Day Trader* (McGraw-Hill) and *The Online Investor* (Wiley) do quite well rather than focus in a very comprehensive way on market strategy or specific techniques.

Online trading can mean the Internet, the World Wide Web, or any other available means of transmitting orders and information such as a private network, satellite, TV, or even pager technology. In the time between the conception of this book and writing this chapter, trading technology made extraordinary advances—from simple Internet order entry access to securities markets to electronic networks available at brokerage sites or total market access on a trader’s PC.

The technologies change daily. As an example, online trading access began as a method to get delayed quotes on a PC, typing in an order to buy or sell a security, and then sending that order to a broker, who would forward it on to be executed. What ensued was the ability to obtain live quotes inexpensively, to enter orders and receive "fills" (i.e., executed orders) directly from the markets that the security trades on, and to have at your fingertips many management tools that serve to organize your portfolio and enhance money management. Following that, new-styled brokers emerged, supplying computer
stations with the most advanced software and instant access to all markets via Nasdaq Level II and various ECNs, and offering information and account management tools in many cities across the nation.

Now, the same level of technology that was available at brokers' offices is available online on your PC for a reasonable fee on a fee-for-service basis. Real-time market quotes, charts, news, ticker alerts, one-button order entry, and almost instantaneous order execution are now a click away with excellent reliability.

The World of Electronic Trading

SuperDot

SuperDot is the electronic platform for listed markets. Almost 40 percent of the shares traded on the NYSE in any one day are executed on SuperDot. This system, which links member firms to the specialists on the floor of the exchange, can handle up to 99,999 orders. Although SuperDot usually is not available to individuals, several other systems offer similar access to the markets.

Electronic Communications Networks

Instinet, Island, Bloomberg, and Teranova are ECNs available to everyone. Traders, market makers, and institutions can have their bid or offers displayed and thereby make a market on Nasdaq stocks. Through ECN order entry terminals or your own PC, you can now participate in the entire Nasdaq market on an equal basis with market professionals.

At the present time the Nasdaq market offers the best opportunity for you, as a day trader, to compete. Because listed securities that are traded on the NYSE, the AMEX, and other exchanges in the United States and around the world are still traded within a specialist system, you don't have direct access to buyers and sellers and thus lose much of your edge in short-term trades. This is not to say, however, that opportunity in the listed markets is lacking. Many good trades and many interesting stocks are available for your portfolio, but you must adapt your methods to the specialist system.

In my view, it is more important to develop a consistent, disciplined approach to trading based on the information available in the market in terms of price and other statistics than worry about whether it's a specialist, a market maker, a hedge fund, or Joe Trader on the other side of your trade.

How to Begin

Hardware

Almost any computer purchased in the past two years should have the capability to put you online. The minimum requirements for online trading are Pentium or an equivalent 133 MHz, 32 RAM, 28 bps or higher modem, and 1 gigabyte or higher hard drive memory. Anything you add as an upgrade or enhancement will increase your efficiency and make your life easier.

More recent software—for example, live NYSE, AMEX, and Nasdaq quotes; Nasdaq Level II displays; live technical charts; custom studies; position manager; a point-and-click execution panel; and custom "hot" keys—may require more than the min-
imum essentials. If you intend to day trade actively, then a higher level of hardware is well worth the additional expense.

**Software**

The different categories of software are the following:

- **Internet access.** Access software is provided by an Internet service provider (ISP) and allows you to make the connection between your PC and the ISP's server.
- **Internet browser.** The two most common browsers are Microsoft and Netscape. Microsoft's Internet Explorer is included in your Microsoft PC operating system and Netscape can be downloaded directly from the Internet.
- **Order entry software.** This software is provided by the brokerage company that holds your account. Along with sending orders and receiving fills, it may keep track of your trades; show you your portfolio; and provide quotes, news, charts, market maker screens, tickers, and supply research reports.

**Analysis software.** Many software choices contain various technical studies or allow you to create your own. Some of this software also allows you to test what you create or test a combination of studies that are included in the software. The product manufacturers and vendors, who are actively soliciting your business, make finding and getting acquainted with your requirements easier. Pick up any business newspaper or magazine, or turn on a local or national financial news station on radio or TV, and you'll find an enormous choice. Some examples of this software are Trade Station by Omega Research, MetaStock by Equis, TeleChart by Worden Brothers, Inc., and Trading Expert Pro by AIQ.

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**Setting Up a Business Plan**

As with any business, content and substance, not wishful thinking, are called for. Write a business plan that contains the following:

- A clear statement of your business goals and philosophy
- A list of resources available now and in the future to pursue a day trading business
- Specific plans for the business—a description of your proprietary ideas, strategies, and tactics for advancing your goals
- A projected cash flow worksheet with a balance sheet that precisely presents your current financial position
- Identification of an ongoing mechanism for evaluation and future testing

With the electronic system in place, your business plan completed, and the costs to do business well calculated, what is needed next is to understand how to take full advantage of the contemporary marketplace.

To decide where to focus your energies, it is essential to understand the various categories of day traders and how they differ. Ultimately, time and personality should determine your specific market approach.

**Categories of Traders**

Following are the various categories of day traders:

- Scalpers
- Market makers
• Quick-turn traders
• Swing traders

Scalpers. Scalping is the most active method of trading and requires real-time access to the markets. The scalper takes a position and immediately bids or offers his position at \( \frac{1}{8}, \frac{1}{4}, \) or \( \frac{3}{16} \) point above or below the market, hoping to take a small profit. If he can repeat this 20 or 30 times a day, he will end each day with a sizable gain. The advantage of scalping is the ability to control losses if traders are disciplined and quick. This trading method requires total focus and a minute-to-minute commitment to the market.

Market makers. Although not as active or intense as scalping, market making requires a total commitment to the market. The trader attempts to buy on the bid and sell on the offer along with the professional market makers. The bid and offer spreads that this trader is working with are usually larger than scalpers’ spreads and, depending on the stock, could be from \( \frac{3}{16} \) point to 1 point.

To trade effectively, scalpers or market makers need to purchase the necessary computer hardware and software that will support an order entry system or, for optimum effectiveness, they need a Nasdaq Level II, which provides bids and offers as well as the depth of the market. Or they can become associated with one of several securities firms specializing in electronic day trading. Either way I recommend an extensive training period before you attempt to trade actively as a scalper or market maker.

Choosing the right firm to hold your account is your first important trading decision. If you intend to be a scalper day trader, a good firm will have a training process in place and give you access to an individual responsible for ensuring that you have the necessary skills to trade on the electronic communications network. These skills include setting up your trading screen so that you can see the markets of your choice; understanding how and what orders are available to you and how to enter those orders so that what you intend to do is what in fact occurs; practicing entering orders not only for accuracy but for speed; and having all the pertinent information on your screen that is available. If your goal is to day trade online, then many of the established firms can meet your needs. Firms such as Charles Schwab or e-trade make it easy to get connected.

The scalper and market maker style of trading requires getting in and out of positions very quickly and keeping the size of losing trades to a minimum. Traders may watch many of the most actively traded stocks and, when sensing movement or a trend developing, jump into that stock hoping to profit by \( \frac{3}{16} \) or \( \frac{1}{8} \) point. If the trade doesn’t develop immediately, traders may sell for \( \frac{3}{16} \) point or for a “scratch” (selling for the same price as the purchase) and take a small loss. They realize one very important fact: Another trade will be along any moment and success means keeping the losing trades small.

Quick-turn traders. I differentiate the scalper and market maker from the day trader who, unlike them, is aware of and capitalizes on market direction. Where scalpers or market makers may be aware of a directional bias to the market they are trading, it is not their primary focus. In contrast, the quick-turn day trader is highly concentrated on market action and studies the sequence of bids and offers to enter the market at a time when he or she feels a move of \( \frac{3}{16} \) to 1 point is about to occur. This day trader may pay \( \frac{3}{16} \) or \( \frac{1}{8} \) point to get into a moving stock and will also sell out of his or her position just moments later if his or her price objective is realized.

Swing traders. Swing traders are fundamentally concerned with market direction. They attempt to trade specific mar-
ket patterns that allow for circumscribed risk where the profit potential is from 1 to 3 or more points in a day. I think this type of trading takes more time to develop and has a wider price and time horizon so that many more of us can successfully use it and thus avoid a minute-by-minute focus on the market or computer screen.

**Position traders.** The day trade position trader tries to accumulate a multiple position in a stock to take advantage of a larger daily or two- to three-day market move. This is an aggressive trading style that usually requires more capital than the other categories.

The discussion of trading philosophy and strategy that follows throughout *Digital Day Trading* concentrates on the last three day trading categories discussed, namely, quick-turn trading, swing trading, and short-term position trading. The specific method and patterns I describe have been thoroughly tested and widely used with successful results over my long-term day trading career. In addition, I have included techniques that were shared with me by proprietary and institutional traders as well as floor traders whose record of success I know of firsthand.

Before we look at specific setups, it is important to clearly understand the strategies and psychological factors that in the final analysis are the ultimate key to market success. As the Chinese philosopher Lao-tzu observed: “He who knows much about others may be learned, but he who understands himself is more intelligent. He who controls others may be more powerful, but he who has mastered himself is mightier still.”

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**The Psychology of Successful Day Trading**

In Bernard Baruch's autobiography *Baruch: My Own Story* (Holt, Rinehart & Winston, 1957), the legendary entrepreneur offers ten rules for successful speculation:

1. Don't speculate unless you do it full-time.
2. Resist so-called inside information or tips.
3. Before purchasing a security, know everything you can find out about the issuing company, especially its earnings and capacity for growth.
4. Never attempt to buy a bottom or sell a top of a market; this is a feat achieved only by liars.
5. Take your losses swiftly and clearly; the first loss is your easiest.
6. Don't buy too many securities; focus on a few investments that can be monitored carefully.
7. Periodically reappraise all your investments to make sure they are appropriate to your particular strategy.
8. Know when you can sell to your greatest advantage (of course, this also applies to buying).
9. Never invest all your funds; keep liquid.
10. Don't try to be a jack of all investments; stick to the field you know best.

Baruch, who was a lifelong skeptic of both giving and taking advice, qualified his rules of sound speculation with the following caveat: "Being so skeptical about the usefulness of advice, I have been reluctant to lay down any rules or guidelines on how to invest or speculate wisely. Still, there are a number of things I have learned from my own experience which might be worth listing for those who are able to muster the necessary self-discipline." And, of course, isn't that the essence of it? All rules of sound investment begin and end with the adoption and mastery of specific psychological skills that successful trading requires.

Day trading, in particular, because of the very nature of short-term trading, forces us to sink or swim in our own psychology. It is the concentrated time frame of split-second decision making within a context—perhaps barrage is a better word—of conflicting and contradictory data that makes it seem at times impossible! Not so.

In my experience, day trading can be enormously rewarding both psychologically and financially. But only if the right attitudes are put in place and the necessary psychological skills are mastered.

The Psychological Skills Necessary to Become a Successful Day Trader

The necessary psychological skills for day trading are these:

- Compelling personal motivation
- Goal setting
- Confidence
- Anxiety control
- Focus
- State of mind management

Compelling Motivation

Compelling motivation involves possessing the intensity to do whatever it takes to win at trading: to overcome a bad day or a temporary setback in the market in order to achieve your trading goals. It also means sticking to your trading plan and not allowing a momentary impulse based on fear and greed to control your decisions. Many day traders live and die on a roller coaster of inhibiting emotion. This is not the soil in which effective trading flowers.

Goal Setting

Goal setting is key for traders. It focuses them on what is important in terms of motivation, outcome, and mechanics. Goals give direction and focus to the trading plan as well. You must know what you are trying to accomplish if you want to achieve an excellent trading result. You must be able to answer without qualification: Am I scalping, quick-turn trading, or swing trad-
ing? Is my time frame 5 minutes, 30 minutes, or five days? Then you must act according to your answers. Goal setting allows you to make decisions without hesitation or ambiguity.

### The Importance of Day Trading Goals

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<tr>
<th>Goal</th>
<th>Benefit</th>
<th>Trading Behavior</th>
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<tr>
<td>Performance goal</td>
<td>Improvement of your own standards</td>
<td>Increase in physical and psychological skills related to trading</td>
</tr>
<tr>
<td>Outcome goal</td>
<td>Helps determine what's important to you</td>
<td>Development of techniques and strategies that match your personality</td>
</tr>
<tr>
<td>Motivation goal</td>
<td>Helps increase effort Directs attention</td>
<td>Increase in enthusiasm and confidence</td>
</tr>
</tbody>
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Ask yourself the following questions:

- Do I have a clearly defined set of trading goals in writing?
- Have I specifically done something to move me closer to achieving my goals?
- Do I have a clear idea of what I want to accomplish right now in the market?
- Do I concentrate on goals rather than procedures?
- Do I evaluate my progress based on accomplishment rather than activity?

As you think about your trading goals, remember that they should satisfy the following criteria. Your trading goals should be **specific**—that is, clear, precise, and well defined. They should be **time framed**—that is, stated within a specific time period. Your goals should be **positive**—that is, stated in a way that is empowering. They should be **controlled**—in other words, your goals should be completely within your control. They should be **realistic**—it's not necessary to become the next George Soros ... that was George's goal! And finally, your goals should be **measurable**—that is, easily quantifiable.

From the experience of training my own proprietary traders, I have found that when traders abandon their goals, it is because they suffer from one of the following weaknesses:

- Self-limiting beliefs
- An unresourceful state of mind
- Poor focus
- An ill-defined personal trading strategy
- A lack of physical and psychological energy

The solution to overcoming these trading obstacles always resides in psychological rather than technical analysis—but of course you already know this!

### Confidence

When I speak of confidence, I'm not referring to cockiness, euphoria, or arrogance. Hubris in trading is lethal. Confidence, on the other hand, is essential and is the trader's natural expression of self-trust and being in control. It is effortlessly expecting a good result based on hard work, discipline, and an effective (tested and proven) methodology.
Anxiety Control

Sometimes I think anxiety was invented just for trading! There are so many anxieties the trader has to confront and master to be effective and apply his proven strategy.

Day trading anxiety stems from a variety of sources. Fear of failure is perhaps chief among them, manifesting itself in traders’ feelings of intense pressure to perform well. And traders’ self-worth is often tied to their trading. Then there are perfectionist traders concerned about what others think. For overcoming—or at least minimizing—perfectionism, traders should focus on applying their methodology, mentally rehearse the mechanics of the trade, and convince themselves that trading is not about proving anything to anybody. If you are a perfectionist, the more you focus on your methodology, the more you’ll feel in control of your anxiety.

Another source of trading anxiety is fear of success. Traders may lose control and engage in euphoric trading, while in fact doubting themselves. If your day trading approach has shown statistical reliability in its performance, rehearse feelings of confidence as you mentally run through the placement, follow through, and close out the trade. Feel in a literal sense how you personally experience confidence.

Finally, some traders are anxious about losing control, feeling the market is out to get them (it’s not!). These traders lose their sense of personal responsibility when trading and must teach themselves how to get into a physically and psychologically relaxed state when trading. If you fear losing control, focus on your specific methodology and expect small losses!

Focus

The following reveals graphically the focus that is necessary for successful day trading results:

The Successful Day Trader’s Focus

Well analyzed and \(\rightarrow\) Automatic execution \(\rightarrow\) Successful day strategized trade (based on highly concentrated focus and confidence) trade results (whether the trade makes a profit or loss)

State of Mind Management

To be successful at day trading you must constantly trade from a state of mind that allows you to maintain a high level of self-esteem, unshakable confidence, and laser straight focus. This state of mind is characterized by relaxation, focus without anxiety, self-trust, and resourcefulness.

The Successful Day Trader’s State of Mind

Positive state \(\rightarrow\) Allows for unhesitating \(\rightarrow\) Positive trading implementation of one’s trading strategy result

A positive state of mind is the result of consistently processing positive verbal attitudes, beliefs, and images that will enhance one’s trading performance. The following are guides to positive processing:

- Expect the best of yourself.
- Establish a personal standard of excellence.
- Create an internal atmosphere for success based on visual, auditory, and feeling (kinesthetic) imagery that enhances performance.
- Communicate positively and effectively \(\ldots\) with yourself! See yourself as positive, resourceful, and self-empowering.
• Rehearse a system of personal beliefs that can enhance your state of mind immediately.

The psychological skills that are necessary to day trade successfully require ongoing commitment and conditioning. They must be practiced day in, day out. I have been keeping up-to-date charts by hand in over 20 different commodities for more than 25 years. Technical analysis is very important. It is not, however, in my opinion, as important as working through the psychological and attitudinal issues of trading in general and day trading in particular.

**The Syntax of Successful Day Trading**

Well-analyzed trade
+
System of empowering personal beliefs and attitudes
+
Proper execution based on positive focus
+
Decisive, resourceful state of mind
+
Successful trading performance

In his book *Melamed on the Markets* (Wiley, 1994), the legendary trader Leo Melamed observed:

You learn to distinguish the good traders from the bad, the successful techniques from the unsuccessful, and the good habits from the faulty. You also learn to distinguish the lover from the fighter, the winners from the losers, the serious from the frivolous, the cerebral from the superficial, and the friend from the foe. But above all, you learn that the psychological makeup of the trader is the single most critical element of success.

**The Essential Psychological Barriers to Successful Day Trading**

What follows is a discussion of the essential barriers that inhibit or prevent traders from securing a positive market result. These barriers are:

• Not defining a loss
• Not taking a loss or profit
• Getting locked into a belief
• Trading on inside information or taking a tip
• Kamikaze trading
• Euphoric trading
• Hesitating at your numbers
• Not catching a breakout
• Not focusing on opportunities
• Being more invested in being right than in making money
• Trying to be perfect
• Not consistently applying your trading system
• Not having a well-defined money management system
• Not being in the right state of mind

**Not defining a loss.** No one enters a trade expecting to lose! No one buys thinking the market will break, and, conversely, no one sells on the assumption that the market is about to rally to new highs . . . but to paraphrase a famous saying, things happen! It is essential for the day trader to identify without qualification his loss point before—not after—entering the trade. When you get stopped out, "just pick yourself up, dust yourself off, and start all over again."

According to Tony Saliba, market wizard:
Look both ways before you cross the street! I’ve heard it a million times, but you know what? A car almost hit me the other day. I was walking across Franklin, talking on the telephone with a trader upstairs, and I didn’t notice that the light changed. A car just came down off the ramp, honked his horn and missed me by about two feet. It scared the hell out of me! My little four-year-old nephew said, “Uncle Tony, stop, look, and listen. Right?” It’s a cliche! How many traders follow that market truth?

**Not catching a loss or a profit.** Each day trade should have its own internal logic based on probability and consistent with your own methodology. When the market has moved to your exit point either on the upside or downside, you must react automatically without hesitation. That is to say, you must take the profit or loss. If the market continues to move in your direction once again, based on probability consistent with your technical bias, find a new entry point. Reacting is an essential element in any trading system. The point is that when the market does give you a profit, I believe it is essential that you take it. It is psychologically important that you walk away from the trade with change in your pocket!

**Getting locked into a belief.** It’s so easy to get locked into a jail cell of personal opinion. The market doesn’t lie; it reveals all to the keen observer. You must not confuse your subjective opinion with the objective action of the market. Remember, the market feels no obligation to gratify your opinion! Day traders need to focus on a single rigorous method that works; all else is just another opinion. Money talks, all else walks.

**Trading on inside information or taking a tip.** For losers only! By the time you’ve heard it, it has circulated widely. If you don’t enjoy playing the role of salami entering the slicer, don’t day trade on someone else’s tip. Typically, this information comes from the phone men or trading desks. They will tell you that if the market gets below a certain level, the trader will start buying or selling. If they were so smart they’d be in the ring carding trades, not manning the phones!

**Kamikaze trading.** What more can I say! Crashing airplanes don’t fly! If you feel angry, betrayed, in need of revenge . . . apply to law school! Don’t trade, you’ll crash land!

**Euphoric trading.** Euphoric trading is the opposite of Kamikaze trading. You’re feeling invincible, heroic, bulletproof. You feel the lottery can’t help but draw your ticket. As soon as you lose your objectivity, bullets start piercing flesh!

**Hesitating at your numbers.** Day traders don’t have the luxury of hesitating once they have identified a setup trade. It is both financially and psychologically debilitating not to pick up the ball and run. The discipline always must be to take the trades that are consistent with your methodology no matter what! If you take the trade and get stopped out . . . welcome to the world of day trading. Remember, you can’t score touchdowns without the ball.

**Not catching a breakout.** Another form of hesitation. It’s like going to the airport and watching the planes take off. Wouldn’t it be fun just once to get on board and arrive at an exciting destination?

**Not focusing on opportunities.** There are many (constant and consistent) distractions in the market. So much of day trading is just having the ability to get beyond the noise, the talk, and the smoke! Consistency in your approach with a high degree of confidence and optimism will keep your focus clear. You must find a way to get beyond all the head fakes!
Being more invested in being right than in making money. Is it your goal to be an analyst or a trader? You must know the answer to that question. If your technical analysis is turning you into a Ph.D. in a particular stock or market sector, join a university faculty; you'll save money! Trading is not about scholarship. It's about making money. That's not to say money should be the object of all efforts; I believe it shouldn't. But this is one game where the scorecard is denominated in hard currency. It's not enough to point to the fact that you had the high or low of the market.

In *The Disciplined Trader*, Mark Douglas wrote:

> I know it may sound strange to many readers, but there is an inverse relationship between analysis and trading results. More analysis or the ability to make more and finer distinctions in the market's behavior will not produce better trading results. Many traders find themselves caught in this exasperating loop, thinking that more or better analysis is going to give them the confidence they need to do what needs to be done to achieve success. I call this loop a trading paradox that most traders find it difficult, if not impossible, to reconcile until they realize you can't use analysis to overcome your fear of being wrong or losing money. It just doesn't work!

**Trying to be perfect.** You don't have to be perfect; merely excellent! Excellence produces results, perfection produces ulcers!

**Not consistently applying your trading system.** It is there for one purpose only . . . to be used so you can garner profits, letting them pile up like pleasing snow drifts!

**Not having a well-defined money management system.** There are literally hundreds of books written on this subject . . . You don't have to read them! For day trading purposes your trade should give you a minimum of a 2:1 risk-to-reward ratio.

**Not being in the right state of mind.** Funny, but it comes back down to this. In my experience, more than 90 percent of all trading failure is the result of not being in the right state of mind. The right state of mind produces the right results!

In our book *The Innergame of Trading*, my partner, Bob Koppel, and I wrote:

> It is our belief that continually elevating your state of mind by focusing on internal and external phenomena that allow you to stay resourceful and true to your trading strategy is the answer. We have demonstrated how to do this through processing positive beliefs and thoughts and by directing your physiology. When a negative thought comes into consciousness and begins to distract your focus, don't fight it. Acknowledge its existence and go forward.

Successful trading, in essence, comes down to this: Formulate a day trading plan that works, overcome your own personal psychological barriers, and condition yourself to produce feelings of self-trust, high self-esteem, and unshakable conviction and confidence. Doing this naturally leads to good judgment and winning trades with a proven methodology based on probability.

So what then is the edge that makes the difference in day trading? Let me suggest the following:

1. Fully understand your motives for trading. Once you know what your motives are, examine them carefully. Most traders trade in a constant state of conflict. From experience I've found that many people who think they want to day trade really don't.
2. Develop a personal strategy that works for you and fits your personality. If the system doesn’t feel right, you’re going to lose before you ever start. Remember, by the very nature of day trading you must trade a system that is totally within your control.

3. It has to be fun. I can’t stress this point enough. Trading has to literally feel good. You must be in a frame of mind that allows you to enjoy the process effortlessly, be resourceful, and make good judgments. Even when you are losing! You don’t have to like it, but you do have to have a sense of humor.

4. Hard work is essential. There’s no way to get around it. You must put in the time. As Thomas Edison said, “The reason a lot of people do not recognize opportunity is because it usually goes around wearing overalls, looking like hard work.”

5. You must have confidence. You must possess a repertoire of personal beliefs that constantly reinforces feelings of high self-esteem and confidence in your analysis and execution of trades whether you win or lose. Needless to say, discipline, patience, personal responsibility, and repeated success in day trading make this a lot easier.

6. You need a positive state of mind. All top-performing traders have developed an internal terrain that reduces anxiety and promotes excellence. They manage to achieve this end by representing external events internally in such a way that ensures success, adjusting and redefining as they deem appropriate. They employ a belief system that doesn’t allow for the concept of failure, and they adopt a personal focus that concentrates on what is essential to achieving this end. In short, they have mastered the ability to create states of mind and body that are resourceful and assure whatever it takes to succeed.

As another legendary trader, Jeffrey Silverman, observed when I interviewed him:

You must spend the time—you must study the characteristics of successful traders. You must study your own mistakes. You must study the mistakes of the others around you. Increasing levels of sophistication will put you in the direction of understanding who you are. You must really study your own self and understand what you’re all about. It’s not clear to me whether I didn’t do this whole thing backwards where I studied the economics and science of trading and worked into the psychology of trading and finally got involved in some sort of philosophical thinking of the whole trading process. It’s not clear to me that I didn’t do the whole thing backward and shouldn’t have studied philosophy and psychology at the start and it might have made the whole process easier.
Strategy and the Overall Game Plan

"All men can see those tactics whereby I conquer, but what none can see is the strategy out of which victory is evolved."
— Sun-Tzu (fourth century B.C.)

As a day trader it is important for you to be able to distinguish between trading strategy and trading tactics.

Trading strategy is the process of determining your major trading goals and then adopting a course of action whereby you allocate the resources necessary to achieve those ends. Trading tactics is the process of translating broad strategic goals into specific objectives that are relevant to a single component of your trading plan.

In Part Two when I discuss my own personal day trading system, The Digital Day Trading Method of Short-Term Trading, my focus is specific tactics and technical analytical considerations; however, to lay a framework for the strategic context of my system's application, I concentrate here on what I believe are the essential elements of a successful day trading strategy that underlie all tactical applications.
The Essential Elements of a Successful Day Trading Strategy

A successful strategy for day trading does the following:

- Assumes personal responsibility for all market actions
- Takes into consideration your motivation for trading
- Allows you to trade to win
- Establishes a clear, precise plan of action
- Creates a point of focus
- Is automatic and effortless in its implementation
- Manages risk and assumes losses
- Allows for patience
- Is practical and profit oriented
- Allows you to produce consistent results

Let's examine each of these characteristics of successful day trading more fully.

**Assumes personal responsibility for all market actions.** Traders often say they “make a profit” but “take a loss.” The reality, of course, is that we do both. You the trader produce the results. This may seem obvious, but I can assure you, based on my 25 years of experience and having worked with hundreds of traders, it is the rare trader who truly lives by this credo. It isn’t your broker, your brother-in-law, the chairman of the board of the Fed, the fill, the computer, the unemployment report—it’s you! It’s a simple fact that must be understood in the adoption of any trading strategy: You are responsible for the results. Good or bad, the buck stops (and starts) here!

**Takes into consideration your motivation for trading.** It is essential that your day trading approach takes into consideration your motive and motivation for trading. In addition, it is imperative that your method feels “right,” which is to say it is consistent and congruent with your personality. If it doesn’t feel natural, it is like taking a ten-mile hike in boots that are two sizes too small. Ask yourself exactly why you want to day trade? Are your personality and approach suitable?

**Establishes a clear, precise plan of action.** The recipe for success in trading is a simple one. Your plan of action needs only three elements:

1. It identifies a signal (opportunity).
2. It allows you to take immediate action (buy or sell).
3. It allows you to feel good no matter the result as long as the trade is consistent with your specific method or technical bias and was based on probability.

Most day traders, however, experience doubt or hesitate just at the moment of action. The way to overcome this is to have a crystal clear point of focus, which allows you to resolve the omnipresent internal and external hindrances.

**Creates a point of focus.** Staying fixed on your particular approach, method, or system is what will allow you to resolve all the debilitating emotions you experience while day trading. It is disciplining yourself to refocus back to your particular method, numbers, system, and the like that helps you to resolve your natural feelings of anxiety as you are experiencing them. I talk more about this later when I discuss the application of the Digital Day Trading Method. But for now the essential point is that you must know what you are looking for and what you are looking at in the market. You must be able to distinguish the signal from the noise and distinguish high probability from low probability trades.
Is automatic and effortless in its implementation. The way all the hard work you have done as a trader pays off, in my opinion, is by allowing you to act absolutely, automatically, and effortlessly in the market when you have a high probability signal. The discipline is to "hard wire" your neurological system to act at just these times. By being in a position to "catch" those trades, you'll find your need to tell colleagues about the great trades that got away has been neutralized!

Manages risk and assumes losses. The one constant shared by all traders is that they take losses. You can't be afraid to lose. Truly, I love the market to take me out and hit my day trading stops. I challenge it to do no less. Do I like to lose? Hell, no! But if the market takes me out, I have paid for some very valuable information. Of course, it goes without saying that my losses are always circumscribed.

Allows for patience. Following your signal religiously teaches you to have patience rather than getting caught up in the minute-by-minute emotions of day trading. The key to success here is to give yourself the distance to make decisions that are based on a thoughtful process, method, and strategy rather than on the exciting emotional gyrations of the market.

According to Mark Douglas, author of The Disciplined Trader:

There are certain characteristics of a mind-set that I believe are essential to creating success in the markets or creating consistency. To me, success as a trader is consistency. There is an often-used saying on the floor of the exchanges that "traders just rent their winnings." As you know, there are many traders who have reached the stage of development where they can put together a substantial string of winning trades for days, weeks, or even months, only to lose all or almost all of their hand-won equity in a few trades and then start the process all over again. If a trader hasn't neutralized his susceptibility to giving his winnings back to the market, then he is not what I define as a successful trader.

Is practical and profit oriented. Many day traders get bogged down in the theoretical accuracy of their particular system. This is not necessarily important. What is important is performance. Making money supersedes theoretical attachment to a particular ideological or technical bias. I believe Winston Churchill said it best: "It is a socialist idea that making profits is a vice; I consider the real vice is making losses."

Allows you to produce consistent results. Although in trading you can never really have certainty, paradoxically, to operate effectively you must act with certainty — that is, resolutely at the point of decision. Consistency in day trading derives from applying a proven method without fail every time a signal is generated. Your trading system provides the organization that allows you to identify and exploit opportunities for achieving consistent results. It goes without saying, the rest is up to you! As Anthony Robbins has written in Personal Power, "The difference between those who succeed and those who fail isn't what they have — it's what they choose to see and do with their resources and their experiences of life."

Accordingly, your trading strategy should allow you to open your eyes and see market opportunities ... so that you can act
PART TWO

Trading on a Level Playing Field
Competing with the Market Makers

This chapter presents the essential elements of what you need to know for electronic intraday trading for small price increments. On exchange floors throughout the world, this is called “scalloping,” and it is the provenance of traders who stand in trading pits and buy and sell throughout the day for their own accounts and those of clients. This same opportunity is now open to you.

The securities markets as they exist today are composed of two distinct systems: the specialist system and the market maker system.
The Specialist System

Traders on the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX) use a specialist system; that is, each stock traded on the exchange is assigned to a specialist who is expected to maintain an orderly market and keep a book of resting orders above and below the current market. The specialist not only bids and offers for others but also steps in during volatile price movements and uses his own capital to take the opposite side of either an excess of bids or offers. Of course, the price at which this occurs is determined by the supply and demand of the stock at that moment. For example, if a favorable earnings report is released for XYZ and there is an influx of buy orders, the specialist will use a combination of sell orders from the public, the book of resting orders, and his own capital to accommodate all the buy orders for XYZ. The price of XYZ will be determined by the sell orders available and, when those are exhausted, the experience and judgment of the specialist. You may have either seen or experienced a stock that opens several points above its previous day's close; this is the specialist attempting to find an appropriate price level.

The Market Maker System

The Nasdaq and over-the-counter (OTC) markets are traded through an electronic network, which brings together market makers, brokerage houses, and traders like you. This system gives everyone the opportunity to "see" the market by its display of bids and offers and the size of those bids and offers. Currently there are three levels of available service:

1. The first is called Level I and provides real-time quotes that reflect the best bid and offer and their sizes. Brokerage houses and the majority of investors who are looking for the most recent quotes use this level of service.
2. Level II differs from Level I in that it shows the best bid and offer not only by size but also by the depth of the market. Depth refers to the market that exists behind the best bid and offer. It may show two or three other bids or offers at the best price and then will show the next best bid or offer for several levels up and down from the last price.
3. Level III has all the features of Level II and is used by market makers. It allows the market maker to constantly update the quotes for the securities they trade.

The Level II trading screen is your window to the world of the securities markets. It gives you real-time information such as stock quotes, bids, offers, volume, time of sales, and much more. Learning what information is available and when and how to use that information is key to beginning the process to successful digital day trading.

There are several software companies that produce the Level II information. For purposes of illustration in this book, we are using information from Tradecast, Inc. Also, we have included excerpts from the trader's manual in Appendix B for your reference with detailed descriptions and instructions.

Customized Windows in Level II Trading Software

Customized windows on your screen include:

- Blotter window
- Stock window
* Ticker window
* Time of sales window
* Board views windows
* Top ten windows
* Fundamental data window
* Order entry window

**The blotter window.** The blotter window comprises three panes: an open positions pane, a summary pane, and a trades pane. The open positions pane, shown in Figure 4.1, keeps track of your current open positions and is customizable with 25 different pieces of information that you may display in the format that suits you. A summary pane, as shown in Figure 4.2, contains information about the current day's trading, which can include equity, margin, P/L, number of trades, and realized and unrealized profit and loss. The trades pane, in Figure 4.3,
allows you to view all trades, today's trades, open trades short positions, long positions, and completed trades.

The stock window. The stock window, in Figure 4.4, is an all-purpose window that supplies most of the information available from Level I and Level II. This information includes individual stock symbols, quotes, bids and offers, various ECNs, and market maker information. This window also can be customized and usually serves as the centerpiece of your trading screen.

The ticker window. The ticker window, shown in Figure 4.5, will keep you updated on price changes in several different combinations. The position ticker will display changes to those stocks that you hold as open positions. A long ticker will display only those stocks that you are currently long. You also have the ability to add any stock you wish to follow merely by clicking on its symbol in the stock window and dragging it to the ticker window. The ticker gives you a continuous update of any number of stocks you may be currently interested in.

Time of sales window. This window displays the actual time of the sale of a stock, its bid or offer, and the number of shares traded. Some traders use this window to get a good idea of price sequence. (See Figure 4.6.)

Board views windows. The board view, shown in Figure 4.7, is similar to the blotter and will list as many symbols as you like, along with information such as bid, offer, high, low, close, last size, time, change, and volume. You may customize several board windows if you wish.

Top ten windows. Top ten windows, shown in Figure 4.8, give you the opportunity to monitor the big winners and losers during the trading day. The categories are for each individual exchange or market and include:

- Gainers/losers
- Percentage gainers/losers
- Volume
FIGURE 4.6 Time of Sales Window

| 14:27 | 101 | 1/16 | 200 | Q |
| 14:27 | 101 | 1/16 | 460 | Q |
| 14:27 | 101 | 1/8  | 500 | Q |
| 14:27 | 101 | 1/8  | 600 | Q |
| 14:27 | 101 | 1/8  | 300 | Q |
| 14:27 | 101 | 1/10 | 50  |
| 14:27 | 101 | 1/8  | 800 | Q |
| 14:27 | 101 | 1/16 | 100 |
| 14:27 | 101 | 1/8  | 100 |
| 14:27 | 101 | 1/8  | 300 |
| 14:27 | 101 | 1/8  | 100 |
| 14:27 | 101 | 1/8  | 900 |
| 14:27 | 101 | 1/18 | 100 |
| 14:27 | 101 | 1/16 | 200 |

FIGURE 4.7 Board Views

- Nasdaq small cap gainers/losers
- Nasdaq small cap percentage gainers/losers
- Nasdaq national Market System Composite (NMS) gainers/losers
- Nasdaq NMS percentage gainers/losers
- Nasdaq NMS volume

**Fundamental data window.** This window displays fundamental information that is not displayed on any other windows (see Figure 4.9). Some of the information includes:

- Rank
- Beta
- Price-earnings ratio
- 52-week high/low
- Year high/low
- Average daily volume
- Dividend rate
- Earnings
- Earnings comment
- Financial comment
- Earnings estimates
Order entry window. This window lets you see the status of your pending orders. (See Figure 4.10.) The window also displays a list of executions and message logs.

The overview of the Level II capability shown here is merely an introduction to the information that is available to the trader. The flexibility of the windows and the various ways to manipulate the information make this a powerful tool. This information and technology will allow you to enter and exit markets, gather the latest information, and keep tabs on hundreds of stocks—all of which puts you on equal footing with professional traders.

The first consideration for the beginning day trader is to familiarize himself or herself with the use of the Level II screens. It is important to learn the information that they convey and how to use that information. Next, practice the physical aspects of order entry and exit to take advantage of the edge that the system gives to you.

As you read and analyze the ideas and information in the interviews that follow, you will begin to see and understand how you can compete on an equal playing field with professional market makers.
David Jamail is a professional day trader and a principal in Cornerstone Securities.

Q: David, what first attracted you to electronic day trading?

DAVID: As you know, I've been a trader for a long time. To answer your question specifically, I wanted to be able to scalp the market without having to be in Chicago or New York.

Q: You mean, like being in the pit?

DAVID: It's the closest thing to being there without really being there.

Q: What kind of trading did you do before you got involved with digital day trading?

DAVID: I traded listed stocks for my own account. In the 1980s I was a broker at E.F. Hutton and PaineWebber.

Q: So you have experience trading the old-fashioned way?
DAVID: Exactly. Calling down to the floor and putting in orders—a far cry from what I do now!

Q: What exactly brought you to this arena of trading on an electronic platform?

DAVID: In 1993 I was a partner in a brokerage firm in Houston, and two guys I know brought SOES terminals into our office. After watching them trade SOES for about a month, I realized its obvious benefits: direct access to the market and the ability to trade with virtually no slippage. Day trading like this was very attractive to me, and I gave up the other type of trading.

Q: Can you describe what specific actions you take on a daily basis to prepare yourself for the trading day?

DAVID: I scan all the news sources, Bloomberg, and Reuters for headlines and for analyst upgrades and downgrades. I also look at earnings reports and any other news that may affect the mid-cap or large-cap stocks. Then I look through the 300 charts of the universe of stocks that I normally trade, searching for particular setups and chart patterns.

Q: Would you say you're primarily a chart pattern trader?

DAVID: My primary input is charts. Initially, I work off a daily chart and then key off a two-minute intraday chart.

Q: How would you contrast electronic trading from conventional trading?

DAVID: Well, for one thing, there's so much less overhead involved in executing the trade. You're freer to make more trades than you would normally be able to do using a broker. I'm more prolific as a trader. I don't know that there is much difference in what I do fundamentally, except that before I couldn't physically call out all the orders, execute them, and have them reported back to me in the volume I day trade today.

Q: What specific stocks do you trade, and how do you arrive at your portfolio mix?

DAVID: Basically, we scan all 5,000 Nasdaq stocks. We watch the ticker for new highs and lows. Every time that a new high or low appears, my partner and I pull up the stock to see if it has the kind of pattern that warrants a buy or sell signal. Typically, we're breakout traders. Ninety-five percent of all my trades are buys at new highs or sells at new lows to initiate the position.

Q: Do you usually trade for a single day or a couple of days?

DAVID: Our primary exit method, which applies to the majority of our trades, uses a trailing stop somewhere between 3/4 point and 1 1/4 point for a big-cap stock. Internet stocks are more volatile. For them, we'll use a 3-, 4-, or 5-point trailing stop loss, depending on the spread and market volatility.

Q: How did you arrive at this day trading method?

DAVID: It evolved as a result of observing the market action indicated in intraday charts; for example, analyzing in a five-day period what are the deepest retracements after a breakout. Let's say a stock has an average range of 3 1/2 points with an average pullback of 3/4 to 1 point. We looked at those kind of stocks and tried to buy them on a retracement after a new high and, over time, just tried to buy as many of those patterns as we could. Of course, we also would cull out the losers as they broke down beyond our defined parameters.

Q: How do you handle the winners?

DAVID: As I said, we hold them until they pull back at least 1 point after a new high. It may take one, two, or three days for that to happen.

Q: Do you find that's also true for the short side of the market after you've taken a sell signal?
DAVID: No. The short moves have been quicker, so you don’t really stay in them as long. We probably are in as many as 150 names at a time. But we’re also turning our portfolio over three or four times a day. I mean, some stocks we’re in and out of within an hour.

Q: Because they back off?
DAVID: Right. We buy them and the trend reverses. And then an hour later, it runs up 3 points, and we start the process all over again.

Q: With 150 names, how do you keep track of all your trades?
DAVID: Through our software we’re tracking tickers of all the Nasdaq Level II data of all the stocks that we’re in. Every time we buy or sell a stock to initiate a position, it puts it in a ticker so we see all Level I and Level II data on that stock. Also, I have an assistant who only tracks new highs and new lows.

Q: Do you put an actual stop in the market or just wait for the dollar pullback?
DAVID: We wait for the dollar pullback, because you can’t put a physical sell stop in the market for a Nasdaq stock. Most days we don’t trade any New York stock, just because we don’t get the same level of information. It’s harder to get a feel for New York over the DOT system, so in general we focus on the Nasdaq.

Q: What unique considerations do you feel distinguish day trading from a longer-term approach?
DAVID: Typically, I think you can better calculate and control your risk. I believe the risk-reward ratio is better in day trading. I mean, looking at all the traders around us, an average gaining day seems much better than the buy-and-hold, risk-adjusted approach.

Many of the trades we make just wouldn’t make sense for a longer term. We’re looking for much shorter-term moves where we think we can observe momentum building. It’s just the unique aspect of the Level II trade of the market makers. In general, it’s more the market maker’s impetus for doing a lot of trades rather than the chart pattern or earnings expectations of a particular stock.

Q: On what time frame charts do you generally concentrate?
DAVID: Normally, I look at two charts; that is, every time I pull up a stock it automatically pulls up two charts. One of them is the past 150 days, daily candlestick, high, low, open, close for the day. Also, I look at the same high, low, open, close data for the previous two days on a two-minute interval—that is, two days’ worth of tick data on a two-minute candlestick chart. And that helps me get a sense of where the shorter-term support and resistance come in.

Q: How do you manage the risk overall?
DAVID: We’re very disciplined and diligent about that. The way we control risk is as follows: No matter what we think about a stock, if the pattern is violated (by definition, any stock that’s 2 points off the high), we punch a button and whack the bid and get out of the stock! I mean, the one thing we don’t hesitate to do is get out of losers. For us there’s no pain associated with selling a stock that’s down. I see a lot of day traders or traders, especially when they start, think that if they’re losing money in a stock they need to make it back in the same stock. They buy the stock; it’s down a point from when they bought it, and they’ve got a resistance to sell it out! They go into a “hope” mode. And I think that’s when risk really starts to creep in.

In day trading or trading in general, you really need to have a disciplined strategy where risks are not greater than rewards. The
risk-reward ratio must make sense. The first thing too many traders want to do is ring the cash register. They buy a stock, it goes up ½ point, then it down ticks. They might be in three stocks. They want to sell the stock that’s up ½ point instead of the stock that’s down ½ point. I don’t know why . . . I mean, I do know. There’s ego involved. They say to themselves, “Gosh, I bought a stock and it didn’t work out!” They go into denial.

I’m a strong believer that making money comes from staying with the momentum. I have no problem selling stocks that have moved against me surrounded by stocks that are experiencing buying pressure.

**Q:** As you have said, David, many traders have difficulty doing that. Is that correct?

**DAVID:** Yes. A lot of traders experience a sort of psychological handicap. I mean, as they go through the normal learning curve, at first it’s hard to read the market. They make mistakes; they push the wrong button. They do things that just don’t make sense. But what is ultimately the most costly to their performance is frustration.

One of the first things new traders do is to get contractive—that is, to quickly take winners. If you don’t do anything else that is different than learn to hold onto winners, I believe it will radically change your risk-reward profile. It distinguishes traders who barely make a living from the big traders. I’ve been a full-time electronic day trader since January 1993. For the first three and a half years, I was a pure scalper. If I saw a stock moving up, I would buy it, and the average trade was probably 45 to 90 seconds long. As soon as I bought it for ½, I was trying to sell it for ¾.

**Q:** Was that successful?

**DAVID:** Yes, but I decided to change in 1996. A friend of mine came over in early 1996, and I saw him trade with expanded parameters and catch much greater market moves. He also would make the market prove him wrong. He would have 4-, 5-, 9-point winners at the same quantity of trades I was doing. Finally it dawned on me that I had to change my mind-set. The riskiest thing about trading is not being in the market when it’s going your way. Missing the upside is a whole lot more expensive over time than being in a little bit too long. I don’t know if that has any meaning to you. It has dramatically transformed my profitability in the market. From making $500,000 to $800,000 a year to making over $4 million in 1998, and $1.8 million just last month. Basically, what has happened is that I’ve gained more confidence to make bigger bets and be in the market when it starts going my way. Also, I try to distill and analyze what’s really different about what I’m doing versus the other trades I see around me. The risk of being out of the market when you must be in!

**Q:** David, what has been your most successful trade?

**DAVID:** That’s a tough question considering how many stocks we trade. We’re probably trading an average of 1,200 or 1,300 shares at a time. Sometimes I’ll trade 5,000 shares of bigger, more liquid stocks. To answer your question: When the Internet stocks rolled over a couple of weeks ago, we sold Yahoo and Amazon and Excite short—just as they broke a big up trend line. We sold the stock and made 80 points in about four hours. They all went into a free fall after that. The point is: You have to be able to enter a trade and maintain your risk profile and have it work as well as that. That is what makes all the difference.

**Q:** And you were able to maintain your risk profile?

**DAVID:** Yes, we didn’t have to take unusual risks to achieve that kind of performance.

**Q:** It was a one-way move, a no-brainer!
DAVID: Right. And the only way to screw it up is to get out too early. You also really have to focus on maintaining the right psychological state to trade in. The best defense is a good offense! I see a lot of traders burn out. They're always trading highly volatile stocks that jerk them in and jerk them out. You know, we trade for a living; we've got to be here five days a week. So, there's a real advantage to pacing yourself psychologically. If you get in positions where you're sitting on the edge of your seat too much, you'll go into a hope mode. Eventually, you'll burn out and avoid trading. You'll enter fewer positions and start inventing reasons not to trade. A lot of our decisions are made as much on that basis: What's the real cost to us in terms of trader brain resources that are taken on a given trade versus how much can I make on this one stock?

Q: Well isn't psychology really the name of the game in short-term trading?

DAVID: It is, and I don't think it's that well defined to the average day trader. But if you sit down and really try to maximize what resources you have, the right psychological approach can greatly enhance your market results. We want to come in and try to take $100,000 a day out of the market. And you know, I'd rather do it with as little volatility as possible, because it's a lot easier to sift through the ups and downs that way. To me it's a lot easier to be in 100 positions and 100 names because I do get some diversification effect. And I get a spread effect, or whatever. And typically, I'm 80 percent and 90 percent on one side of the market. I mean, I'm not really that diversified. I want to do a bunch of different positions that kind of minimizes the negative effect of any one trade.

Q: Isn't your 100 names going to do what the overall market is doing on any particular day?

DAVID: Well, you know, I don't think that the correlation is as high as a lot of people think it is. I mean, with a lot of stocks, there's a significant disparity relative to the composite or Russell 2000. And so there's a lot of room to significantly outperform the averages every day by picking the right 100 stocks versus the 2,000 stocks in the Russell or the composites.

Q: David, how long did it take you to familiarize yourself with the electronic platform?

DAVID: Probably a good two to three months.

Q: So it really was important to spend time and focus on learning the platform?

DAVID: I think you can learn enough just to get started in a couple of days, a week or so in terms of what the buttons do. I'm assuming you know and understand what a bid and an offer are and what the different execution systems are—whether they're SOES or Selectnet or Island and how to interface them. I think you can learn how to punch the buttons in a week. To achieve "video game" reaction time, that is, to reach a professional level of efficiency, takes a couple of months.

Q: Now you're not trading for 1/4 or 1/8 or 1/2, but you still feel it's necessary to get up to a reflex level of functioning on the platform.

DAVID: Yes, because I'm trying to manage 100 names at a time. You know, I'm doing 1,000 trades a day and probably buying or selling stock every 15 seconds on an average day. So, any enhanced efficiencies in terms of proficiency in monitoring and executing new positions pays real dividends.

Q: How has electronic trading changed your perception of the overall market?

DAVID: Differently at different times. More recently, probably in the past year and a half with the popularity of the ECNs, there are more public customers in the market as a percentage of trades. I've found the added liquidity has dampened some of the volatility in some of the moves—maybe 1/4, maybe not as
much. But certainly you don’t have quite the swing when you have all these day traders. The whole mass psychology effect of trading, fear, and greed kind of tempers movement. I favor taking a little longer-term perspective, meaning longer than just the next ⅛ or ¼. You know, the stock goes up, and all of the people that bought it here are now offering it at the top. Then as soon as they get taken out, it goes up to the next level, they buy the stock at 115, and everybody is offering 115¾. You see all the 115¾ prints get taken. The next group of day traders are buying it from the other day traders who want to make ⅛, and it kind of stair-steps up and up. If it were just up to the Goldman Sachs and the First Bostons only representing the bids and the offers, they would be a little better at disguising what’s going on. They’re not nearly as transparent. And so I think it has been easier to read the market by watching the order flow of the ECNs and the day traders.

Q: David, you alluded to the idea that you’re looking for particular patterns. Do you think that increased participation helps achieve the patterns that you’re looking for?

DAVID: I think it does filter some of the “noise” out of the pattern where Goldman is a particularly effective market maker and he’s got 300,000 to buy. For a period of time he can make it look like the stock is going down if other ECNs and participants weren’t visible to the whole market, showing that there really are buyers out there. It’s harder for the market makers to really disguise their intentions with all the new public customers in the market.

Q: Well, in the end I think it’s probably is a good thing.

DAVID: I think it dampens volatility. And if it dampens volatility, that’s good for investors and a fair price is represented more of the time than not, rather than just six market makers deciding what price they want to post at any one given time.

Q: What would be your advice to an aspiring digital day trader?

DAVID: I think the first thing is to assess why he or she wants to become a day trader. Honestly enjoying the process of trading or the “video game” skills required or the information-gathering process, rather than just viewing it as an easier way of making money, is an essential first step. Then, once the trader decides trading is consistent with his or her personality, he or she will need to commit for six and a half hours a day and think of it like graduate school. There’s a cost to learning digital day trading, and you’re going to lose money for three to six months, depending on the market conditions and how quickly you can learn the right psychological attitudes about taking losses and holding winners.

Once the trader accepts the analogy of going to graduate school, then he or she will have a great job after graduating. But don’t expect to make any money, and you’re going to have to pay the tuition! You must also learn how to calculate and manage risk. To know trading is not the same as rolling dice.

You need to have a plan and understand the risk reward of every strategy, tactic, and trade. Once you do start day trading, you will be using real money, trading 100 shares at a time to test market ideas. In my opinion, your only risk in the first three to six months of trading is running out of capital. And so, being out of the business is a big risk. Really, you need to understand that it may cost $20,000 or $30,000 to learn how to trade. Of course, nobody wants to lose that kind of money, but when you do, you must know it’s not going to be the end of the world. Be fully prepared, psychologically strong, and knowledgeable about both the risks and rewards of day trading.
Stuart Shalowitz is a professional day trader of stocks residing in Chicago.

Q: What first attracted you to electronic day trading?

STUART: I was introduced to day trading by a friend of mine from college. Basically, he told me that trading this way was the wave of the future. This was in early 1995. What attracted me was—and bear in mind I was no great floor trader and didn't have a lot of capital—just the sense that the future was going electronic, that people would be trading in cyberspace. Also, I knew a couple of traders who were making a very nice living day trading.

Q: Could you describe what specific actions you take on a daily basis to prepare for your trading?

STUART: I try to get in at least 45 minutes to one hour before the market opens. I have a daily routine: I read through investors
Business Daily, The Wall Street Journal, the research that Cornerstone compiles, and various news reports. I also check out earnings and which stocks are hot. I'm also aware of where the market is opening and current futures prices to get a sense of the general market. I don't come in with a lot of set plays or preconceived notions of what the market is going to do, but I do want to know where the market is trading and what sectors are going to be hot. Also, I look at my account and make sure all my positions are in order. In truth, I really don't do any deep analytical stuff in terms of trading stocks.

Q: How would you contrast electronic trading with conventional trading?

STUART: The main difference with day trading electronically is the personal interaction with the market. You control your own orders, prices, volume, timing, and overall market action. There's so much creativity involved today in trading the Nasdaq, for instance. With my software, if I want to buy a stock, there are at least ten different ways I can enter the trade. You're not waiting for a broker, you're directly interacting with the market. With a Nasdaq stock, there is no floor or trading exchange; everything is cyberspace. And physical location is unimportant. You may have a market maker in a particular stock in Los Angeles who works for a firm out of New York. So to sum up, the big difference is the trader's direct interface with the market and the speed and control of execution. You know, the speed and power of the electronic trading platform are just mind boggling!

Q: You said a moment ago that you had different options for buying and selling stocks electronically, could you be more specific?

STUART: In terms of the Nasdaq system, you can buy a stock through the Small Order Execution System, or SOES, from a market maker only. That can be PaineWebber, Merrill-Lynch, Morgan- Stanley, etc. If I don't want to use SOES, I can also go through any one of the eight ECNs (electronic communications networks).

Q: Which do you prefer?

STUART: In terms of day trading, Island, in my opinion, is probably the fastest and most widely used; however, I personally prefer SOES. It's not only more cost effective (only 50 cents per transaction rather than 1½ cents per share) but also entails trading with a market maker.

If the market is not really moving, I will invariably go SOES because it's cheaper. It saves me $14.50 (on 1,000 shares). Also, I know that if I hit a market maker, I can see what someone like PaineWebber did—refresh a bid or an offer, meaning replace the shares I bought or sold, or better yet, drop down a level. In other words, if I bought them at 3/4, did PaineWebber go to 3/8 or 1/2? Did they flip over the bid? I want to know! Did I move them out of the way? Now, after they take that initial hit, they can refresh their bid to 100 or put up 2,000, whatever they want. It's all part of the game. They might have 20,000 to sell and just do 1,000 at a time. But, none of that bothers me; it's just additional information.

Q: Eventually, the market is going to do what it's going to do!

STUART: Yes, and I'm a firm believer in that. Although lately, the proliferation of day trading on the Nasdaq, I believe, has artificially run up stocks—in other words, increased the volatility.

Q: Run up stocks? Are you referring to the Internet stocks or the market in general?

STUART: Both. At times you will see stocks certainly rip up. And the sole reason is there is a finite number of people selling and a greater number of people buying, which sets up near-term volatility and allows for a good short-term sale.
Q: What specific stocks do you trade, and how do you arrive at the mix?

STUART: I tend to trade a lot of mid-cap Nasdaq stocks. I understand them and feel I know the way they move a little bit more. I don't trade the Dow or what people call the dirty dozen (Microsoft, Intel, Cisco, etc.) for a couple of reasons. I believe they are overly populated with traders and volume. I mean, they trade the 16th spread; that is to say, they tend to be very tightly traded stocks. Probably more importantly, the market makers in those stocks are some of the best market makers around. It can be Goldman Sachs or some other pro—they're very good.

Q: And they have a lot of capital.

STUART: Unbelievable amounts of capital. They put on big positions. They're just very good traders, and they know how to work the stocks. Now if I'm going to sit and trade all day, I'd much rather trade against a younger guy who is a little wet behind the ears, just out of school, maybe trading some of the mid-cap stocks. He or she is a market maker whose system isn't as good as mine. And I feel I can work some of the mid-cap stocks and get in and out easily.

Q: What are the specific techniques that you work with and have found reliable over time?

STUART: I use a couple of different techniques. I'll trade off basic momentum, the direction in which the market is moving, focusing on the particular sectors that are moving and using a combination of technical indicators. I try to keep my approach pretty simple. The more simple, the better the result. I don't think stock trading is rocket science. I've done many more complicated things that frankly didn't work, which is to say that the trading part is not the most difficult thing. The simplicity is great because it allows me to focus on money management and psychology. So in general, if a stock is going up and I feel there's a lot of buying pressure coming in or it's bottoming out, I will buy it. I watch the moving averages. I look at 20 and 50 days. In a strong market, you see everything hugging a 20-day moving average, finding support there. In a weaker market, I'll use a 50-day. So, it depends on the market.

Q: Specifically, how do you use the moving averages?

STUART: I'll buy the stock when it starts to spike up off the average. It might go sideways, it might come down and start to find support there. I'm not too big on catching falling knives, but when the market was beat up late last year, there were some stocks I did buy because I knew they were good companies. Stocks that traded literally at $60 or $70 were crushed to $5 and $6. Little stocks that are good companies. I didn't analyze PE ratios or dividends, just stocks that I felt had come back when the market turned.

Q: Do you use a tick chart?

STUART: Yes. I keep two candlestick charts on my machine. I have a daily chart that goes back from 135 to 150 days with the moving averages so I can track where the stock has been. I also use an intraday three-minute candlestick bar chart. I trade more off momentum than anything else.

Q: What do you mean by momentum?

STUART: I perceive the stock is bottoming and ticks up or simply observe that the market makers are piling on the bid. Really, it could be that simple!

Q: Piling on?

STUART: Maybe they're all starting to bid 30% and I feel the stock is going up. I'll take a shot and buy it.

Q: And the advantage you have, again, is seeing the bids and the offers and how deep they go.

STUART: Exactly. You see the depth for the bid and the offer. As far as I'm concerned, buying the stock, that is, initiating the
trade, is not the hard part. Anyone can tell you to buy Microsoft. It's the person who knows when to sell Microsoft, when to get out, that's the real test. So many times I can buy a stock thinking I'm only risking $5. Or sometimes I'll buy stocks knowing I'll let the stock fold 50% against me or more. It just depends on the market and if I have profit in it. It sounds silly, but you know, that's the way it is! People ask me how much I let a stock go against me. The real answer is, it depends. It depends on the stock, it depends on the day, it depends on how much money I'm up or down in that stock. I'm never going to get it exactly perfect. A slew of things are constantly going through my head. Managing risk becomes a dynamic thing. It's not set in stone. Really, I think money management and risk management are the most important considerations for trading.

**Q:** When you're trading your entire portfolio of stocks, do you always know exactly how the entire portfolio is performing?

**STUART:** Not exactly. I pretty much micro-analyze each trade. For example, I have certain stocks I won't let go against me even ½ point, because I know if I'm wrong, I'm going to be really wrong and I don't want to deal with that! Whereas with other stocks, I'll give more of a back and fill.

**Q:** But your cardinal rule is, Never take a large loss?

**STUART:** Without doubt, always take small losses! I have a few little rules. I mean, I definitely try to be consistent and disciplined. If you're going to have small winners, you can't have big losers. You can make money having small winners. There are traders who do this every day and pound out a great deal of profit from the market. The key is that they manage their money. I mean, it's simple: If you have more winners than losers and your winners are bigger than your losers, you always will make money. I mean, you have to! That's just the way it is. We try to teach newer traders how to make a little money in order to help them mold a profitable style. For most people who day trade and want to go home flat, the goal is simply to leave the office with more money than they came with every single day. But again, money management and risk control are essential. Everyone is different. No two people have the same risk tolerance.

**Q:** How long did it take to familiarize yourself with the electronic platform?

**STUART:** The software keeps changing all the time. It can take people anywhere from a few days to weeks or even a month. The main thing to keep in mind is how powerful a tool this is. If you lift your finger off a button or incorrectly click a mouse, you're buying a lot of stock. And if you do that with a Microsoft or a Dow, you might never want to make that big a purchase in your life! So to answer your question, most of the software is user friendly but it's extremely powerful. In terms of time, depending on the person, from a few days to a few weeks. As you know, many firms have training programs or classes that teach the software.

**Q:** What advice do you have for an aspiring electronic day trader?

**STUART:** The first is that you want to look around. Find a firm where you feel comfortable, that is going to help you become a profitable trader. Second, understand this is definitely not a game. I mean, people come in and see the screens and the colors, and it looks exciting, but it is extremely competitive and highly intense. This is trading! There's a lot of money flying back and forth and you want to have good discipline and money management skills, as well as strong support from a firm that will help you progress as a trader. You can be successful, but it takes a lot of hard work.
Andy Kershner is a professional day trader of stocks and a principal of Cornerstone Securities.

Q: What first attracted you to electronic day trading?

ANDY: A friend of mine figured out how to pick stocks; that is, he thought he could predict which ones were going to go up based on technical analysis. We put our money together, all of $5,000, and started trading options. As it turned out, a lot of our ideas were right, but the executions were poor, so we naturally gravitated toward electronic day trading. Electronic day trading allowed for better fills and information than we were receiving.

Q: When was this?

ANDY: The spring of 1994. For me, it started getting pretty heavy duty in July of 1995. Before that I did an average of only a couple trades a day. My trading was more long-term position trading.
Q: And then you made it more short term?

ANDY: Yes, because someone funded me, that is, funded a $100,000 account for me. From there, I started trading on a much grander scale and really turned it into more of a day trading deal. On a daily basis I would buy and if they went up, hold them. If they went against me, I'd get out. It was a very simple mechanical system back then, and it suited my personality.

Q: Can you describe what specific actions you take on a daily basis now to prepare for your trading?

ANDY: I go through all the volume numbers, look at Investors Business Daily or the Internet to find out which stocks have volume. I'll take a look at the charts and set them up in special tickers, so I'll be ready to jump on them if they make a move. I guess I would say the main thing I do is identify good trades by running volume filters on a selected group of stock charts.

Q: What timeframe charts do you use?

ANDY: I'll start off with a 120-day chart, then use a daily chart, and I'll have a two- or three-day intraday chart as well, based on a one-minute variable. In addition, I really do a rigorous analysis of the previous day.

I've found that if you analyze your trade sheet every day, writing down what you did well or poorly on every trade helps immeasurably. Personally, when I get away from that, I usually get into trouble. So that's one thing that I would encourage everyone to do: Keep a log when possible of your reactions to all your trades.

Q: How would you contrast electronic trading with conventional trading?

ANDY: For one thing, you get much better fills. You also have more control over your trading. When you call a broker, you've got to wait. Today I can buy 10,000 shares of a stock before I can dial the number for a broker. So if you're going to trade on a short-term basis rather than invest on a long-term basis, I think it only makes sense to be hooked up to an electronic terminal. It's just cost effective. You don't have to pay brokers or agency fees. You're not constantly paying up for the spread.

Q: In your opinion, for most traders to trade professionally, do you think it's necessary to trade from a brokerage office like the one in Austin that you're in or does it make more sense to trade right from your own PC?

ANDY: I think that eventually bandwidth won't be a problem, and when that happens people will be able to trade with a professional market maker's efficiency from their own PC. The reality is that today, oftentimes, the electronic software is not as user-friendly as it could be, because there are so many things to integrate in your trading.

If you are really trading as a profession, I think it helps to be around other traders who can provide an important synergy. You get to see and hear what other professionals are doing, assuming they are accomplished traders. You don't want to go where other people are blowing themselves up, which happens far too often with trading.

I think a lot of positives have been added to my performance by sitting around other professionals, calling out trades and talking about various market entries and exits. It gives you a better feel for the market. And sometimes, you see that added opportunity you wouldn't have seen on your own. That alone makes it well worthwhile.

Q: What specific stocks do you trade, and how do you arrive at your portfolio mix?

ANDY: I've got 450 stocks on my screen. I can't watch the ticker very much anymore with all the ECNs and the small price changes, as you can imagine. That used to be my strength. In the past, I was able to read the ticker, and I could remember all the prices on the old Nasdaq workstations, one and twos. But
now it goes too fast, so I've changed my style a bit. Today, I just
add stocks that look good and have volume. On a given day, I'll
do 500 or 600 roundtrips, usually for about 1,000 shares apiece.
I'll do a healthy mix of New Yorks as well as Nasdaqs. I should
add, though, for the New Yorks the price discovery is poor.

Q: There's a different standard for the New York than for
Nasdaq?

ANDY: Yes, there's the specialist system. I won't say they're
out to screw you, but they certainly aren't showing the order
flow.

Q: What kind of criteria have you used to create the 450-
stock mix in your trading portfolio?

ANDY: Basically, it's the same thing that I was talking about
earlier. Simply identify stocks that are coming into new high
territory that have big volume. There are stocks that are coming
out of IPOs, or whatever, that start in the 15s and go up into the
100s.

Q: By 15s, you mean price?

ANDY: Yes, 15s in price. And just as they're coming on,
they're the ones with the most volatility and volume. Ultimately,
they are the ones I end up trading.

Q: What about household names like Microsoft, Cisco, and
the other Internet stocks?

ANDY: All those guys too.

Q: What specific techniques do you use?

ANDY: In general, I truly believe that you can pretty much
buy new highs and sell new lows and end up all right at the
end of the month, if you have good risk control and move
quickly out of losers. It's not going to work every day, but most
of the time it will, if you weed out the losers and hold onto the
winners, or even add to the winners.

Q: What kind of risk are you taking when you go into a po-
osition at a new high?

ANDY: Well, that's what changes every three to six months!
When I first started day trading, there were quarter stocks and
eighth stocks on the Nasdaq. You had your Intels and Cascades
and stocks like that trading for quarters and eighths. At the
time, I would buy a stock that was, let's say, in the 80s. I'd call
that a quarter stock; it was usually spread by quarters. If I
bought Microsoft at 80, then a quarter stock, I would be willing
to risk a ¾-point stop loss from my initial entry point if it then
went against me. Now if it went in my direction for a while, I
would use a 1-point trailing stop. For instance, if it got to 82½,
I would sell it out at 81½. That is just the kind of mechanical
process that I was speaking of earlier.

Now for an eighth stock, I'd give it ½ point against me. I'd
take a ¾ loss immediately if I was wrong. But when I was right,
I'd give it only ½ point and go on from there. But now, of
course, the spreads have been wider. And with liquidity and
market makers wiggling the market, you've got to expand your
parameters.

Q: How often do you find that market makers wiggle you
out, and then you experience the market run for 3 or 4 points
in your initial direction?

ANDY: Actually, it happens quite a bit. So you've got to get
back in. Really, you can't blame it on the market makers; it's
their job to make money.

Q: Of course, I certainly didn't want to imply that they were
doing anything wrong.

ANDY: You know, price goes against you and you get out.
Then it comes back up. So what's new? That's pretty much
what happens. And really, now it seems like the market makers
don't have as much effect on the market as they did because of
all the ECNs.
Q: Would you say that with the 450 names you now trade you’ve probably had to widen the risk a bit for some stocks but not for others?

ANDY: That’s pretty much the case. For Yahoo, for instance, I’ll give it 5 points. Initially, if you get in right or wrong, it doesn’t matter. You just need to let it have 5 points to see if you’re in the right direction.

Q: And what gets you out? If the market keeps moving your way, you won’t take profits until it reverses the 5 points, right?

ANDY: That’s right—not until it breaks through the wiggle area, for the most part. I try to just hold on to them. I’ll give up the fat on the back end in order to stay with the main part of the move. Sometimes, I end up being in certain stocks for days at a time.

Q: Because they don’t reverse?

ANDY: Yes. The pros tell you that there’s nothing like a big bull or bear move that lasts for three or four days. It can be pretty profitable.

Q: And you can go three or four days without a stock reversing more than a point?

ANDY: It’s hard to do that. But, in general, I’m giving up more than a point today, except for the smaller stocks.

Q: So your parameters keep widening out?

ANDY: Today, there’s a lot more market feel involved because the volatility is so much greater. And it’s hard to see the full depth of the market. The actual spread is much wider, so you’ve got to expand with it.

Q: What unique considerations do you feel distinguish day trading from a longer-term approach?

ANDY: That’s a good question. I think it depends on what you’re comfortable with, and certainly for me day trading is great. If you’re a professional, I think you must watch the market all the time. Doing otherwise can be hazardous.

Q: If you’re trading 500 times a day, that’s got to be a lot of turns per hour.

ANDY: Yes. I mean, I’m moving in and out all the time, preferring market makers. I’ll get into 10,000 Dells and 7,000 or 8,000 Cisco, and 3,000 or 4,000 Yahoo. I am probably in 150 to 200 names during the course of the day. I’m just getting in and getting out.

Q: Taking losses, taking profits?

ANDY: Pretty much.

Q: It’s a busy day.

ANDY: Yes, it’s very busy. Crazy, but it’s good if you can manage the risk.

Q: We’ve talked about risk on the micro level. In a macro sense, how do you handle risk?

ANDY: In general, I will not take on any positions that are going against me. Anything that has posted a loss I do not take home. Other than that, I really don’t think I have a whole lot of macro risk. I guess if I were long when a nuclear war hit and the market was cut in half overnight, I could be wiped out. But you know the real reason is that I don’t do anything to manage that specific type of risk.

Q: But you go home long or short 100 names, right?

ANDY: Yes, and the diversification helps too. Look, if you play the numbers, over time you’ll be right. If the market is going up and the stock is closing at its high, there’s a good chance it also will go up the next day. Of course, sometimes you come in and it gaps open against you. I’ve come in and had, you know, 300 points erased in a hurry. But I’ve also had
it go the other way or come in short a bunch of stocks, make a couple of hundred points, then flip it and go long.

**Q:** Can you talk about how long it took you to familiarize yourself with the electronic platform?

**ANDY:** It really didn’t take that long when I got started. But that was early in the game when the software was pretty simple. Now it’s much more complicated. There’s a lot more activity to adjust to and a lot more buttons to push in order to get things that you want done. Before there were no ECNs, whereas today there is an enormous amount of information you have to learn to deal with to trade effectively. On TradeCast, for instance, there are probably 35 or 40 different functions you can use on function keys. Remember, all I really want to do is buy or sell at the market. I don’t want to have to try to figure out all the different functions. But currently, there’s not a lot of smart logic in the keys. I think that will come around pretty shortly. I just want to keep it simple.

**Q:** On average, how long does it take to learn the electronic trading platform?

**ANDY:** Everybody that comes in our firm goes through a small training class. We start them off trading 100 shares, and they’ll train for weeks. Of course, you’re the worst trader you’ll ever be when you first get started, so you want to trade the smallest amount at that point.

**Q:** A legendary trader used to say when he was asked what he does for a living: “I take losses.” That was part of a successful trader’s job description. It’s tough for people to understand that. What has been your most successful trade?

**ANDY:** I’m not exactly sure what my biggest trade has been, but I’ve made a couple hundred points in a trade before. Generally, my worst days will be about a third of my biggest days. And the same thing goes for my trades. My worst trade ever was a 60- or 70-point loser. I think I made a couple hundred points in size once; I was short 20,000 shares. I made 10 or 15 points in it. I’ve also been stuck in 35,000 shares ripping against me for a couple of points once. I experiment a little bit and then find out my heart really can’t take it. It’s just too much size.

**Q:** How has electronic trading changed your perception of the overall market?

**ANDY:** In truth, I can’t say that I knew anything of the overall market before I started. So I can’t say that it has changed my perspective. It’s really the only perspective I’ve ever known.

**Q:** What would be your advice to an aspiring day trader?

**ANDY:** I would find the most successful trader you can possibly find and see if you can convince him or her to teach you.

**Q:** Is that what happens in your trading room?

**ANDY:** In general, but not completely like that. I do think that success breeds success. And you’re going to save yourself a lot of agony if you can find someone that’s really good and have them keep you out of troubled waters. I think that it’s certainly worth getting some sort of apprenticeship or internship.

**Q:** You mean have a mentor?

**ANDY:** Exactly. It only makes sense. But like I said before, success breeds success!

The following charts reveal short-term tick and candlestick price data as described in the trader interviews. Specific chart formations, both buy and sell signals, will be identified and discussed in detail in Part Three, “Technical Analysis and Day Trading.”
PART THREE

Technical Analysis and Day Trading
Technical Considerations

"The trading system gives the trader the ability to control his or her emotional states rather than allowing them to control him. A system is a disciplined method for organizing dynamic, ever-changing market phenomena."
— Robert Koppe1 and Howard Abell, The Innergame of Trading

The stock market is a huge marketplace with well over 9,000 individual stocks from which to choose. In the following sections I present many ideas, patterns, setups, and approaches to day trading stocks. However, the beginning of a successful outcome, in my opinion, is the portfolio of stocks that you choose to focus your efforts on.

Stock Selection Criteria

The following should be your basic stock selection criteria:

- Liquidity
- Volatility
- Sponsorship
• Information
• Price level

**Liquidity.** Position traders have the luxury of slowly accumulating a favored stock even if the daily volume and participation are light. Short-term day trading requires selecting stocks that have a trading following and therefore usually have depth in bids and offers throughout the day. It can be quite frustrating to have bought a thinly traded stock just right but see the potential profit disappear because there are no immediate bids to take you out of the market.

**Volatility.** Successful day trading requires movement. Selecting your favorite long-term stock as a trading vehicle isn’t the answer. A good stock for trading is a stock that moves in a wide daily range most of the time. This doesn’t mean you have to restrict yourself to high-priced flyers or the stock in the news of the day. Many stocks at different price levels will provide you a fair opportunity over a day or two for profit. No one should select the stock for you to trade. Part of gaining an edge is being attracted to a stock and focusing on the way it moves. Because one particular stock is not active all the time, selecting one dozen or two dozen stocks to watch should provide you with frequent opportunity.

**Sponsorship.** Your portfolio selection should be fluid. Stocks move in and out of favor continuously. Focusing on some obscure company that you know will wake up some day is, in my opinion, a waste of time. Dull stocks that have little movement or no financial industry sponsorship are a lost opportunity and a waste of your trading resources.

**Information.** Stocks that move and have sponsorship usually are in the news or are widely talked about. Analyst research, rumor, merger, or a “story” creates information that helps in making many trading decisions.

**Price level.** Many traders select stocks on the basis of price. This is the wrong approach because the day trader is interested in movement. Yes, it’s true that a $20 stock that moves a point or so has a larger percentage move than does a $50 stock moving a point or so. However, the probability of the $20 stock giving you the move you need in the short term is so small that you should look elsewhere. If the size of your trading capital is not sufficient to trade 1,000 shares of a $50 or $100 stock, then trade 100 shares or even 50 shares to maintain a trader’s edge.

In the following sections I concentrate on concepts associated with day trading. Until recently, only two approaches allowed participation in the stock market. For most people in or out of the financial community, investing for the long term was the accepted method. Short-term trading or market making was the sole province of industry insiders, who were able to maintain an edge by making access to the market very difficult.

Even though, as described previously, the public now has equal access to the markets, I believe the best opportunity for trading success lies in the day swing trade. For most people, the intense concentration and discipline required to scalp for 3/8, 1/4, or 1/2 point are difficult at best to master. The competition from insiders, who have engaged in scalping for years, and even from newcomers is formidable.

There is, however, a trading niche that makes more sense. In between the scalper or market maker and the large players who enter the market for longer time frames is the day trader. Market makers supply liquidity by scalping the spread between high bids and low offers, and longer-term players put on positions for weeks or months.

The opportunities lie in the movement of stocks over a full day or even two or three days. These moves are difficult for the
Large investors because large investors can't move in and out without affecting their own position. In fact, the pattern, ideas, and setups discussed here are the result of the interplay between the market maker and the long-term trader. The natural ebb and flow of price movement that we witness day in, day out offer us our greatest opportunities. Although not technical analysis in the classic sense, what follows are patterns and setups designed to put you into a low-risk trade and get you out of that trade in a short period of time.

All of the trading patterns discussed below fall into one of the following three categories:

1. Breakout trades
2. Retracement trades
3. Tests

**Breakout trades.** Breakout trades occur after a period of consolidation (Figure 8.1) or after setups such as an inside day (Figure 8.2) or after a constricted-range day (Figure 8.3). Entry in the breakout trade is usually not as advantageous as in other categories but entering the market in what appears to be a strong directional bias can make up for that.

**Retracement trades.** Retracements occur in the context of a trend. Buying on a pullback in an uptrend by using a percentage retracement such as 50 percent (Figure 8.4), a moving average, or a trendline (Figure 8.5) helps define the risk.

**Tests.** The market is constantly testing previous price levels: two-day lows or double bottoms and tops (Figure 8.6). Here again is a low-risk opportunity to enter the market.

Each of these types of patterns and setups occurs in time frames from 5 minutes to weekly. My personal preference is a
daily time frame for most stocks and a 30-minute time frame for some of the more volatile stocks.

Short-term trading telescopes all market movement and behavior into a self-imposed time requirement that enlarges and distorts the impact of the market on the trader's emotional state of mind. Therefore, day trade swing trading demands organization of thought, discipline of action, and commitment to allow numerous trading decisions to be made in the face of suffering repeated losses.

Jerry Jones, the flamboyant owner of the Dallas Cowboys football team, made his fortune in oil and gas. In answer to a question about his successful style, he recounted his early days of wildcatting: "When that telephone rings at two in the morning, you never know if the news is a strike or a dry hole that just cost you a million dollars. More often than not the news of a dry hole is followed by another phone call requiring you to commit to another project whose outcome you won't know for many months. It takes tenacity and a belief in yourself to move on." Successful traders resonate with this advice; would-be successful traders must learn its lesson!

All successful traders have tenacity and a belief in themselves. Although their methods or systems differ, their approach and state of mind are remarkably similar.

The necessary technical ingredients for a successful approach to swing trading are the following:

- Trend identification
- Market entry point
- Market exit point
- Money management
Trend Identification

What use, you’re asking, is trend identification in day trading? Can you identify a trend in a day trading system? You bet! Markets exhibit consistent characteristics in uptrends, downtrends, or sideways moves. For example, it’s almost axiomatic that buying lower openings in a bull market is a high probability trade. So, too, is selling higher openings in a bear market.

Trend, however, has many time frames and the day trader can incorporate and capitalize on each one that can be identified. I like to break trend down to three workable areas. The intermediate-term trend, usually three to ten days, is derived from what most traders see as the long-term trend of the market. The short-term trend, which lasts from two to five days, can be in the direction of the intermediate-term trend or a reaction to it. And the daily trend can result from the setup of the previous day or two, of an overnight news event, or of the morning government report.

In my proprietary trading system, we have honed the number of computer-generated numbers to just a few, which we use to identify the various trends in each time frame and which also create support and resistance within those time frames to trade against. I believe strongly in the KISS philosophy of trading: the simpler the better. So now that we have determined our trend in each time frame, we must decide on entry.

Market Entry Point

Without a plan of action—that is, without knowing where the market is in relation to where it has been—the tendency of traders to react to the emotions of the market and get caught up in the crowd increases. In simple terms, this often results in buying the highs and selling the lows, a common, painful experience! In short time frame trading, efficient entry can be the difference between a missed market, a smaller profit, or a larger-than-necessary loss.

By planning several potential entry scenarios that fit into your system, you prepare yourself for opportunities that the market offers. The most difficult thing for most novice traders to do is to buy the market as it comes crashing down to your point, number, or area. Planning and a conviction in your proven method will put you into that market. Buying a hard break or selling a sharp rally to your preplanned point is usually the smallest risk trade you can make. This applies also for buying or selling a breakout. You generally know right away if your buy or sell is a good one and, if it isn’t, whether it has the least dollar risk attached to it.

Personally I try to determine if the market is set up to buy a break, to sell a rally, or, if it’s in a breakout mode, to follow strength or weakness. I then place entry orders in anticipation. This requires patience.

Many times day trading appears like running for a crowded elevator whose doors are just beginning to close. Forget it! Remember there will be another one along in a minute. It’s important to get into the elevator that will arrive at your floor, and that leads us to our trading exit.

Market Exit Point

Steve Connors, an investment adviser and author of the book Confessions of a Hedge Fund Manager, said it best: “I want my stop hit!” He emphasized this point by trailing his stop loss orders on profitable trades so close to the market that it almost
guaranteed he would be stopped out, forcing him to take his money. The same attitude goes for that stop loss order. Nothing is so wasteful to a day trader as a market that wallows in a no-man's-land between a small profit or no profit and a small loss. Pat Arbor, former chairman of the Chicago Board of Trade, tells a story in The Outer Game of Trading (Irwin, 1994) about Everett Clip, one of the senior members of the Board of Trade:

Everett will take a new trader and march him right down to the middle of the bond pit, and he'll say, "Now, watch this." And he'd say, "What's the market?" "Five bid at six sellers," someone says. Everett would say to the new trader, "Watch very closely." He then turns to the guy who gave him the market, "I'll sell you one at five and I'll buy one from you at six." Then he turns back to the young trader and says, "You see what I just did?" The young trader would kind of look, his eyes wide open, and say, "Yeah, you just lost a tick." Everett then says triumphantly, "That's right. Never forget it!" You see, that's how you take a loss, dispassionately, no emotion. If you can learn that, you'll be a successful trader.

You're a day trader. Take that small loss. Move on with your business!

Taking profits, on the other hand, is another matter. A sound approach should include price or some other objective for the market's performance. A reasonable price objective will vary with the volatility and risk of each individual market. For example, many systems created for trading stocks reduce the risk to 3/8 to 5/8 point. Under those circumstances, trying to squeeze 2 points out of the market might be a little greedy. In other words, reward should have some relationship to risk taken. There are other objectives to consider: How quickly does the market move in your favor after you enter? Something can be

said for instant gratification. Also, how does the market perform as it moves toward your price objective? Is it making a new high, then backing off, and then making another new high? Or did it go into a "fast" market condition but fall short of your price objective in the middle of the day? Reacting to these differences can add dollars to any system you are using.

**Money Management**

Many traders confuse risk management with money management. Risk management is what we have talked about above. It is taking small losses and managing the rewards as they relate to the risks taken. Money management refers to the proper use of capital, which includes using it for maximum benefit and preserving it for maximum longevity. It makes as little sense to commit $100,000 to day trading and then trade just 100 shares, for example, as it does to trade 10,000 shares, which is too many. There is a balance to be arrived at through careful consideration of your personal comfort level, risk parameters of each system, and the volatility of the market being traded. Keep in mind that short-term trading is like hitting singles and doubles and stealing bases to win baseball games. You can win a lot of games that way but only if you have a good defense.

Whatever method, approach, or system you create for day trade swing trading, you must resolve several important issues if you are to be successful. The market must be viewed as a vehicle or tool from which your objective is to extract profits. Entering the market on your terms is your edge and reduces risk to the smallest possible level. However, as important as your entry into the market is, taking the money when it's available is a close second in importance. Trying to turn a swing trade into a home run will doom you to failure. Don't mix time frames.
You can't make a trade based on a five-minute chart and validate turning that trade into a position. Your day trading goal is to enter the market with a small risk, take your profit, and move on to the next opportunity. Worrying about what you might be leaving on the table will distort your focus and inhibit you from making good decisions. You'll find more opportunity in the markets from a sound approach or system than you'll be able to take advantage of.

Another issue you must come to terms with is the sheer number of trades you will have to make as part of your process. Believe it or not, this is a real problem for many people. Whether it is the constant decision making or the flow of paper or a stream of losses, many people fold under the weight. And this goes for pit traders as well. A clearing firm in Chicago assists traders on the floor of their exchange by teaching a proven method of scalping in the trading pit. trading for the smallest of increments throughout the trading day. The first thing traders are taught is to "scratch," or buy and sell at the same price, which teaches the traders to enter and exit the market quickly to protect themselves if the market turns. But the most important aspect of this lesson is neither of these.

The real lesson for traders is in forcing them to make trades. Yes, to just make the trades! Even when the cost of a scratch is measured in pennies, many novice traders will spend a full trading day with less than a handful of trades on their trading cards. You have to force them to enter and exit the market many times a day. I'm not suggesting that an off-floor trader should or could trade for very small increments, but the psychological barriers to making the trades are the same as for large increments.

In the following pages I show my approach to swing trading by day. I say approach because I believe that the essential ingredients to a successful trading method is not the system but what the trader brings to that system. By approach I mean the attitudes, emotions, focus, and state of mind that the trader incorporates into whatever system or method he or she uses. My earliest training in trading was in classic chart analysis, and I really believe in keeping it simple. That is why, except for a few computer-generated numbers that define the market's trend and create some support and resistance areas, my primary tool is the simple daily bar chart. Most of what you read here will apply in any time frame.
The following are some personal axioms that are integral to the Digital Day Trading Method:

- Patience is your edge.
- Good day trades result from a high percentage of setups.
- Anticipation of market opportunities is critical.
- Predetermined buy and sell areas must be executed.
- Trade one setup trade per stock per day.
- Ignore the noise and follow the signal.
- Take "fast market," or climax condition, profits.
- Abandon dull or nonperforming stocks.

Patience is your edge. Patience and preparation serve to create an edge that helps build and conserve equity. Knowing what you expect the market to do and waiting patiently for the