

THE BEST MARKETS FOR MICRO-TREND TRADING

Successful micro-trend trading is, in part, a function of volatility. The more volatile the market, the better the trading conditions tend to be for micro-trend trading. This isn't true of all our micro-trend systems, but it is true of the majority of them. In general, I can say that the more volatile the market—that is, the wider the intraday swings between highs and lows—the better candidate that market is for micro-trend trading. For reasons I outlined earlier, the U.S. markets are likely to remain volatile for some time to come. Hence it is essential that those who want to earn income from trading learn to micro-trend trade.

WHEN YOU SEE THE VIX ASCEND

One measure of volatility, as mentioned earlier, is the Volatility Index (VIX) indicator. The VIX measures anticipated near-term market volatility by gauging how much premium traders are willing to pay for “insurance” on their

open long positions. In general, when the VIX is high (>20), the markets are choppy and/or in a downtrend. And when the VIX is low (<20), the markets are quiet and/or in an uptrend. The old adage “When the VIX is high, it’s time to buy” is taken right out of the long-term investor’s bible. And there is certainly truth in this proverb based on historical precedent. But a high VIX is also an excellent time to dust off the micro-trend systems and put on some short-term positions.

The following chart (Figure 2.1) shows the VIX (dotted line) behind a line chart of the Standard & Poor’s 500 Index (S&P 500; solid line). One can see clearly how spikes in the VIX correspond with market selloffs and vice versa.

One thing I like to do is to overlay a 10-period simple moving average of the VIX on a price chart of the S&P

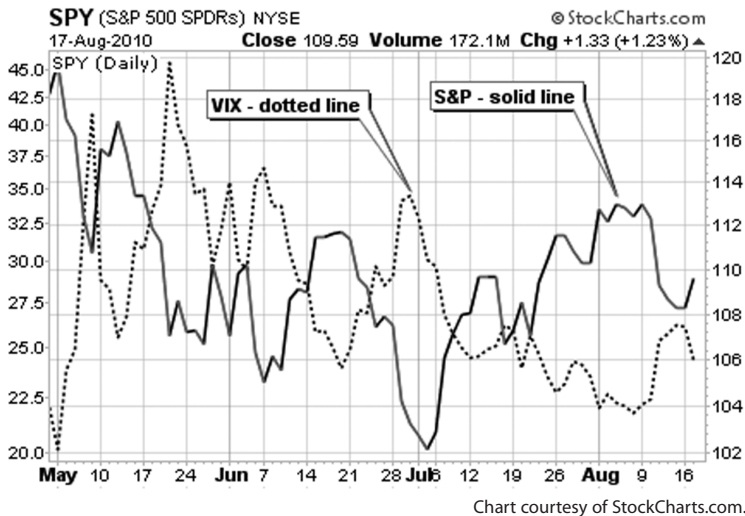


Figure 2.1 The S&P 500 with the VIX overlaid.

and mark the trends and pivots of the VIX. A falling VIX trend signals a market that favors bulls and swing/position traders. Market price action tends to be characterized by low-volume, tight-range trading with quiet uptrend days interspersed with days of modest profit-taking and distribution. A rising VIX, on the other hand, signals a very different kind of market, one that favors bears and micro-trend traders. Here, market price action tends to be characterized by high-volume, violent selloff days interspersed with the occasional strong upthrust of “short-squeeze” relief rallies. Figure 2.2 provides an example of what this looks like. The black arrows on the chart show where bullish and bearish pivot points on the VIX intersect with the S&P. You can see that this simple overlay captures most of the market’s major moves.

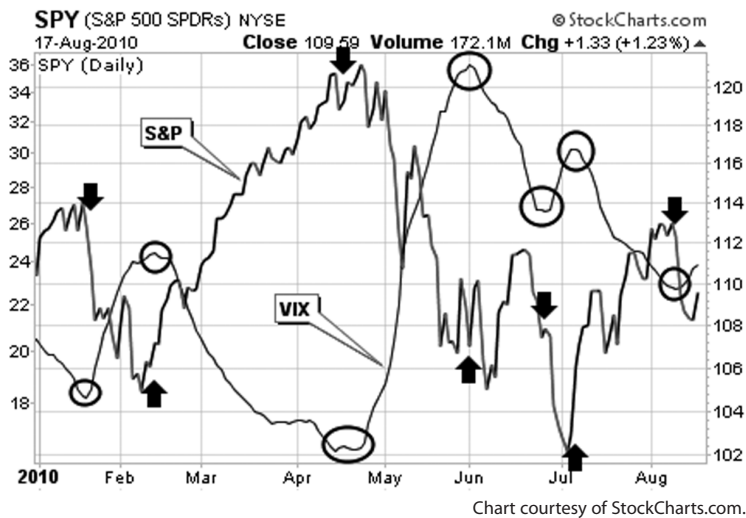


Figure 2.2 VIX trends overlaid on the S&P 500.

While it is ideal to micro-trend trade in a volatile market, one that causes wide intraday swings in price movement both up and down, one still can find excellent micro-trend opportunities in quiet markets. Among the systems taught in this book, there are several that have proven to be profitable in all types of markets. Still, it is important to know whether the general market is trending toward higher or lower volatility. Volatility means uncertainty, which leads to unpredictability. The ability to predict where the market will close next month, next week, or even the next day runs inversely with market volatility. Therefore, the more volatile the market, the shorter one's trading time frame (i.e., the holding time for each position) should be. With that said, I'd like to propose a new VIX proverb: "When you see the VIX ascend, it's time to micro-trend!"

ALL HAIL KING BETA

Generally speaking, the best markets for micro-trend trading come from one of three sources: volatile stocks, leveraged exchange-traded funds (ETFs), and stocks that show up on one of our system scans. This does not mean that one should micro-trend only stocks and ETFs. Those are simply the markets with which I am most familiar and so are presented here as examples. In the end, a chart is a chart is a chart. This is to say, if a market can be charted on an intraday basis and has sufficient liquidity to display consis-

tent intraday price patterns, then it can be micro-trend traded using any of the systems outlined below. Thus, with the exception of my calendar effect system, the micro-trend systems I teach here can be applied to such markets as E-minis, currencies, and other futures contracts. Some readers also may want to know about options. While options normally are not liquid enough to meet my system requirements, they certainly can be used to leverage the stocks and futures that do meet my requirements.

With that said, let's look at how to find the most volatile stocks currently trading. If the VIX is the best marker for the volatility of the general market, *beta* is the best gauge for the volatility of individual stocks. Beta is calculated for individual stocks using regression analysis against the market as a whole, normally with the S&P 500 serving as a proxy. The market (S&P) is assigned a beta of 1.0. If a stock shows a beta of less than 1.0, it is expected to be less volatile going forward than the general market. And if a stock shows a beta of greater than 1.0, it is expected to be more volatile going forward than the general market. Note that I say *expected to be*. Beta signals a forward-looking expectation based on a backward-looking algorithm. Unlike the VIX, beta is based on past price action. Thus it is always possible that a high-beta stock will trade in a quiet, tight range. It is also possible that a low-beta stock will suddenly explode in a flurry of extreme price movement. In general, though, beta gives us a good sense of whether a stock is *going to be* more or less volatile than the market as a whole.

Generally speaking, the best stocks for most of the micro-trend systems described here share three characteristics:

- *They trade in high volume.*
- *They trade at high prices.*
- *They trade at a high beta.*

When you set up a watch list of stocks suitable for micro-trend trading, you therefore must first screen out stocks that are thinly traded, cheap, and not very volatile. To do this, you will need to use a screening tool. Fortunately, there are a couple of free sites online that will allow you to do exactly what you need to do to find the best micro-trend stocks that satisfy my three essential parameters. You will find free screening tools at the following two sites:

- *Yahoo! Finance:* <http://screener.finance.yahoo.com/newscreener.html>
- *Finviz.com:* <http://finviz.com/screener.ashx>

Of these two, Finviz.com is the better choice. While the Yahoo! screener is certainly adequate (use the Java version, not the Basic version), it requires a download to function, and its results cannot be customized. Finviz.com, on the other hand, allows the user to access the screen directly online, to save the screen for future use, to save the results in a watch list, and to customize the viewing of that watch list, which can include seeing

the average true range (ATR), the size of its most recent gap, and thumbnail charts for easy analysis.

The screen parameters themselves are very simple. They are as follows: screen for U.S. stocks that shows

- Beta > 2.0
- Price > \$20
- Average volume > 1 million

It also needs to be said that you will not get identical results using these two screeners. For example, I ran both screens on a nonmarket day in late May 2010. The Yahoo! Finance screen produced 72 stocks, whereas the Fin viz.com screen produced only 61 stocks. This may due to differences in the way each service calculates average volume (over x number of days), and there are slightly different ways of calculating beta. More problematic, perhaps, is the fact that the top 10 stocks issued by each screen did not agree. Tables 2.1 and 2.2 list the results for comparison (the scan was run in May 2010).

TABLE 2.1 Top High-Beta Stocks from Yahoo! Finance

<i>YAHOO</i>	<i>TICKER</i>	<i>BETA</i>	<i>PRICE</i>	<i>VOLUME</i>
1	DTG	5.11	22.90	5,307,473
2	LVS	4.67	21.00	59,180,344
3	AIG	4.35	45.61	1,530,002
4	TRW	4.09	41.70	7,894,830
5	TCK	3.98	35.96	10,094,453

TABLE 2.2 Top High-Beta Stocks from Finviz.com

<i>FINVIZ</i>	<i>TICKER</i>	<i>BETA</i>	<i>PRICE</i>	<i>VOLUME</i>
1	HGSI	5.21	22.90	5,307,473
2	LVS	4.45	21.00	59,180,344
3	DTG	4.38	45.61	1,530,002
4	DNDN	4.18	41.70	7,894,830
5	AIG	3.97	35.96	10,094,453

Note that only three stocks show up on both sets of the top five high-beta stocks: DTG, LVS, and AIG. Also note that Yahoo's screener, for reasons that are not spelled out, tends to assign beta ratios about 40 basis points higher than those assigned by Finviz. But it remains a real mystery why HGSI and DNDN, which ranked first and fourth on Finviz, do not show up among Yahoo's top five high-beta stocks. In fact, they do not appear at all on its list of 72 stocks despite the fact that Yahoo! Finance's "key statistics" page assigns HGSI and DNDN beta ratios of 5.62 and 4.54, respectively. It seems that even though Yahoo's screener produces more "hits" on its high-beta screen, it does not allow biotech companies to pass—both HGSI and DNDN are biotechs—which is a major flaw because biotech companies traditionally are among the most volatile of stocks and, as such, make great micro-trend trading vehicles.¹

Regardless, either screen and its results list will serve up a great portfolio of liquid, higher-priced, and highly volatile candidates for micro-trend trading. Again, volatility

is not the only factor making for an ideal micro-trend market in which to trade. But it will serve several of my micro-trend systems well if you start by highlighting volatility.

THE NEW EXCHANGE-TRADED FUNDS (ETFs)

Since *Trend Trading for a Living* was published, a whole new universe of ETFs has emerged, many of which make excellent candidates for micro-trend trading. *ETFs* are baskets of stocks normally grouped together around indexes or industries. They trade on the U.S. exchanges exactly like individual stocks. The very first ETF created was the Standard & Poor's Depository Receipt (SPDR or "Spider"), which was launched in 1993. Trading on the American Stock Exchange (Amex) under the ticker symbol SPY, the SPDR quickly became a commercial success. With price action tagged to the S&P 500, SPDR allowed the retail investor to invest in each one of the 500 largest-cap stocks trading on U.S. exchanges simply by buying a single stock. Soon other ETFs began to appear, many of which are today the most highly traded securities on the exchanges. There are currently over 750 ETFs actively trading, which together comprise over \$700 billion in assets. There are ETFs that cover foreign indexes, currency exchanges, commodities, bonds, Treasuries, and even trading strategies such as covered calls and arbitrages.

Many of the listed ETFs are too thin to micro-trend trade, but a healthy number of them are among the most liquid and most volatile securities available.

The most recent development in ETF-land has been the launch of inverse ETFs and ultra ETFs, both of which appeared in late 2007. An *inverse ETF* is one that acts as a short position on the underlying index. Thus, for example, if you wanted to go long the Dow Jones Industrial Average (DJIA), you would buy the Diamonds ETF (ticker DIA). But if you had a bearish outlook on the DJIA, you could buy the ProShares Short Dow 30 Fund (DOG), which shorts the DJIA. If the DJIA goes down 5 percent, the DOG should rise 5 percent (the 1:1 correlation works better in theory than in practice, but it is always close). Likewise, if you were bearish on the S&P 500, you could short the Standard and Poor's Depository Receipts (SPY), or you simply could buy the ProShares Short S&P 500 Fund (SH) (the 1:1 inverse ETF for the S&P 500).

An *ultra ETF* is a leveraged ETF. To date, leverage comes in two types: double (2×) and triple (3×). A 2× leveraged ultra ETF will move twice as fast as the underlying index or industry, and a 3× leveraged ultra ETF will move three times as fast. In other words, if a given index closes up 2 percent at the end of the trading day, its 2× ultra long ETF will close up about 4 percent, and its 3× ultra long ETF will close up about 6 percent. To risk really confusing everyone, there are also now 2× and 3× ultra inverse

ETFs. These will move twice or three times as fast up as the underlying index moves down and vice versa.

For example, if you were bullish on U.S. large-cap stocks, you now have at least three position choices among the ETFs. You could:

- Buy SPY (S&P 500) for a nonleveraged long position
- Buy the ProShares Ultra S&P 500 Fund (SSO) (S&P 500) for a 2× leveraged long position
- Buy the Direxion Large Cap Bull 3× Shares (BGU) (large caps) for a 3× leveraged long position²

Conversely, if you were bearish on U.S. large-cap stocks, you also have three choices among the ETFs. You could:

- Buy SH (S&P 500) for a nonleveraged short position
- Buy the ProShares Ultra Short S&P 500 (SDS) (S&P 500) for a 2× leveraged short position
- Buy the Direxion Large Cap Bear 3× Shares (BGZ) (large caps) for a 3× leveraged short position

The following charts (Figures 2.3 and 2.4) demonstrate the leveraged and inverse nature of the new ETFs. You can



Chart courtesy of StockCharts.com.

Figure 2.3 The 2× and 3× ultra long ETFs for big-cap stocks.

see that while price movement of the ultra ETFs on the S&P 500 is closely correlated with the index itself (as represented by SPY), the ratio of leverage among them is not exactly the expected 1:2:3 ratio. Still, it is close to the expected ratio.

There are now 2× and 3× ultra long and inverse ETFs for most of the major indexes and sectors: the DJIA, the S&P, the Nasdaq, the financials, China, the Treasuries, the Brasil-Russia-India-China (BRIC) complex, crude, gold,



Figure 2.4 The 2x and 3x ultra short ETFs for big-cap stocks.

small caps, the euro, metals, aggies, consumer goods, health care, pharma, and the list goes on and on. While the future direction of ETFs is uncertain, their commercial success ensures that they will be around a long time. In the near future, we may well see 5x and even 10x leveraged ETFs and ETFs based on fundamental stock pickers (e.g., a Buffett or Lynch ETF) or mechanical technical systems (e.g., bullish and bearish Befriend the Trend ETFs).

For micro-trend trading purposes, you can harness this new universe of leveraged ETFs for profitable gains using my systems. I will explain below that there are certain problems inherent to the ultra inverse ETFs that can make them troublesome in certain market conditions. For the most part, though, they make excellent trading vehicles for our purposes here.

SCREENING FOR MICRO-TREND CANDIDATES

The third source for appropriate micro-trend trading vehicles is to use one or more mechanical screens specially constructed to match the setups and systems I teach here. In the pages that follow, I will teach you several trading setups for both longs and shorts that can be encoded easily into one of the screening tools I suggested in Chapter 1. I've read too many trading books that show you examples of great-looking setups but then never show you how to find those setups for yourself. With the screening information I give you here, however, this will not be a problem. If you have looked through your watch lists of stocks and ETFs and find nothing tradeworthy, a simple click of the mouse should turn up several viable micro-trend candidates.

Once these screens are formatted and saved into whatever screening tool you decide to use, you can run them throughout the trading day for new setups. You can run them right after the market opens for a nice gap play, on

your lunch break to catch a few quick scalps, or around 2:30 p.m. EST to catch the afternoon reversal and break-out moves. I personally find screen running a more profitable process than simply eyeballing the charts for setups. Because it is a mechanical process, it reduces the human element that so often leads to error. Sometimes when eyeballing a chart, I'll see something in the chart that is not really there. Wishful thinking can create a setup in the imagination that does not exist in the chart. But screening bypasses this cognitive step.

MICRO-TREND TRADING FUTURES

When *Trend Trading for a Living* came out, I received numerous e-mails from readers about trading futures. The most frequent question was, "Can the *Trend Trading for a Living* systems be applied to futures contracts?" My answer was always an insistent "Yes." As long as there is sufficient volume and price movement and a relative absence of overnight gapping, any market that is charted is a prime candidate for the technical systems I outlined in that book.

Although my own expertise is in trading stocks and stock options (the latter of which is not suitable for most micro-trend systems), all the systems outlined in this book also can be applied to futures contracts. In fact, the last system I teach here (Chapter 12) works best when trading the E-mini futures contract (ES) on the S&P 500. The application of futures to micro-trend systems, however, is not as

straightforward as it is for the longer-term trading systems found in *Trend Trading for a Living*. The main reason for this is that the volume and price-movement requirements for intraday trading are higher than they are for swing trading. If you wish to trade futures, you will need to focus on contracts that bear the highest volume and that show very coherent price movement throughout the trading day. Some contracts can go very quiet for several hours at a time. Other contracts are sensitive to overseas trading and often show large price gaps owing to overnight movement. Of the futures markets where these factors are minimized, the best candidates are the E-mini contracts on the major U.S. stock indexes—the S&P 500 (ES), the Nasdaq 100 (NQ), the DJIA (YM), and the Russell 2000 (TF). These four primary E-minis are very liquid and therefore form coherent intraday chart patterns. Among the commodities, oil, natural gas, and gold are all suitable candidates for micro-trend trading. The U.S. currency pairs are also decent candidates for micro-trend trading, and because they maintain liquid trading around the clock, they are suitable candidates for insomniacs and those who cannot trade during U.S. market hours. The fact that they are susceptible to large overnight moves, however, all but rules out their application to my multiday systems.

TAKING THE NEXT STEP

If you have followed this book up to this point, you now know what kind of computer is best for micro-trend trad-

ing, what sort of Internet connection you will need, which are the best discount brokers to use, what are the best online and software resources you will need for your charting and scanning needs, and what kind of stocks make the best vehicles for micro-trend trading. After all that, you might think that you can go straight to Part Two of this book and begin your new adventure in micro-trend trading. Please do not do that. Resist the temptation to skip over the next chapter. It is perhaps the most important chapter in this book.