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SECRETS OF STOCK MARKET TRADERS EXPOSED!

How To Trade Options Like A Pro

With Kim Reilly

The Ultimate Trading Solution
Special Abridged Edition
for readers of
Secrets of Stock Market Traders Exposed!
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Module One

Introduction to Options Trading

Intended Outcomes

The intended outcome of the 'Ultimate Trading Solution' is to understand both the 'big picture' of how the stock market and in particular, the 'Exchange Traded Options' market, function in Australia.

Initially I will be looking at what options are, how they work, and how I can narrow my choices down to one or two suitable contracts.

Then, I will look more closely at some common, yet simplified technical analysis techniques.

By the end of Module 5, you will have mastered an understanding of how to navigate your way through 'Paper Trading'.

Methodology

How to get the most out of this programme.

Firstly, I recommend that you master some simple accelerated learning techniques. In doing so, you will gain far more from the Ultimate Trading Solution, than by simply clicking on 'play'
and then trying to absorb everything that takes place in front of you.

Accelerated learning is a science in itself, however, it is certainly not my intention that you should be proficient in every aspect of this science. Having said that there are a few simple techniques which will assist your progress:

30 Minutes Session
Each CD Rom contains over an hour of information. However, when you start the programme for the first time, you may spend a lot more than 30 minutes on each CD Rom by reviewing and putting into practice what you have learnt.
If you are anything like me, you will want to complete the entire programme in three hours so you can immediately begin to trade.

Keep your sessions short— maximum 30 minutes per session. Set yourself a goal to complete one or two sessions per day. In doing so, your brain will find it much easier to file and store bite size chunks of information.

Be Pro-active
Whenever an opportunity arises, put your theory into practice. For example, draw a trend line, look up an option quote. In doing so, you will demonstrate to your sub-conscious the techniques you are trying to acquire in no time at all.

Avoid Distractions

If you are finding it difficult to progress through the various modules, it may be due to setting your target too high. Alternatively, if focussing more than 30 minutes a day is impossible for you, then you may need to reduce this time or choose a different location. Ten minutes of concentrated learning is worth ten days of being distracted.

Take Short Notes

All the information you need to master the Ultimate Trading Solution is contained in these modules. However, if you are experiencing difficulty in grasping a particular point, then try writing it down differently to the way it is presented in the module. Make a short note (avoid writing an essay) on how best you understand it and then move on.

You may find you need to re-write the trading rules so that they are easier to follow. However, this does not mean you can alter their application.

Control your Environment

Ensure that your work space is conducive to learning by engineering your surroundings. You may wish to be near a window with natural light. The cathode ray in your computer will sap your energy where as natural light will not. It's also a good idea to have a pot-plant or two near to your desk. Play some soft music, preferably without lyrics. Mozart is one of the best as his music tends to be baroque and plays at 120 beats per minute which sets up the optimum level of brainwave activity.

Make Trading Fun

Your live trading will mirror the way you learnt your craft. If you found it tedious and boring, this will be reflected in your trading. If you make it fun and your excited at the prospect of doing it every-day then your trading will benefit.

References

While there are thousands of books on the subject of investing, experience has shown me that most of these pertain largely to the American stock market and those that focus on the Australian stock market are somewhat confusing.

Having traded for a few years now, I still find difficulty in taking information from a book and applying it successfully in any investment, let alone the options market. There are many 'gurus' who will have you believe that if you buy their book and read their pearls of wisdom, you will become a millionaire within three days.

The only things I teach are the mechanisms that I know and I have successfully applied myself. True knowing can only come from trial and error. You will make mistakes and you will suffer losses. Get this idea firmly planted in your mind before we begin. If you cannot bear to lose, or for some reason you believe that the market will let you escape unscathed, then my advice to you is to never trade.

I am a great advocate of continuous education and I have learnt many things along the way which in turn may assist you. Be mindful of trying to learn too many different approaches or techniques from too many experts at one time. I do not contend that my approach is the optimum trading system. However to allow yourself the chance of making it work for you. Remain focused on this method until you ready to move on.

If you are committed to plotting a course for your own financial freedom and you're prepared to do whatever it takes to succeed, then you will never fail. The information presented in these pages will never replace commitment, practice and patience. This course is designed to give you a raw plan for your voyage, it is not the 'be all and end all' and it is certainly not the 'holy grail'. I have learnt from many authors, but my greatest teacher is the market itself.

The Seven Secrets to Investing

1. Make investing your Hobby

In general, hobbies delivery more satisfaction and joy than our careers. By making investment your hobby, you will become proficient in a short period of time and you will also become wealthy.

"If you want to become extremely wealthy...you must let your money work for you. The amount your paid for your personal effort is relatively small compared with the amount you can earn by having your money make money". John D Rockerfeller

2. Pay yourself

To make money you must have money. Later I will show you an example of a formal budget, but for now, deduct 10 to 20% from your income as soon as you receive it and store it away. You always manage to find money to pay the bills, so you will find it in order to pay your monthly 'profit' as a bill—the first one.

3. Know yourself

You are the only one who knows your internal 'risk profile'. Your financial planner will help determine this, but only you can decide your '*sleep at night factor'*. This is important, as you will see later, in determining asset allocation.

First, you must know WHY you react the way you do in certain investment situations.

4. Don't try to outsmart the market

You must learn to place the long term odds heavily in your favour. Don't try to swim against the all-powerful tides of wealth creation. Let the long term tides work for you by effortlessly carrying you along to greater and greater wealth.

Following is a quote from Sir John Templeton, who is revered the most successful fund manager of all time. $10,000 invested with his fund when it first began in 1954 is now worth more than $.12 million.

Consider what this legendary investor says about using stocks to make your portfolio safer:

"*Over a period of 62 years, investing in stocks yielded 10 times as much gain as investing in bonds, CD's or mutual funds. So the question is: What are you trying to preserve? Are you trying to preserve the number of dollars or are you really trying to preserve the purchasing power?"*

"*If you're trying to preserve the purchasing power, its better to an owner rather than a lender. That's why in the long run, common stocks are your best protection. In terms of purchasing power, the worst thing you can own is cash. You can't play safe with cash. If you want to play safe, put it into something that is genuine, something that has fundamental value—such as real estate or common stocks...I believe you care far safer with common stocks than with cash.*"

5. Never ask an Encyclopaedia Salesman if you should buy an Encyclopaedia

The answer will always be—yes. I am not saying that all sale people are unethical, but it pays to be aware of any bias. This applies to every area of your life, including Fund Managers, Accountants, Brokers, Course Facilitators—everyone.

6. The Billionaires' simple secret

This secret was shared with investor J. Paul Getty and in essence means if you want to make money, really big money, do what no one else is doing.

"*Buy when everyone else is selling and wait until everyone else is buying. This is not merely a catchy slogan, it is the very essence of successful investing*". J. Paul Getty

7. Carpe Diem (Seize the Day)

Or in more modern times and in 'Nike' terms, 'Just do it.' When opportunity knocks, you'd better run and open the door. Get in the habit of making decisions.

Some tips from the pro's

Speaking of **LONG TERM** investing, ***Warren Buffet*** has this to say:

"*Never buy a stock unless you would be happy with it, if the stock exchange closed down tomorrow for ten years. Buy into a company because you want to own it permanently, not because you think it might go up…..When we own portions of outstanding companies with outstanding management, our favourite holding period is forever…."*

When you have your eye on such stocks, any dips in the market only present greater opportunities to buy.

"There are only a handful of businesses, about which we have strong long term convictions. Therefore, when we find such a business, we want to participate in a meaningful way. We agree with ***Mae West***:

"Too much of a good thing, can be wonderful."

"When I was young, I used to think that money was the most important thing in life. Now that I am older, I know it is."
Oscar Wilde

"Money is like an arm or a leg….. Use it or lose it."
Henry Ford

"You are affluent when you can buy what you want, when you want; do what you want, with whomever you want, as often as you want, without giving thought to what it costs."
J. P. Morgan

"Do or do not, there is no try."
Famous American Philosopher—***Yoda***

Battling the Belief System (BS)

It is my belief that 99.9% of your investment and trading decisions are based on what you already think you know. As human beings we are designed to operate almost totally on habit. Think of how much you would actually do if this were not the case. Do you know how many individual decisions are required just to get dressed. First you have to get out of bed and place your feet on the floor, then there are about 40 more separate decisions just to get to the bathroom. I could go on and on although I think you get my point.

Every single decision we make is based on historical beliefs. The problem with this process is that most of us are totally unaware of these beliefs. Even more disturbing is the fact that we don't know who they came from, or for what purpose.

By keeping things in their own perspective, we can begin to unlock the reasons why we continually RE-ACT (repeat the same action over and over). If you have trouble saving money now, it is due to some belief you have around money. If you believe the only way to make money is to work hard, there is a high chance you absorbed this from your family and close friends. The reason they believe this is because they don't know another way to do things. If they did, wouldn't they be doing it? Is it fair to say that the wealthiest people in the world do not work hard for their money.

For me, the only way to adjust my own personal BS is through education. Not the traditional kind, but education based on results that one can only learn from someone who has done it. Those who can do, are those who can't teach, is a saying which is disturbingly true. Although I would like to consider myself a teacher, I am committed to teaching by doing. I was always taught to 'do as I say, not as I do.'

Since having children I have learned the most valuable lesson. People, particularly little people, may not always understand what you say, but they can always tell what you do.

Your success in trading will be directly in proportion to your success in understanding your own reactions when pressure is applied. Paper Trading is one thing, live trading is a whole new ball of wax!!!

The good, bad & ugly

Take a few moments to jot down a few of your beliefs that have led you to make a poor investment decision in the past.

A……

B……

C……

D……

Ask yourself where these beliefs come from. Are they real or could they be influenced by someone else?

A……

B……

C……

D……

Your friends and family will probably try to 'save' you from doing something a little different from what they know. This is quite common and is probably the reason why most people eventually give up trying to do different things. There is always someone willing to give their opinion on the way the world works.

The next time someone tries to talk you out of doing something different, ask them to pay ALL of your bills, should they decline, advise them that you are taking care of your life and that they should take care of theirs.

Controllable States

I. Physical/Psychological Environment

The way you move is directly linked to what you think. If you are tired and bored, your posture will be collapsed and stooped. If you are excited about something you will generally smile, your posture will be upright, and you will not feel tired. Try this exercise. Think of a depressing thought, then while still thinking about that thing, put a huge smile on your face. If you do it properly, you cannot maintain a depressing thought and a smile at the same time!!

2. Language (Internal and External)

There are three words that have changed the way I look at life. Next time you find yourself in a challenging situation insert these three words in front of your challenge:

How……?
Instead of Why……?

3. Belief Systems (BS)

We **ALL** operate on BS, whether we know it or not. It is not within the context of the course to uncover what it is, although through practice, it becomes very easy to spot when the BS is kicking in. Usually it will bring with it a whole lot of stories, reasons and excuses. If you hear this beginning to happen, you can rest assured it's the good old BS.

Once you begin live trading you will become very familiar with the 'voices' . No, it doesn't mean you're going crazy, the 'voices' I'm referring to are the ones that already drive you around you day-today life—most people call them thoughts. These thoughts are driven, in most of us, solely by BS and no basis in fact. The 'voices' to be wary of are the hysterical or excited ones, the ones that make you feel totally euphoric or drown you with fear. These are your emotions and have no place in your trading plan.

Later on, when you understand the system and begin live trading successfully you will develop your own trading style and eventually trade 99.9% of the time on your intuition. Intuitive trading is very profitable. However, this system is designed to get you that point it does not contain the 'holy grail' intuitive trading. Begin to trust your intuition and you will progress as long as you are no INTO-WISHING!

Module Two

Market Overview

Chronology of the Australian Stock Exchange

1829: Matthew Gregson advertised that he had received permission from the Bank of NSW to trade in its shares.

1835: William Barton, father of Australia's 1st Prime Minister Edmund Barton, established himself as an "agent for the transfer of shares" Melbourne Brokers' Association was formed.

1871: Sydney stockbrokers held meetings in the newly opened Greville's Rooms. Sydney Stock Exchange formed.

1882: Hobart Stock Exchange formed.

1884: Brisbane Stock Exchange formed.

1887: Adelaide Stock Exchange formed.

1889: Perth Stock Exchange formed.

1901: Federation of the Colonies to form the Commonwealth of Australia.

1903: First interstate stock exchange conference was held in Melbourne, over the Melbourne Cup. Melbourne, Sydney, Brisbane, and Adelaide Stock Exchanges were represented.

1937: Formation of the Australian Associated Stock Exchanges (AASE).

1938: Publication in the first share price index.

1942: The Australian Government limited price increases, in the shares of listed companies.

1947: Open market conditions were re-introduced.

1962: Uniform Companies Act and revised uniform listing requirements became effective.

1969: Mining boom. Poseidon shares rose from 75¢ to $280 in 4 months.

1972: National listing for all securities was introduced.

1974: Report of Parliamentary Committee recommended formation of a National Companies and Securities Commission. (NCSC)

1976: Australian Options Market commenced trading.

1980: National Price & Accumulation Indices replaced Sydney & Melbourne Indices.

1981: Formation of the National Companies and Securities Commission (NSCS.)

1982: Companies' legislation based on co-operation between Commonwealth and State Governments became effective.

1984: Deregulation of Stock Exchange membership and abolition of the fixed scale of commission.

1987: Formation of the National Australia Stock Exchange (ASX) to acquire the six state's stock exchanges. October stock market downturn. Launch of computer based trading (SEATS) for limited range of ASX listed stocks.

1990: Closure of the trading floors and conversion of all stocks to SEATS trading from October.

1991: National Corporations Law replaced co-operative legislation. Sydney trading floor occupied by Australian Options Market. The Australian Securities Commission (SEC) replaced to NCSC.

1992: ASX Derivatives Board formed. Memorandum of Understanding adopted by ASX and ASC. T+5 settlement for ASX transactions.

1993: Fixed-Interest securities added to SEATS.

1994: First stage of an electronic clearing and settlement system (CHESS) introduced, to lead to full automation in 1996.

1995: Major redevelopment of the trading system initiated. Electronic announcement system commenced. Stamp duty is cut in half.

1996: ASX voted to become a public entity. CHESS phase 2 is implemented. CHESS Units of Foreign Securities (CUFS) settlement is introduced for foreign companies.

1997: Derivatives trading automation project begun. Demutualisation legislation passed by Australian Parliament. SEATS 97 trading system upgrade began. Internet based Enterprise Market (EM) developed for smaller businesses.

1998: ASX became a public listed company. Derivatives trading automated and floor closed. Share registers fully de-certificated. Investors gained internet access via brokers.

1999: T+3 settlement replaces T+5. ASX Sydney moves to 20 Bridge Street. New clearing system for derivatives market.

2000: ASX forms joint venture with Perpetual Registrars to form ASX Perpetual Registrars Limited (APRL). ASX and the Singapore exchange agree to develop an electronic trading link between the two markets; expected to be in operation by July 2001.

Simplifying the Market

What is it that makes the market head North, South or East?

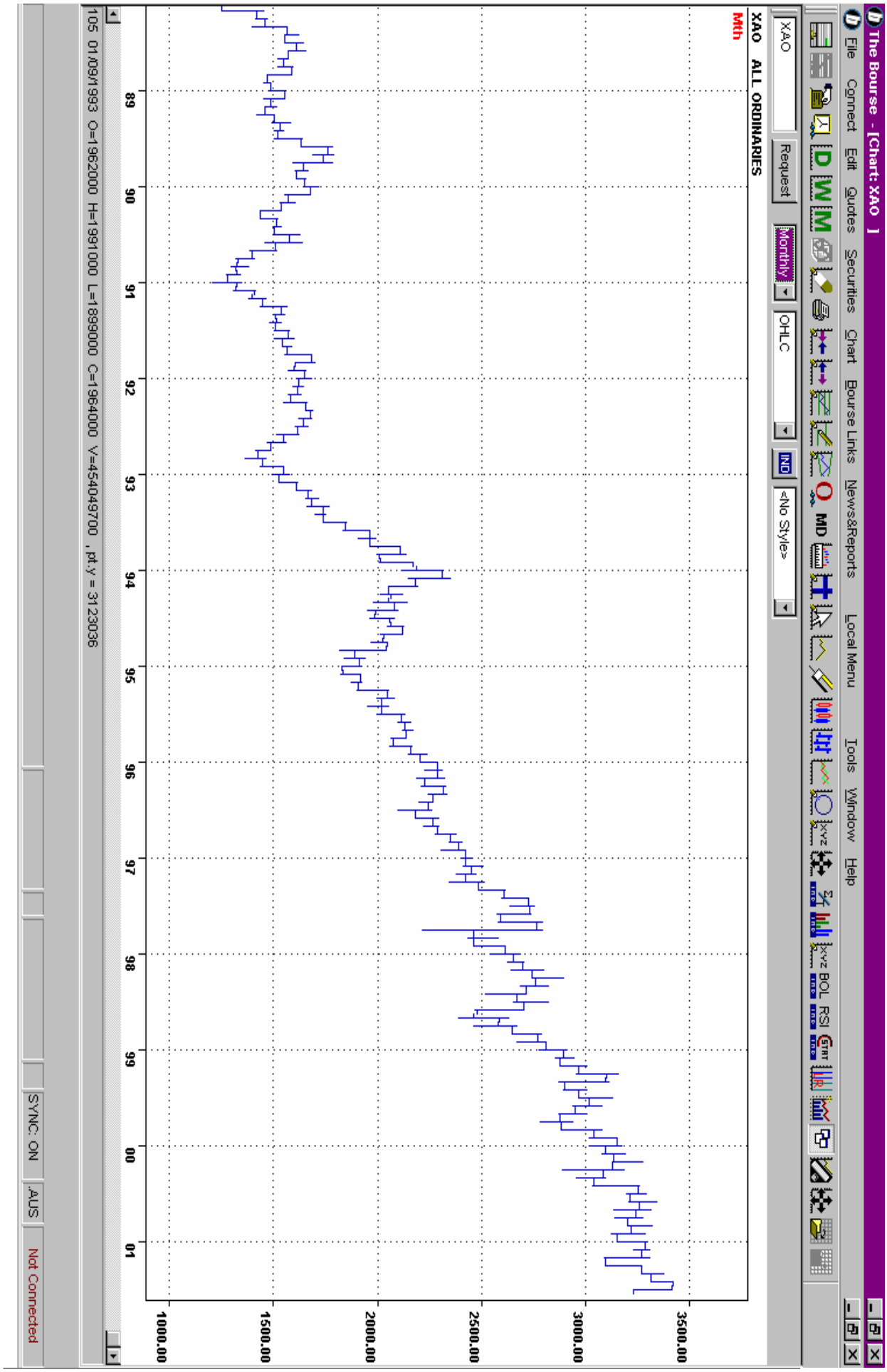
If you have ever looked at the stock market, bought shares or even talked about it at a cocktail party, you already understand that it is dynamic. It never stands still. For some longer term investors, it may be a week, a month or even a year before the price of a stock will move enough for them to make a buy or sell decision. I will examine this later in the programme. However, as an option trader, a 'long term' view could be next Tuesday.

Essentially it is the emotion of the market that will carry it North or South. Usually the higher the emotion the faster it will move in either direction. If a stock is moving Eastward, or sideways, it generally implies a consensus of apathy toward that particular stock. It is almost as though the buyers and sellers agree on the current price. This agreement is quite often short lived.

A large number of experts agree that 'Fear' and 'Greed' are the dominant emotions that will send a stock to its highs and lows. I have no reason to disagree with this philosophy, although I am inclined to believe that a large majority of market movement is determined by astute, professional investors. It is this movement which I endeavour to follow. The investors, not the gamblers.

The Greed associated with the big win will invariably drive the market sharp North and the fear of losing will drive it South. Short, sharp moves such as this are generally short lived and you will discover, do not really make for professionally planned trades.

In simple terms the market will move according to the attitudes of investors as a whole. Every stock is at its current level because of every piece of information known about it. As soon as new information is available, the price will move. While it is not my intention to examine this type of analysis here, it will serve you well to be aware of external factors whilst you are trading .



Module Three

Types Of Options

Objective

The objective of this module is to fully understand how option contracts work and the different applications for rising and falling markets.

In later modules you will discover how to analyse a stock and identify the various trigger points to either enter of exit a trade. This analysis is just an effective for share trading as it is for option trading and does not necessarily need to be confined to the top 20 or 30 stocks. Nor does it need to be confined to the Australian stock market.

The purpose behind understanding what options are and how they work is to allow you (the trader) more 'options' to choose from. By understanding the basic analysis and stock selecting techniques, you will be able to add option trading to your tool box. There are many institutions and experts who have personally told me that trading options is strictly for professional share traders and one should not consider using options without years of experience in the stock market.

I personally traded very few shares before beginning my career as an options trader and thousands of graduates from my seminars have moved directly into the option market without ever trading shares.

For me, it's all about choice, understanding options and following a strict and precise trading plan. You have the ability to balance your activities between trading and investing. I consider trading as holding an asset for six months or less. I know share investors who think short term is five years. I also know traders who think short term is five minutes. Whichever category you find yourself in, by equipping yourself with a variety of tools you will enter the market as a professional trader and the probability of your success will be greatly increased.

Exchange Traded Options

There are three main reasons we should consider options;

- **They provide massive leverage**
- **Can limit our downside risk**
- **Potentially unlimited upside**

What is an Option?

Options are used every day, in every industry, in every country. The names may differ. However, the general concept remains the same. Quite simply, an option is a contract between a buyer and a seller of an asset. There are three elements required to form an option. These are:

1. An asset or security
2. A set time frame
3. A fixed 'strike' or agreed price

Example 1:

Imagine for a moment you were looking to buy an investment property, let's say a three bedroom unit. You are new to the property market and you are not certain whether or not you should commit yourself fully, until you gain more experience and have a better feel for the market.

Your brother-in-law learns that you are in the market and finds a 'perfect' opportunity for you. He knows a guy that has just finished developing some units and he thinks he can buy one for you at $200,000.00. Hesitantly, you agree and arrange the 20% deposit, or $40,000.00 plus fees, so you avoid mortgage insurance.

You then arrange to finance the rest of the money and set about finding tenants etc. Your brother-in-law informs you to expect 15% capital growth on your investment. Let's take a look at the numbers:

Initial Cash Outlay	$40,000.00 plus fees
Borrowings	$160,000.00
Total outlay	$200,000.00
Theoretical downside	$200,000.00

Assuming you are insured (additional costs) your maximum potential downside will be less than your total outlay.

What is an Option? (cont'd)

Let's see what happens 12 months after the purchase date. Imagine for a moment that your brother-in-law is an absolute legend and you achieve a 15% capital growth on your investment. Assuming you had great tenants for the year, and the return was neutral to slightly positive let's see what you made:

Initial Investment:	$200,000.00 plus fees
Realised Capital Growth	15%
Current Asset Value	$230,000.00
Total growth	$30,000.00

Example 2:

You find a development that meets your criteria and the developer is keen to show his finance company a few sales. He informs you that the property will take about 12 months to complete and therefore, you only need to pay the deposit now, and the balance in 12 months. The current sale price is $200,000.00, so you agree to pay a deposit of $5,000.00.

In 11 months time, you have the property valued at $230,000.00. That means, you own the right to purchase the property for $200,000.00, when in reality it is valued at $230,000.00. Therefore you could simply sell your 'contract' to another buyer for at least $25,000.00. In effect, your downside was always limited to your initial outlay of $5,000.00, your upside potential was unlimited, and by leveraging your money you realised a cash-on-cash return of a whopping 400%.

NOTE: *This is a theoretical example of how leveraging works for you. It is by no means a recommendation to purchase property off the plan; consult your licensed advisors.*

Option Contracts

The *Exchange Traded Equity Options Market* has been operating in Australia since 1976. The Option Clearing House (OHC) is responsible for deciding which companies are allowed ETO's, and currently there are about 70 companies. While this number will vary, it does not change often.

Australia is the third largest Options Market in the World and while the ASX averages about $1.5 Billion in trading every day, the OCH (Options Clearing House) averages around $15 million per day.

ASX

Option contracts are continuously opened and closed. The terms OPEN and CLOSED are use to describe the position, or obligation of a trader. When a 'WRITER' opens a contract, they are said to be SHORT that amount of contract. When a TAKER buys a contract, they are said to be LONG.

The taker BUYS to open and SELLS to CLOSE, while the writer SELLS to open and BUYS to CLOSE.
Taker Broker ASX (OCH) Broker Writer

Option Components & Aspects

1. The type of Option
2. The company it relates to
3. The expiry date
4. The strike (exercise) price
5. The option pricing fundamentals

Types of Options

** NOTE: I am referring to American style options, which allow the holder to exercise at any time up to expiry.*

Call Options:
A Call Option gives the right, but not the obligation, to BUY a parcel of shares at an agreed STRIKE PRICE for a pre-determined period of time.

In the following modules you will learn how to read the charts to assist us in forming a view of a particular stock. If it is my view that a stock is going to head North, I can take call options in much the same fashion as our property example.

Because I am locking in a fixed price at which to buy the shares, the Call option will generally increase in value as the share price rises. Similarly, should the share price fall, so too will the value of the Call Option.

The most important thing to remember about a Call Option is that it gives the holder the RIGHT to BUY. By owning the right to BUY something, you are relying on an increase in the value of the asset to realise a gain in your contract price.

Types of Options

** NOTE: I am referring to American style options, which allow the holder to exercise at any time up to expiry*

Put Options:
The major difference between a Call option and a Put option is the rights they deliver to the holder. While a Call option gives the holder the right to BUY, a Put option gives the holder the right to SELL

By locking in to a fixed price at which you can SELL a security, you rely on a FALL in the price of the security for you to make a profit. Until the advent of options, the most common way to make money in a FALLING market was to SELL SHORT.

While still available, short selling is becoming less popular among investors as the risk and margin requirements are usually very high. Essentially, short selling means you would actually SELL the stock before you purchase it. Think of it this way, let's say you feel the value of ABC corporation is falling. You could sell it at today's price of $10.00.

If you are right and the price falls, you can then buy the stock at say, $9.50, close your position and realise the difference. The downside risk of this strategy is potentially unlimited. Should the stock rally, you would have to purchase it at the higher price and therefore realise a loss.

Put options give the holder the RIGHT to sell the stock without having to physically sell it, thereby reducing your maximum exposure to the initial trade amount.

When I began trading I was a little uncertain about how Put options worked. Call options seemed easier to me as I was so conditioned into understanding that if you buy something and the value rises, you make money. It took a little time for it to sink in exactly how I could make money in a falling market. The key for me was to focus on what I needed to know to make money, instead of trying to understand the inner workings of the most intricate financial instruments. The following explanation will allow you to assimilate the process of the put option.

Put Options

Essentially, Put Options work like an insurance policy. They are becoming more and more widely used as investors begin to understand the importance of protecting your assets, or 'hedging' as it is known. A sound professional investor will generally take less risk than your average 'punter'. While some people think that the Stock Market is risky, the people who deliver consistent returns do so, BECAUSE they understand the importance of managing risk

Imagine you were to purchase the property mentioned in the previous examples. Your financial institution will not let you borrow money until they have your insurance details. I had a phone call recently from one of my bank managers and she was in a panic. I have known and dealt with this lady for most of my income generating life yet she remains very uncomfortable with trading or the stock market. The reason she was in a panic was because the insurance policy on one of our properties had expired. She was so involved in fear that she didn't want me to hang up the phone until I had given her the new policy details.

I explained to her that I needed to end the call with her, in order to re-establish our policy. Once she calmed down, I assured her that by close of business, I would have the new policy details for her. Why was she so afraid? She has been trained to be that way by her bank. Her bank knows how to manage risk and to have a mortgage on a property without insurance is an unacceptable risk/reward situation to be in. What does that have to do with put options? Everything.

Perhaps an easier way to think about it is by taking a look at car insurance. You may remember a few years ago a massive hail storm hit Sydney and did millions of dollars worth of damage. I had previously been involved in the automotive repair industry, so when my car got beaten to a pulp by the storm, I knew exactly who to call. I got my policy rushed through and had an assessor come out to asses the damage

I got talking to the insurance writer and he told me what had been happening since the storm. It didn't take him long to assess that my car wasn't worth repairing. I has insured the vehicle for about $30,000.00, the cost of repairing the car was approaching $15,000.00.

Because the car was a 'write off', owning an insurance policy with an agreed value, or 'strike' price of $30,000, effectively gave me the right to SELL my car back to the insurance company for $30,000.00, even though the current market value of the vehicle was about $15,000.00.

In this case, due to the amount of damage that was caused and the time it was going to take to carry out repairs, the insurance companies were writing off most vehicles. In this process the insurance company bought my car off me for $30,000.00 and because I had some contacts, I was able to buy it back off them for less than $15,000.00, carry out repairs for way less than $15,000, and sell it to someone else for market price.

Put Options

Imagine this was a Stock Market Trade. I had $30,000.00 worth of shares. The stock market corrects (hail storm) and my shares are trading at $15,000.00. I had the foresight to buy an insurance policy (take a put option) for about $800.00. This gave me the right, but not the obligation to SELL the shares (car) to the insurance company (put option writer) for an agreed value (strike price) of $30,000.00.

After exercising my option (cashing in my policy), I sold my shares (car) for $30,000.00 in cash. Because the market had fallen significantly it represented a great opportunity to buy the same amount of shares (car) for half of the retail market value.

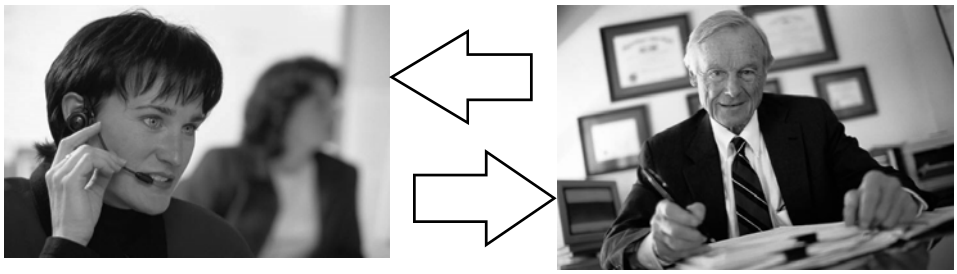
Once the market rallied (carried out repairs) I was able to re-sell the shares (car) for the original market value. In effect, this trade represented two separated income generating avenues. Firstly, by using the insurance policy (put option) effectively, I could capitalize on the falling value. Secondly, by understanding the market, I was able to buy the car (shares/call option) at it's low and capitalize from the following rally.

The reason I was able to capitalize on these opportunities was my knowledge and experience in that particular market. Trading options is no different. I use Technical Analysis to guide me through the sea of options, constantly checking that my ship is safe and my risk is always manageable.

Call Options

In a Call Option trade, the writer of the Call sells the right for the taker of the Call to BUY his or her shares at an agreed price for a given period of time.

Taker (buyer) *Writer(seller)*



The Writer receives the premium from the taker and should the option expire worthless, the writer keeps the whole premium. The writer maintains the obligation to deliver the stock should it rally and their position carries an unlimited risk Potential

In any trade there is always a writer and a taker. It is important to understand that there is only ever one writer of a contract, while there may be an unlimited amount of takers for that same contract. Imagine you bought one Call Option, which gives you the right to buy a parcel of shares. You hold the option until it rises in value where you on-sell it to another taker.

This does not make you a writer. The writer is the person who initiates the contract and it is then bought and sold among takers until it either expires worthless, exercised or closed out.

It is also important to note the obligation always remains with the writer which carries the associated margin requirements, as well as limiting the maximum upside to the initial premium collected.

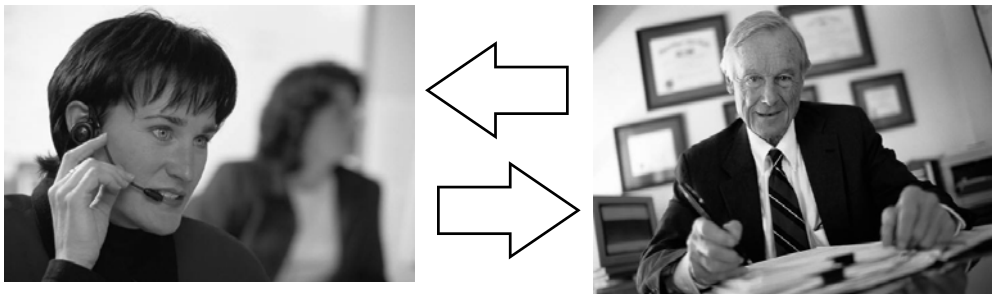
Option Writing is a valuable part of a complete option strategy, although experience has taught me it is much easier, and far less risky, to gain a full understanding of options by initially holding long, or taken positions.

THIS LIMITS YOUR DOWNSIDE RISK TO THAT OUTLAYED.

Put Options

The taker of a Put Option pays the Writer a premium for the right, but not the obligation, to SELL a parcel of shares at a given price, for a given period of time. In this fashion, the writer of a Put Option is effectively acting like the insurance company by giving a written guarantee to purchase a parcel of shares.

Taker (buyer) *Writer (seller)*



The Writer of the Put Option receives the premium from the taker and providing the stock remains above the agreed 'strike' price, the writer will keep the entire premium.

Writing of Put Options is widely used by investors to lower the entry price of owning shares. While it can be a very valuable strategy when used correctly, it is important to remember that the premium the writer receives will always carry an obligation to buy shares.

Many individuals are told that Writing Put options is a safe way to gain income and lower the entry price of a share. It is important to remember that while it can be valuable, psychology of investors, and institutions is always slanted when it comes to a market correction.

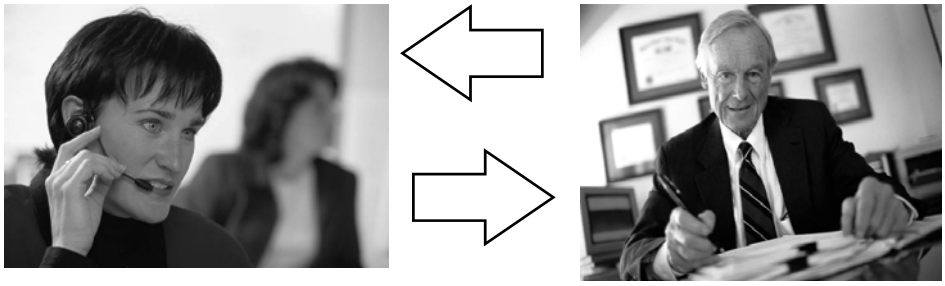
It is a common operating strategy for experienced traders not to sell or short Put Options without some form of protection. These protective measures can be a little involved, so for the purpose of gaining experience, it is sound advice to avoid writing Put Options until you have a solid foundation and understand all the associated defensive strategies.

The taker of a Put Option does not have to own the underlying shares at the time of taking the put as they have the right, but not the obligation, to sell the shares.

The Long and Short of it

Before I begin to play the money game on the stock market, it is important to understand a few basic terms. It is important that you know how to communicate with your Broker by using their own language. You wouldn't expect everyone in China to begin speaking English simply because you were there on holiday, likewise you shouldn't expect your Broker to understand if you are not speaking their language.

The 'taker' is long *The Writer is short*



LONG POSITIONS:
When I buy (or take) an option, I am said to be opening a brand new position. If I was to 'buy to open' one specific contract I am now said to be 'LONG' ONE CONTRACT. Once I am satisfied that it is time to exit my trade, either at profit or loss, I can 'close' my position. In closing my long position I am simply 'selling to close' my contract. Once the contract has been sold, my position is said to be closed, or I am back to neutral.

SHORT POSITIONS:
There are many different ways to use options and it is not always necessary to 'buy to open' a new position. I will talk more about writing options in a later module, however, for the purpose of terminology I will briefly explain how 'short' positions work.

By taking and option I am buying to open. It is also possible to 'sell to open' a new position. Selling, in this instance is called writing as I am not selling a long position, I am selling to create a new position. When I 'sell to open' I am said to be SHORT. To close a short position I simply buy an equal amount of the same contracts which brings the position back to neutral.

Always remember 'Long' positions have a limited downside and an unlimited upside. SHORT positions have a limited upside and carry an 'obligation', or a theoretically unlimited downside.

Types of Options

As I have established, the TWO types of options I am dealing with are the Call Option and the Put Option.

The Call Option gives you the right to BUY shares,
While to Put Option gives the holder the right to SELL shares.

Option contracts were first used as a means of capital protection by allowing the taker to use a small amount of money to either insure their portfolio, or to lock in a certain price with a view to purchase the shares at a later date. While this is essentially still what happens, the ETO has become a stand alone secondary market where individuals, traders and institutions can take, write, buy and sell options without the necessity of owning shares. Take a look at this example:

XYZ Current Share Price = $12.00

Your analysis indicates XYZ shares may rise in the near future. If you bought 1000 XYZ Shares, it would cost you $12,000 plus brokerage. If you were correct and the share price did rise to $13.00 you would make $1,000 profit, or in percentage terms about 8.5%. Not a bad return?

Alternatively, you could buy *ONE CALL OPTION CONTRACT* which gives you the right, but not the obligation, to buy 1,000 XYZ shares for $12.00 at anytime, within the next three months.

This *CALL OPTION* would cost you approximately $500. In the same scenario, as above, and the share price has risen to $13.00, you could sell your *OPTION CONTRACT* in the market for at least $1000. That means a $1,000 profit or in percentage terms around 100%.

(All figures used are examples only)

The Company

Exchange traded options (American Style) are only available on certain securities on the ASX. These securities (shares) are referred to by different names including the 'underlying securities' or 'underlying shares', the 'underlying' or are even sometimes referred to as 'the physical.'

Before allowing ETO's to be issued over a new security, the Options Clearing House must be confident that the company will stand the test of time. There are around 1,300 securities traded on the ASX, yet only around 70 of those pass the necessary qualifications.

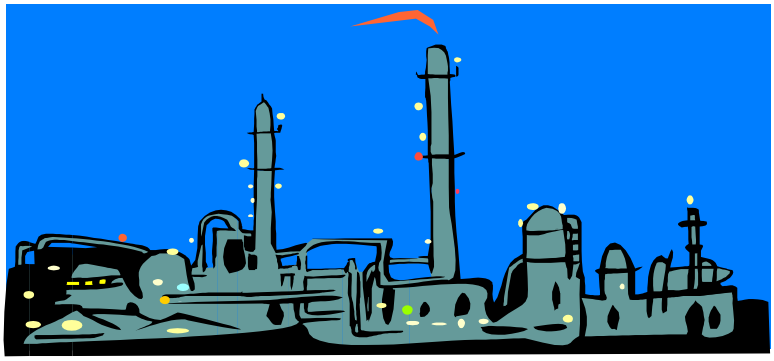
Each company which trades on the ASX has a three letter company designator by which it is recognised. For example:

Mount ISA Mining is known as MIM
News Corporation is known as NCP
BHP is strangely enough known as BHP etc.

Regardless of the expiration date, which will be covered in a later module, every option traded over a particular company is referred to as a 'class'. That means the THREE letter designator for Lend Lease is LLC therefore, all call options and put options over LLC fall into that particular class.

In my experience, restricting your trades to the most liquid companies, delivers a much more consistent return.

A list of all Classes of options trading on the ASX's Derivatives Market can be found at http://www.asx.com.au



Ten Most Liquid Stocks

Generally speaking, you will get a closer spread, and more often than not a better price, when the volume of contracts is high. In particular, the series you are bidding/offering. Here is a least of the top ten most liquid option stocks for 2001.

OCT 2001	Volume	Mkt. %	O.I.	Vol/Op	Share Vol.
TLS	100 254	8.9%	193 032	51.9%	341 100 000
NCP	92 802	8.2%	115 926	80.1%	120 495 000
BHP	90 009	8.0%	111 569	80.7%	263 532 000
ANZ	89 324	7.9%	42 539	210%	134 257 000
NAB	85 151	7.5%	62 393	136.5%	115 986 000
CBA	79 709	7.1%	66 199	120.4%	71 519 000
MIM	69 660	6.2%	73 890	94.3%	329 753 000
WMC	69 579	6.2%	66 886	104.0%	142 746 000
WBC	54 848	4.9%	36 033	152.2%	122 044 000
WOW	40 737	3.6%	62 541	65.1%	70 507 000
Top 5	457 540	40.5%	525 459	87.1%	975 370 000
Top 10	772 073	68.3%	831 008	92.9%	1 711 938 000
Mkt.	1130 397	100%	1520 141	74.4%	4 890 551 000

Monthly Trading Volumes for a 12 month rolling period: **12 Feb 2002**				
Date	**Equity Trades**	**Options Contracts**	**Warrant Trades**	**Futures Contracts**
Jan 2002	1,145,909	1,114,342	34,176	88
Dec 2001	941,020	934,177	30,990	0
Nov 2001	1,229,665	1,228,748	46,494	0
Oct 2001	1,108,728	1,130,397	49,972	0
Sep 2001	1,218,136	1,265,567	51,584	0
Aug 2001	1,150,916	1,190,269	38,557	0
Jul 2001	1,166,720	1,143,337	33,987	0
Jun 2001	1,285,112	1,290,099	38,421	0
May 2001	1,203,521	1,292,484	42,733	0
Apr 2001	870,596	998,189	30,997	0
Mar 2001	1,097,630	1,266,924	36,331	0
Feb 2001	996,825	1,104,026	26,109	0

Option Expiry Date

As I have already mentioned, every option contract is issued with an expiry date. This means that at some point in time the option MUST expire totally worthless.

The expiry day is the day on which all unexercised options in a particular series expire and is the last day of trading for that particular series.

Generally speaking Option contracts will expire on: *the last Thursday of the month, prior to the last trading day of the month (Friday).*

NOTE: The Options Clearing House reserves the right to change this day should the need arise. The reason there is a trading day after expiry is to allow all contracts to be settled.

The general cycle for all options of a particular class will be one of the three quarterly cycles listed below:

January/April/July/October
February/May/August/November; or
March/June/September/December

Options are usually listed for the next three months in the quarterly expiry cycle.

In simple terms, if an option is following a particular cycle, as soon as the current one expires, the next series will become active. This is not always the case, although it gives you a good indication.

One strong indication that a particular series will have good liquidity is the fact that it will have MONTHLY option expiry cycles. As an example companies such as the BIG FOUR banks, News Corporation, Rio Tinto and the other big companies have monthly Option series.

NOTE: This is by no means a recommendation to trade these securities as there are many other factor to consider.

Module Four

Option Pricing

Exercise or 'Strike' Price

The strike price, or sometimes called the exercise price, is the predetermined price at which the option is exercised.
The Strike Price is generally fixed throughout the period of the option contract.

The Options Clearing House (OCH) sets the exercise price for all options listed with the ASX. Normally , there will be a range of exercise prices available for options with same expiry day.

For a Call Option, this is the price at which the taker (buyer) of the Option can BUY the shares. Whereas for a Put Option it is the price at which the taker (buyer) of the option can SELL the shares.

There are three key Strike areas to look at:

IN-THE-MONEY - **ITM**

AT-THE-MONEY - **ATM**

OUT-OF-THE-MONEY - **OTM**

Exercise or 'Strike' Price (cont'd)

In-the-Money

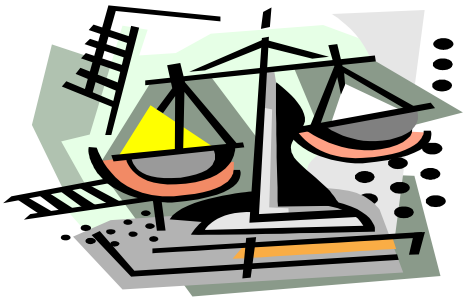
When an option is *In-the-Money (ITM)* it means that it has intrinsic value. In other words, it is (at present) making money for the taker (buyer) by allowing them to BUY the shares for less than the market price. So a Call Option is in-the-money when the strike price is *BELOW* the current share price.

For Example: CBA 31.50 July Call

If the share price is $32.00 and the strike is $31.50, the option is clearly in the money.

Put Options are the same concept, however remember that they operate in reverse;

NCP 22.00 SEP PUT
If the current share price has fallen BELOW the strike price of $22.00 to $21.50 then our put option is IN-THE-MONEY.
This is because we have an option contract that allows us to sell NCP shares for $22.00 even though they are trading at $21.50



Exercise or 'Strike' Price

At—the-Money

An option is described as being ***At-the-Money (ATM)*** when the strike price is equal to the current share price. This is the same for both Call and Put Options.

For Example:
CBA 31.50 JULY CALL is At-the-money when the share price is also $31.50.

Similarly, NCP 22.00 SEP PUT is At-the-money when the share price is at $22.00

Out-of-the-Money

An option is ***Out-of-the-Money*** (OTM) when the share price moves in the opposite direction to the option. When an option is out of the money, it has no ***Intrinsic value.***

NOTE: it may still have time and other value components.

CBA 31.50 July call is Out-of-the-money when the share price is below $31.50. So if the share price is $29.50 the call option is out-of-the-money because it would be cheaper to buy the share on the open market, rather than to exercise the option.

Therefore, a Call Option is out-of-the-money when the share price is BELOW the STRIKE price, and a Put option is OTM when the share price is ABOVE the STRIKE price.

Exercise or 'Strike' Price

Out-of-the-Money: Let's consider our NCP 22.00 SEP PUT. If the share price of NCP rose to $24.00 the put option would be out-of-the-money. This is because it would be better than to sell the NCP shares on the market at $24.00 rather than exercise the option and sell them for $22.00

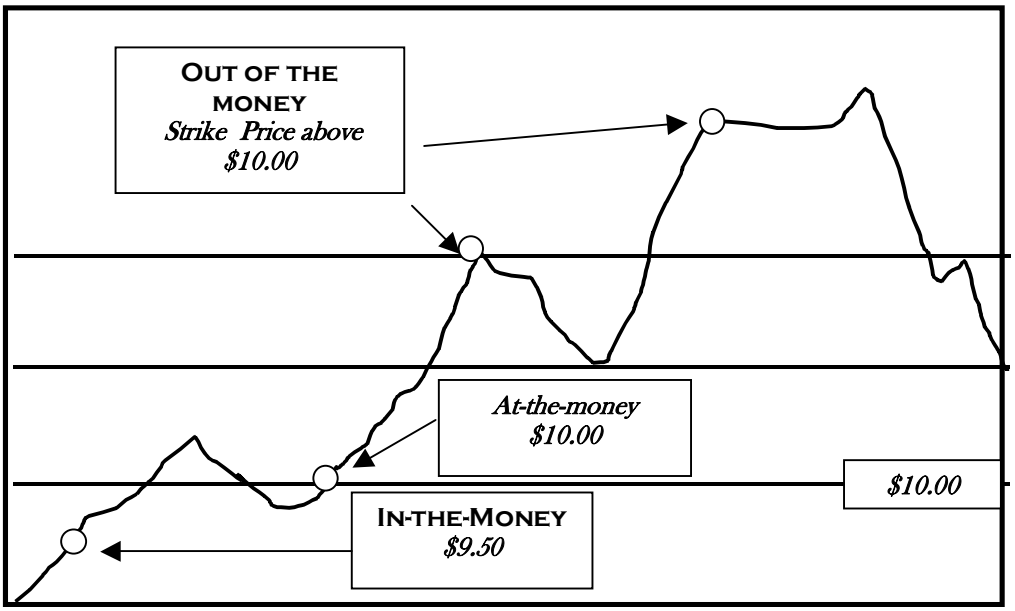
A Put Option is Out-Of-The-Money when the strike price is BELOW the current market price

If you find yourself getting a little confused, congratulations, you're normal. Just go back to basics.

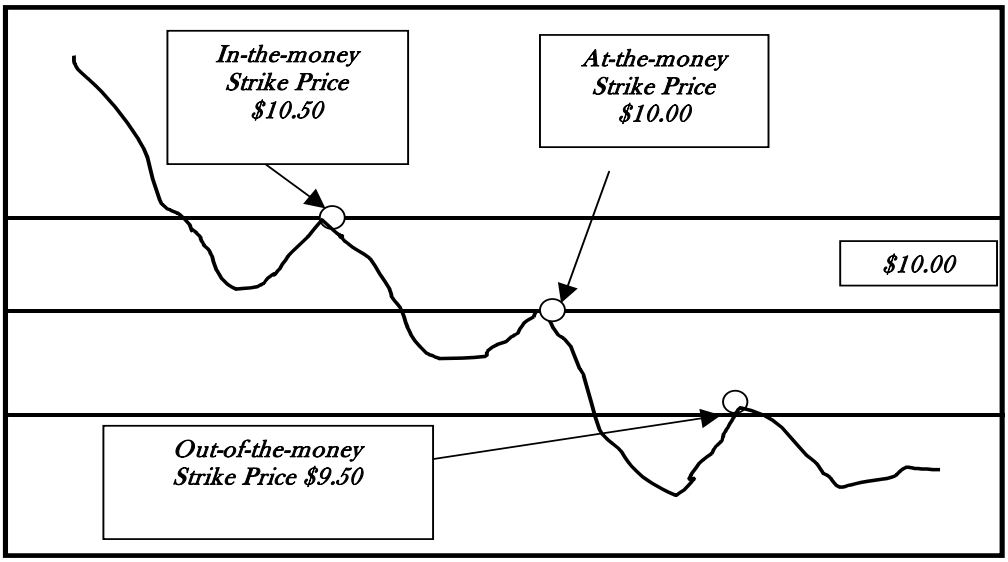
- Is it a Call or a Put?
- Have I got the right to BUY or SELL?
- If I am buying do I want to pay more or less?
- If I have the right to sell, do I want to receive more or less?

If you go through each one carefully, you will soon be able to describe which one fits your situation.

Call Option Strike Price



In the above example, the share price is $10.00, so for a Strike Price to be in the money would be anything below $10.00



Put Option Strike Price:

In the above example the Share price is $10.00 so an In-the-money Strike Price is anything above $10.00.

Review of Important Points

1. The ……. Price, which is sometimes called the '…….' is selected by you before making your trade.

2. There are three areas in which you can select your strike price, …….the money, ……., the money, or …….of the money.

3. I always recommend dealing with …….the money options.

4. A Call Option is …….the money when the **Current Share Price** is **Above** the selected **Strike Price**, because it gives you the opportunity to …….the shares for …….than they are worth.

5. A Put Option is …….the money when the **Current Share Price** is **Below** the selected **Strike Price**, because it is gives you the ability to …….the shares for …….that they are worth.

6. The reason you select …….the **money options** is that they you a slight cushion should the stock decide to move in the opposite direction.

Option Pricing Fundamentals

Intrinsic & Time Value

The intrinsic Value is the difference between the exercise price of the option, and the market value of the underlying security at any given time.

The following example is of a Call option over ABC security with a Last Sale Price of $10.00.

Strike Price	Premium	Share Value	Intrinsic Price	Time Value
$ 9.50	$0.90	$10.00	$0.50	$0.40
$10.00	$0.46	$10.00	$0.00	$0.46
$10.50	$0.18	$10.00	$0.00	$0.18

While you can use the following formula to calculate the intrinsic value of an option, it can be come more complicated than it's worth. If you simply remember that an option only has intrinsic value when it is worth something real.

If a Call Option gives you the right to buy a share for LESS than it is currently trading, it has intrinsic value.

If a Put Option gives you the right to SELL a share for more than it is currently trading, it has intrinsic value.
Current Share Price – Strike Price = Intrinsic Value
e.g. $10.00 – $ 9.50 = $0.50

The other component in the option price is TIME value. Time value refers to everything other than intrinsic value:
Premium – Intrinsic Value = Time Value
e.g. $0.90 – $0.50 = $0.40

Option Pricing Fundamentals

Time Value

As a general rule, an option contract will lose one third of its TIME VALUE during the first half of its life, and two thirds during the second half.
The Stock & Options Markets operate along the same principle as 'Paddy's Market'

As an option trader, you are in the same business as any other trader in the world. You are not like wine collectors who employ a buy and hold strategy, you are more like the importer who buys at wholesale and sells at retail. The faster you can make a transaction, the less chance there is of something effecting your products.

While there is not a Bank in the world who will sign a written guarantee over your money, the fact remains that your money is safer in the Bank than it is in the market. As a trader, the less time your money is spent holding a particular trade, the less chance there is that something unexpected can effect it.

The investors philosophy is 'Time in the Market', while the traders philosophy is 'Timing of the Market.' In this type of trading we are not concerned with the capital growth potential because we are working against time. Your goal is simply to buy your options at wholesale and sell them at retail before any time decay has a chance to spoil your fruit.

Time Value

I have already discussed the difference between time value and intrinsic value. To simplify things, time value refers to everything that is not of intrinsic value. For example, the premium of an option which has no intrinsic value will consist solely of 'time' value.

1. The longer the time to expiry, the greater the value of the option.

2. The present level of volatility will dramatically effect the option price. The higher the volatility, the higher the premium.

3. While interest rates do effect option pricing (an increase in rates will cause Call options to rise and Put options to fall and vice versa), the duration of our trades limit this effect on or this type of trading

4. Dividend payments will always be factored in to the price of the option. The price of put options will generally increase slowly during the lead up to the payment of the dividend, which will in turn 'cushion' the effect of the payment. Dividend payments alone are definitely not a good enough reason to take puts'

5. Market expectations will ultimately govern supply and demand and therefore determine the market value of options. During strong demand premiums will be higher.

Which Contract to buy ?

It is common for new traders to be misled into believing that they will make money when the share price reaches their selected Strike Price. This is not necessarily so, as a matter of fact this is very rarely the case. I have discussed buying options In, At and Out of the money, however, this does not relate directly to how much you have invested into a particular trade.

Let's say you purchased 1 ANZ DEC $12.50 Call option, which had a premium of $0.55, or $550 for the contract. The current share price is $12.95, therefore, your contract is $0.45 in-the-money. Imagine the share price drops to $12.60, your contract is still $0.10 in-the-money, however, you are losing money because your contract has dropped from $0.55 to $0.20.

While you are getting your feet wet with Options, I STRONGLY RECOMMEND buying only in the money Options. With experience you will soon see that most of the volume in options, as well as a good majority of the Open Interest, will be in the first and second out of the money. The reason for this is that most institutional traders or Market Makers trade in these options.

Trading in out-of-the money options can be a very lucrative style of trading. It can also destroy your trading bank before you have had the time to develop your belief and experience. History has shown me that 85% of traders who trade out of the money options too early, will end up working for income.

DON'T DO IT—UNTIL YOU ARE MORE THAN READY!!

The thing to remember is that you should always cut your losses early, and let your profits run. The ego has a tendency to operate in reverse by cutting profits short and letting losses run.

Should you find yourself listening to that little voice that says "It'll come back…….I hope."

STOP TRADING IMMEDIATELY!

What is 'Delta'

In simple terms, the Delta of an Option relates to the amount the Option price changes, in relation to the amount of movement in the price of the underlying security (share). In general, an Option Contract that is deeply In-the-Money will have a Delta of 1. This means that for every point of movement in the price of the underlying security, there will be an equal movement in the price of the Option contract.

For example; ANZ is trading at $13.50 and you are looking at a Call Option with a Strike Price of $11.00. As you are aware, that contract is deeply In-the-money because it allows you to buy the shares for $2.50 below the current market. This contract is likely to have a Delta of 1, meaning for every cent of share price movement, there will be an equal amount of option contract price movement.

Conversely, an Option which is deeply Out-of the-Money will have a Delta of 0. This means that once an option contract has past a certain point, it can no longer move with the share price. This is not an indication that it cannot recover. If the underlying security turns and moves in a favourable direction, the contract and the Delta will adjust accordingly.

At a glance, if an option is In-the-money the Delta will be around 1, if it is Out-of-the-money, the Delta will be around 0 and if it is At-the-money it will be around 0.5. Most Options will lie somewhere on this scale.

(Put Options are the same concept, however, the Delta will be referred to as a negative figure or 0 to -1.)

Why is the Delta Important?

The Delta can be used to judge profitability of a trade. One thing to remember, is that the Delta of an option is linked to an underlying security and they are dynamic and forever changing. For this reason, the Delta should not be used as a decision making tool, but more as a profitability guide, once the decision has been made.

There are many other formulas in the family of 'Greeks'. There are thetas, gammas betas etc. For me, trying to remember the names is an arduous enough task without trying to discover when to use them, or what they do. The KISS principle couldn't be more valuable than it is in trading. If you find you need to re-analyse every trade you make time after time, you will find you are attempting to trade using "left" brain logic only and one thing the market is definitely not - is logical.

Generally, in a Call situation, the higher the Delta, the more likely the price of the option is likely to rise, in accordance with the price of the underlying security. Likewise, in a put situation the larger the number, the greater the effect on the rise in the option price. (The reason I say the larger the number is because put options are measured using a negative delta.)

For Example: A Delta of 0.80 indicates that for every $1.00 rise in share price, the option price will rise 0.80 cents, but don't get trapped into believing that the highest Delta is the best investment.

While Delta is an indication, personally I never use it as an entry or exit guide due to it's volatility. Working out the Delta is like painting the Sydney Harbour Bridge. Once you have given it your consideration, it has changed so you need to reconsider it again. There are much easier and faster ways to select the most profitable contracts.

What is Open Interest ?

When I talk about open interest, I am not talking about the volume of contracts traded. Open Interest refers to the amount of OPEN contracts in any particular series, at any given time. The reason I require open interest is quite simple. As an up-coming trader you do not know all there is to know about the stock or option markets, therefore, you will want some other 'interest' in the contracts you are seeking to purchase.

Open Interest does not necessarily move with time, although it is a good indication of market sentiment. For example, if there was a rally in a particular stock, the open interest in Call options for that series would increase due to a higher demand. Likewise, should the sentiment in the stock fall away, so too would the open interest of the options series as traders may begin to close out their positions. It is interesting to note that in general the OI of the first and second OTM contracts is generally the highest and will move with the stock as market makers follow the fastest moving contracts.

It is difficult to establish a fixed number of contracts required. A $1.00 stock may have an OI in a particular series of 6789, where a $30.00 may only have 160. As a rule, I require more than 150 in any particular series with reference to the value of the stock.

By that I mean, if I was looking to trade MIM for example and the open interest was 140, this would be a concern. On the other hand, if I was looking to trade CBA and the OI was 140, I would be less concerned as the value in the amount of contracts is much greater.

The reason I need a good OI is liquidity when it comes to the time to sell my contracts. Stick with the rule of a minimum OI of 150, I have used this and never been in a situation where I couldn't sell my options. The more the merrier.

Even experienced traders need a checklist. Several times I have forgotten to check the OI only to find I owned the whole thing.

Q. *Which Option will provide a cushion should the stock move against us?*

A. The in-the-money option

Q. *What is meant by Open Interest and why is important?*

A. Open interest refers to the amount of current open positions in a particular series and is a critical indication of the liquidity . It is important to have at least 150. However, the high the better.

Q. *What is mean by Out-of-the-money?*

A. The term out-of-the-money refers to an option which has no intrinsic, or real value. The premium is constructed solely from time value.

Q. *It is important, yet not absolutely essential have some traded volume on the day you wish to trade. True or False?*

A. True.

Q. *An option which has monthly expiry cycles will more often than not be less liquid than one that does not. True or False?*

A. False, monthly options generally provide far better liquidity.

Checklist for option buyers

1. Always buy your options FIRST or SECOND ITM.

2. Always ensure you have at least FOUR WEEKS to run on your contract.

3. Always ensure the open Interest is above 150.

4. It is advisable not to trade contracts which have little or no volume for the day.

5. Never hold your contracts with less than three weeks to run.

6. Check the option price against the share price to determine good value. (This will be covered in more detail in the live trading module.)

Module Five

Trading Systems

Market Terminology

Before we begin playing the stock market game, it is important to understand the basic language of the teams involved.

If we were to go to France for a holiday, we wouldn't expect the entire French population to speak English just for our sake. Likewise, we should not expect our Brokers to understand our orders if we don't use their language. Bullish and Bearish are the two most common terms used to describe market direction.

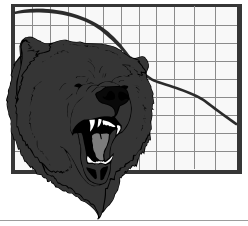
A Bullish market is when there are more buyers than sellers, therefore, giving the security a higher. This will generally increase demand for the stock and push the price North

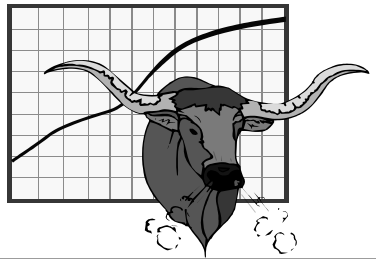
On the opposite side, a Bearish market is one where there is more sellers than buyers. The selling pressure will often be enough to encourage the price to head South.

Once you develop a basic understanding of Technical Analysis, it will soon become obvious to you that the difference between trading and investing is only to do with the time frame. Every technique you learn can be applied to both short and long term positions and as you already understand with options, there is always an equal and apposite way to construct a trade.

It is critical to develop a solid foundation on which to build your analysis, By using the correct terminology you will be able to establish a rapport with your Broker a lot faster which will facilitate a smoother transition from paper trading to live trading. Having said that, you will see that some of the terminology I use, I have fabricated to serve my own purpose.

The Terms we use are "Bullish", "Bearish" or "Rubbish" (time for Golf)





Market Sectors

The Market is made up of various 'Industry Sectors'. These sectors are divided into indexes and each index provides investors with important information regarding the general sentiment of each index. For example, in one session we may see a strong rally in is the banking sector, although something like the media sector may be struggling. We can use the various indices as a guide to the direction of individual securities

Indices are represented by 'baskets' of shares and measure the broad performance of the markets. The All Ordinaries Index includes around 300 of the 1200 publicly listed companies on the ASX, although it accounts for around 90% of the total value of Australian listed shares.

Companies chosen to represent the 'All Ord's' are done on the basis of market capitalization or, the share price multiplied by the number of shares issued. While the All Ords is still a valuable index, the recent introduction of the ASX top 100 & 200 is taking over as our bench mark.

For Example:
If ABC Corp's stock price is $10.00, and there are 100,000 shares in circulation, the Market Capitalization would be
100,000 x $10.00 = $1 million

Because all of the Securities we will be trading are part of the ASX top 200, this is the index we will look at. While the index gives an indication of direction, I personally only use them as a guide and never make a buy or sell decision based on the index alone.

Unless of course, I am trading an index option which is also a great way to gain exposure to a whole market sector. Index options work exactly the same as ETO's, although a point system is used and they are always settled for cash.

Systemising your Selections

There are two very different schools of thought around share selection and analysis. Both can be very valuable if used correctly. The biggest drawback with the amount of information available to us today is information overload. If you attempt to analyse things in too much depth, your window of opportunity as far as option trading will close before you are ready to trade.

Technical Analysis:
Relies on price and volume movements of stocks and does not concern itself with financial statistics. For hundreds of years professional investors have relied on company reports and statistics to determine buy and sell decisions. With the recent advent of computer software, the average person now has access to the latest information at the click of a button. For this reason, charting has become very popular indeed. This type of analysis will form the basis of our decisions. It is subjective and limits the variables, thereby reducing confusion. This is not say that it is foolproof, nor would I say it's the best way to analyse, it's just the quickest and easiest way which, with practice once can develop a fairly high strike rate—high enough that is to make money!

Fundamental Analysis:
Is an analysis of the balance sheet and income statements of companies, in an effort to forecast their future stock price movements. Fundamental data is the type of information you will find on a company's annual financial report, and is sometimes referred to as financial analysis, or the value-oriented approach to analysis.

There are many experts on either side of the analysis fence and there are some experts who advocate a healthy balance of the two. During this process you will find the information tending to be more technical for two reasons:

1. Using Technical Analysis allows the use of a system,
2. Charts always tell the truth, the trick is to know what to look for.

In life, we all know that balance is key to success. However, with trading, I do recommend supporting your technical data with fundamental evidence, should you try to 'balance' you will find it almost impossible to make a decision.

The reality is that Fundamental Analysts rarely agree with the Technical specialists and vis a versa. Later on I will illustrate the importance of being informed bout company reports, dividends payments and some other general fundamental points. Although 90% of my analysis is based on the charts. Should I happen to see something on the news or get a red hot tip from my local cab driver, I will always check with my charts first. If the charts don't offer me an entry signal, I won't trade it—it's that simple!

The more time I spend around the stock market and the people involved then the more I learn. I imagine in 40 or 50 years time I may consider doing something else and I may venture into Fundamental Analysis. However, for the present, there are plenty of expert analysts whose global information you can buy for around $75.00 per trade. My father has a saying that (I tend to agree,) "if it ain't broke … don't fix it".

For investors looking to buy, hold and pray, your prayers would be best supported with some quality long term analysis from some the well known and respected analysts. For more information, contact your broker.

Technical Analysis

Charting is the point where our voyage begins. Learning to read a chart of a security is in many ways the same as reading a navigational chart. There are clues everywhere as to safety and hazards, it's simply a matter of practicing until you can rely on your skills. The most important part of charting is to identify significant reference points, or landmarks, set your course and follow your rules.

"History doesn't repeat itself, but it rhymes." Mark Twain

The very act of consulting the charts deems that we are looking at the historical picture of where our stock has travelled in the past. This being the case, we take on the underlying assumption that wherever the stock has been before, there is every reason to believe it could go there again. Also, if there are areas the stock has not been, the assumption is that it will take extraordinary information to cause that stock to journey to those areas.

One trap a lot of people fall into with Technical Analysis is that they try to analyse it to death. Being thorough and accurate is important, however, if you find yourself becoming critical of every chart, you will find it difficult to spot good entry signals. If you are experiencing difficulty in identifying more than about 6 to 8 trades per month, then may be you are looking too hard. On the odd occasion, the market will move through quiet times although generally they don't last too long.

The beauty about this system is that once you have developed your analysis and mastered the ability to enter and exit a trade, there are more advanced techniques which offer consistent opportunities every day of the year. To attempt these type of trades before you complete your apprenticeship, however, is one sure way to commit trading suicide.

Human nature tends to react to similar situations in consistent ways. The animal that resides in all of us is a creature of habit. It likes things to be the same and is uncomfortable when pushed out of it's routine. There is nowhere this behaviour is more evident than in the historical movement of the stock market.

Every stock is at its current price because of everything that is currently known about that stock. New information will generally force the price North or South depending on the nature of it. We do not know when, what, why or how this information will come so the only way to trade consistently is by charting.

Think of it this way, if you were to work with the same person, day in and day out, for the entire year, do you think you would get to know their habits? More than likely. Well it is the same when looking at your stocks. I have been looking at the same charts almost every day for the past years, and I have now developed a good 'feel' for how certain stock react to certain situations. This is not say I don't have to remain alert and neutral when conducting my analysis, but it does give you confidence when you trade and that's what it's all about.

The market can be compared to a wild horse—it smells fear it will capitalize on it straight away. I used to take this very personally until I realised it had nothing to do with the market itself. Every bad trade I have made, I have done so because I reacted on my emotions instead of responding with a decisive action.

Trading Systems

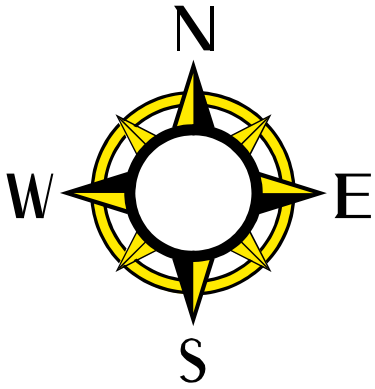
Why do you think the McDonalds chain has become the most successful franchise in the world? Is it because they serve the greatest hamburgers? Not a chance, there are millions of better places to eat. The reason they have excelled is because of their systems. More importantly, there are two sides to the 'system' coin. The first, is that the system provides safety and certainty for the employees, owners, managers etc. This certainty is to allow them to work in a precise environment to produce the same result every single time. The system has been tried and tested and is guaranteed to deliver the exact same products and services over and over again.

The second, and for me the most important, is the certainty these systems provide for the customers. As I mentioned before the animal instinct in all of us loves certainty and hates surprises. That's why you'll find for example an Australian in Hong Kong going to McDonalds simply because they know what to expect. They probably don't eat the stuff at home, but because it all looks a little unfamiliar or scary, they will retreat to the tried and tested, even if they know it tastes like plastic.

What has this got to do with trading? Everything. Do you think it's important for you to have faith in your system? If so, how can you accelerate that faith? One way is to paper trade. Use the system without using your own money until you have grasped how it works. By doing this, you will build a platform upon which you can begin to expand.

Think of your system as your navigation plane. It will tell you all you need to know, and your navigational (trading) experience will fill in the blanks. This is the only way I know to build a successful trading record.

Use the system until you have developed your sense of direction and safety. Once you have established this certainty using the system, then you can try eating at a different restaurant once in a while.



Trade within your limits

Whether you know it or not, the most important part about any system is the person operating it. If the system you are learning to operate was guaranteed to produce cash without human input it would sell for billions of dollars.

It doesn't matter whether you have the fastest and most technological-advanced speed boat in the race, if you don't know how to pilot it, you'll crash. The same applies here. The mechanical system can be learned in a couple of days. However, the important thing is to recognise your tolerance level before you enter the market.

Someone once said, if you want to find out what sort of investor you are, just put a thousand dollars out in the stock market. In my opinion, you need to have a basic understanding of your risk aversion levels before you start. By now you have discovered the difference between Abundance and Scarcity mentalities, and while it is important to practice being an abundant thinker, too much of both can be detrimental to your cash account.

The key for me is to remain neutral. If I find myself getting excited or fearful of a position, I know it's time to take a break. It may sound easy in theory, however, this is the rock upon which most traders get shipwrecked. To believe what is happening to your trading bank is external to you, as much as it is external for you to believe that the world is flat. You will never produce consistent returns if you are slave to the emotional roller-coaster.

Trading within your limits

One of the most widely used ways to determine your personality profile is by conducting a Myers-Briggs type indicator. When I was first exposed to this kind of testing, I was a little sceptical, as I didn't want to be type cast, or put in a 'you are this kind of person' box. Interestingly enough, the result for me was exactly the opposite.

It's a little bit like the franchising manuals issued by McDonalds. At first glance it may seem to be totally restrictive and difficult to work within. In practice, however, the certainty generated by the 'no-brainer' systematic approach produces far greater, and more consistent results.

Once I could establish what my 'habitual' personality traits are, it became far easier to recognise my own behavioural patterns with regard to trading. I discovered that most of my losses could be directly contributed to rash or impulsive decisions, both to enter a trade and to exit. These rash decisions were very costly indeed, with realisation and using the personality indicators made me aware of what was happening it was easy for me to adjust.

The most important part about this whole trading game is to be aware of what is happening. Not necessarily to change anything, but to give yourself certainty of your actions. As we have already discussed, it is certainty, or the lack of it, which will ultimately determine your results. By beginning with awareness and combining it with certainty, you have the formula to repeatedly produce your desired outcome.

Repetition itself will create experience and eventually lead to mastering your craft. One of the key problems in our society is the fact that most of the population sails through life totally unaware of what is happening. If you can 'wake up' and embrace change when you identify it, you can unlock the secrets to your ultimate lifestyle.

This in itself is the topic of a whole different seminar, although I feel it is important to at least introduce it here. After all, your results depend on it. By learning to trade options you are transcending the nine to five syndrome. The definition of 'Transcend' is the end of a trance. As if you have been sleeping and suddenly awake to new opportunities.

When I look back at my trading register, I can see that all of my substantial losses came directly after extremely long profitable runs. This is no coincidence! This is the first sign that I had let my ego get out of control and started to make silly trades. Even now, if I have a great week or month, I may take week or so away from the charts and have a little 'smug' time. By doing this, I can return refreshed and there is less chance of my emotions blowing away my account.

This is easy to say, although I would love to receive $1.00 for every time I've heard a trader say "You know, I thought I had it nailed there for a while, I was doing great when suddenly it all changed…" I don't need to finish this phrase. There are all sort of stories and excuses about this, but the bottom line is that it has nothing to do with September 11, Enron or Ansett. But it has everything to do with the fact that after a little taste of sugar (just like the child in the candy shop) we don't know when to stop. We just keep on eating the sugar until eventually we can't take anymore.

Trading is exactly the same! Know your limits and know when enough is enough. In the words of that famous farmer "...that'll do pig! That'll do…"

Who are you? Exercise

A simple way to begin to develop a keen awareness of whom you are, and more importantly, how you respond to various forms of stimulus, is to make a list of your likes and dislikes.

Take a few moments to jot down a list of 10 things you like about yourself. Sometimes it is easier to write down what you would like other people to say about you, for example she's warm, funny, cute, outrageous etc.

1. .....
2. .....
3. .....
4. .....
5. .....
6. .....
7. .....
8. .....
9. .....
10. .....

Now take a few moments to come up with a positive opposite to what you already have. By doing this process we can begin to examine life's mirror, and how life is continually pointing us in the direction of our most sacred desires. The problem for most of us, is the fact that we are so busy denying ourselves, or justifying our actions to others, we completely miss the signals.

1. .....
2. .....
3. .....
4. .....
5. .....

6. …….
7. …….
8. …….
9. …….
10.……

Make sure you can find an empowering side to these opposites, otherwise it will be difficult for you to integrate them into your new philosophy.

It is important to remember that ALL parts of our being are important in order to achieve a truly balanced and fulfilling life. To deny any part of ourselves leads to certain discomfort and 'disease'. For example, if you are 'organised' you may see the opposite as being 'flaky'. We can replace this with 'carefree' and realise the gifts related to the art of relaxation, etc.

Risk Profile

Now that you have identified a few of your likes and dislikes, it will be easier for you to see through each trait without judgement. The desire to be 'right' or 'true' can be a very expensive one indeed. I know personally, my own righteousness has led to my downfall on many occasions. By failing to see the lesson's I had learnt, I continued to repeat the same pattern. With an awareness of the 'mirror of life' I began to understand that my circumstances always remain linked to my core desires.

By accepting these lessons and recognising each one as a truly valuable gift, I am able to move through the most uncomfortable situations with gratitude, instead of in a constant state of restriction and denial. We are exactly where we are today, due to the combination of every decision we have ever made. Our physical health, our bank balance, our relationships, as a matter of fact everything we are, is linked to our past decisions and their consequences.

The law of the universe is action and re-enact Every action carries with it a consequence, and every consequence carries consequence. For me, the mere act of accepting responsibility and becoming an active participant instead of a passive bystander ensures my life is constantly exciting and fulfilling. The good news is it is born out of one simple decision. The decision to be accountable.

Accountability combined with a deep sense of gratitude for every experience you have ever had will release you from the bondage of blame and insecurity. Once you become truly accountable for your circumstances, things begin to change rapidly.

Look back at your list of dislikes and identify with them as the things you need to accept. The pinnacle of life experience for me is to be able to accept everything as it is and not to judge, criticise or condemn, but to gain valuable lessons from all experience.

The Chinese symbol for crisis represents not only challenge, but also opportunity. For every challenge we are confronted with, we also have the opportunity for an equally empowering lesson.

The Western version of this is 'Every cloud has a silver lining' and it's more than just a catchy phrase. If you adopt this as a core philosophy, there is nothing on earth that can ever knock you down.

Module Six

Trading Periods

Bars Charts—OHLC

There are many different ways to identify what is actually happening in the market. A popular method, and one which I recommend is Candle Stick charting. The only draw-back with Candle sticks is that initially, they can be a little confusing. For this reason, the price indicator we will use here is called a price bar, or an Open, High, Low and Close (OHLC) indicator, which in my opinion, is the simplest to start with.

The OHLC indicator is a simple graphical representation of the price movement for a particular session. The following is an example of one days movement.

For Example:

We will be using the OHLC to recognise the significant reference points required for trading. This indicator forms the basis of our Navigation plan and provides an instant reference to individual price movement.

It is important to note that the Close may not necessarily be the Last price for the day. For this reason I refer to this indicator *as the Open High Low and Last (OHLL))*

Daily, Weekly and Monthly

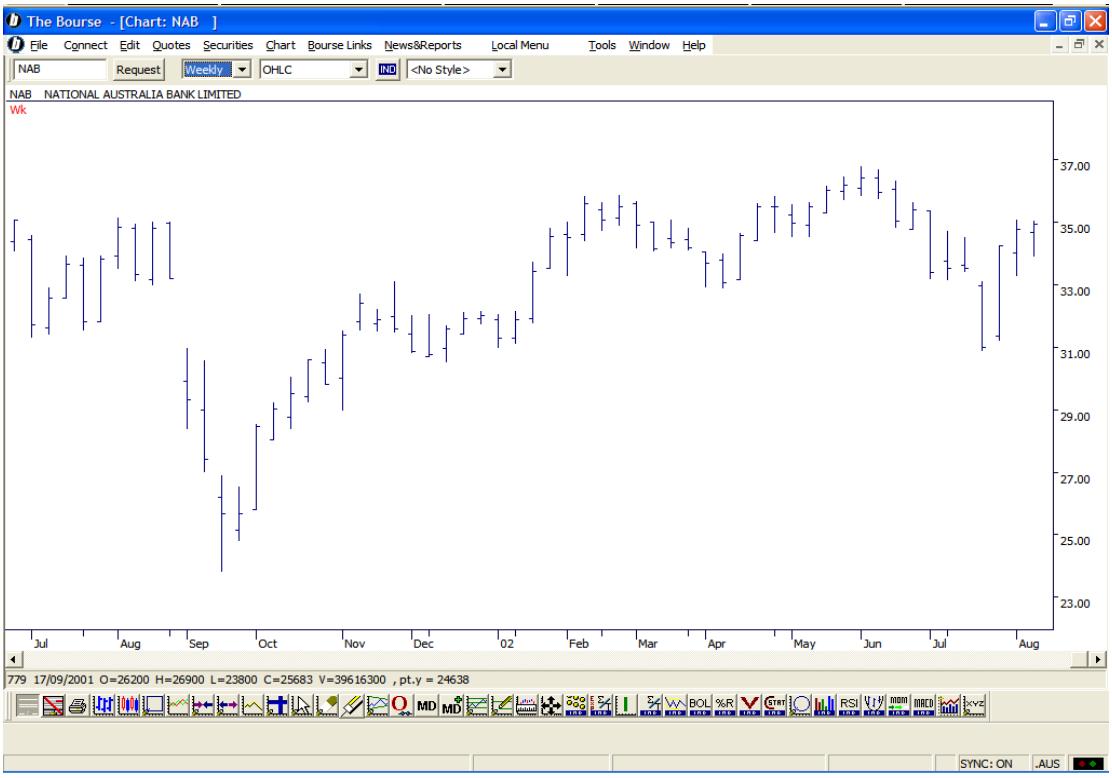
You have looked at the common bar chart, or western bar chart, which shows you the Open, High, Low and Last price for a particular trading period. These trading periods can vary from one minute to one month, depending on the type of trading your are doing.

I will concentrate mainly on the daily and weekly charts because of the relatively short term trades I am conducting. A day trader would use what we call an 'intra-day' chart, which would separate each trading session into small blocks of time such as five or 10 minutes. Conversely, a long term investor might only be concerned with the monthly charts.

While each chart looks the same, it is important to note that a daily chart will show you the Open, High, Low and Last for that particular day. A Weekly chart will show you the Open, High, Low and Last for that particular week. While a monthly chart will provide the Open, High, Low and Last for the month.

Whenever I vary the trading period, I must also vary the way I read the chart. I will look more closely at how to read the daily and weekly charts in a later module. However, the examples on the following page show how 12 months looks different when comparing the daily chart with the Weekly Chart.

Daily vs. Weekly

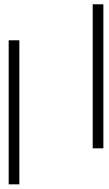


Trading Periods—Daily Chart

Northern Days

A 'Northern' day, in simple terms, is a particular trading day which has a 'Higher High' and 'Higher Low' compared to the previous day. When I am looking to trade, I'm waiting for the market to indicate to me that it's intention is to move one way or the other. History has proven that a great majority of Northern moves begin with one specific northern day.

This type of day is one of only two which can constitute the beginning of an entry signal. We require both the HIGH for the day and the LOW for the day to be above that of the previous days trading

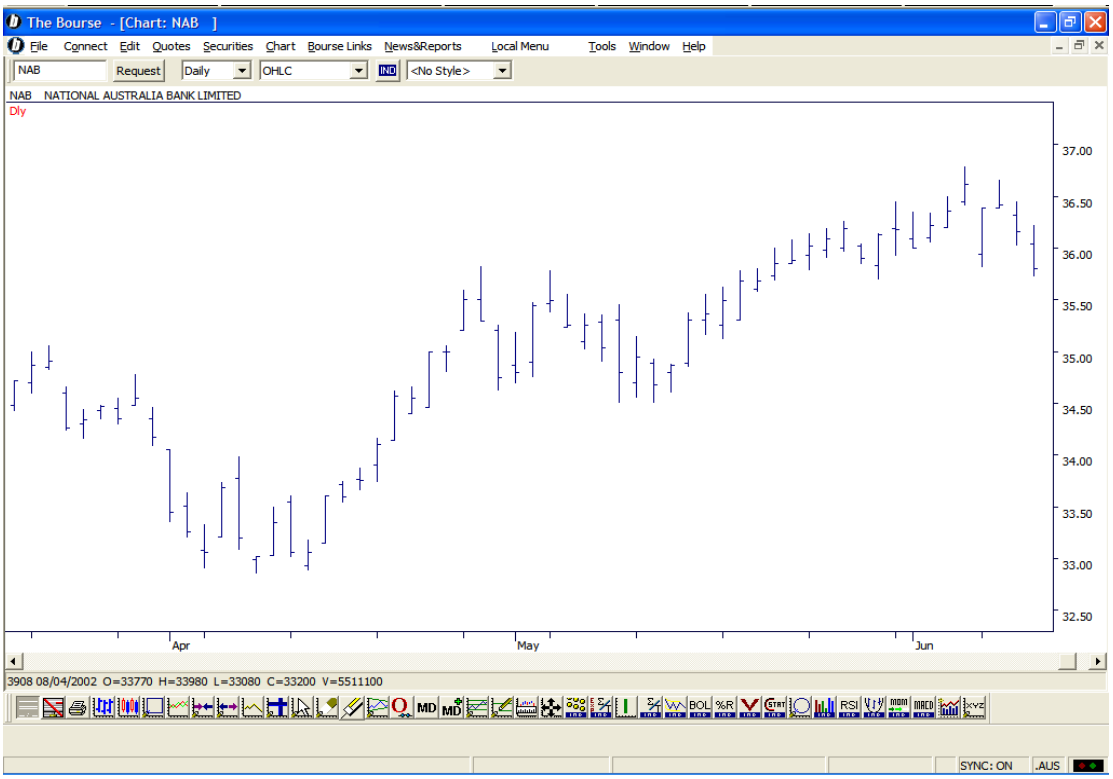


Southern Days

A "Southern" day is simply the opposite of an 'Northern' day. A 'Southern' day exists when a particular trading day has a 'Lower High' and a 'Lower Low'.

Both the 'High' and the 'Low' of today's range is below that of the previous days trading and could be the beginning of a Southern move.

North and South Days

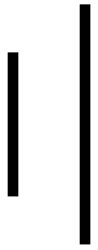


Sideways Days

As I have established, Option Trading, or "long" positions perform much better in a volatile, or North and South manner. For example, if I were to buy either a call option or a put option and the stock moved sideways, 'Time Decay' will begin to eat away at my option price. Eastern, or sideways movement does not give me a clear indication of market direction and therefore, should not be used as entry signals.

If today's range has a Lower High and a Higher Low than yesterday, it is said to be an 'Inside' day.

Should today's range have a Higher High and a Lower Low it is said to be an 'Outside' day.

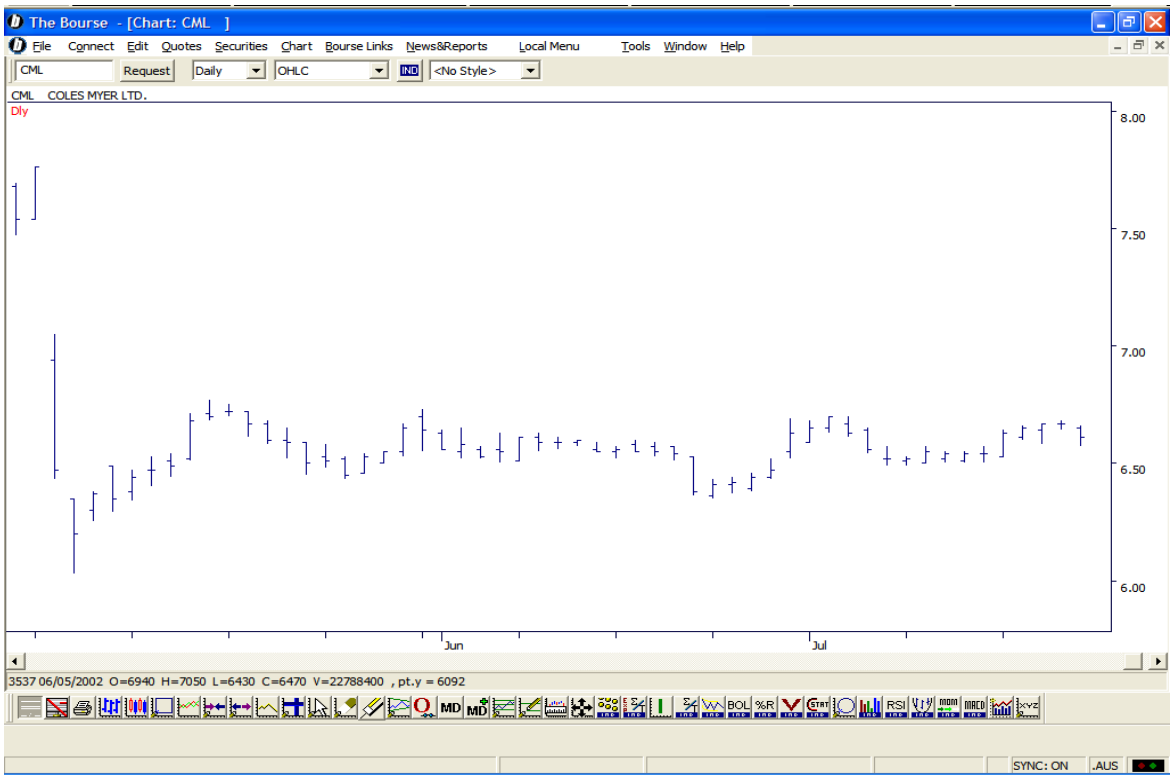


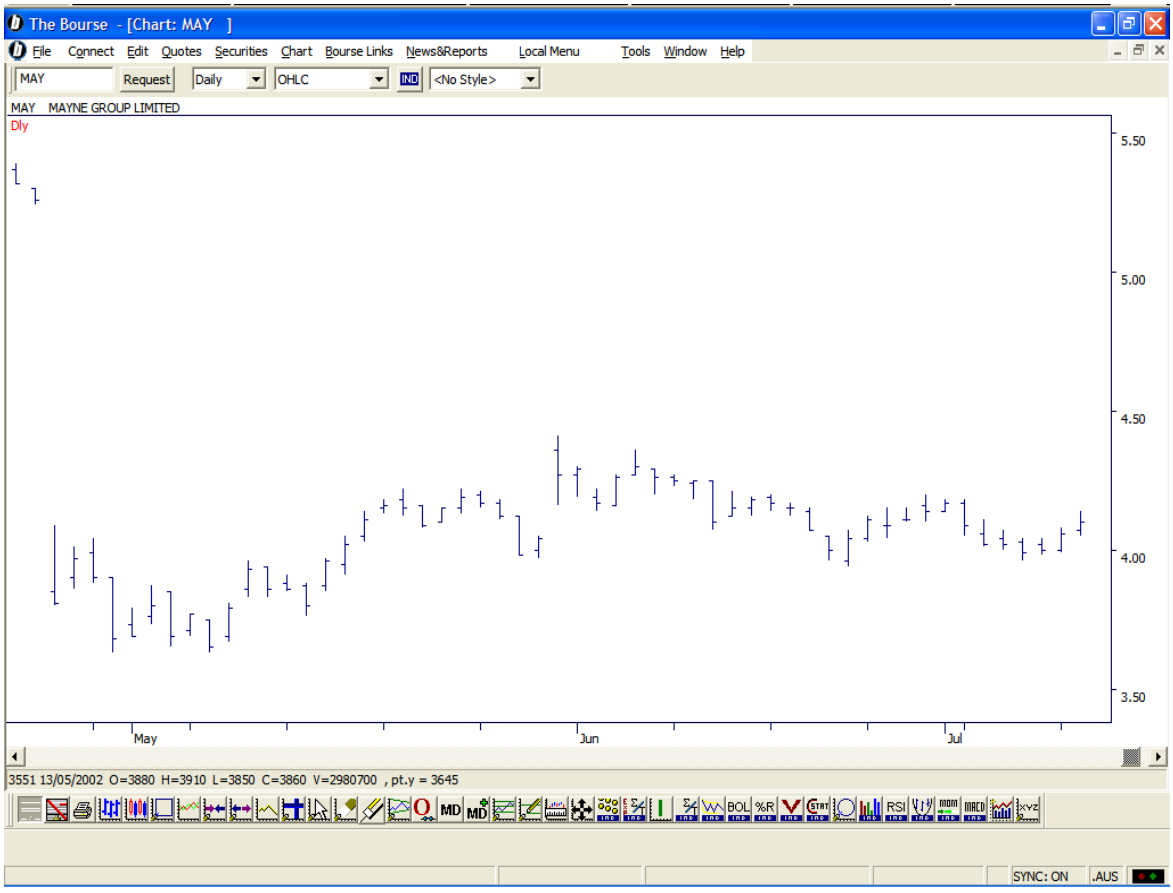
In both of these examples the operative word is 'side'. Both in-side and out-side days indicate to the short term trader that there is significant indecision between buyers and sellers. Therefore, the overall direction of the stock is not clearly apparent.

It is wise to avoid trading on these particular days based on Western Bar Charts alone. There are some situations where Candlestick charting can offer earlier warnings of impending price movement, although at the basic level of trading, we should be content to wait for the market to show its hand.

There are certain rules about dealing with an open position should the stock begin to move sideways and these will be covered shortly.

Sideways Days





Range Sizes

It is important to realise that for us to embark on a successful trading career, our trading strategy must be based on sustainable trading patterns. I have lost count of the amount of times I have seen people try to chase the market, after the horse has bolted. By this I mean something extraordinary happens to a particular stock and the thing takes off like a rocket—one way or the other.

Human nature dictates that we have to make the big hit, or the home run, in order to be successful. The challenge is that most of us are not equipped to enter such trades until after the event. More often than not an extremely large range will indicate that buyers and sellers agree on the direction of the move. It is important to compare range sizes with that of the 'normal' ranges of a particular stock.

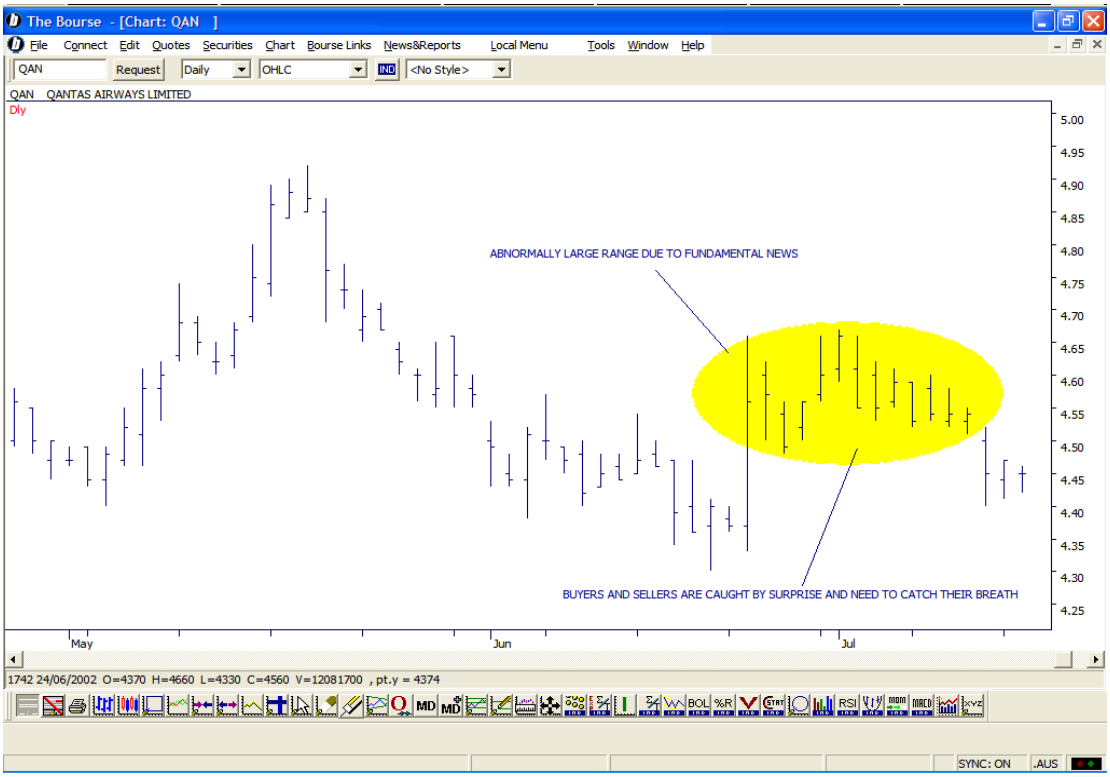
By 'normal' I am referring to the good old, everyday, nothing too special, run of the mill ranges. By sticking to this basic type of trading and not searching for the 'big hit' we increase our chances of a long and fruitful trading career. More often than not a really large range will be followed by a period of consolidation where all the buyers and sellers will catch their breath.

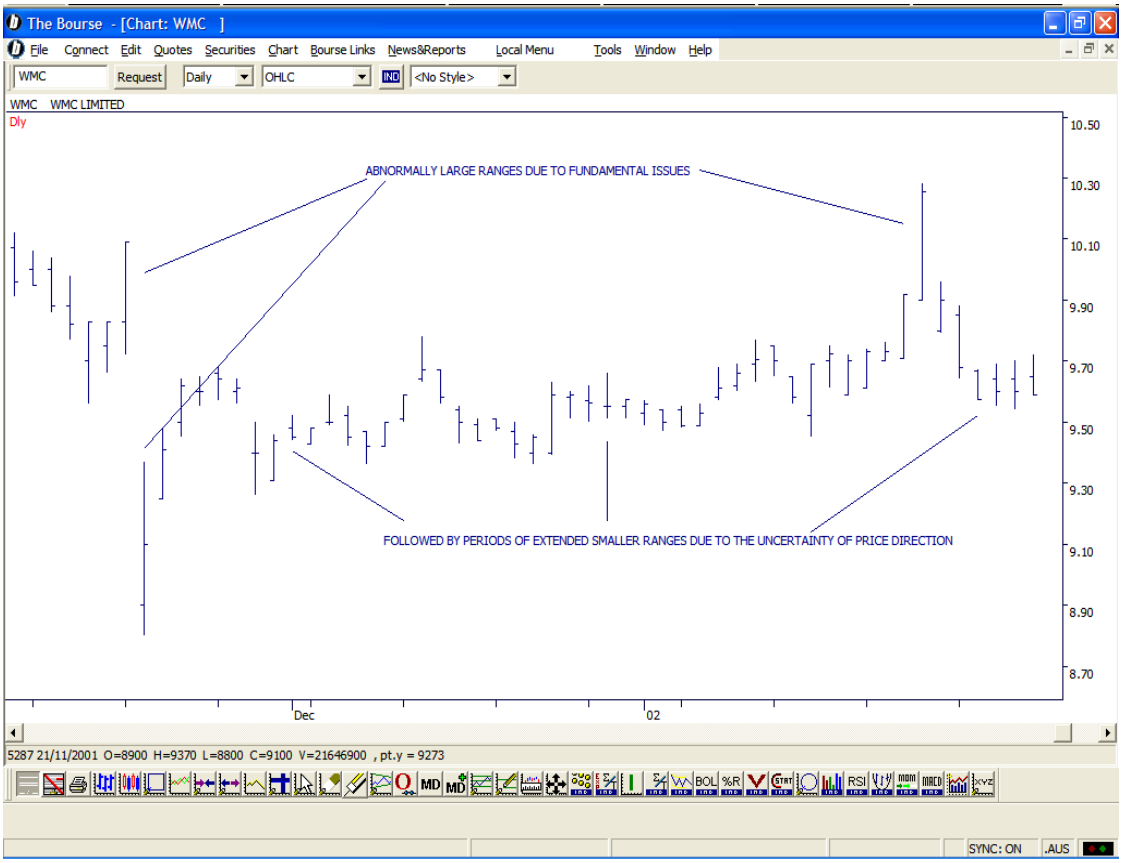
Likewise, an unusually small range indicates that neither the buyers or the sellers are willing to forecast the direction of future price movement and therefore the stock could sit for days, weeks, or even months at the same, or similar levels.

You will see with the examples on the following page what can happen after 'Large' or 'Small' ranges. It is always good trading practice to stick with stocks which tend to follow a reasonably predictable pattern, bearing in mind that we are looking for stocks which head North and South at regular intervals.

Our goal is to be like Goldilocks, not too big, not too small, just normal, everyday ranges which can continue without pushing the stock to its limits.

Range Sizes





Module Seven

Trend Analysis

Trend Analysis

So far I have looked at how to recognize price movement which may be significant enough for me to profit from. One of the most important factors to bear in mind, regardless of the type of trading you are doing is to be aware of what the 'Underlying' trend is doing.

The term 'Underlying Trend' has many different meanings and can be applied to almost every type of trading or investing. For example if I was investing in a long term hold strategy, the 'Underlying Trend' I follow may be up to two or three years, possibly longer. On the other hand, if I was day trading a position with a view to hold for only a few minutes, the three year trend is next to worthless, and for that matter, so are most others. The point being, the Underlying Trend will vary depending on what your trading strategy is.

When I am trading with a two—five days outlook, the most significant Underlying Trend for us is the: Three Month Daily Trend.

There is one guarantee when it comes to trading and that is if I trade against the trend, eventually I will lose money. The major institutions set the trend for almost every stock on the market and for me to trade against that established trend would not only be risky, it is also saying that I think I can outsmart the market. Many have tried and failed and those tempted to trade against the Underlying Trend are destined for a brief trading career.

Always remember to adjust your position on the Underlying Trend in accordance with the expectation of your current trade and if the trade has an expected 2-5 day life, then experience has taught me to follow the most recent three months of price movement on the DAILY chart.

Let's take a look a how we established a valid trend line and therefore, how we can determine what the Underlying Trend will be.

Trend Analysis

By now you will have noticed that the price movement of a share is quite similar to that of the ocean. Sometimes it is calm and serene and within minutes it can be whipped into a frenzy by new information. The simplest way to determine whether or not a trend exists is to begin to apply 'trend lines' which highlight any significant highs or lows in the stock price. When looking at the most recent three months period it is quite often easy to spot two, three or even more trends. To do this is quite simple.

When applying your 'trend lines' there are a few rules you must follow. The most significant thing to be aware of when applying these lines is to look for the 'Crests' and 'Troughs' in the share price. When a wave reaches a high point we refer to it as the 'Crest' and it provides a reference point as to how high the wave is comfortable to go. Likewise, when the wave reaches a low point I refer to that as the 'Trough' and in the same way offers a reference point of a comfortable low spot.

By applying this theory to share price movement it becomes easier to see where these significant reference points occur. One thing to bear in mind when you begin to apply these lines is that you are operating under the pretense that the closing price is the most accurate price for that days trading. This being the case, I will quite often sacrifice one or two low points, if it means I can pick up a number of closing points.

This will become more obvious in the next few pages as you begin to practice trend line application. It is also important to be aware that not everyone will apply these lines in the same place as everyone has a slightly different view of the picture before them. As long as you apply the line where YOU see them, and not where you would LIKE to see them, you can't go wrong.

While most of the lines you will apply here will be set to an angle, you will shortly be looking at levels of support and resistance offered by these trend lines.

Northern Trends

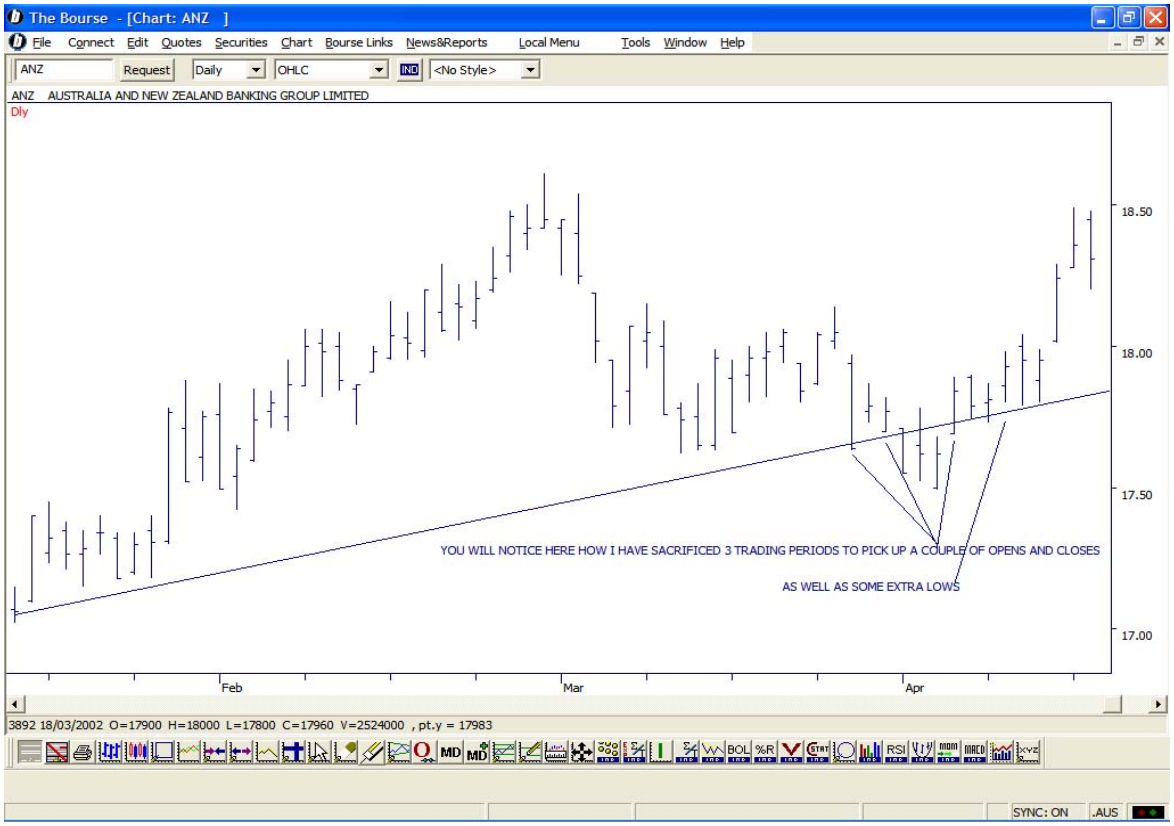
As you would imagine a Northern Trend is established when the price of a stock moves to a higher level. More specifically when you can identify a 'Crest' in price action that has reached a higher level than that of the previous 'Crest' you can apply your lines to highlight this point.

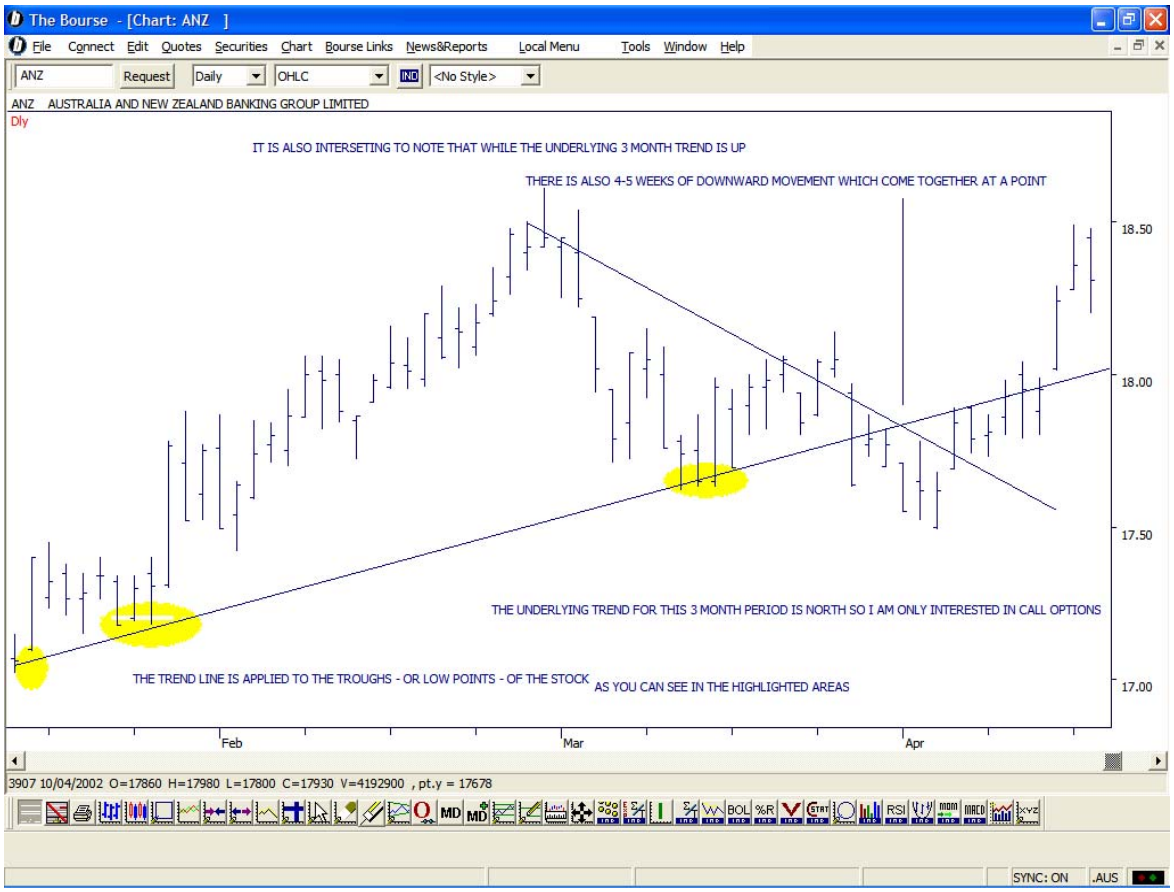
When applying lines to a Northerly trending stock it is best to apply them from 'Trough' to 'Trough'. In other words, a Northern trend is only established once the most recent 'Crest' has reached a higher level than the previous one, and they are highlighted by connecting the 'Trough' with a trend line.

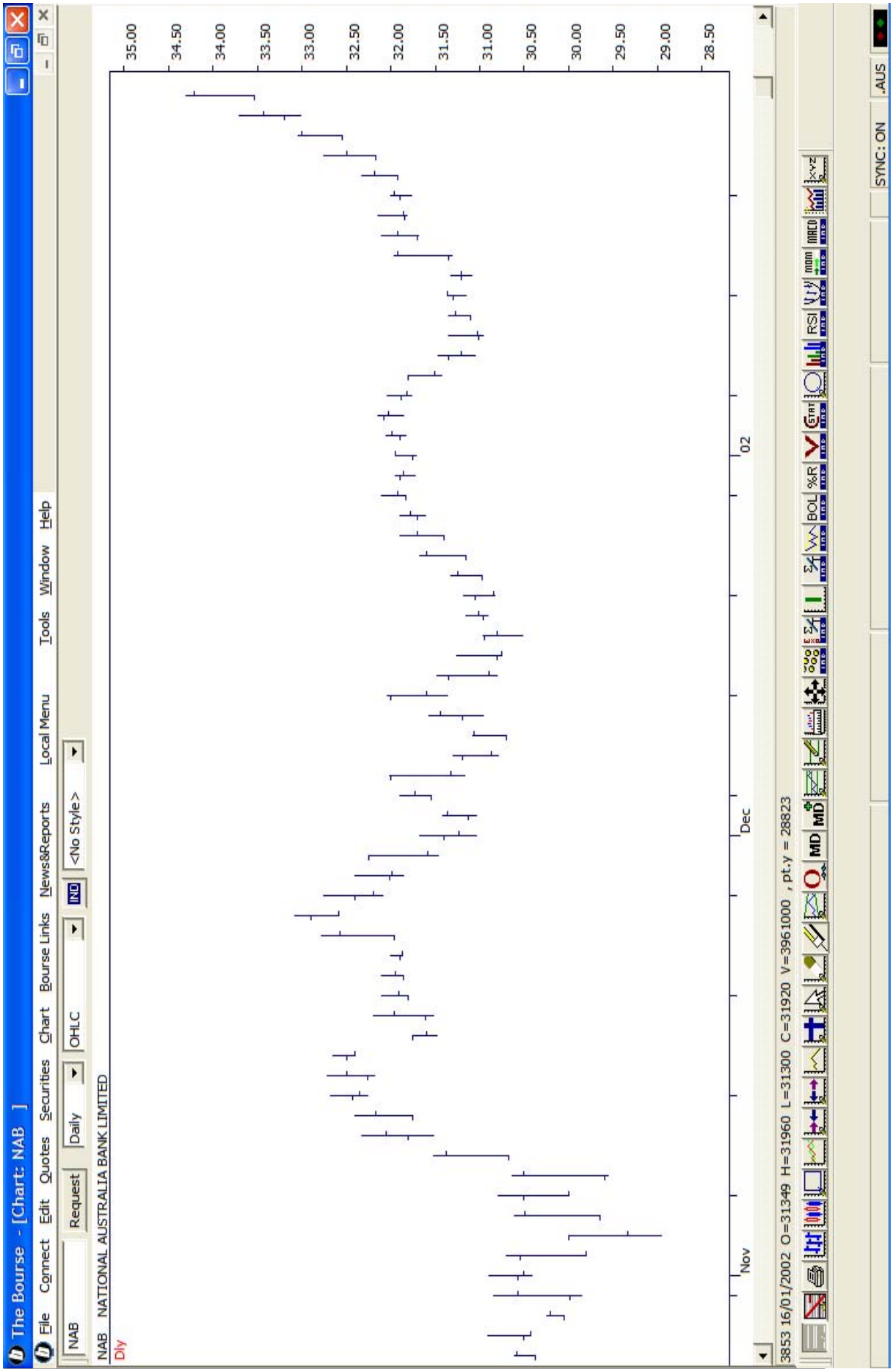
The more times the stock touches the line, the more valid the line becomes. As I mentioned before, quite often I will sacrifice a few lows to pick up an area of congestion of stock movement. It is also wise to compare the angle of the line to the overall angle of price movement for the period. This approach will come easier with practice, although it is much more beneficial to begin with the end in mind. By that I mean practice applying your lines where you see them and you will begin to form your own style of trend line application.

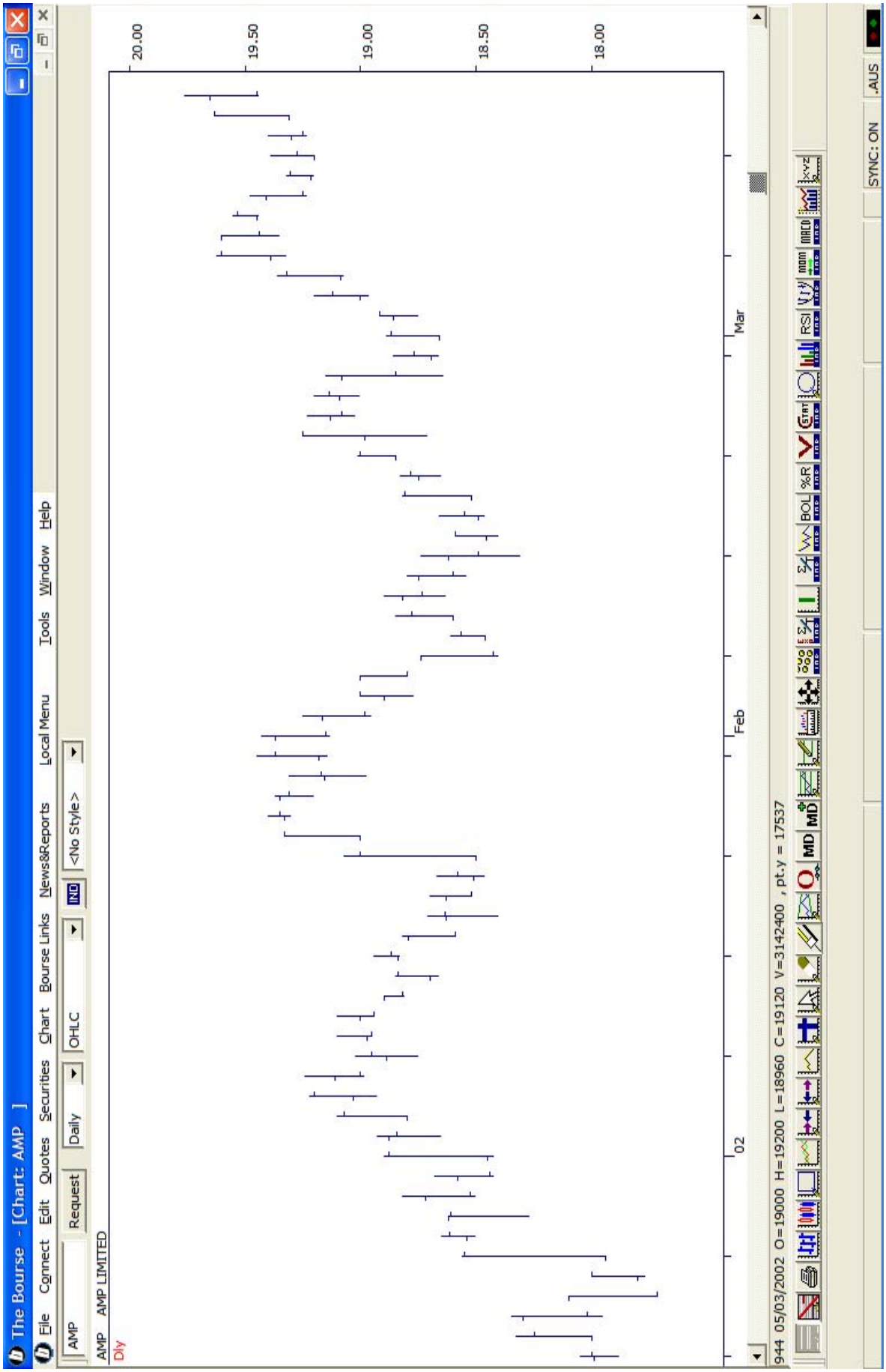
Although it is not a 'text-book' approach to trend line application, one method I find very useful is to extend the line once it has been breached. More often than not, if I apply a Northern trend line to a stock and for whatever reason the stock breaches the line, instead of removing it and re-applying a new line, I will extend the original line. The rationale behind this approach is due to the number of times a stock will gain support while it is above the line. Once the line has been broken, in a majority of cases it will now act as a resistance level and possible hold the stock from reaching new highs.
These trend line extensions provide a significant reference point should the stock return to those levels.

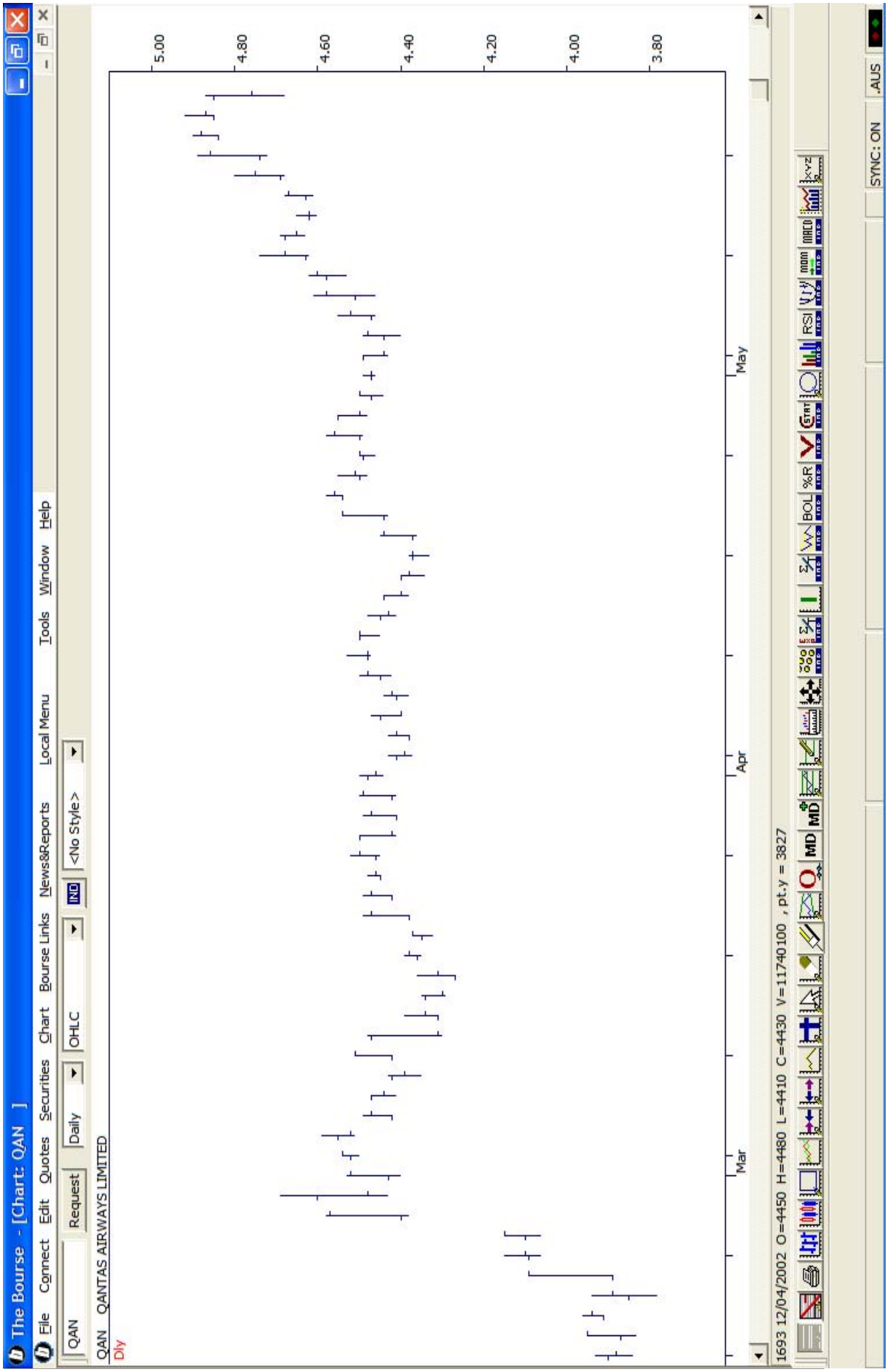
Northern Trends

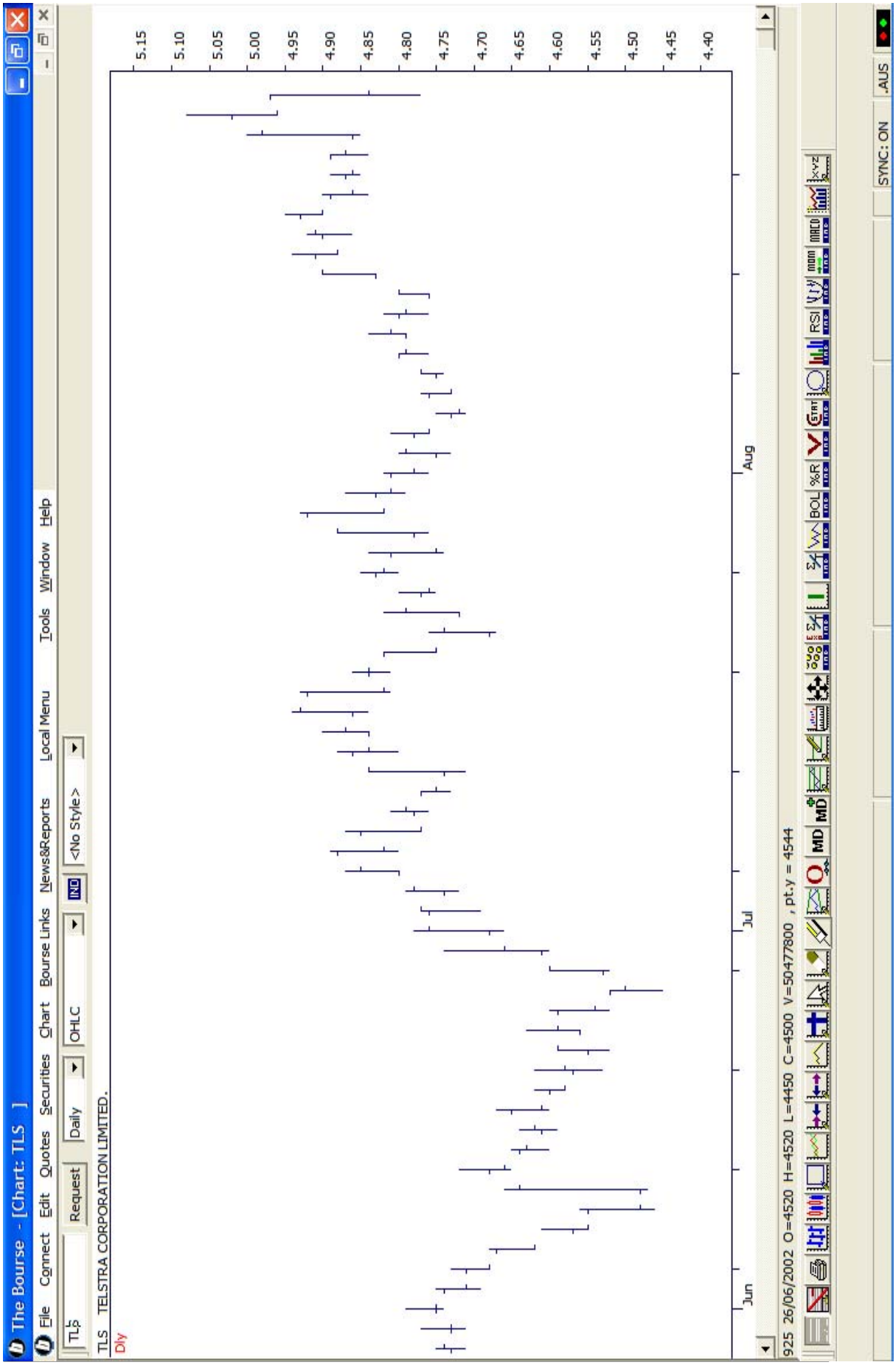










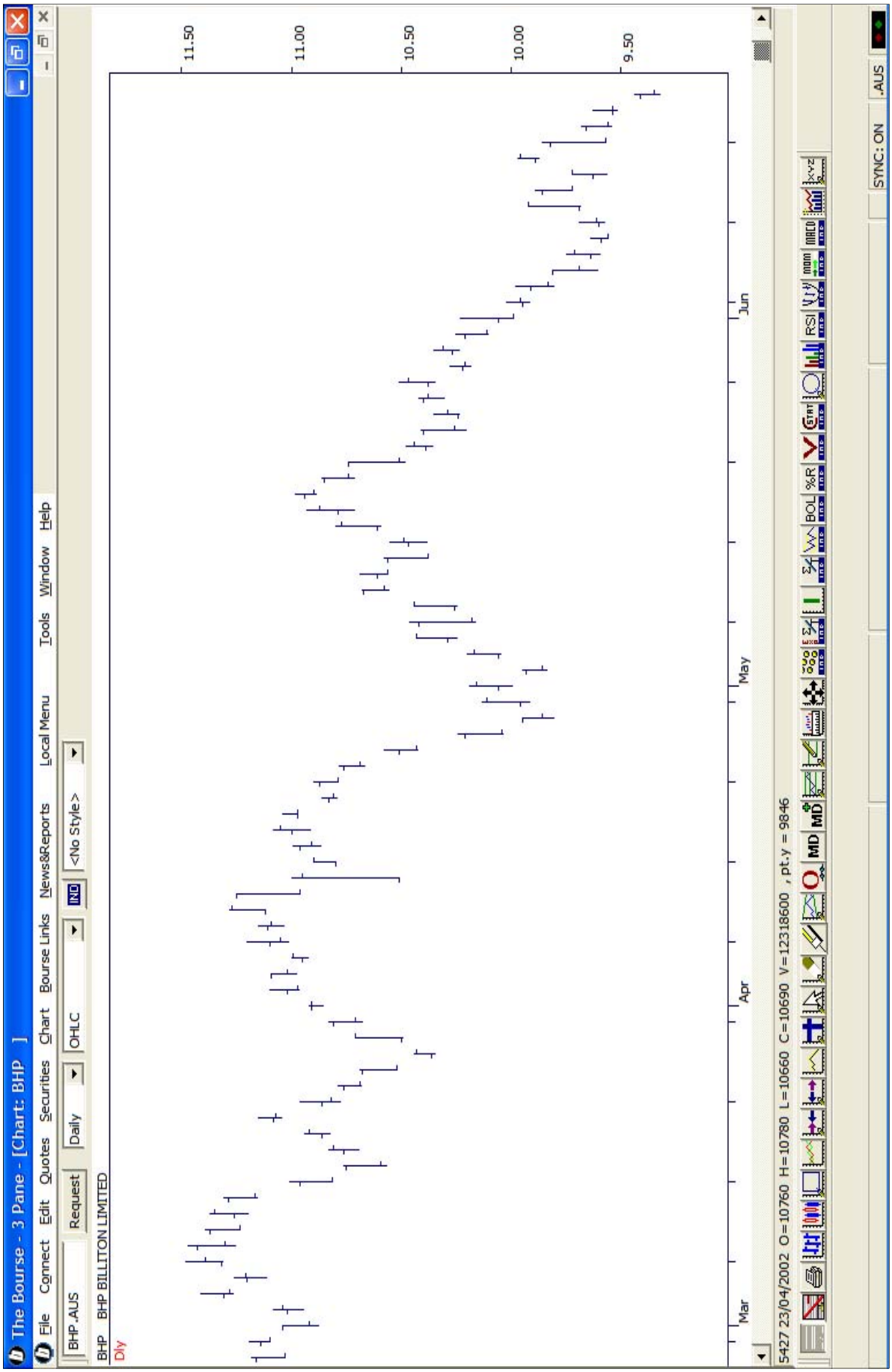


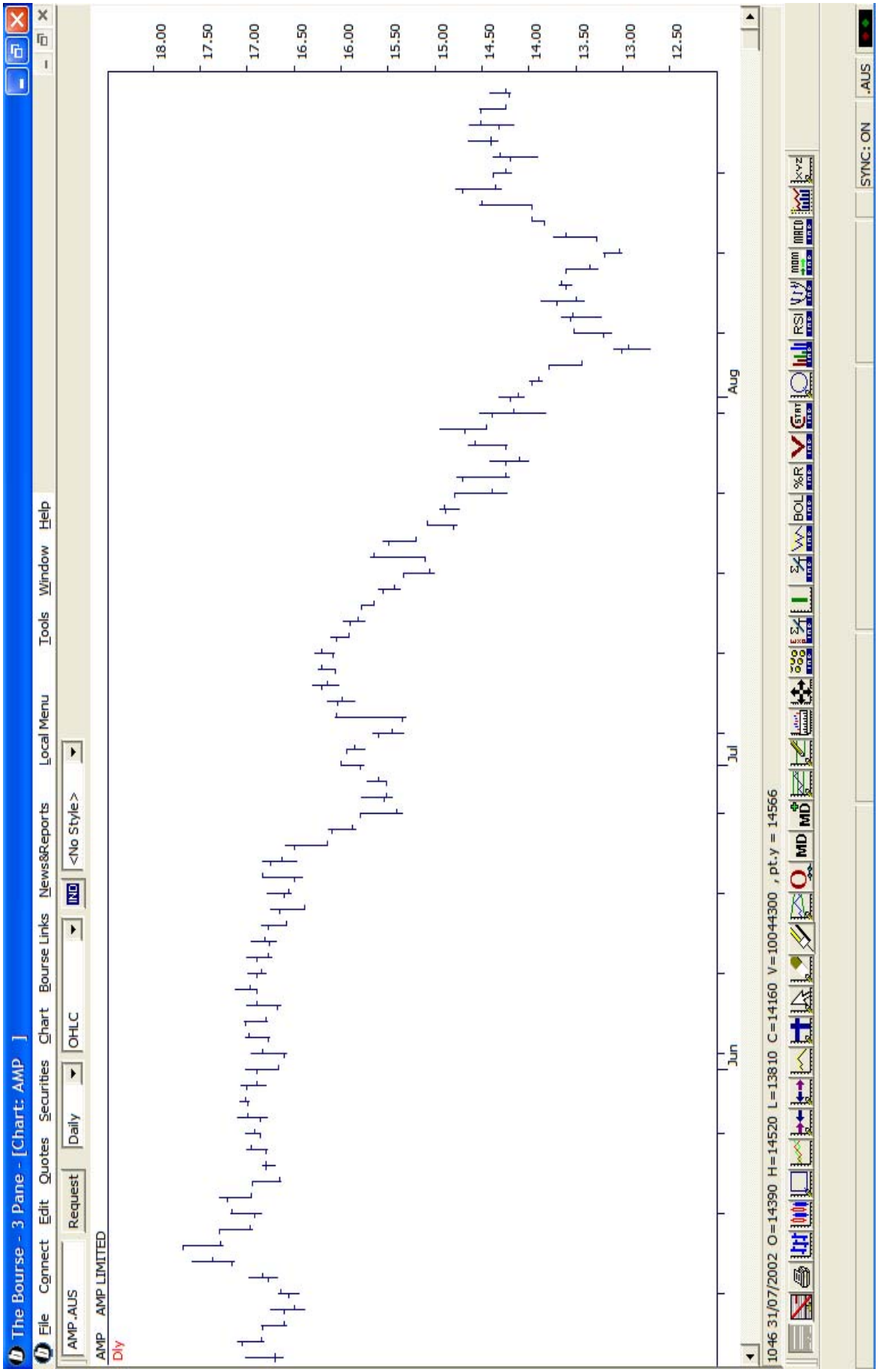
Southern Trends

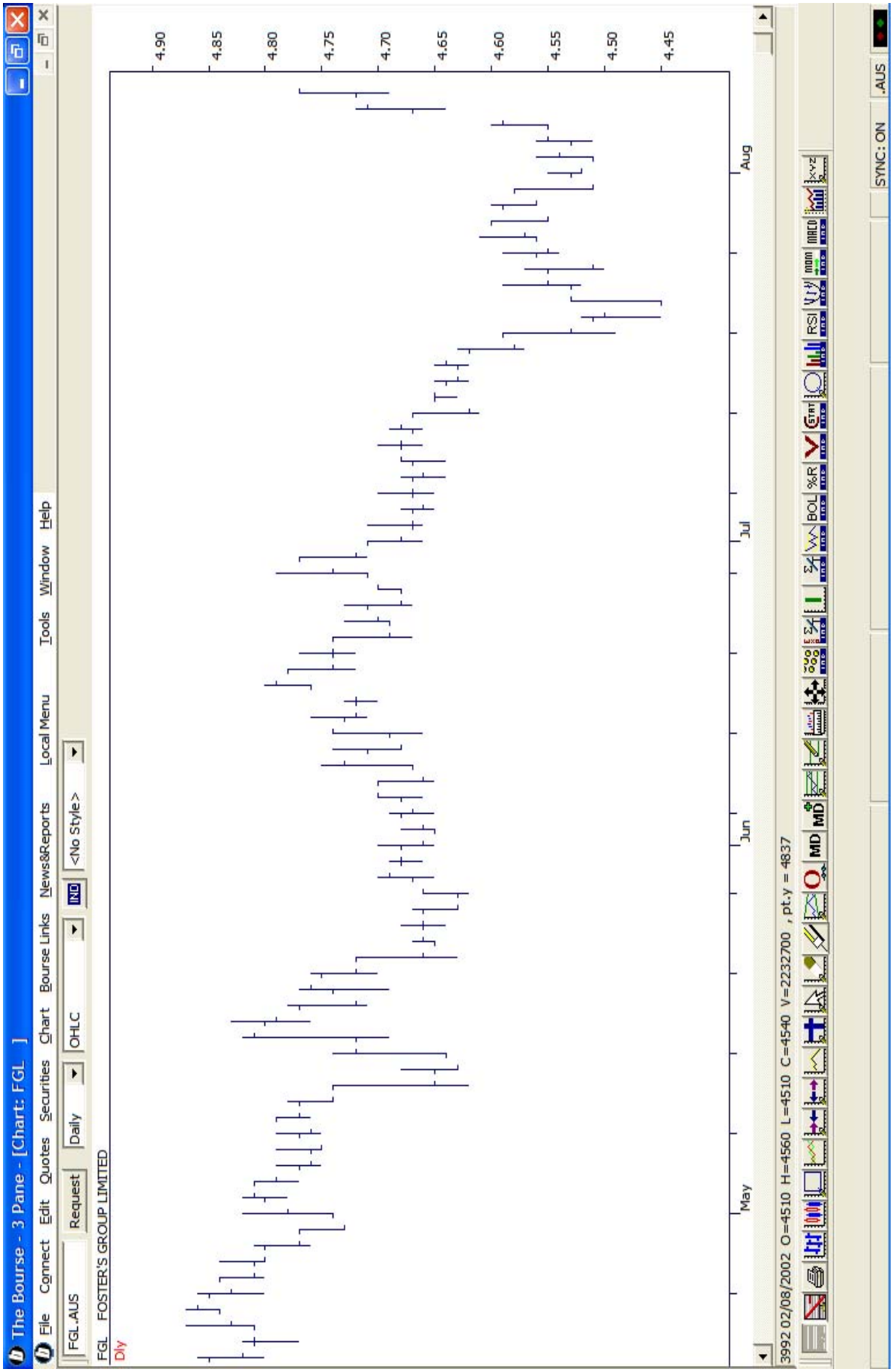
As a great mathematician once said, "every action has an equal and opposite reaction." This could not be more true for the type of analysis you are following. Regardless of whether the stock is rising or falling, the methodology behind what you do as traders remains constant—you simply turn it upside down.

As one would expect, if a Northern Trend is evident when prices combine to form a higher 'Crest', then a Southern Trend is evident when prices combine to form a lower trough. Likewise, if Northern Trend Lines are applied to the 'Troughs', then it follows that Southern Trend Lines are applied to the 'Crest'.

The same rules apply for applying these lines. The more confirming touches you see on a particular line, the more valid the line becomes. It is also a good idea to extend any valid lines to alert you of possible areas of support.







Module Eight

Supporting Patterns

Everyday Patterns

It is very common for the large Blue Chip Shares you are looking at to follow a fairly steady rate and direction of price movement. This being the case, it is quite normal to watch these stocks trade in similar patterns from day to day.

If you look at the Stock Market the same way you look at any other market, it is easier to understand the rationale behind price movement. One trap that a lot of young players fall into is believing that every other trader has the same trading plan. This could not be further from reality. There are millions of traders with millions of reasons to buy and sell shares and to assume that these will all react the same way would be to assume that the stock market is predictable. If you have not gathered by now—the stock market is anything but predictable. It does, however, offer you the ability to use hindsight as a way to forecast future direction with a greater confidence and accuracy than simply throwing a dart at the Financial Review.

By observing the price movement for almost any given Blue Chip Share, it becomes quite apparent that the price seems to follow a few basic patterns. There are scores of different patterns which have been developed over time, some of which can offer valuable insight as to the sentiment of other traders and investors.

I will take a closer look at some of the more common patterns in a later module, although for now there are 2 very powerful patterns you need to understand that allow you to add even more confidence to our entry signals.

I refer to these two patterns as - Pullbacks and Consolidation Patterns.

Pull-Backs

A 'Pullback' is probably the most common of all patterns and is quite easy to recognize. In any particular trading period there will be an established trend. I will concentrate more on trend analysis in the following modules. However, for ease of explanation a 'Pullback' is generally one to four days of price movement in the 'Opposite Direction' to the established direction.

The rationale behind this type of price anomaly is really quite straightforward. Regardless of the direction of price movement, there are certain levels at which traders and investors are either happy to take their profits, or disciplined enough to implement their stop losses. Whatever the case may be, this type of trading shows up in almost every chart you look at.

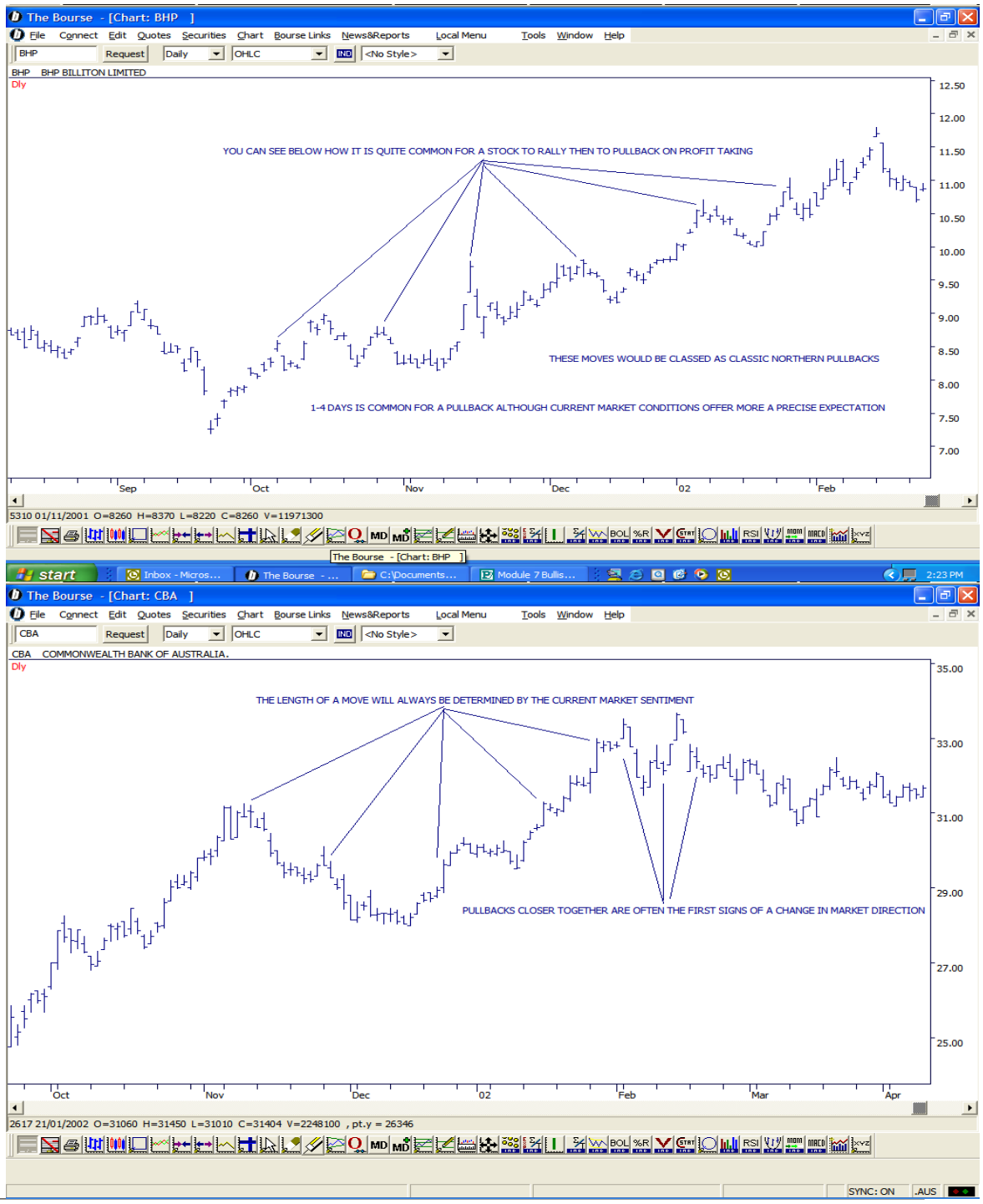
It is very uncommon to see a stock price move great distances, either up or down, in any one trading period. It is more common to see the move begin and pick up momentum, before profit taking or bargain hunting reverse the price action for a time. As mentioned, it is more common to see a 'Pullback' last between one to four days, although this is always dependant on the prevailing market conditions.

The reason a 'Pullback' is important to us is that it identifies areas of both profit taking for a Northern run, and consolidation after a Southern push. It is important to note that while 'Pullbacks' are common, they share the same characteristics as a trend reversal and therefore caution should always be exercised.

For example, a ‘Pullback’ does not constitute an entry signal, however, should you identify and entry signal directly following a pullback, there is a stronger possibility that our trade can sustain your forecast.

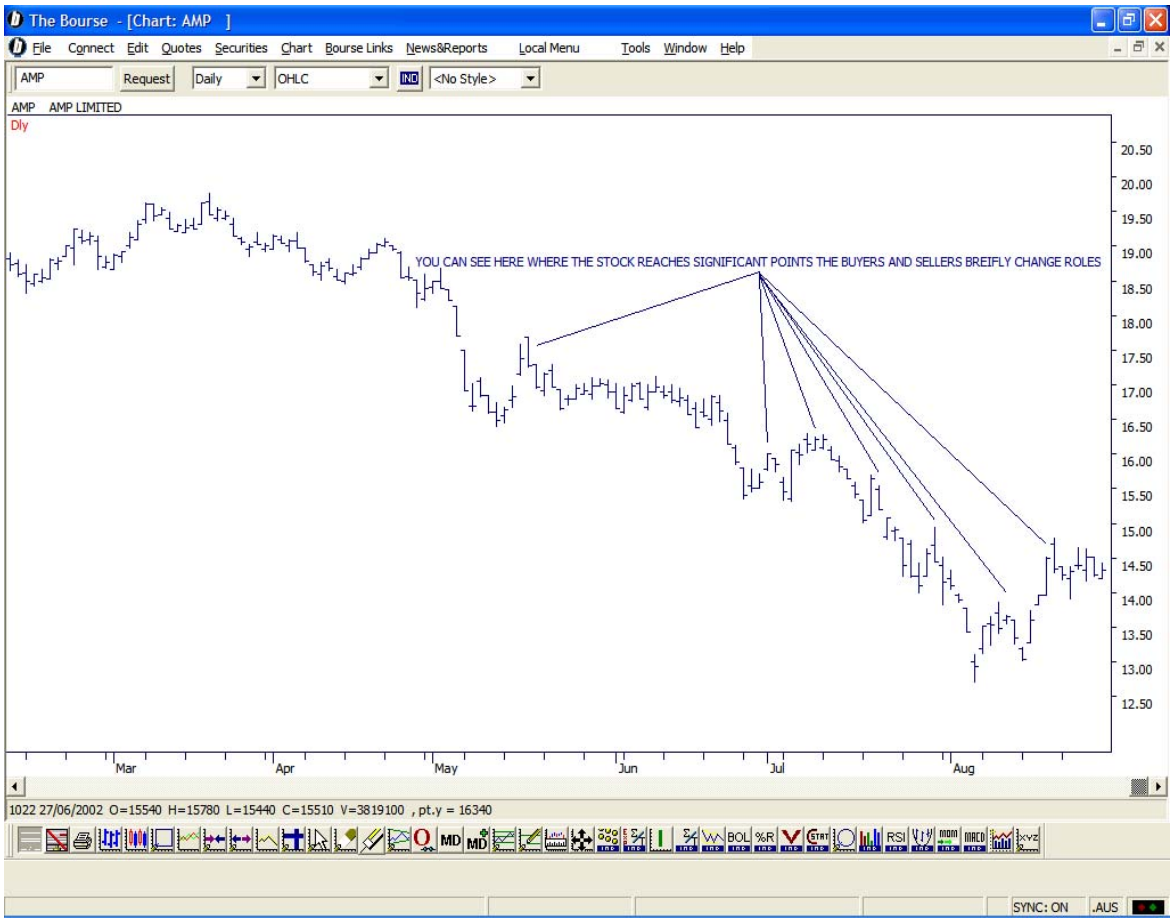
Northern Pullback

A Northern PULLBACK is a pattern that occurs frequently in a stock that is heading NORTH. As you can see below it is quite common for a stock to rally and PULLBACK a number of times over an extended time frame to form a complete Northern or Southern swing.



Southern Pullback

As you would expect, the Southern version of the 'Pullback' is a mirror image of it's Northern counterpart. In a stock that is heading South, the Pullbacks offer various points along the way where traders and investors can catch their breath.



While it is common for a 'Pullback' to last one to four days, it is also important to take into account the current market conditions.

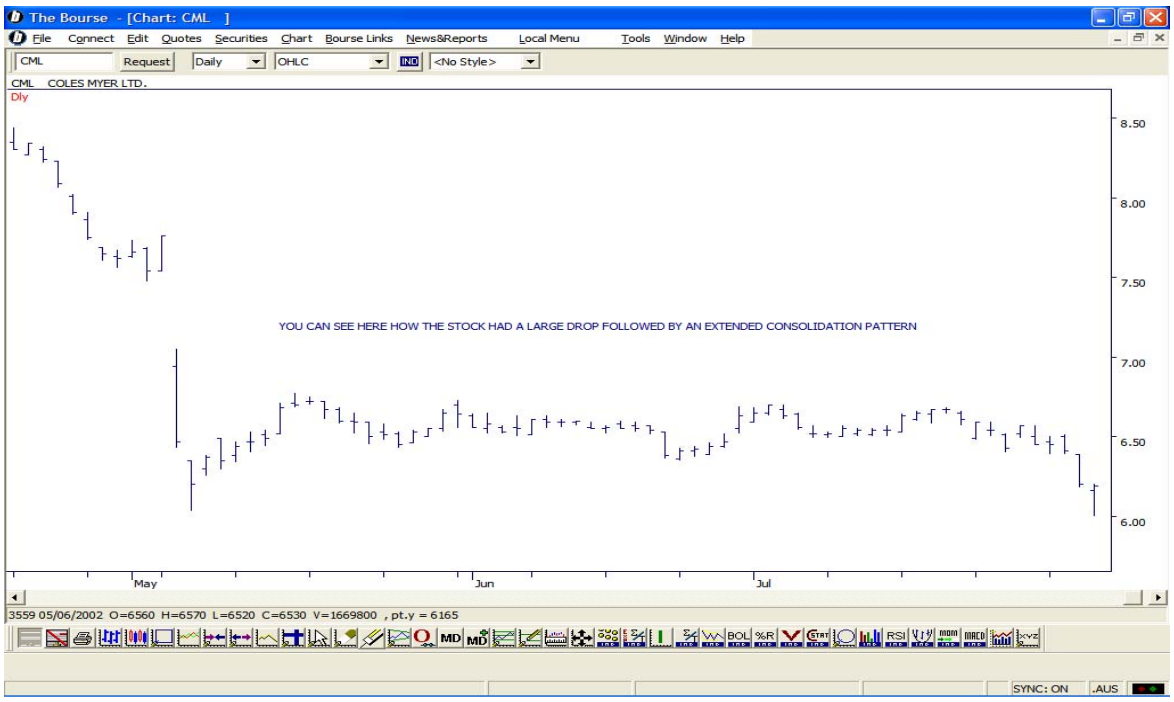
For example, during 1997/8 the moves I am referring to would last for anything up to four weeks and the 'Pullback' would continue for four to five or even six days. Post September 11, I witnessed both one day moves and one day 'Pullback', which meant the market was very choppy indeed. The easiest way to check is to look at the average over the past three months to get an idea of what the current situation is likely to be.

Consolidation Patterns

Now that I have established the most common way for Stocks to move, that being a Northern or Southern move, combined with a series of 'Pullbacks', I can look at the next most common pattern and that is a 'Consolidation Pattern'.

As the name suggests a 'Consolidation Pattern' is a period where traders and investors are consolidating their holding of a particular stock before the next move. These patterns can last for extended periods, particularly following fundamental news or reports. A 'Consolidation' can occur in both Northern and Southern moves and are generally established after two days of sideways movement.

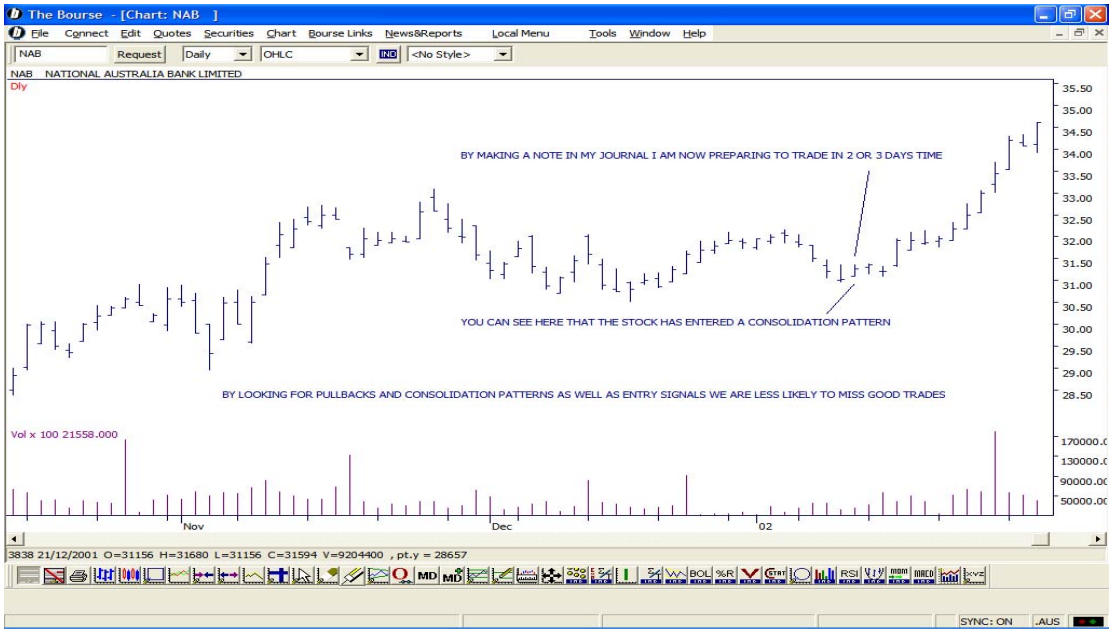
The easiest way to recognize a consolidation is by looking for two consecutive sideways days. If today's range is either 'In-Side', or 'Out-Side', it suggests a period of consolidation is imminent.



Consolidation Patterns

A 'Consolidation Pattern' can be very useful when combined with our initial prognosis. I have established that a trading period with higher highs and lows than the period before, and directly following a 'Backing Pattern', could form the basis of a solid entry signal. In similar fashion a stock moving sideways in a 'Consolidation Pattern' can alert us of a possible North or South break.

One technique I have found extremely valuable is to operate a trading diary, or journal of some sort. I use Microsoft Outlook for my email and it is also very useful as a trading journal because I can make notes about each different stock and keep a running commentary on my analysis. By recognizing 'Pullbacks' and 'Consolidation Patterns' early, I can begin to prepare my trades a few days in advance. Not only does this allow me to fully analyze the trade, it also ensures that I am never short of a possible upcoming opportunity and therefore I am less likely to trade anything that is not a great entry signal.



Consolidation Signals

There are a few ways you can use both the 'Pullback' and the 'Consolidation Pattern' to assist you in managing our positions. In the initial stages you can use our early recognition of both patterns occurring to alert you to the possibility of price reversal. Then, once the consolidation is complete and you see solid price movement in one direction or another you are able to determine very early whether or not it will form a complete entry signal.

The guidelines for trading around 'Pullbacks' and 'Consolidation Patterns' are as follows:

- A 'Pullback' occurs in all kinds of markets and can last from one to four days taking into account the prevailing market conditions—emphasis on the one day period.

- A 'Consolidation Pattern' can occur at any time and is first identified after the second consecutive sideways day.

- Both 'Pullbacks' and 'Consolidation Patterns' signal a period of 'time out' for the stock and can mean either profit taking, or accumulation of the stock.

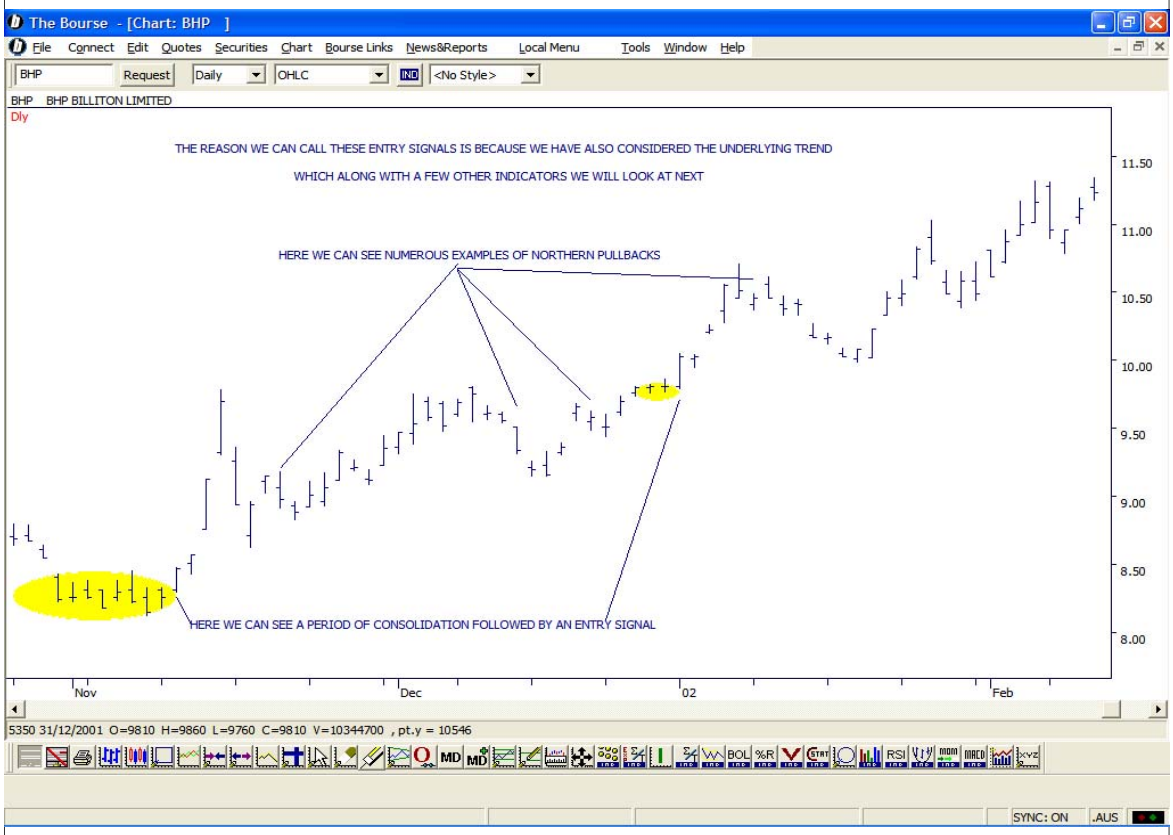
- Neither of these patterns are entry signals as such, although experienced traders can take advantage of the early warning they offer.

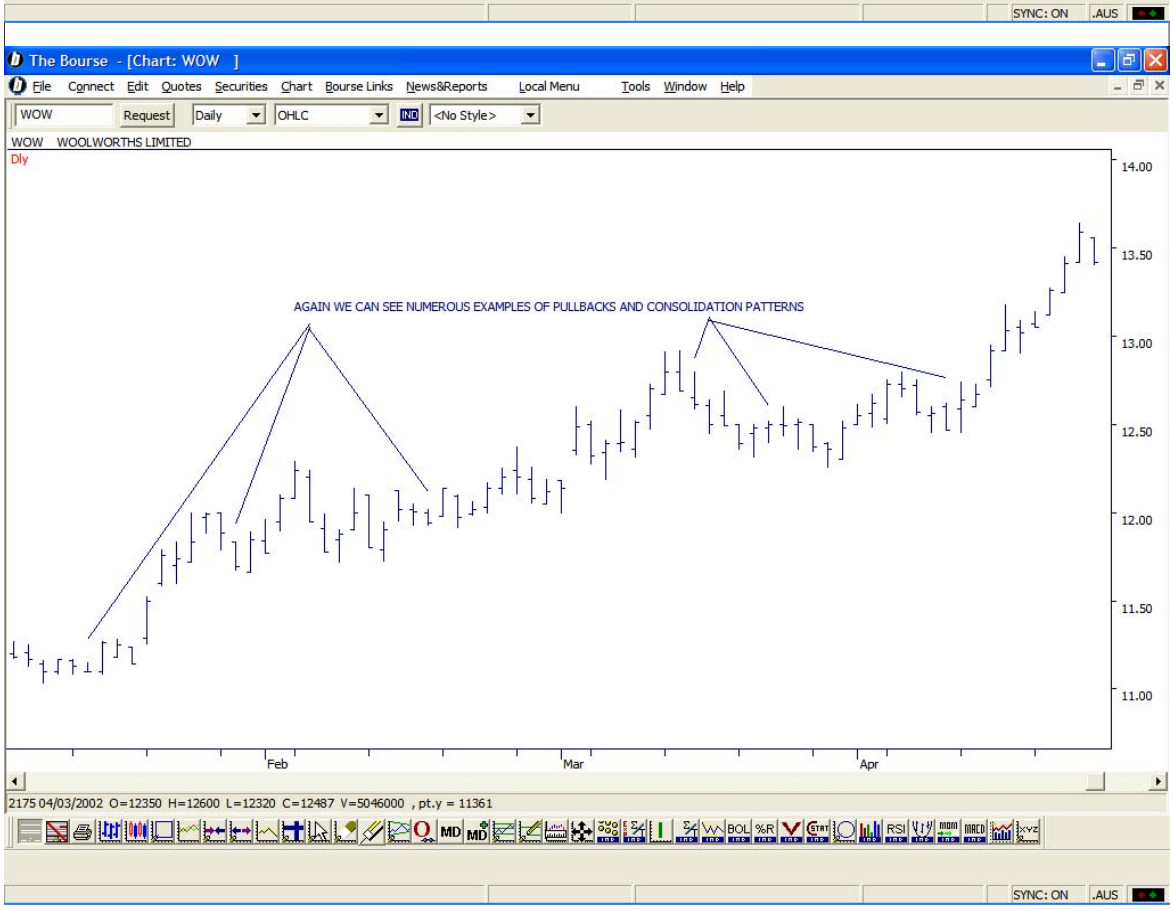
- If you have entered a trade and the stock moves into a 'Pullback' or a 'Consolidation Pattern', exit the trade immediately to avoid any unsustainable losses. This is providing your strategy is a short term trade and not a medium to long term position.

- A ‘Pullback’ or a ‘Consolidation Pattern’ is almost always the first indication of a change in direction, or strengthening of the current price movement.

- While it is comforting to have these early indications it is important to avoid pre-empting the markets movement. Wait for the stock to tell you which way it is going to go and provided your signals stack up it is much more profitable than attempting to outsmart the market.

Consolidation Signals





Module Nine

Validation Levels

Validation Levels (VL)

With experience it is quite evident that once a significant trend line has been established the stock tends to react with a reasonably high degree of predicability around such lines. For example, if a short term trend line is established consisting of only one or two troughs or crests, it will require less effort for the stock to break through the line than it would if there were three or more approaches to that line.

In the same fashion, it is possible, and in some cases even probable, that a stock will gain either support or resistance at a particular price point, rather than an angled trend line.

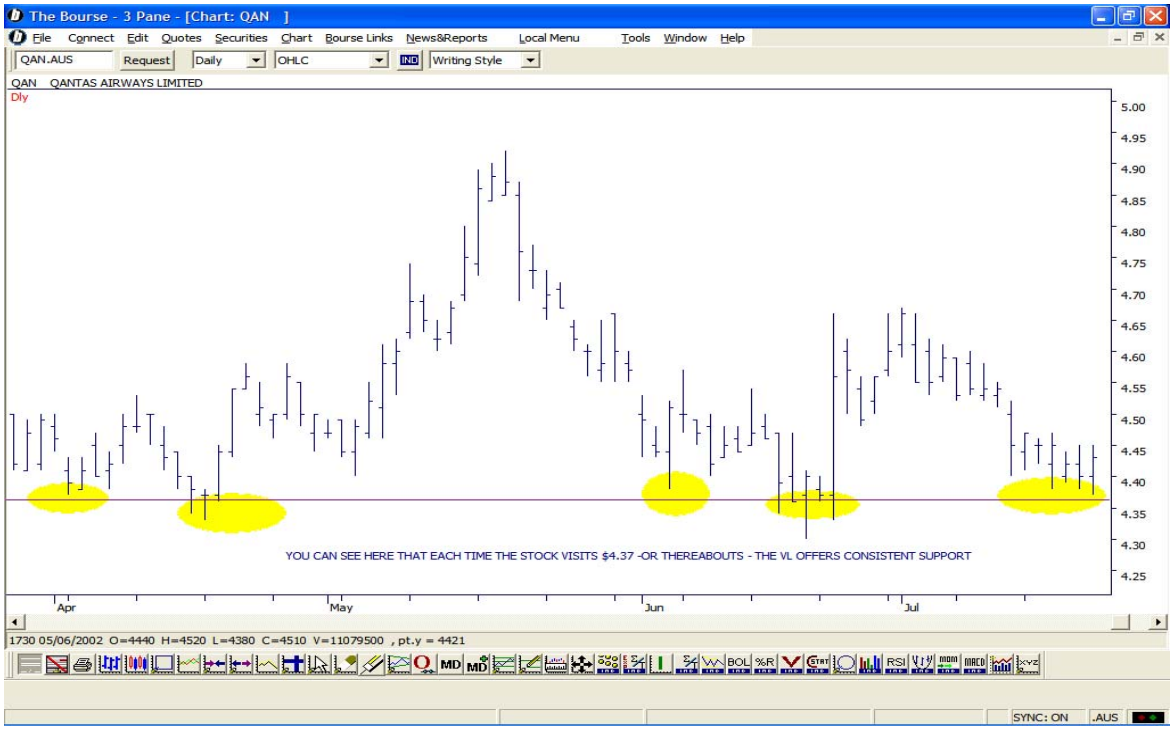
'Validation Levels' (VL) act in the same way as trend lines do, the only difference is that they are drawn horizontally and can last for years. Support and resistance levels can be drawn after one touch at a significant point, although they should be validated by a second or third touch.

Like the standard trend line, a VL can offer a base support level or a ceiling level depending on where it is in relation to the stock. For example, if the Stock is trading ABOVE a validation line, it can provide support to it's current level. Conversely, should the stock be trading below a validation level there is a possibility the stock will be rejected and fall away from that level.

One of the most significant aspects of the VL is that it can, and often does, reverse roles. Should the stock gain enough momentum to break through the VL on the upside there is a chance the VL will provide future support. Should gravity take hold of the stock and force it through a VL on the downside, there is a strong chance the VL will provide future rejection of that level.

As with any analysis, the VL is strengthened each time the stock reacts to it and it is well to bear in mind that these levels can last for years and years should the stock re-visit a particular price point.

Validation Levels (VL)



Channels

Just like navigation, I use a safe water channel to exit and enter every port, securities quite often form these 'comfort zones' between two significant price points.

The Channel is constructed out of two VL's. When you are initially setting up your charts, it will serve you well to look back at least 12 months to see if there are any established VL's. This is particularly relevant when a stock has pushed either North or South and has retraced into a previous comfort zone.

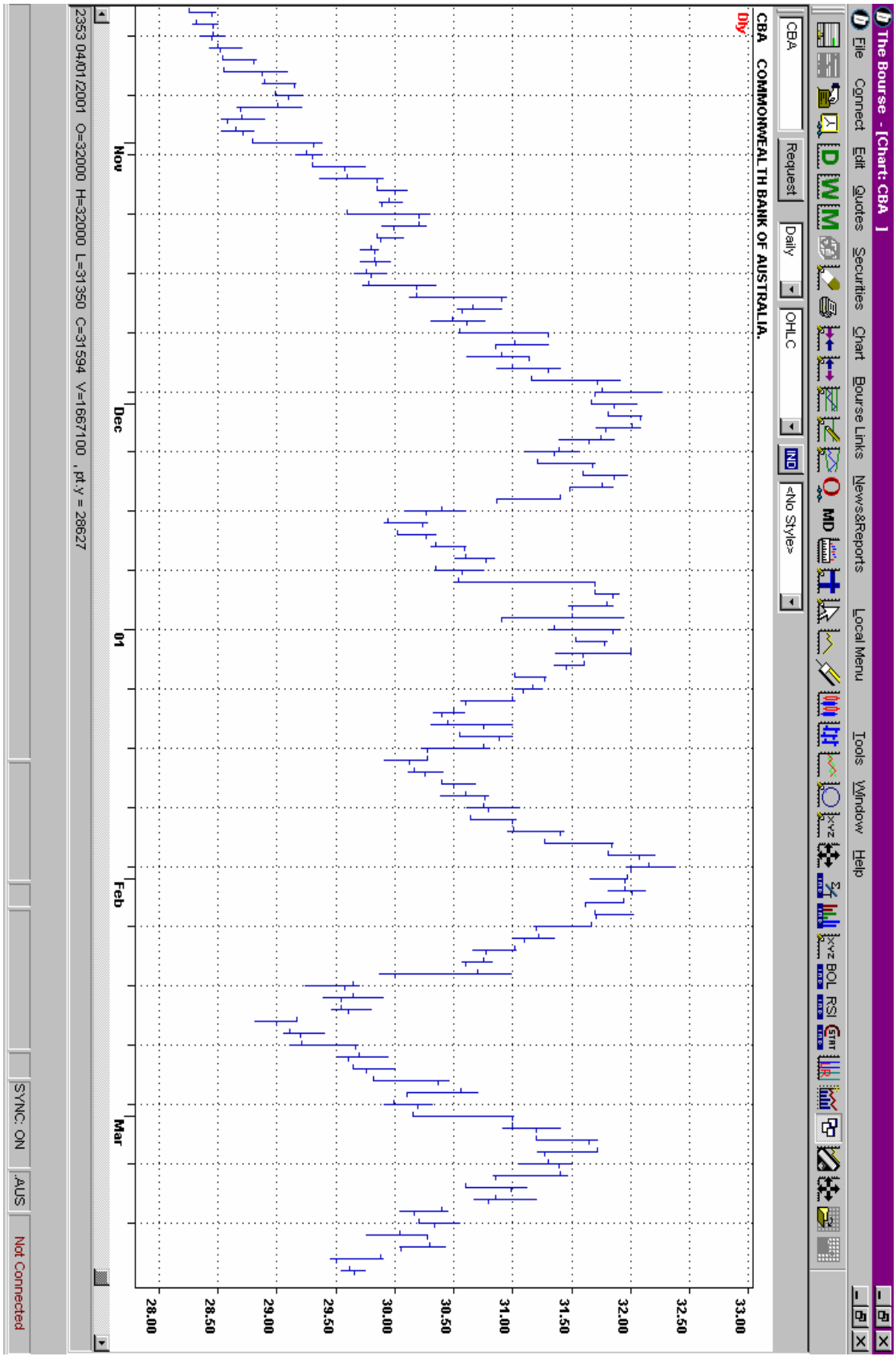
While it is more common, and easier to recognise, a Channel moving east, it is possible to have a channel which trends North or South. It is vitally important when constructing channels to apply any trend lines first, then check to see if a trend channel exists. If so, you can construct the second line using the parallel line drawing tool.

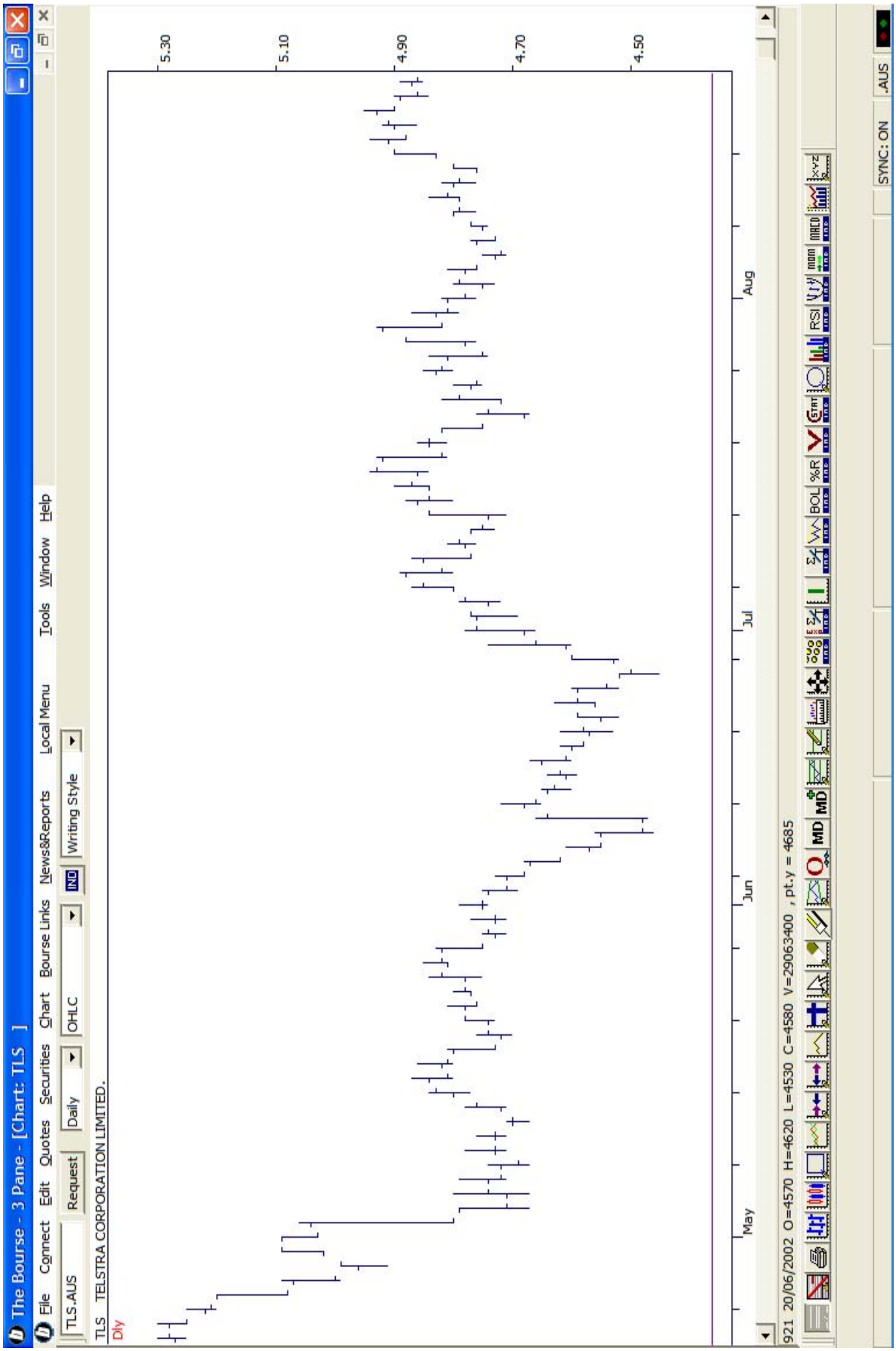
Possibly the greatest advantage to Channel trading is the ability to trade in both directions. A good rule to follow when trading in a Channel is to trade Calls only from the very bottom with the stock close to support, and to trade puts from the very top, with the stock just below the resistance line.

While it can be very profitable trading channels, it is important to realise that the Channel will end at some point and you will always be safer to trade with the underlying trend only. Otherwise you may find yourself trading a 'Pullback'.

Channelling can occur in any stock, at any time, however there are certain periods where it is more common. In particular, during a major shift in direction such as a swing from a Bull market to a Bear market. Also, during extended periods of market uncertainty, such as post September 11 2001. These periods, when identified early enough, can offer a great insight to the sentiment of the market as a whole, as well as providing significant trading opportunities.

As with all technical analysis, HINDSIGHT is the most powerful tool ever. The trick in identifying a channel is to do so as early as possible, bearing in mind that it offers more of an early warning, rather than a trading opportunity. Caution should be exercised in trading based purely on a Channel.





Trend Channels

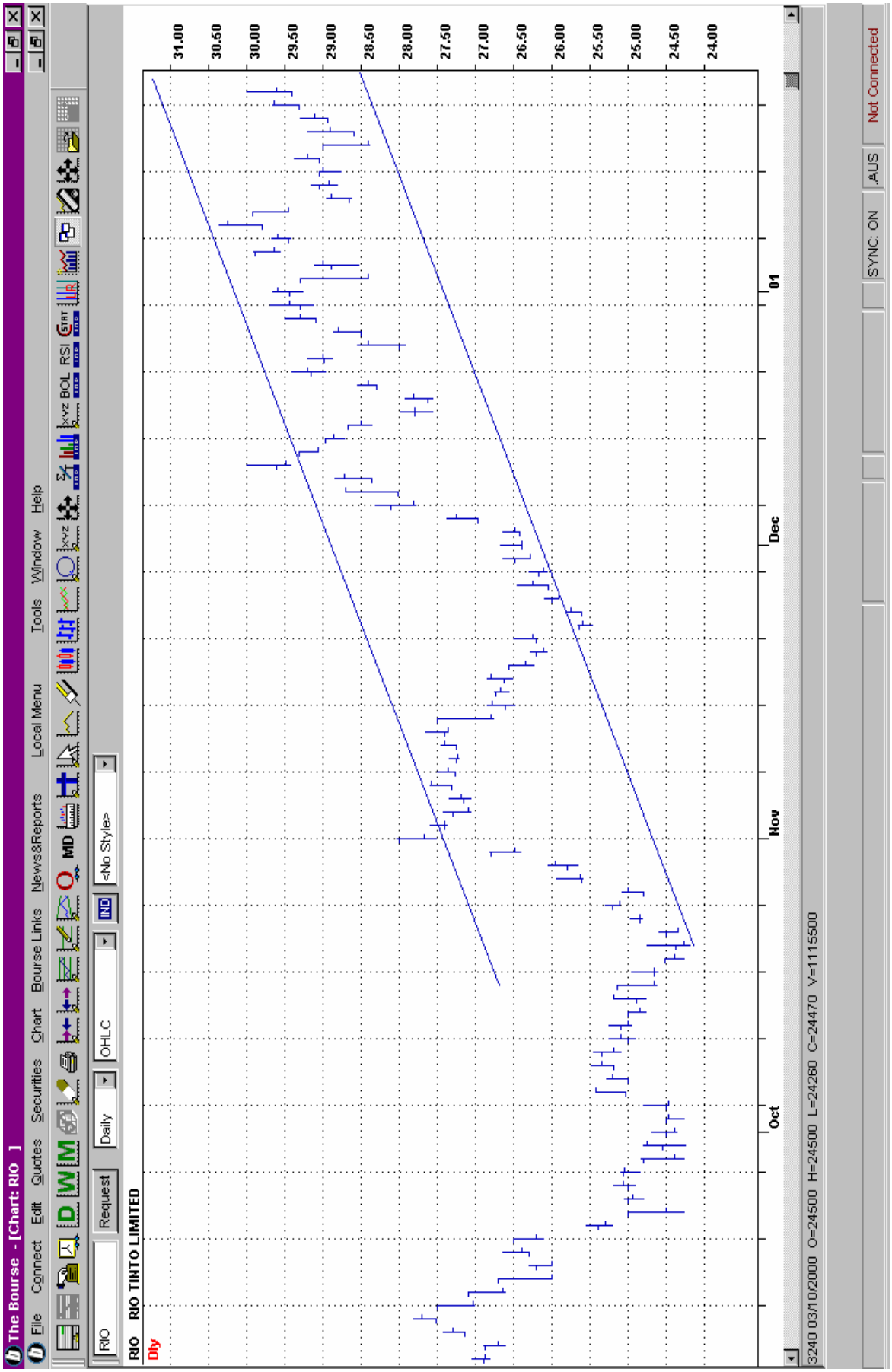
Prices can move within a Channel like this for extended periods of time. Look at the following real examples, of how a trend channel can develop over time. Like other types of trends, the longer the channel persists, the more momentum will be required to break out of it. As a side note, you may after extended channel trading, you may be tempted to hop in before the stock turns, the rule here is don't do it. Wait for the stock to let you know what it's up to before you go telling it what you want it to do.

I place a high degree of importance on VL's particularly when they combine to form a Channel. It is one thing to be able to spot a channel when the stock is moving directly sideways, it is something else entirely to recognise when a stock has formed a trending channel due largely to the fact that it is no longer measured at a particular price point.

Trending channels can be somewhat subjective, although it is vital to identify a valid trend, before there can be a valid trend channel. In a majority of cases, the average trader will only spot the trend channel after it has completed it's final swing and therefore is only useful as and example of what to look for. The key to it is being able to train your eyes to recognise these patterns while they are forming, and to have the discipline not to trade until your analysis combines with a high probability entry signal.

As with a standard sideways trending channel, a trend channel should only be traded from top to bottom, or bottom to top. In Australia, very few stocks have VL's wide enough to provide multiple entries in either direction so it is best only to trade those that begin at either extremity.

For more experienced traders, the use of certain candle stick patterns combined with a VL or two can offer early warning of an impending reversal and therefore a lower cost of entry to any trade. Keep in mind the perils of trying to pick the top or bottom of the market before it happens.



Channelling Stocks

When you recognize a channel it is possible to trade both the Northern and Southern movements. When the price hits the support level you would expect it to start moving in the opposite direction. Securities are bought and sold by investors who have developed certain investment strategies. This being the case it is common for a security to develop what I refer to as a comfort zone.

Two things to bear in mind: Trading channels:

1. The Channel will end at some time. This is the most important thing to keep in mind. We are not in the business of fortune telling and therefore do not want to make any decisions about what might happen. Wait for the market to tell you which way it is likely to go and never trade in a channel before you have recognised an entry signal. This is not guaranteed, however, history has shown it to be far more profitable.

2. The of the greatest problems with technical analysis and charting in particular, is the determination some traders have to see certain patterns on their chart. If you have to make exceptions, draw strange lines and bend over b a c k ward to make your Channel appear, then you probably should NOT be trading that Channel. Like all your trading, use your common sense and remember there is an abundance of moves, every day, we do not need to make them up.

Having said that, I personally know a few traders who will only trade stocks that are channelling. Do they trade often? No. Do they produce consistent returns? Yes.

It will serve you well to keep in mind what you are trying to accomplish. If you want to pay the most brokerage, spend 5 hours a day in front of your screen and not sleep that much—trade everything. If you want to make consistent returns and hone your craft as a trader, stick to trading high probability trading opportunities.

Rules for Trading Channels

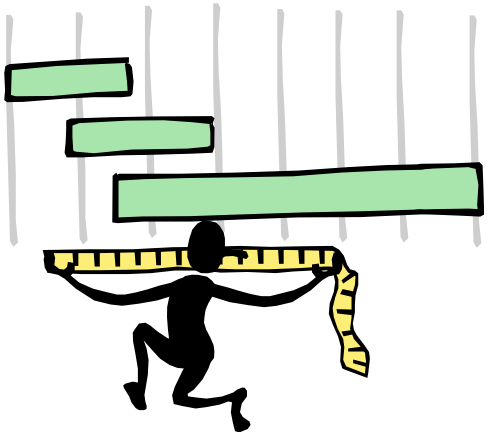
Don't rely on the trend exclusively, be alert to possible changes in the trend. If the price significantly breaks the channel, stay out of the stock until a new trend is established.

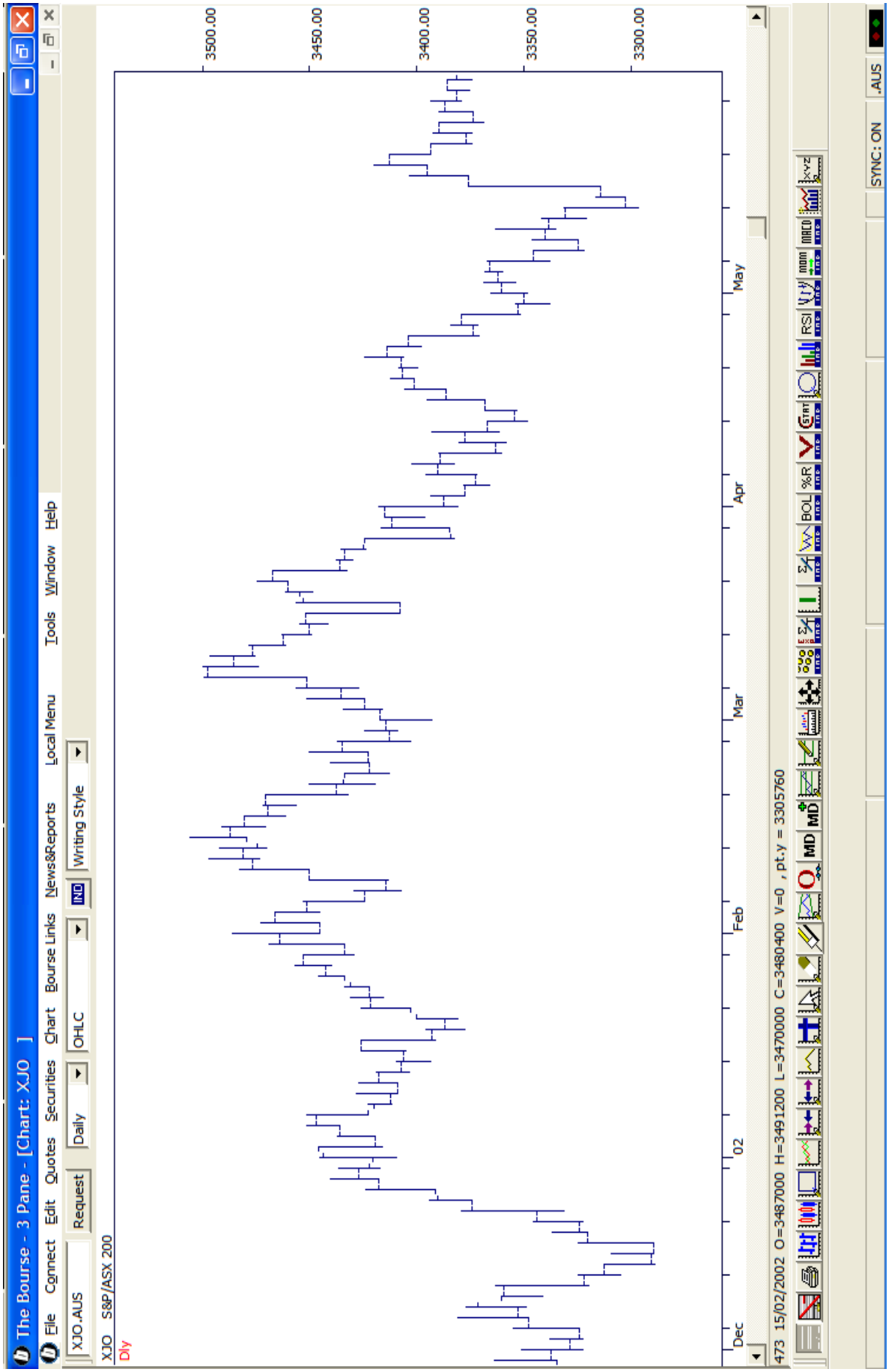
Remember, *The Trend is your Friend, y*ou should only ever be trading with the underlying trend, not in every small move. Aggressive traders may try to trade minor swings in the market but we do not recommend this strategy for new traders. For now, trade with the trend.

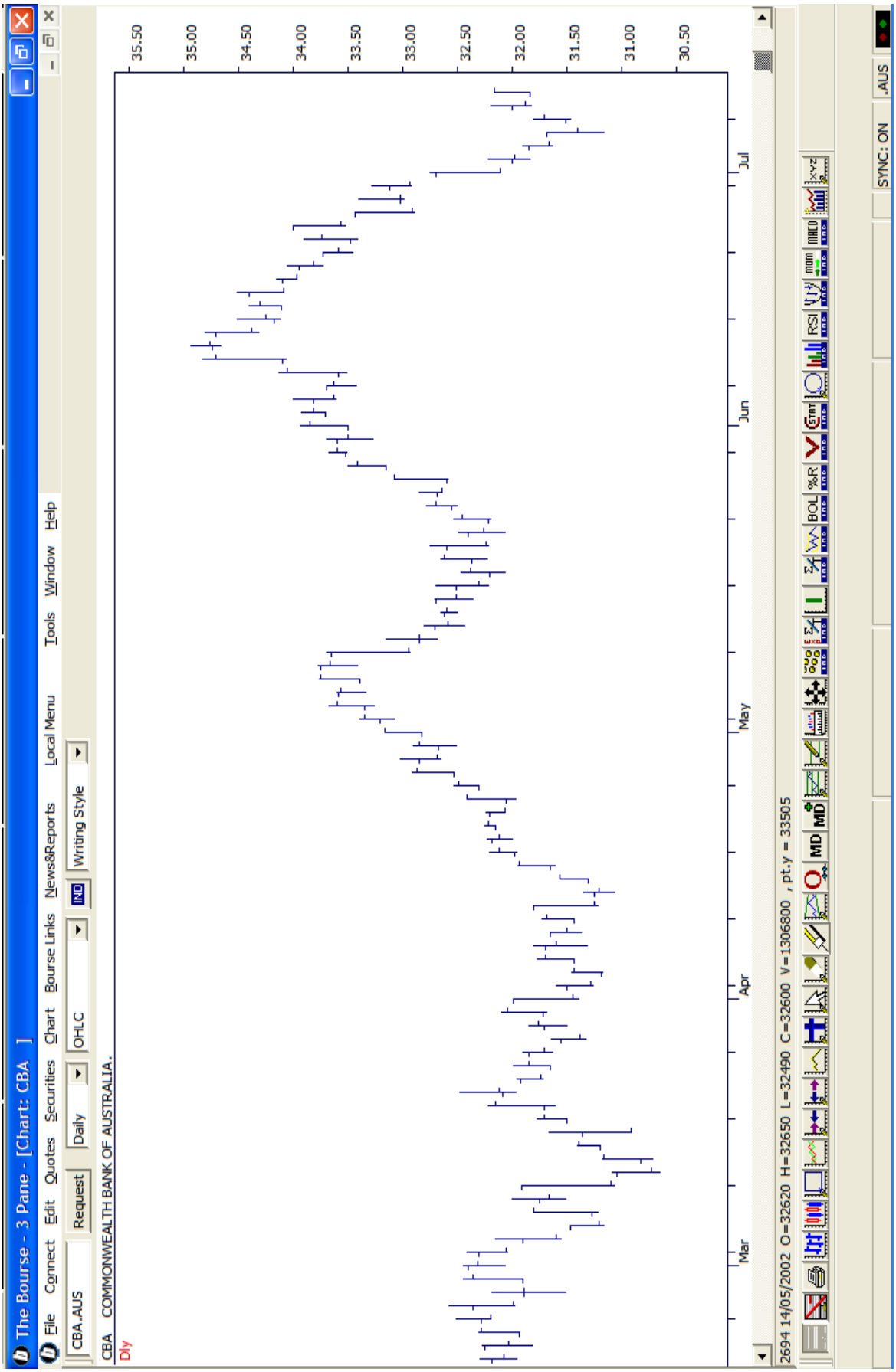
One thing you need to keep in mind always, whether trading Channels or trends, is the liquidity of your positions. Remember your open interest must be above 150 for it to qualify. With experience you will notice that the open interest on the first and second out of the money contracts will quite often be higher than that of the ATM or ITM options. This is especially true with Channelling stocks approaching support or resistance.

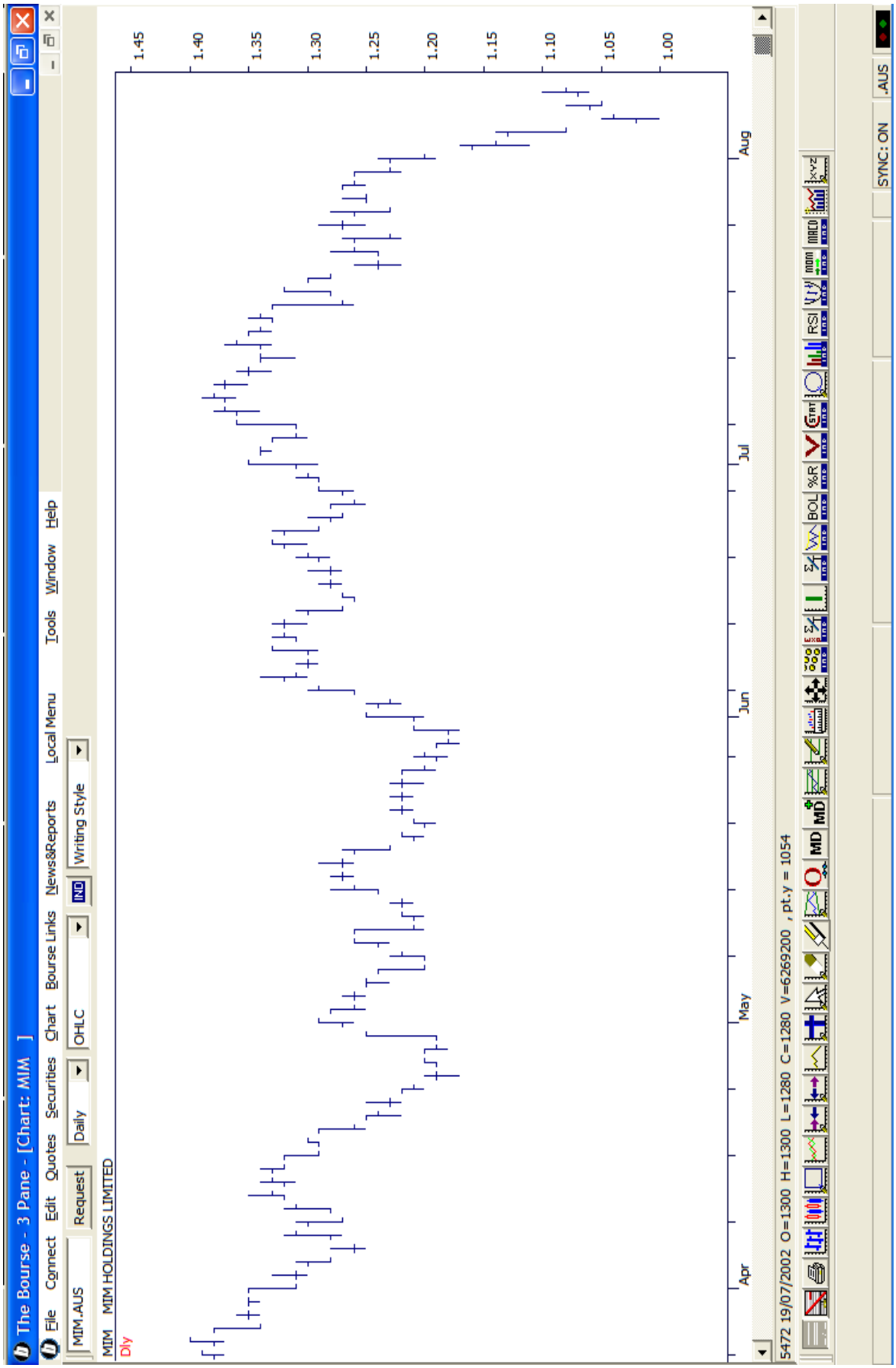
While most market makers will not use technical analysis, they are very aware of significant VL's. They can determine this simply by looking at the number of buyers and sellers which stack up at these levels.

The reason it is possible for you to be competitive in the market is the fact that you are forecasting a price move, whereas the RT's are only interested in what's happening right now. They employ all sorts of hedging techniques which will be explained later.









Double Tops

Looking at the tops and bottoms on a chart can give you more insight into the ongoing strength of the market trend.

A top is simply the highest point on a price chart. A bottom is simply the lowest point on a price chart. Tops and Bottoms are significant reference points and how the market behaves at these levels can give us important trading signals.

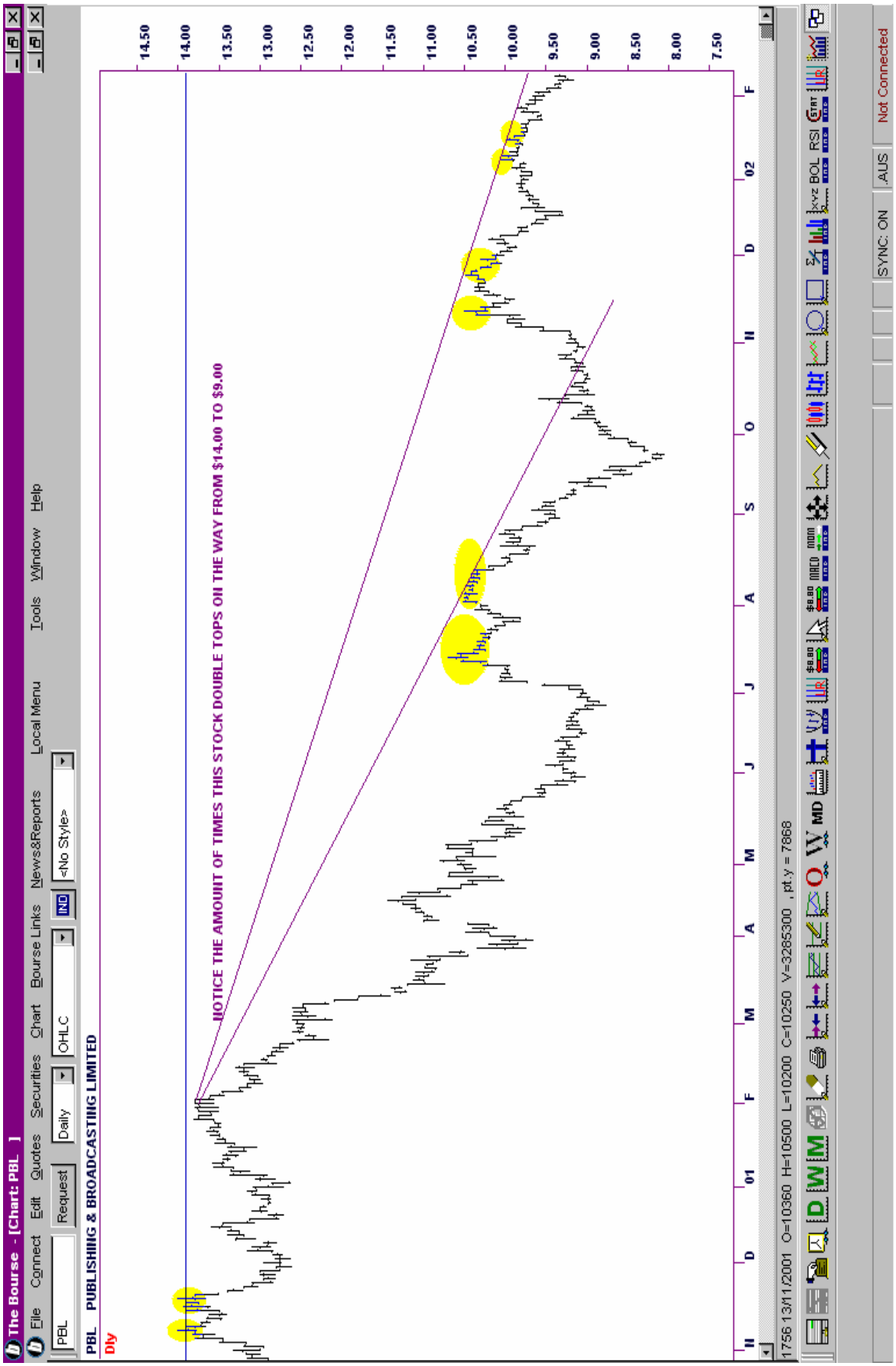
You can see in the *Double Top* e.g., it appears a faltering up trend as there is less and less buyers willing to push the price up. Look closely at the second peak. The new rally cannot make a new high and if it is on lighter volume we are probably watching a *Double Top* form.

Tops and bottoms are very often overlooked as they can vary greatly between periods. I have not found examples in too many text books, however my thoughts are that a double top or bottom can be valid either a few days apart, a few weeks apart, a few months etc.

A lot of the time if we cannot switch our focus between 'small' picture and 'big' picture we cut ourselves off from the overall view of things and can therefore miss quit a few solid entry signals. It pays to flick the charts outs to a 12 month view, or even longer, sometimes to give you perspective on where you are at right now.

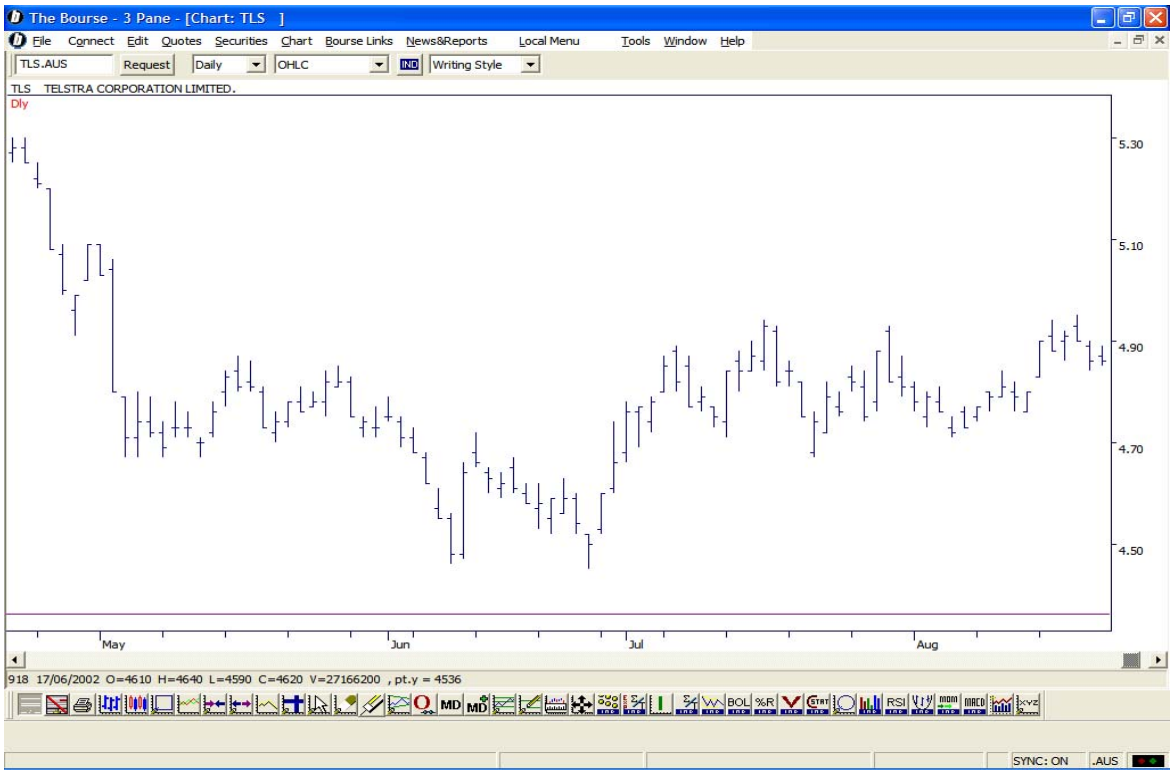
A ship at sea cannot remain safe for very long if the Navigator is to focussed on the ship's position rather than it's port of destination. Nor will it be able to return safely home if it's historical track is not followed.

You can see in the following example how the stock formed several 'Double Tops' on it's way from $14.00 to $9.00



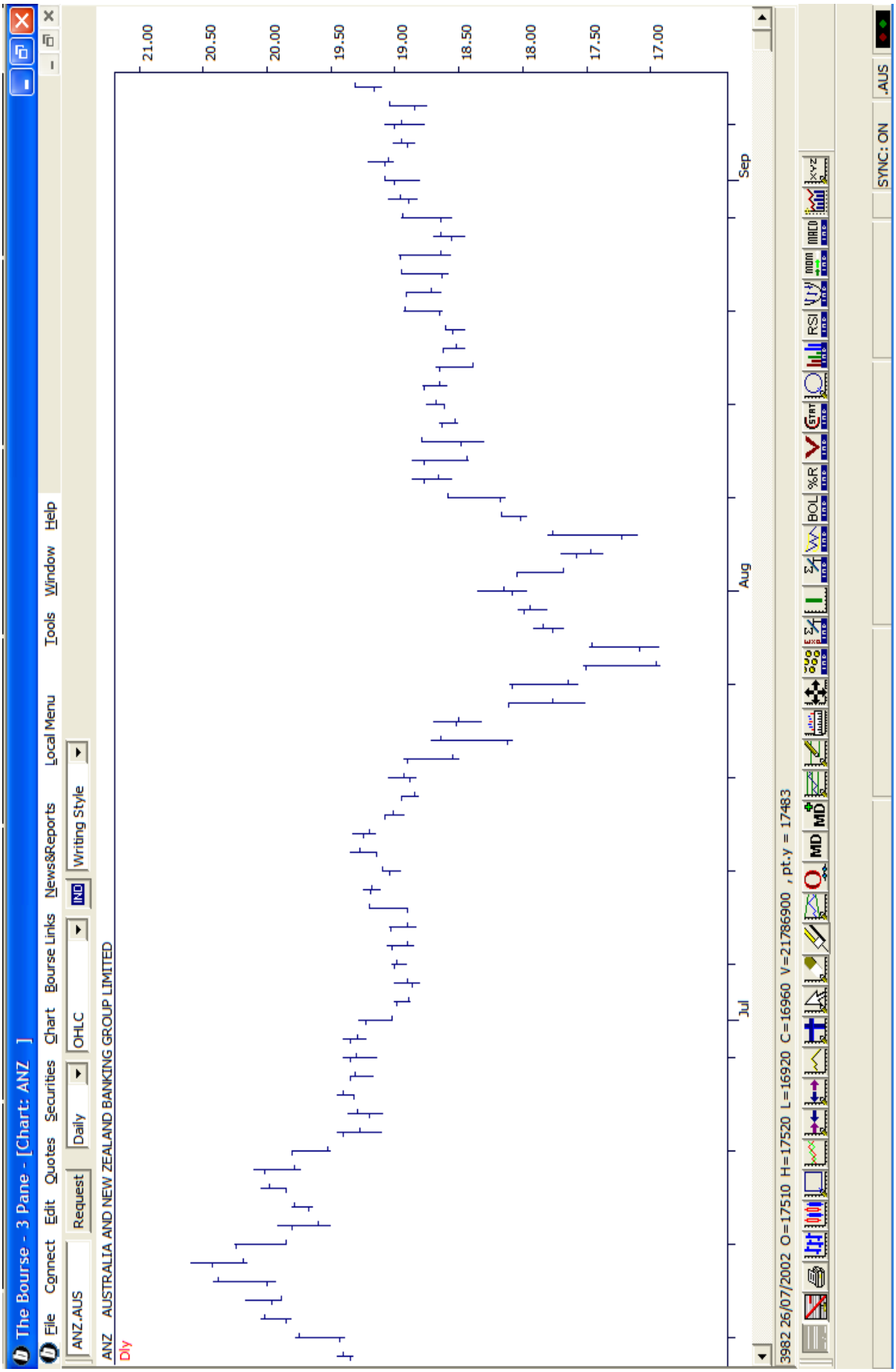
Double Bottom

A *Double Bottom* is essentially a mirror image of a double top. It occurs as a down trend begins to falter and prices form a base at a support level. The double bottom is formed when the price cannot move past this support level to form a new low.



You can see how the sellers are losing momentum and are unable to push the prices down any further, this is a very *Bullish* signal.

What you are looking at here are simply indicators. They are not rules set in stone. The most important aspect of trading is understanding and learning to read the charts. You need to identify the *Patterns* and make decisions based on the whole scenario – *The Big Picture*.



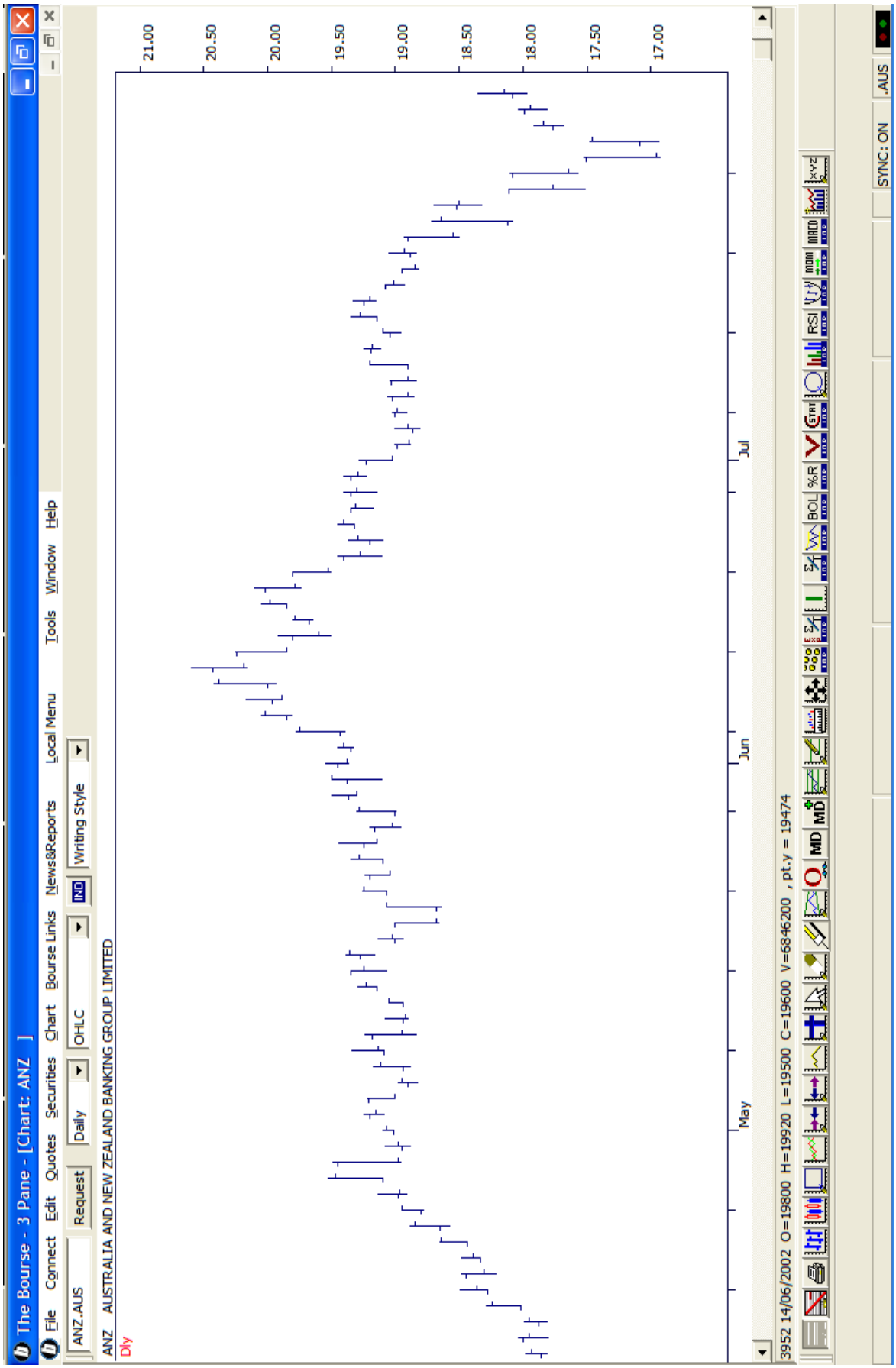
Head and Shoulders

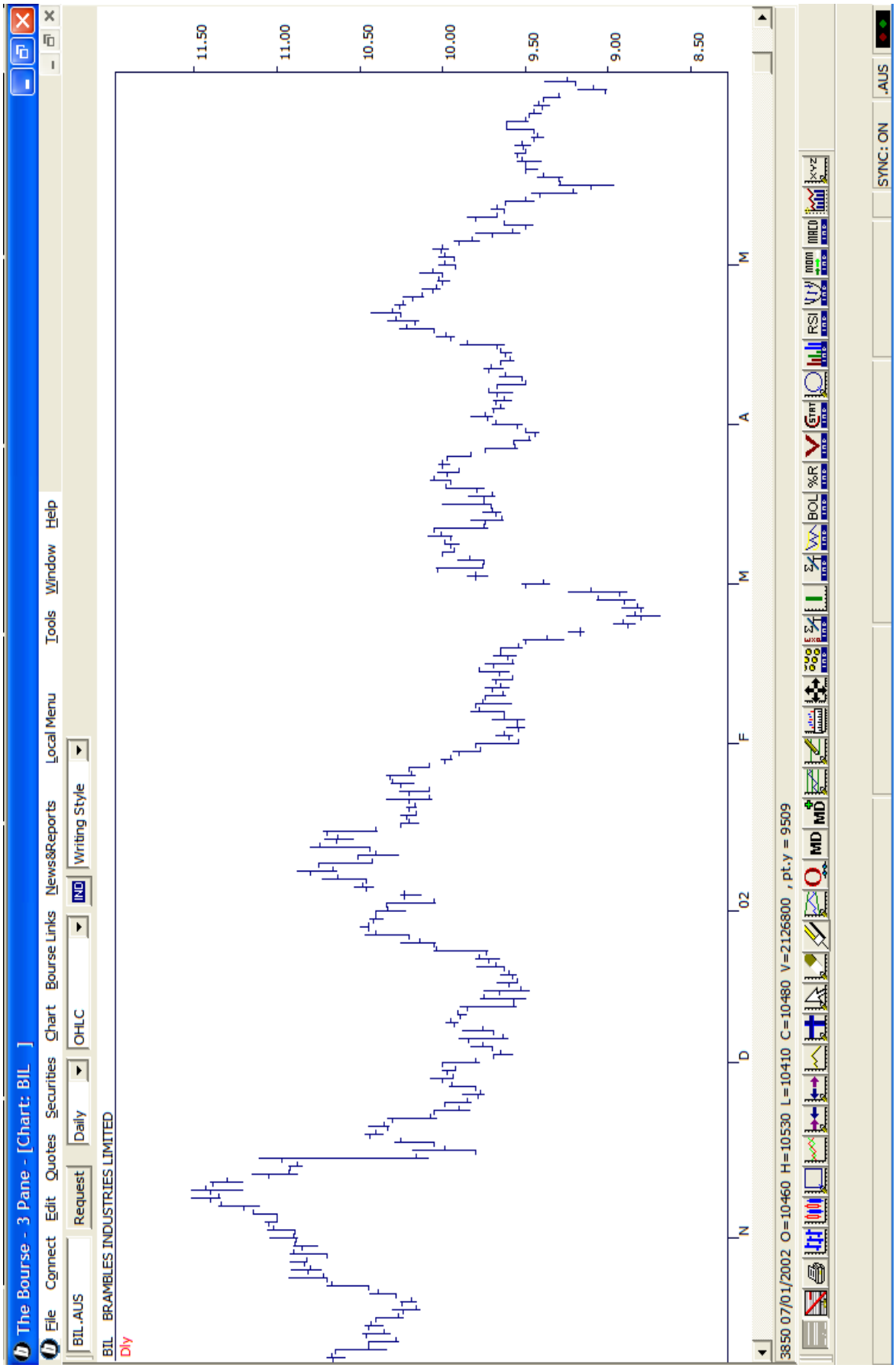
A slight variation on the double top formation is a pattern known as a 'Head and Shoulders'. As you can see below, the stock found resistance at the $12.00 (forming the first shoulder) before it broke through and found a new resistance level at $13.00 (forming the 'head' of the pattern). The stock could not sustain its strength at $13.00 and subsequently fell back to the $12.00 level (forming the second shoulder.

NOTE: This pattern is not as common as a double top or double bottom and may take some practice to recognize early enough to take any action. All charting patterns should be traded in accordance with your level one break out signals.

It also very common for a Head and Shoulders, or an inverse Head and Shoulders to re-test the Neck Line once it has broken though before continuing it's initial movement. These patterns are frequent in turning market and can offer an early insight into the possible future direction of the market.

The important thing to remember is that using patterns to identify a trade is slightly more aggressive than standard trend trading and therefore, should you miss them, it shouldn't cost you any money. It is primarily to allow you to enter a trade earlier.





Module Ten

Trend Types

Trend Types

With option trading I use the same indicators as share trading. However, due to the short term nature of your trades, you must modify our terminology and use of trends.

For share trades a long term trend maybe five years, for option traders, a long term trend maybe 6-12 months.

Following is a guide for trend line classification:

	SHORT	1 WEEK
DAILY	**MEDIUM**	1-3 MONTHS
	LONG	3-6 MONTHS
	SHORT	3-4 WEEKS
WEEKLY	**MEDIUM**	3-6 MONTHS
	LONG	6-18 MONTHS
	SHORT	2-4 MONTHS
MONTHLY	**MEDIUM**	1-2 YRS
	LONG	2-5 YRS

In option trading, it is also valid to use 'Live' trends. By 'Live' I mean the most recent 2-3 days/weeks movement.

Weekly trends are vital to your analysis and should be checked before proceeding with a trade.

Trend lines support & resistance etc. should be applied to determine where the stock lies on the weekly chart.

Trend Types

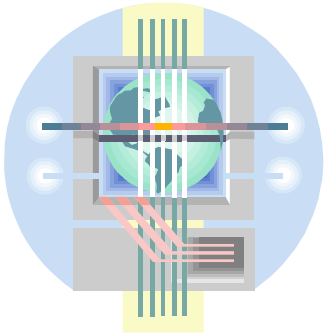
You are no doubt familiar with the term 'The trend is your friend'. However as the previous page shows, there are many different trends and deciding which one is your friend can take some practice.

Our standard operating chart (SOC) is the most recent three months price action on the DAILY chart, which will be referred to as the SOC. It is important to understand that the fewer factors left to interpretation, the tighter the trading plan becomes and therefore the level of human involvement can be kept to a minimum.

By beginning with the SOC you now have a fixed time frame in which you can construct our analysis. I prefer a simplified approach to analysis and this begins with the application of as few lines as possible.

Generally speaking, three months worth of daily price movement will have one or two 'Underlying Trends'. It is important to understand that while the entire three months are required to establish an 'Underlying Trend', the most important data to you is the most recent.

While your initial entry signals are key before making a trade, it is just as important to trade 'with the trend' by ensuring that the most recent three months price movement is in the same direction as the present Daily signal.



The easiest way to remember this is to simply refer back to your trading logic. If today's signal is Bullish, then this information can only be married to a corresponding Northern Trend. Similarly, a Bearish entry signal can only be married to a Southern Trend.

In addition to this, we will now look at how the Weekly Chart can effect our trading decisions.

Weekly Trends

At a first glance the Weekly Chart gives a similar picture to that presented by the Daily Chart. Quite often, however, there will be numerous slight differences between the two. These differences offer a slightly longer term insight a short term trade by allowing us to view the same information in a more concentrated way.

For example, if today was a normal trading Monday on a particular stock, the Daily OHLC western bar would offer the OHLC for today's trading period. Because the weekly chart is designed to show the OHLC of the week, it represents exactly the same information as the daily chart—that is on Monday. On Tuesday, the weekly OHLC will carry the Open from Monday, and the HLC for Monday and Tuesday combined. This continues until the last trading day of the week, usually Friday, where the weekly OHLC is now complete.

Another way of thinking about the Weekly OHLC is as a combination of the five Daily Bars for that particular week. The most important thing to remember about these two charts is that while they show a 'similar' pattern, definitive Validation Lines may be in slightly different places and therefore give you a different picture than simply looking at the daily alone.

When reading the Weekly chart it is also much easier to get a feel for the 'Big Picture' by pre-selecting 12 months worth of price action. Obviously the same rules apply in as much as the most recent three months is priority, although with respect to trend lines and the overall view of the Weekly chart, 12 months worth is valuable.

Reading Weekly charts

As previously mentioned, you will read the weekly chart (WC) slightly differently to how you read the daily chart. The most important thing to remember when analysing the WC is that you ARE NOT looking for an entry signal. By this I mean it does not concern you what type of pattern or signal the most recent weekly bar shows. The two things that do concern you are:

- Where are the recent Validation Lines, and,
- Where is the stock right now in relation to those lines.

Always remember that in Trading (two to five days) you are not only concerned with where the stock is right now, but more so where you 'think' it will be in two to five days time. When looking at the WC you may not be able see any possible VL's which may not be as evident on the DC. Also, it is important to note when the stock is tight on, either above or below the line.

Assuming you have found a valid entry signal using the DC analysis, you would then consult the WC for any possible reason to stay out of this particular trade. While the importance is placed over the past three months, notice where the stock is right now. Are there any VL's that will possibly hinder the stock from reaching the target you have it set for?

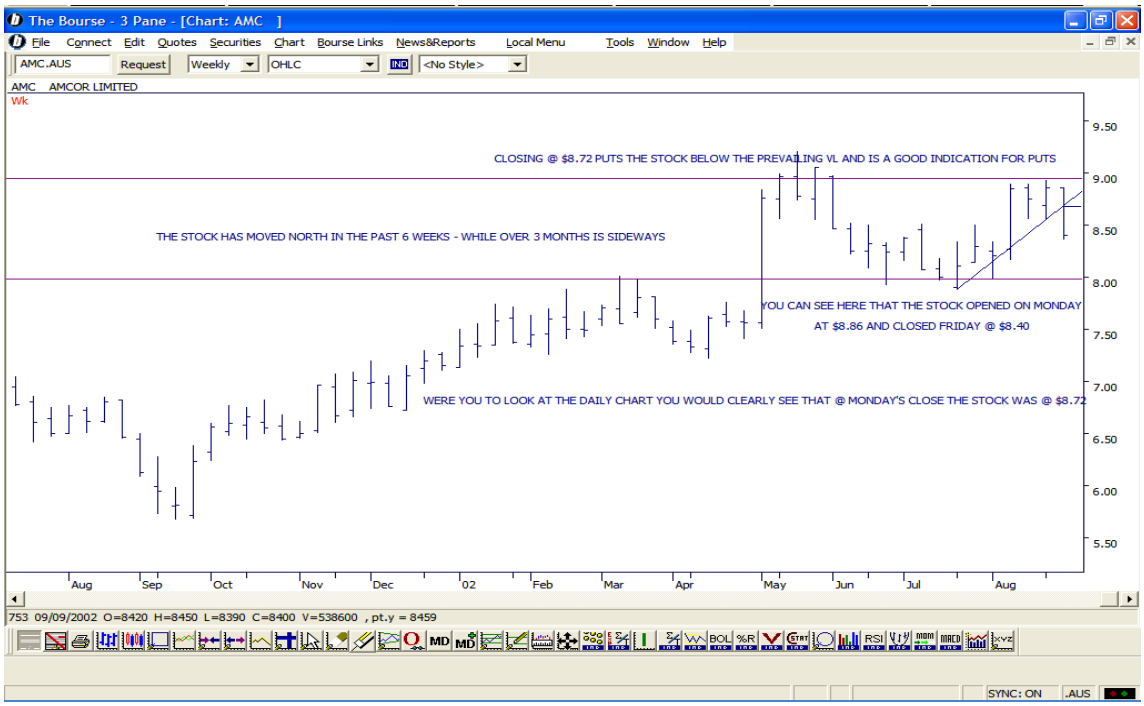
In more simpler terms, if we are considering Call Options, either for a two-five Day Trade or a longer term hold, it is important that the current price is ABOVE any prevailing trend lines.

On the other hand if you were to look at taking Puts, the reverse would apply and the current price must be BELOW any prevailing VL's.

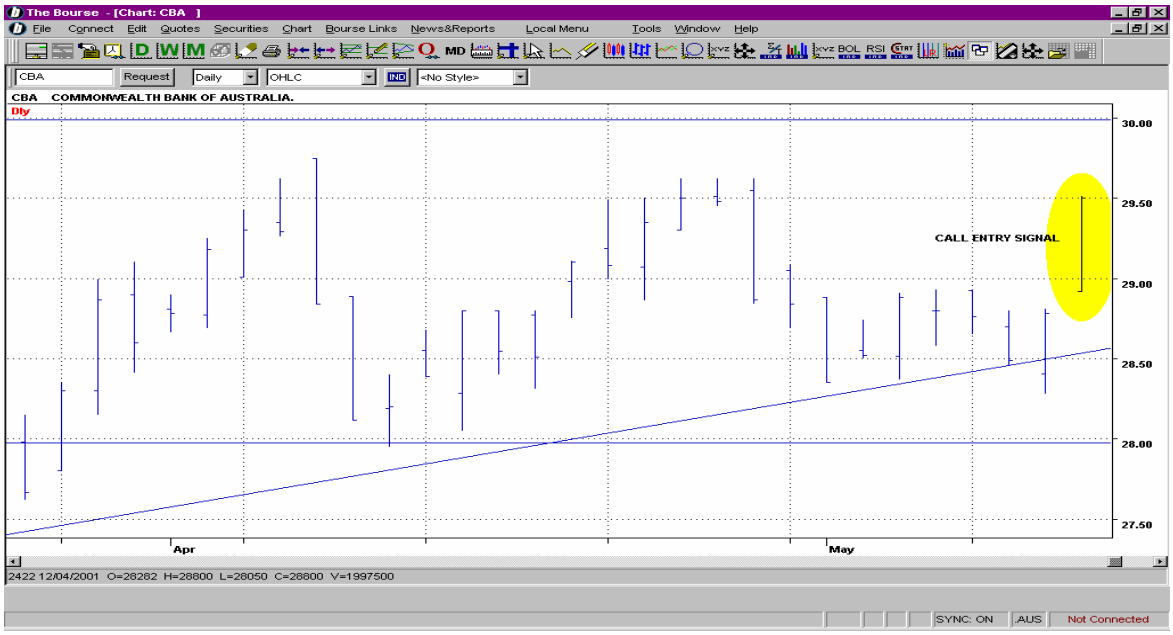
Early in my trading career, most of the losses I sustained were due to a failure to check the WC. The reason for this failure was that I didn't know what I was looking for. Never trade if you are uncertain of the WC.

Weekly Charts

Weekly Charts

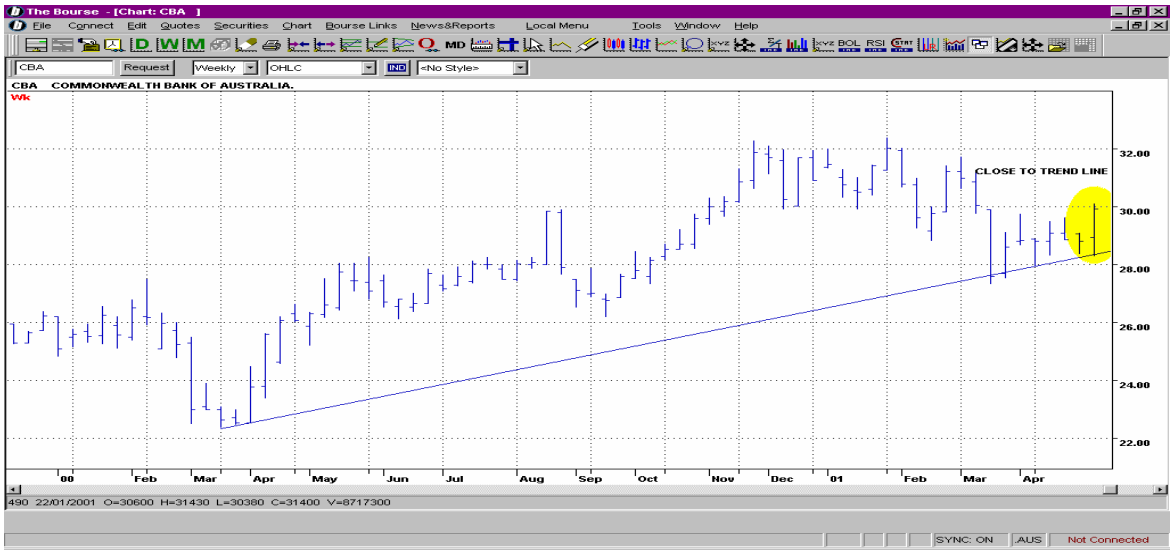


Daily Chart Entry Signal



Weekly Chart—Same Signal

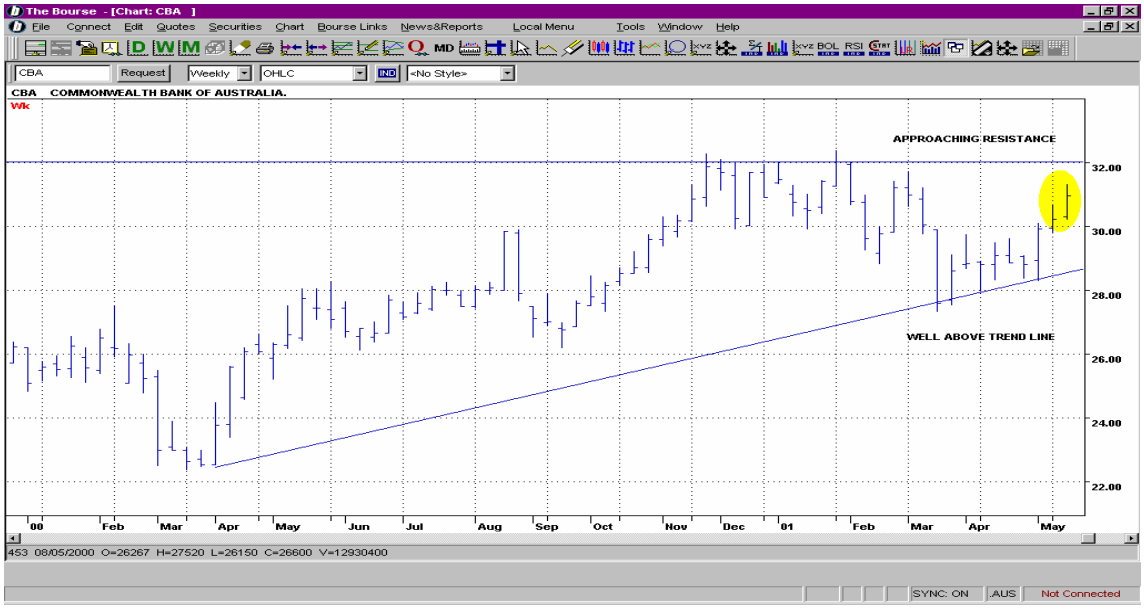
Looks Good



Daily Chart Entry Signal

Weekly Chart—Same Signal

Not So Good



Analysing Trend Lines

You are now aware of how to use trend lines to show you the direction of the market. However, you can also use them to show you the health of a trend through its duration. In addition to this you, can also judge the intensity of the trend through the slope of the trend line.

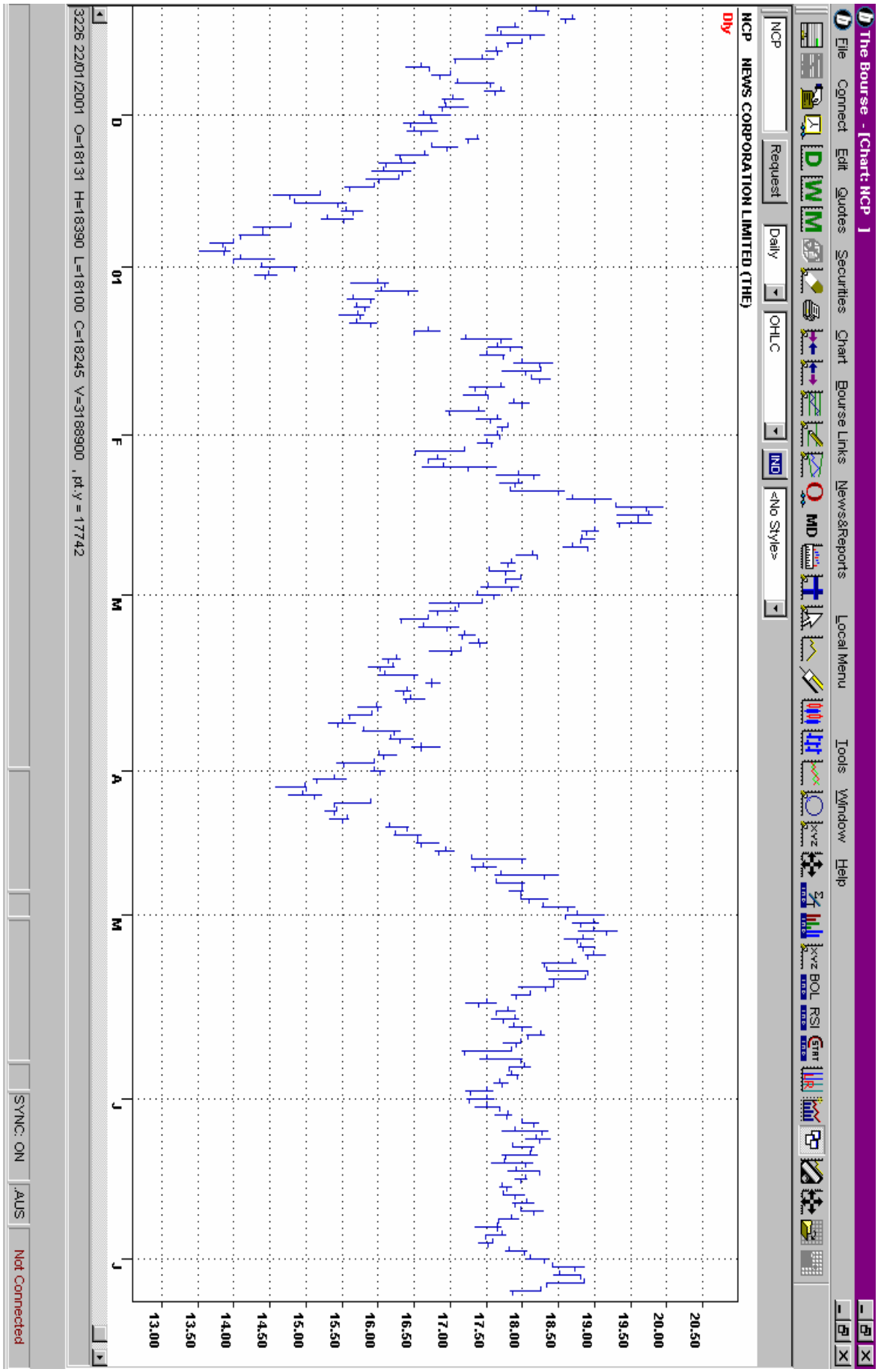
The angle of attack, whether it be north or south, is often the first indication you have as to the VOLATILITY of the stock in question. I will concentrate more deeply on how to gain the maximum from volatility levels in a later module, however, it is important to be aware of some stocks to avoid due to uncontrollable volatility.

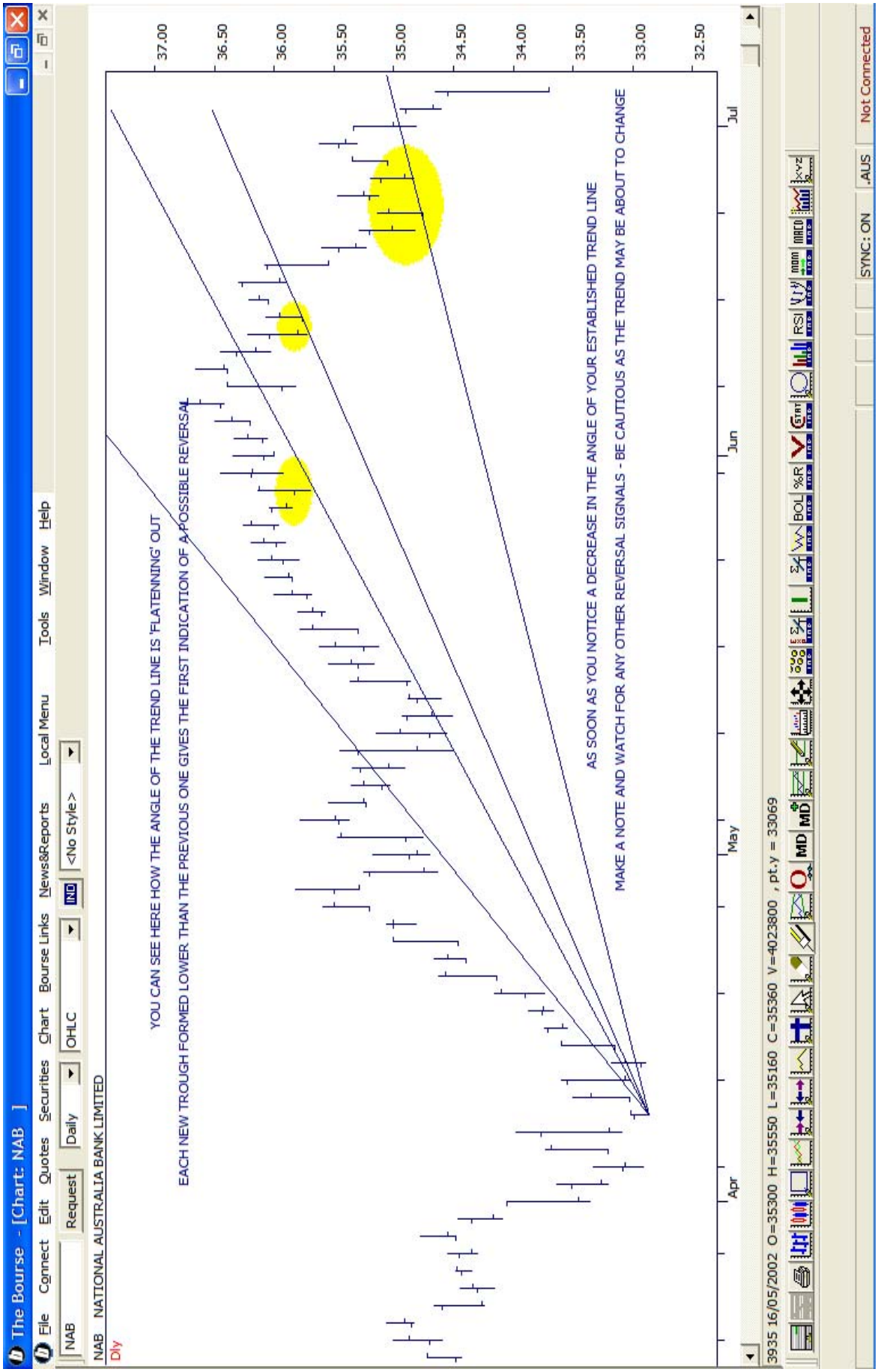
One of the all time leaders for Volatility is unquestionably News Corporation (NCP). For this reason, and many other personal ones, I no longer trade NCP. While a certain degree of volatility is required to ensure Option price swings, stocks that display extreme levels of Volatility can often be very unpredictable which introduces an unacceptable risk/reward factor. Due to the overwhelming fact that the market is a dynamic and forever changing entity, the volatility levels of a particular stock will change.

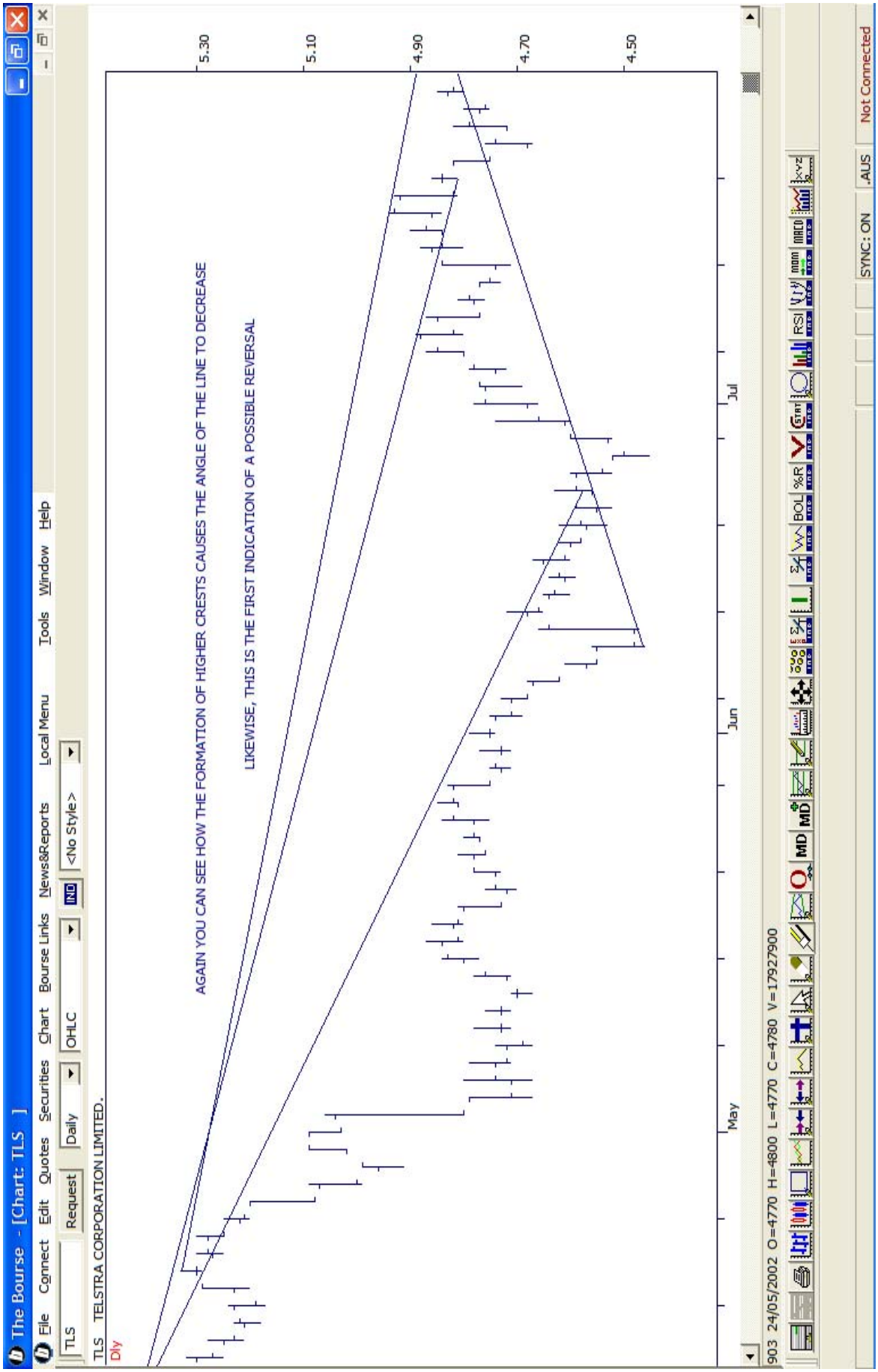
Some stocks may enter a period of higher volatility due to fundamental issues such as takeovers, reporting season, announcements etc. While most of this volatility can be linked to the fundamental issue, the chart is generally our first indication that something is changing.

Simply by looking at the angle of rise and fall you can immediately determine whether or not the stock is going to provide a consistent pattern. In my experience the highly volatile stocks should be left until you have gained enough live experience to handle them. I will look more closely at how to determine current and historical volatility levels using a simple indicator in a later module. However, for now let's look at the angle of the trend lines and how they assist your analysis.

Another valuable signal that can be gained from the angle of the trend lines is something I call 'Trend Flattening.' If you watch the trend closely over time and notice that the angles of your prevailing lines are beginning to flatten out, it can be an early sign of a possible trend reversal.







Module Eleven

Bulls and Bears

Scanning for Entry Signals

Now that you have established how an option contract functions you can take a closer look at how to analyse your underlying assets and begin to determine what constitutes an entry signal. An average term for short term trading would be two to five days, where an average investment trade may be as long as two or three years or more. For me, both are valid, and valuable ways to trade, and both methods are very similar once you understand the basic principles of analysis.

Peter Lynch, ex-manager of the 'Magellan Fund', is arguable one of the most successful stock pickers in history. His sustained returns are proof positive that a human being can consistently outperform the market using a combination of analytical skills and intuition. One of Mr Lynch's favourite sayings is that trying to pick the bottom of the market is like trying to catch a falling knife. You might get the handle! Then again, you might not! I attribute most of my success as a trader to the ability to not only recognise what works, but also to recognise what doesn't and further to take action with each new insight.

Your task as a professional trader is not to pick the bottom or the top of the market. This is the art of knife catching and while it can be very profitable for the experienced trader, the novice is well advised to begin by following the market. All the analysis techniques we will cover in this program are designed to recognise a change in market direction as soon as possible AFTER it has occurred.

The reason you wait for the market to turn is quite simple. Until you have developed a keen trading intuition, it is far too speculative to pre-empt any changes. By waiting for the market to show you which way it wants to run, you are far less likely to suffer early losses and while the frequency of your trading may be somewhat reduced, our profitability will certainly increase.

Looking Closely at price action of over the short to medium term can provide a number of clues as to the thought patterns of investors, and therefore the direction of the market.

Scanning for Entry Signals

The following module is designed to show you how even the slightest movement on the DAILY price bar can provide a fantastic insight into where the stock might be heading. While it is important to bear in mind that no signal, no matter how strong it seems, is a guarantee that the market will agree with your prognosis, it is also important to remember that to trade against the present trend will more often than not lead to failure.

Short term (2-5 days) trading is often best executed as early as possible in the move to provide maximum gain in the shortest possible time frame. In my experience it is far better to enter a trade on the first or second day of the move. By entering early you are limiting the amount of time you are exposed to any movement which does not correlate with your analysis.

When I first began trading live, the only reference point I had was that of a mountain of text books, which all seem to have one common theme. That was to be cautious about entering a trade too early and that it is better to delay the entry until confirmation of the move is available. This approach seems to work well for share-traders, although options represent a whole new way to trade. Experience taught me that more often than not, a late entry would result in either a less profitable trade, or a loss.

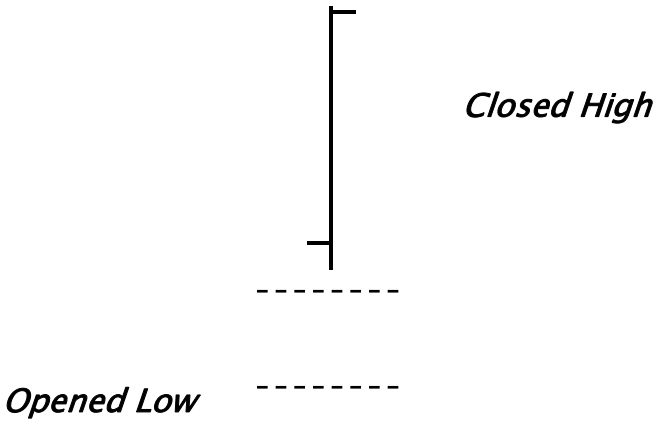
When you have located what you believe to be a good entry signal, the time to decide whether or not to trade is right at the point of recognition. The more time I need to evaluate a trade, the less likely it is that the trade will be successful.

This approach is not as critical in a running market, Bullish or Bearish, as the moves tend to be sustained for an extended period. In a tight or somewhat choppy market, however, an early entry and decisive exit strategy is a must.

The following pages indicate some common entry signals using Western Bar Charts

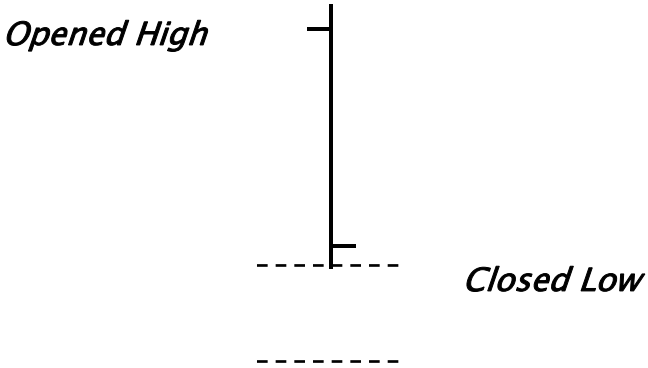
Bullish and Bearish Triggers

Bullish Bar

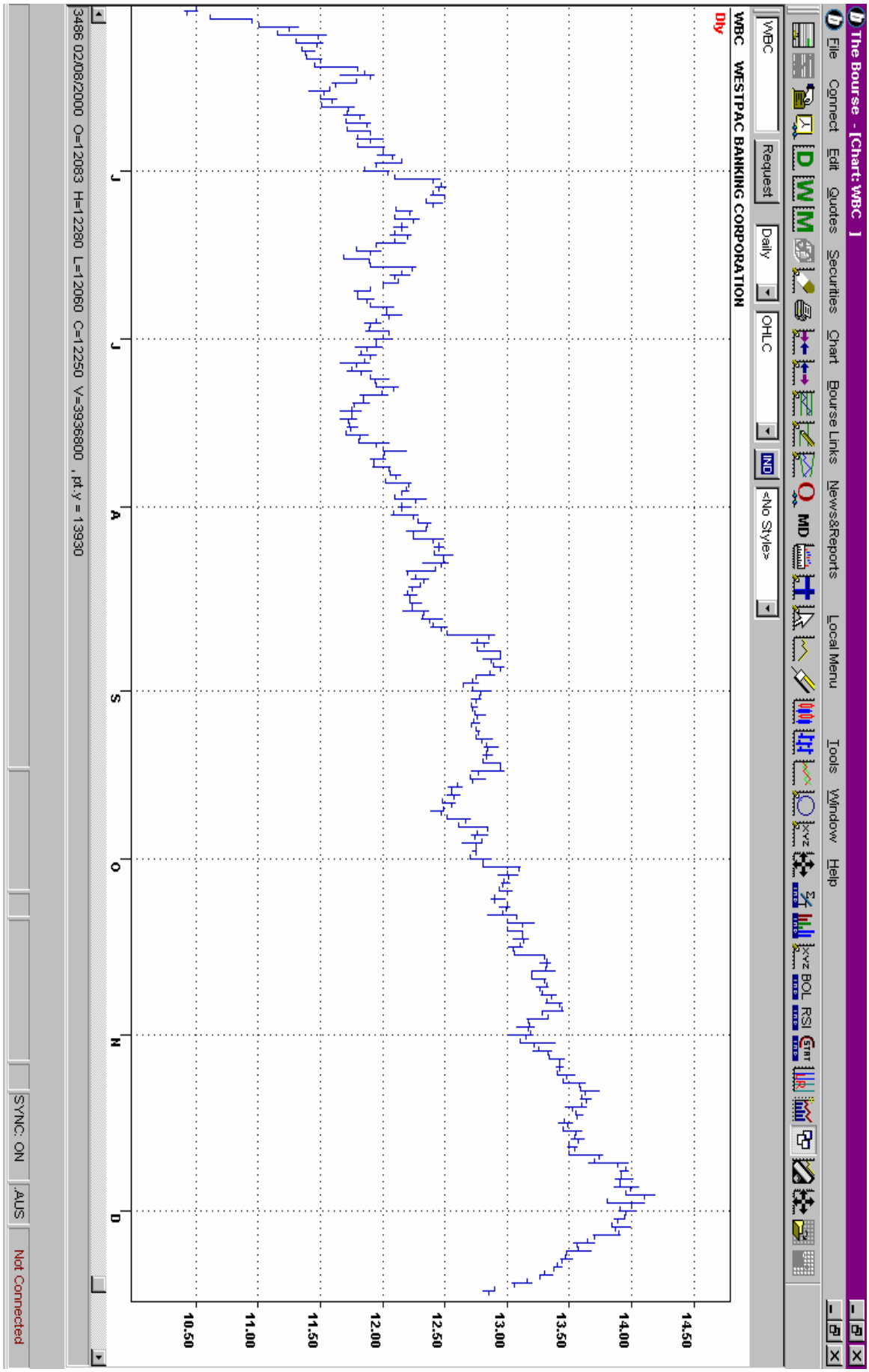


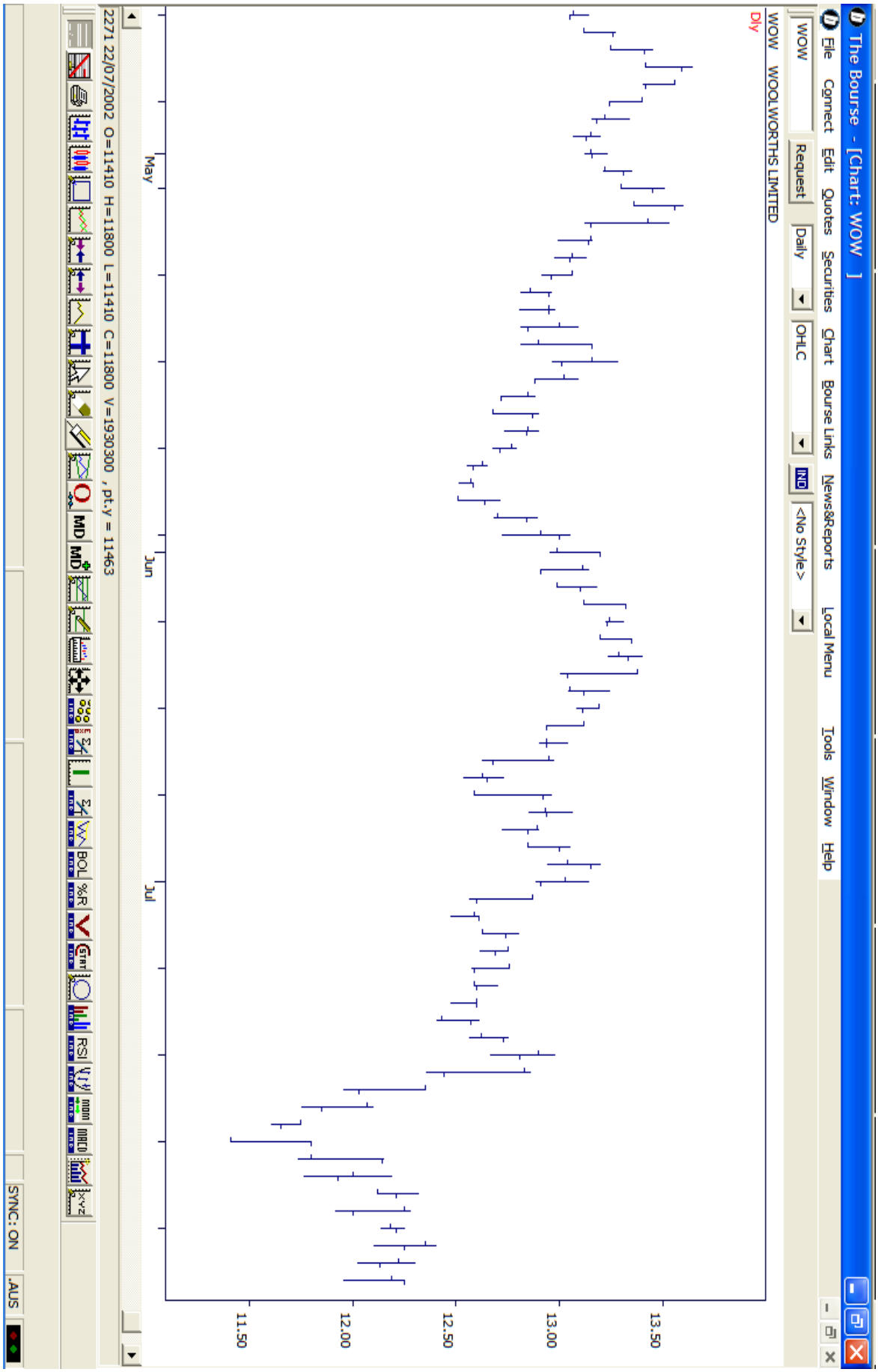
Note: As a rule of thumb, the stock must open in the lower 1/3rd of the range and close in the upper 1/3rd to constitute a relevant 'Bullish Day'

Bearish Bar



Note: Likewise, for a 'Bearish Day' to exist, the stock must open in the upper third and close in the lower.





Supporting Entry Signals

Once you have developed the ability to recognize Bullish and Bearish market action for a particular day's trading, you can then add support to your initial entry signal by comparing today's range with that of the previous period to strengthen your decision to enter a trade. You are now aware about how to determine a NORTHERN day from a SOUTHERN day, and also how to determine a BULLISH day from a BEARISH day.

By combining this information you can establish a stronger indication of the sustainability of the impending move. For example, if today's trading period was bullish, yet when compared to the range of yesterday, you determine it to be a southern move, your two sources of information conflict, and therefore, this signal would not represent an entry signal. Similarly if today's period is bearish and the range compared to yesterday is northern, it would no longer be an entry signal.

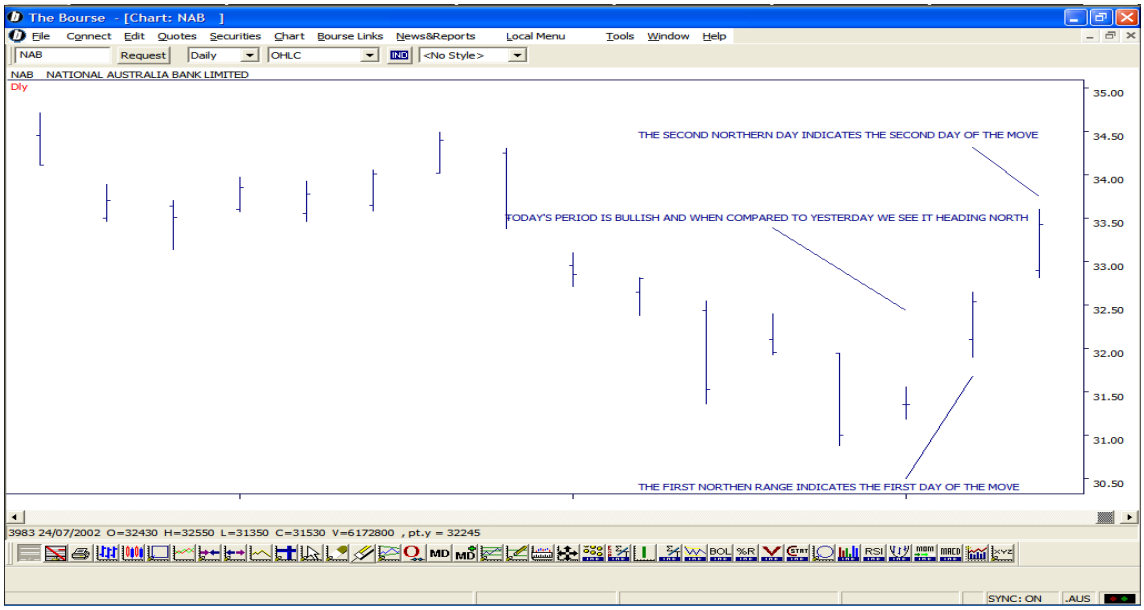
On the other hand when you begin to add supportive evidence to your initial entry signal you can quickly build confidence in your proposed trade. For example, if today's trading period is Bullish, and the range compared to yesterday is heading North, the signal is stronger. In the same way, if today's period is Bearish and the compared ranges show the stock heading south, this would add to your forecast that the stock could be weakening.

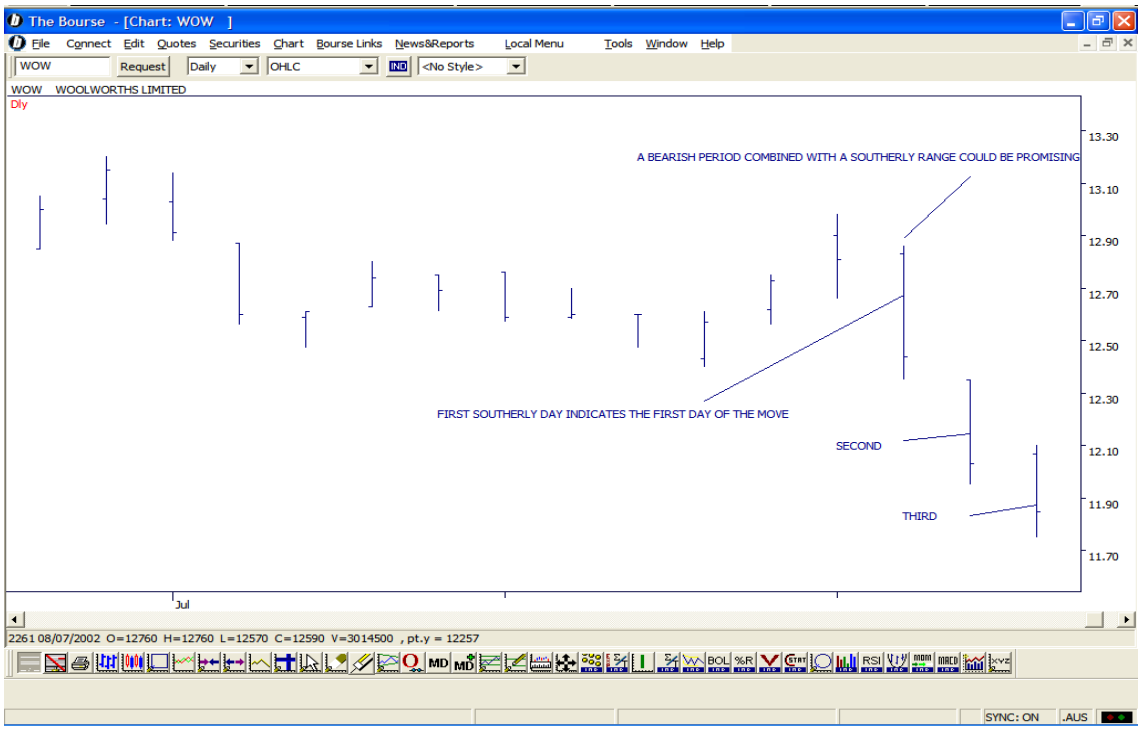
From the moment you recognize either a Bullish or a Bearish current trading period, your focus should shift to looking for any reason not to proceed with a trade.

I have found this method the most precise way to sift through the daily offering and select the strongest signal.

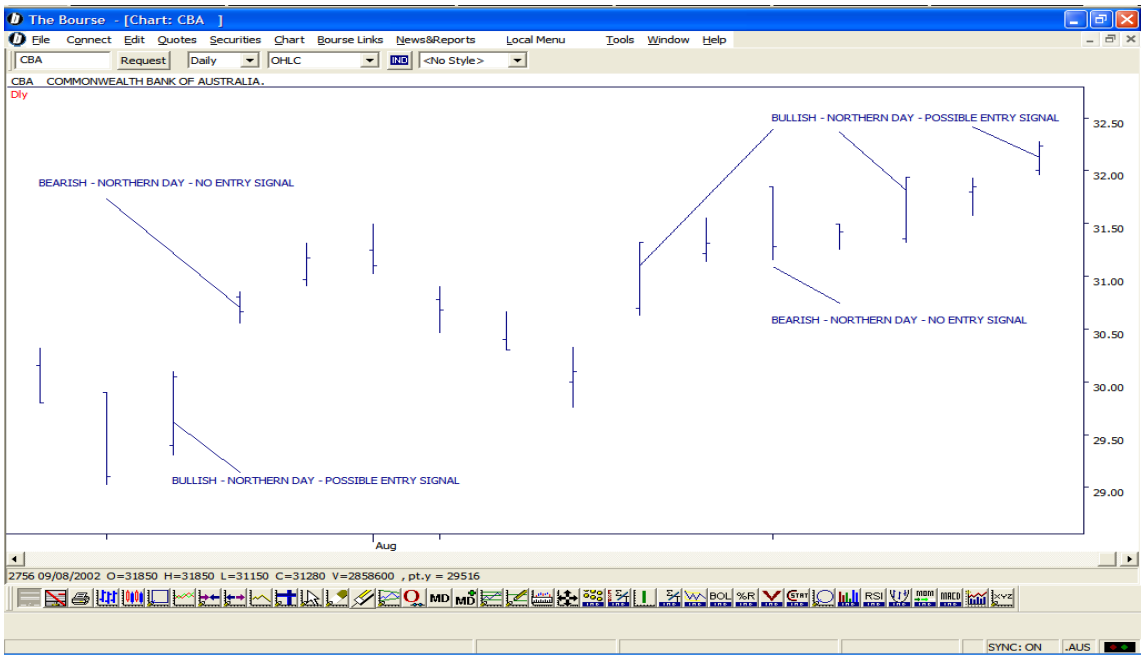
You are beginning to add weight to your initial signals and increase your 'sleep at night factor' in entering the trade. Following are some good, and some not so good examples of possible entry signals using the first two parts of your selection criteria.

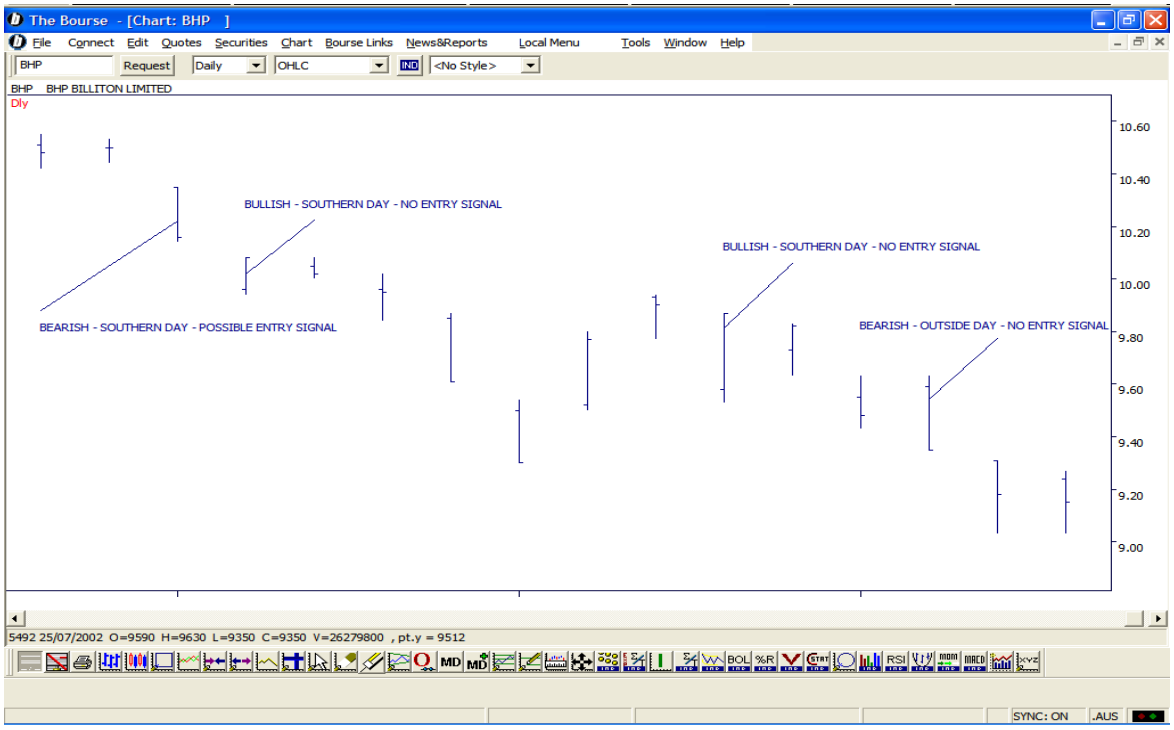
Prospective Entry Signals





Bullish and Bearish Variations





Module Twelve

Entry Signals

Bullish Triggers

Due to the vast amounts of 'almost' entry signals it is important to maintain careful focus on precisely what it is you are looking for. You will delve into the area of trend analysis in the next modules. However, it is vital you have a complete understanding of exactly what it is you are looking for. You have now established that there are as many ways to trade the market as there are people in the market, if not even more so.

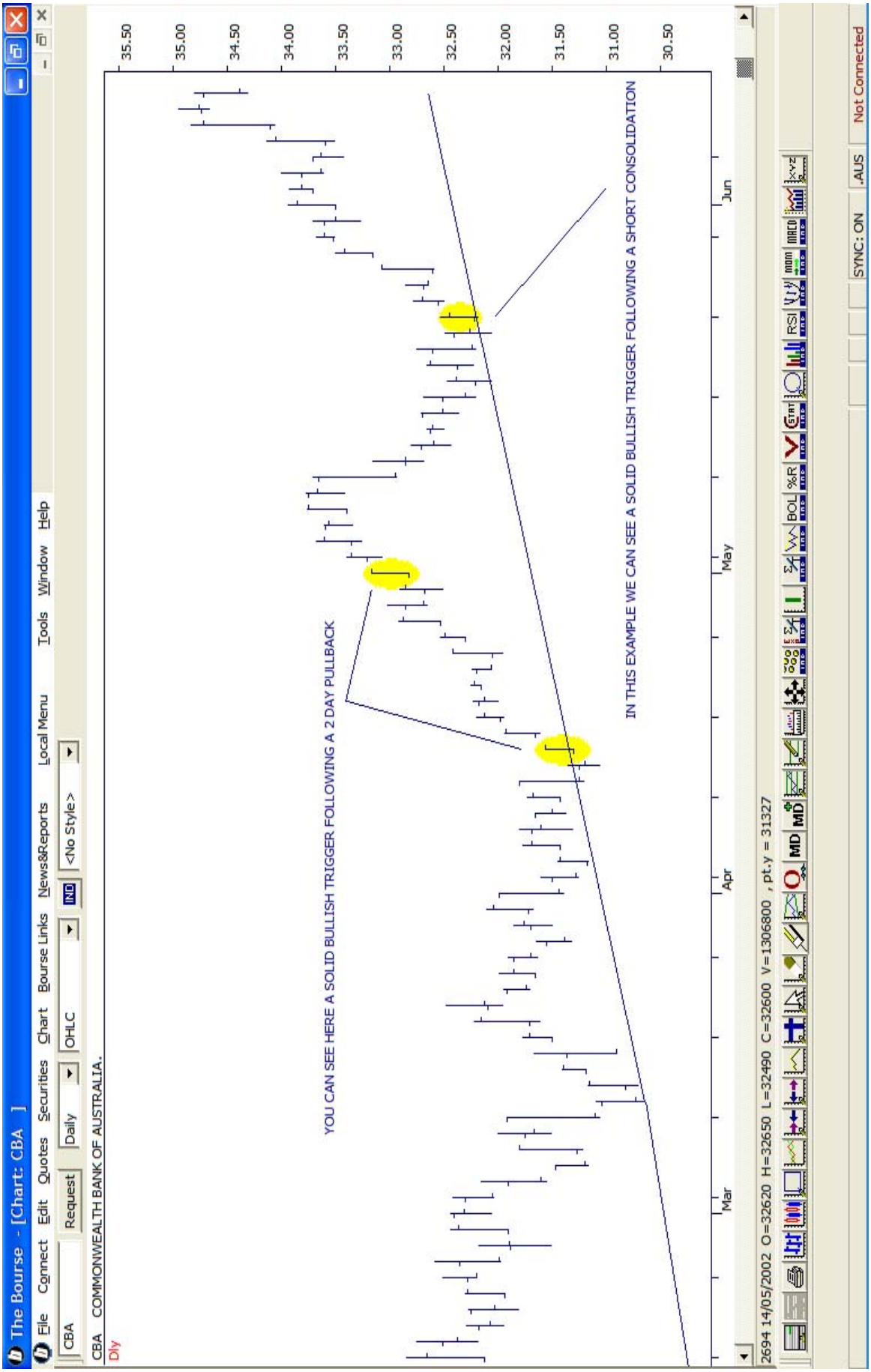
Your objective in the beginning is to follow a strict set of rules, which will allow you to narrow down the possibility of sustaining a loss. Once you have developed the discipline to follow a strict set of rules, and you are confident with your 'live' trading ability, you will be able to gently 'massage' the rules to suit your own individual trading style. In the beginning, however, it is vital to have a plan to follow which leaves little or no room for error.

I have always treated my trading in exactly the same manner as I did with my navigation. Gently at first, slow speed and check my position constantly to ensure I stay as close as possible to my intended track—following a strict set of rules. Once in the relative safety of the open ocean I could relax a few of the rules and adopt a different style, which allowed me to increase speed and manoeuvrability. In the same way, once I gained more confidence in my own ability to trade successfully, I could adopt a slightly different approach. This is certainly not to say that I can ignore the basic strategies I have learned. I continue to trade using these same rules you are learning to take on board today.

The only difference is, I can now afford to trade once or twice a week instead of once or twice a day. My desire is to only trade on solid entry signals. After all, there are only two types of entry signals which you are looking for on the first sweep of our stocks at 3.30 pm, that is Bullish or Bearish.

To identify a true bullish trigger you must have the following features:

- The range must be true north having a higher high and a higher low than the previous day,
- It must be a bullish day, opening in the lower one third and closing in the upper one third of the range,
- It must be in the direction of the underlying (three months) daily trend, (Up)
- It must be either out of an consolidation pattern or directly following a pull back
- It must be obvious to you as soon as you open the chart, if you have to measure it, then it doesn't exist
- If you have identified a Channel, then it must be at the very bottom of the channel, above the support line. (This was covered in detail in module 9).
- If the price was rapidly dropping in the back-down, there must be an increase in volume for support. (Volume is covered next)



Volume Oscillator

The volume indicator is very useful to determine the underlying sentiment of stock price movement. Never fall into the trap of believing that an increase in volume will lead to an increase in price. Volume is simply a measure of the number of securities traded during a particular period. A day for daily charts, a week for weekly charts, etc.

Another important point to note about volume is that usually a great majority of the day's volume will only come in during the last hour or so of trading. This is where you can see the institutional investors taking the stocks to their desired overnight levels.

For this reason, you should never make a buying decision before 3 pm. No matter how great the temptation may be to jump in ahead of the crowd, you must wait until at least the last hour of trading to gain a full picture of what the stock is doing.

Volume is used to support our entry signals only!

Institutional volume will normally begin to dry up BEFORE the stock price begins to fall, and it will generally pick up BEFORE the price begins to climb

During consolidation periods, the volume tends to remain low, although does tend to pick up before the price either rises or falls thereby giving a valuable indication that something is on the move.

A higher than usual volume is normally present at all turning points in most stocks. For example, before a pull back the volume will pick up toward the top of the move before easing in front of the price drop. Likewise, in a southerly push, volume may increase rapidly due to panic selling.

An increase in volume is vital before you consider trading Call options off a 'Bullish' entry signal. Gravity works in the stock market and therefore most securities will need an increase in buying support (volume) to sustain a northerly push long enough to take profits. A volume increase is most important after a significant and sudden drop in price, wait for volume confirmation.

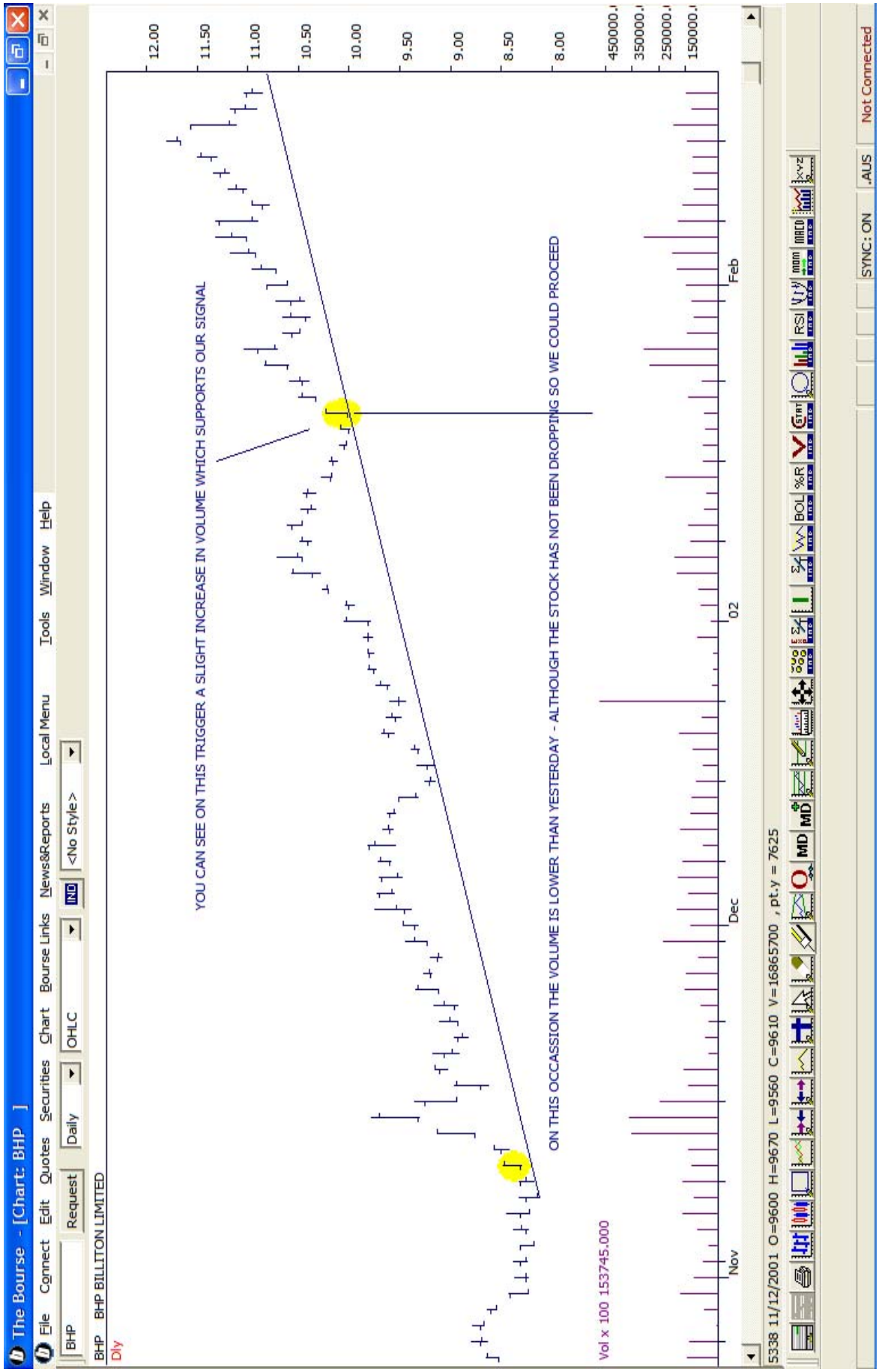
Volume

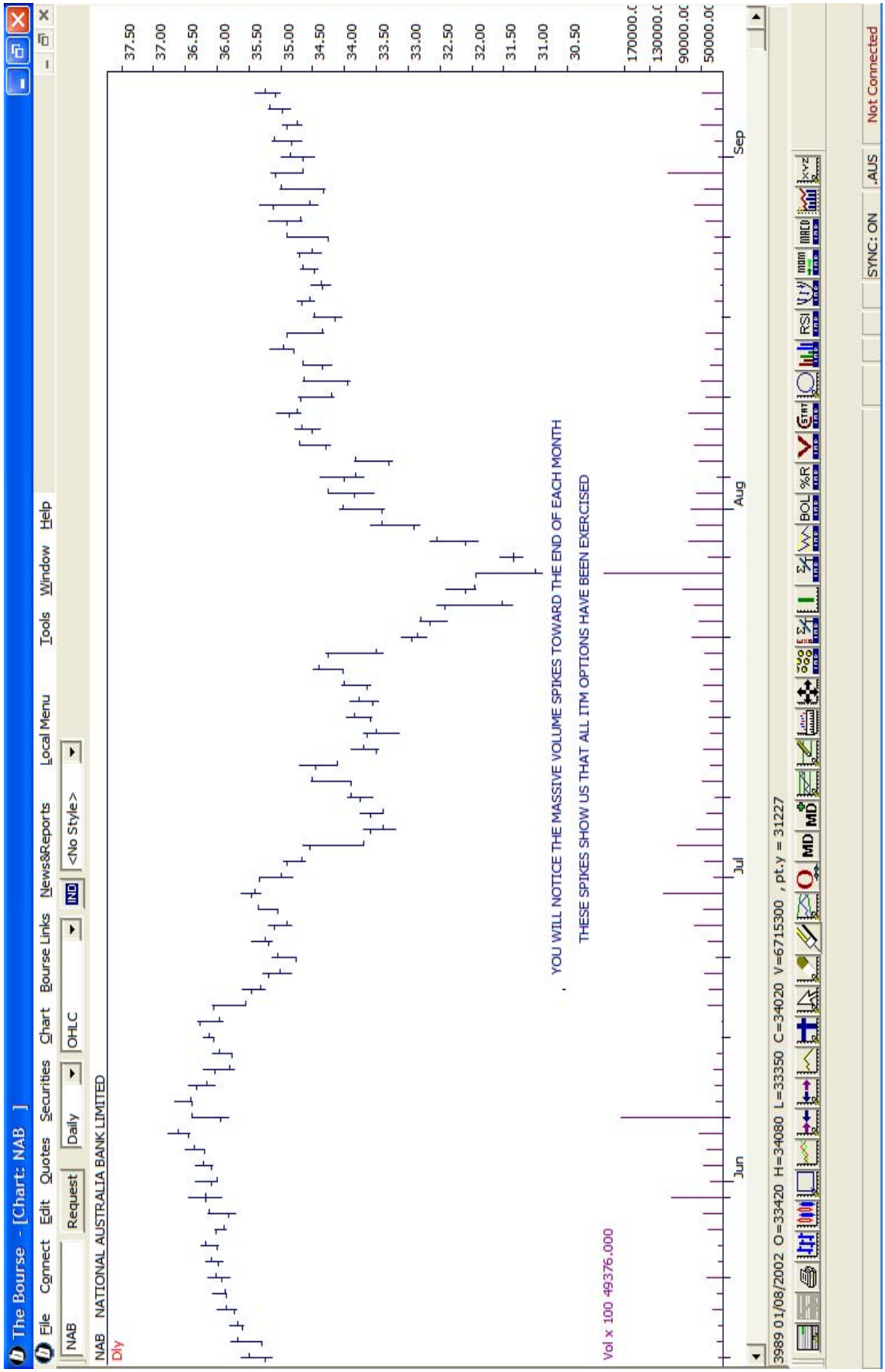
Another interesting point to note is that the volume will generally explode on Option expiry day. This is a more recent phenomena and highlights the dramatic impact option contracts are having on the underlying equities.

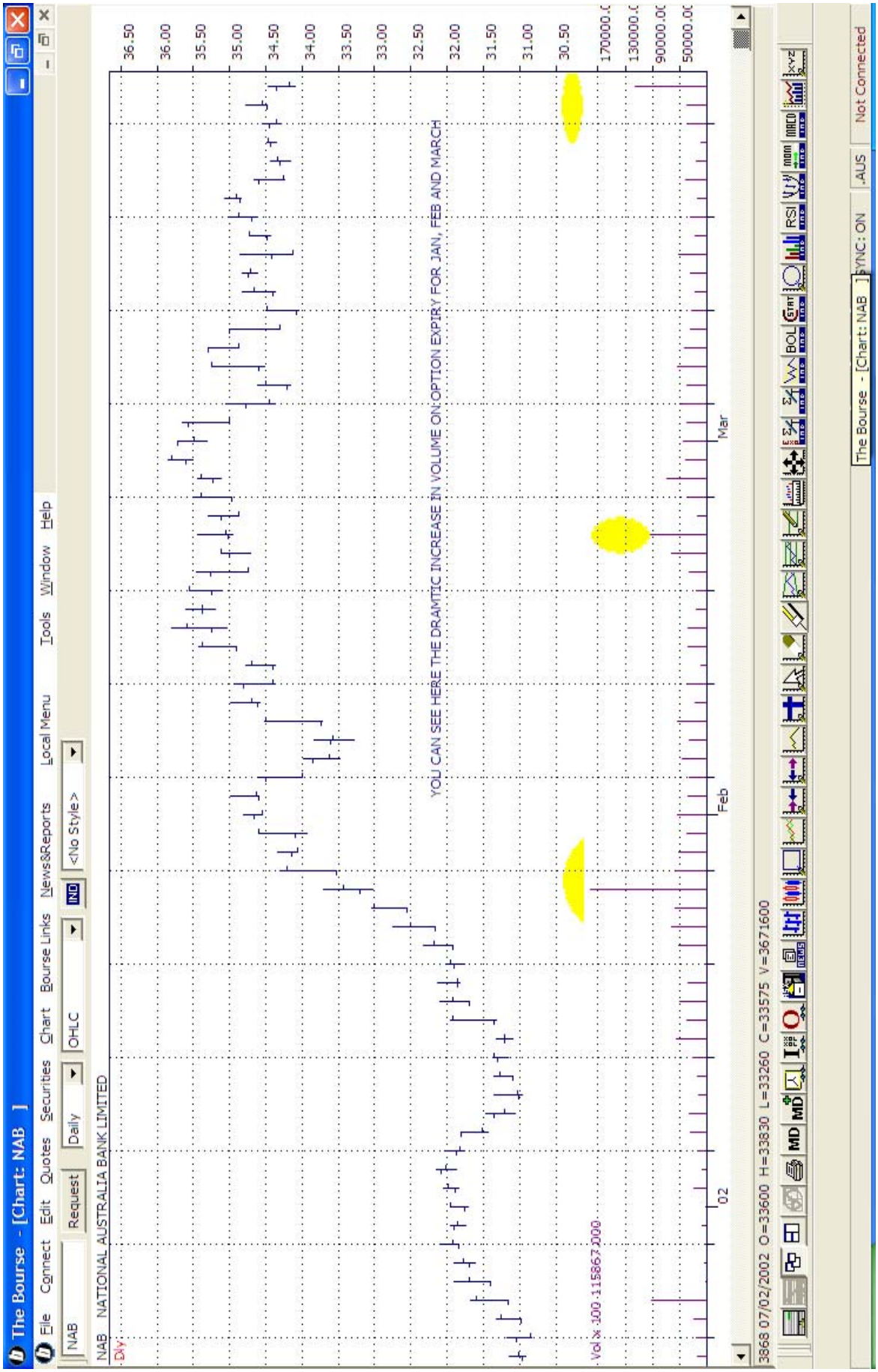
A simple way to look at volume is as though you were taking the stocks temperature. The volume works like a thermometer and measures the intensity of the move. It is common for a stock to have a very small range, yet an extraordinarily high volume. This situation tells us that the buyers and sellers aggressively agree on the current price of the share. You will see in later modules how this agreement is very often short lived.

The volume measures the intensity of price movement. If the price is rising, along with an increase in volume, this confirms buying support.

For call options, volume is a 'nice to have' if the stock has been moving sideways or slightly down. If the stock price has been sharply heading south, an increase in volume is a MUST before executing a trade.







Bearish Triggers

As you would expect the definition of a Bearish entry signal is the direct inverse to that of a bullish signal. Aside from being inverted, the only real difference between the two signals is that there is not as strong a requirement for an increase in volume with the Bearish Trigger. Gravity works in the market, therefore when a stock is rising it requires the added buying support of an increase in volume. When a stock is heading south, sentiment dictates that an increase in volume, while a 'nice' to have, is certainly not a 'must' have.

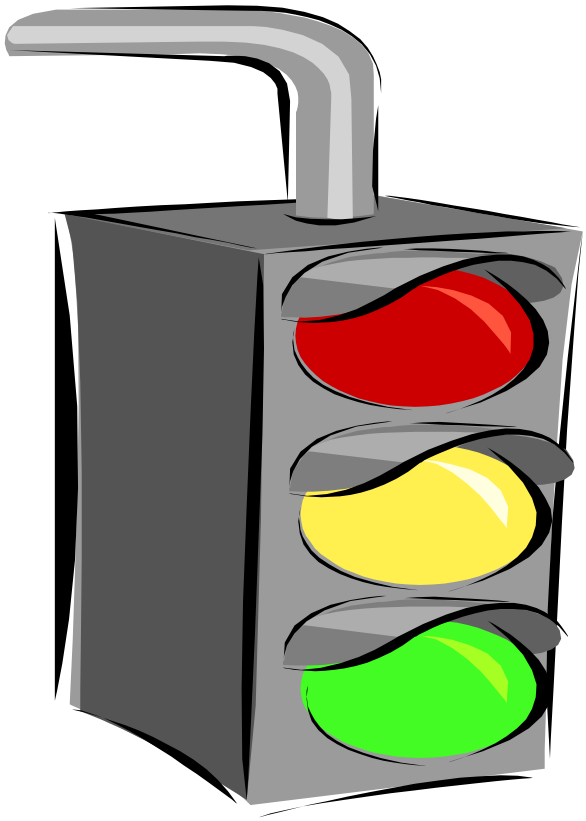
It is also important when looking at both Bullish and Bearish Triggers to look for any Validation Levels. Remember to check the price as close to the close as you are comfortable to trade for possible rejection off a VL.

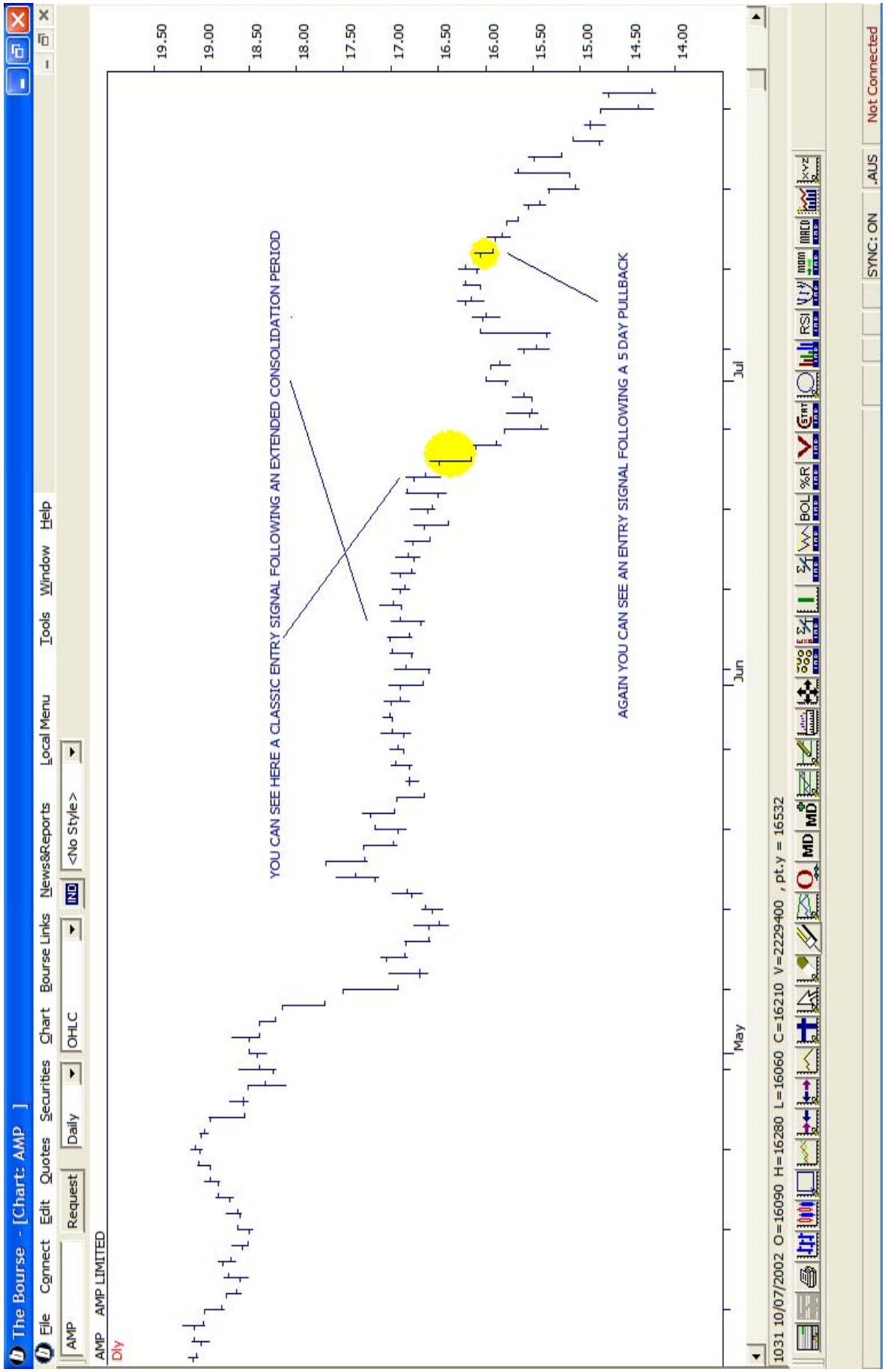
The requirements for a 'Bearish Trigger' are:

- The range must be true south having a lower high and a lower low than the previous day,
- It must be a bearish day, opening in the upper one third and closing in the lower one third of the range,
- It must be in the direction of the underlying (3 month) daily trend, (Down)
- It must be either out of an eastside consolidation pattern or directly following a back-up
- It must be obvious to you as soon as you open the chart, if you have to measure it, then it doesn't exist

- If you have identified a Channel, then it must be at the very top of the channel, below the resistance line. (This was covered in detail in module 9)

- Volume is not critical for this entry, although increase in volume combined with a drop in price is good confirmation.





Module Thirteen

Divergence and Convergence

Relative Strength Index (RSI)

The Relative Strength Index (RSI) is very popular, and one of the very few indicators which gives a reasonably accurate indication of 'future' price movement. The RSI was developed in the 70's by a trader named J Welles Wilder, and is widely available in most software programs. The RSI uses a series of calculations to produce a graphical representation of the internal strength of a security and gives two very powerful indications.

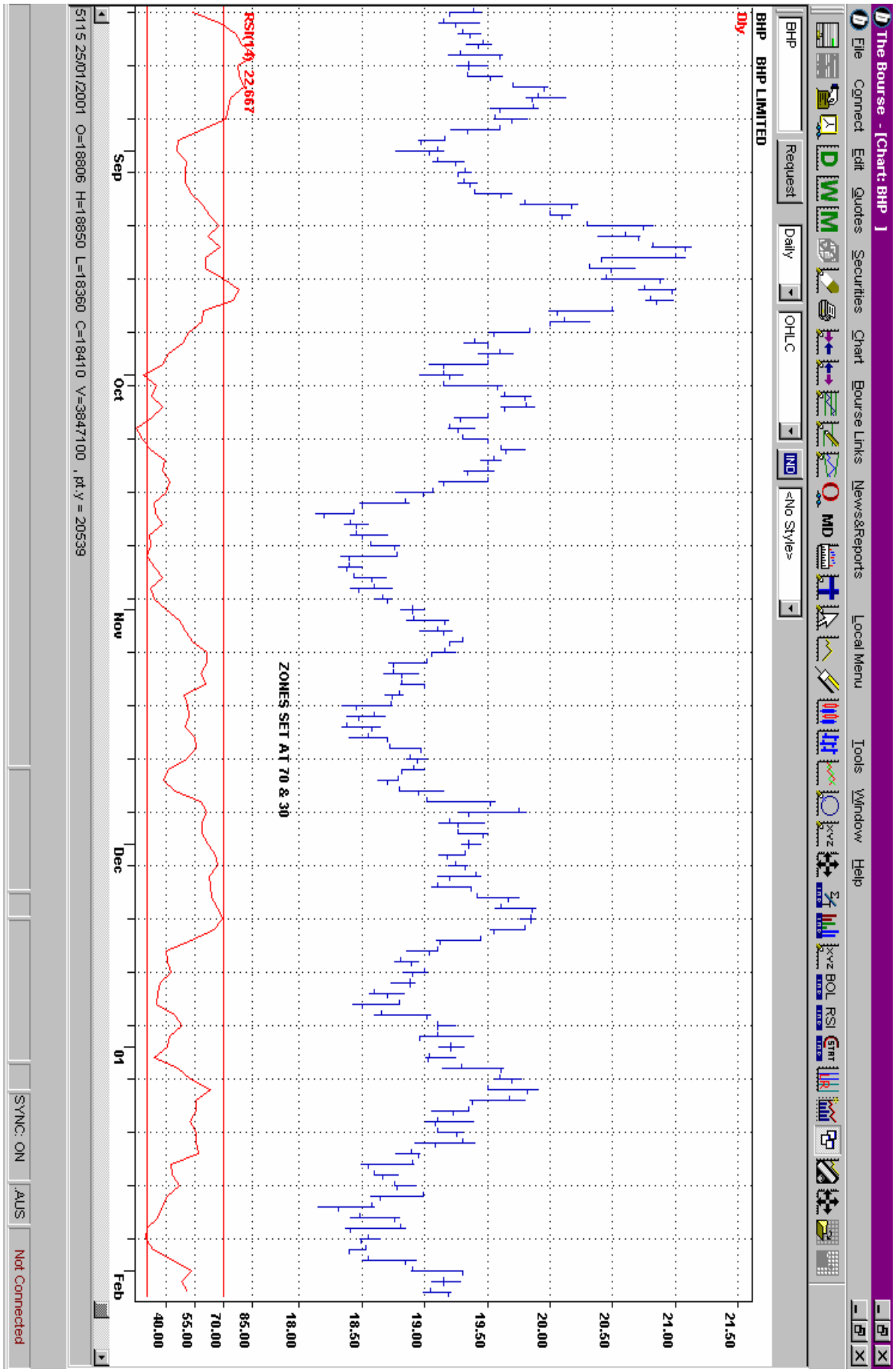
The RSI gives you possible warnings of a *Trend Reversal.* A trend reversal occurs when price movement changes direction. For example, if the stock price is rising and the RSI began heading south, the indicator is in conflict with the actual price movement and therefore, could represent a reversal. Similarly, if the price was falling and the RSI began to head North, the same would apply.

The RSI is what you call a price-following oscillator that ranges between 1 and 100. You can include an 'oversold' horizontal line at the 30 level and an 'overbought' horizontal line at the 70 level. These overbought and oversold areas are your first indication of a possible reversal. As mentioned the RSI gives two separate, yet distinct reversal indications:

1. The first indication is that the RSI may use the 30 and 70 lines as support and resistance respectively. It is common for the RSI to 'bounce' off the 30 level up to three days BEFORE the stock price heads North. Similarly, the RSI can bounce off the 70 level up to three days BEFORE the stock price heads South.

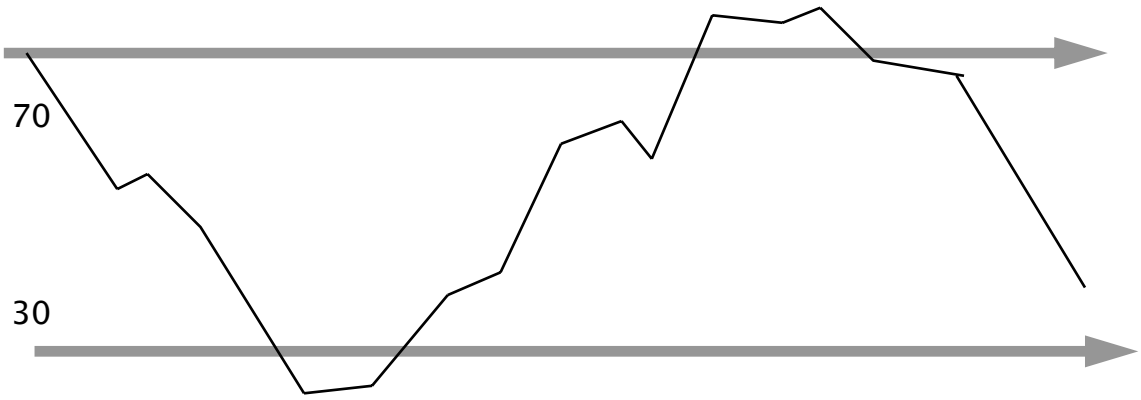
While this is not guaranteed, back-testing the top 10 most liquid stocks will show that it is very common. Using the RSI in this fashion, combined with our *trend analysis and entry signals*, can produce consistent returns.

NOTE: It would be wise not to use this indicator as a substitute for your analysis, it should be used as an early warning of a 'possible' reversal only. If it were correct every time it would be a formula to print money!!



Divergence and Convergence

2. The second way you can use the RSI is to recognise a patterns you refer to as 'Divergence' and 'Convergence'. Divergence occurs when the RSI makes a peak ABOVE the 70 line and a second peak lower, while the corresponding peaks in the security are higher. This indicates that the relative strength is falling, while the stock price continues North. A line drawn to connect the peaks in the RSI and another connecting the peaks in the stock will indicate diverging lines. On average this price movement cannot be sustained.



Convergence occurs when the RSI makes a trough below the 30 line followed by a second higher trough with corresponding LOWER troughs in the stock price. Lines drawn to connect the troughs will indicate convergence. This is less common than divergence, although is still a powerful sign that the price may be about to reverse and head North.

The choice of term used for the RSI can vary according to your particular strategy. The fewer the days used to calculate the RSI, the more volatile the indicator becomes. You can vary the number of time periods in the RSI calculation until you find the period you prefer.

J Welles Wilder used a term of 14—I' m not about to disagree.

REMEMBER!

This new indicator should be used in conjunction with your Bollinger Bands and basic trend analysis.

By looking out for Divergence between the RSI and the stock price, it is most effective on strongly trending stocks, although I recommend leaving the RSI on at all times to allow for early warning.

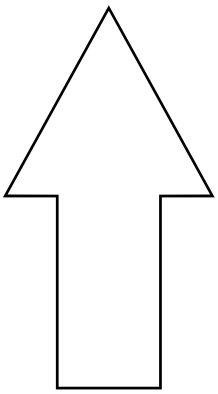
Divergence and Convergence.

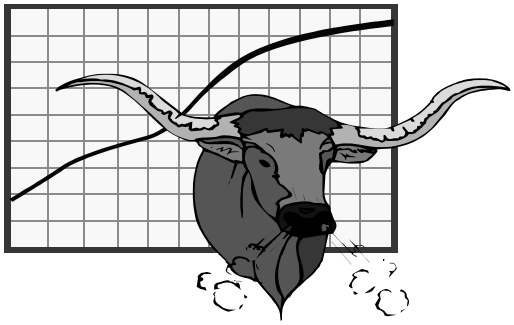
Divergence occurs when successive peaks and troughs in the price data move in the ***OPPOSITE*** direction to the corresponding peaks and troughs in the Oscillator indicator.

Look for divergence on both daily and weekly charts.

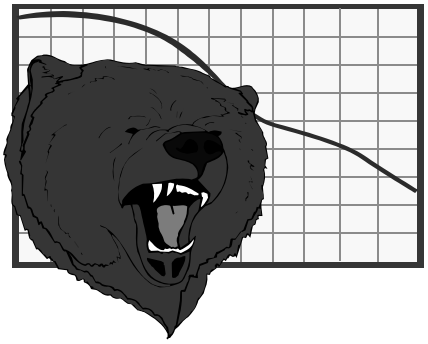
Evidence of divergence is common after a prolonged period of Northern price movement. Keep an eye on the RSI as it is sometimes a very subtle indication.

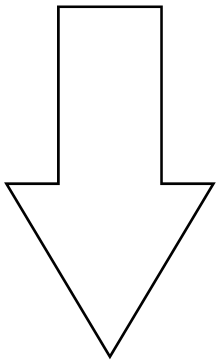
DIVERGENCE - PRICE MOVES NORTH
RSI MOVES SOUTH

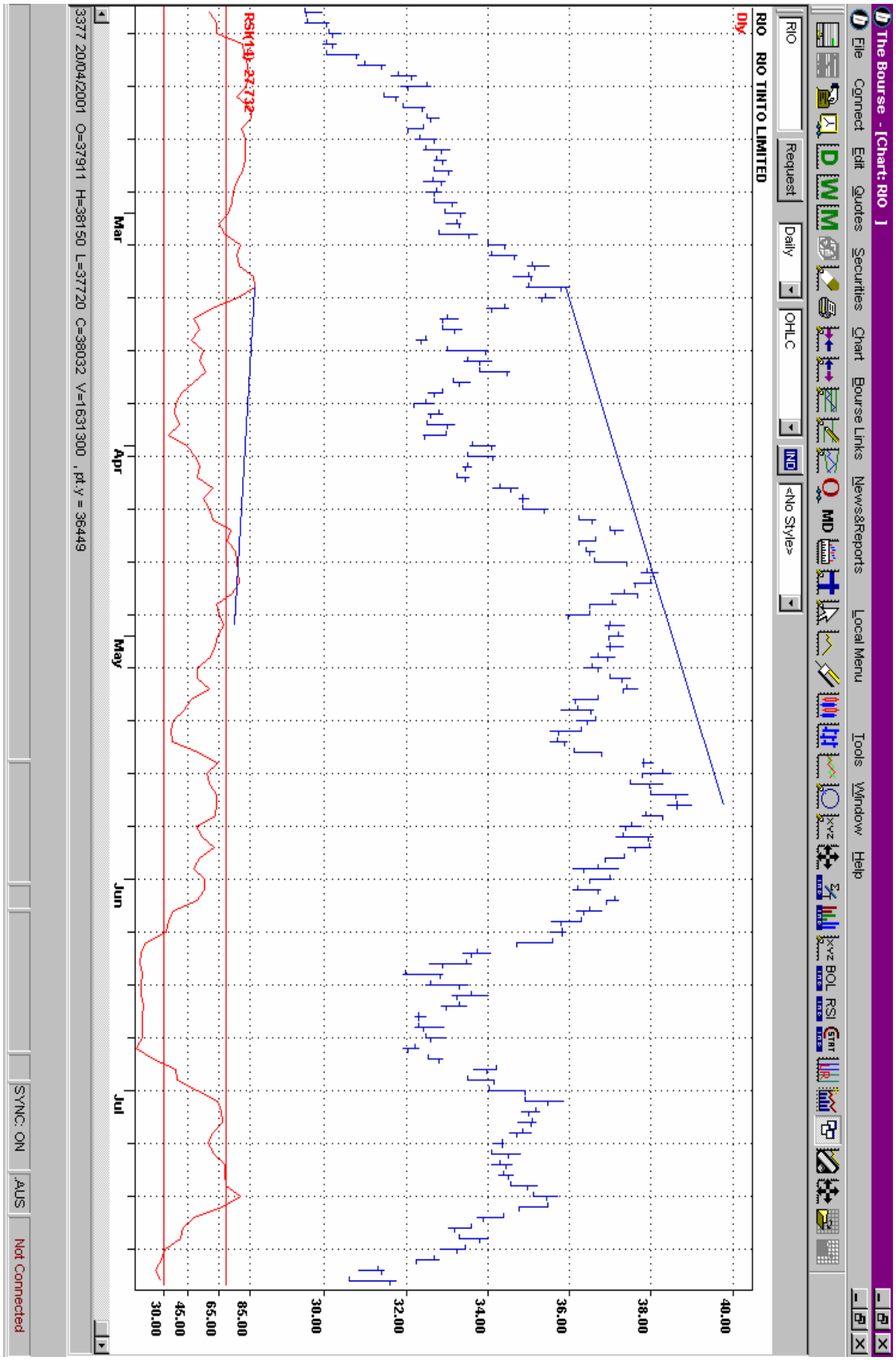


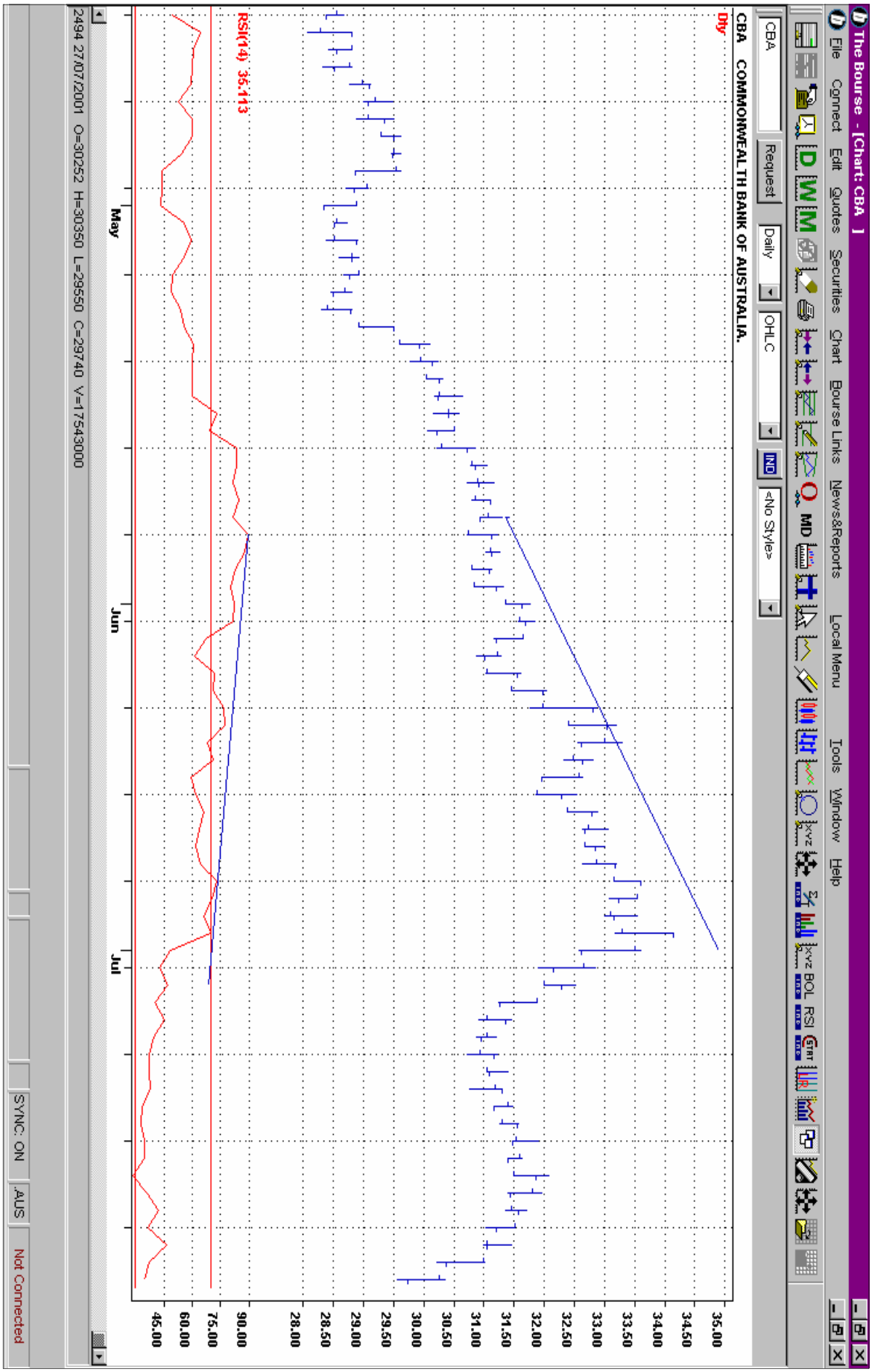


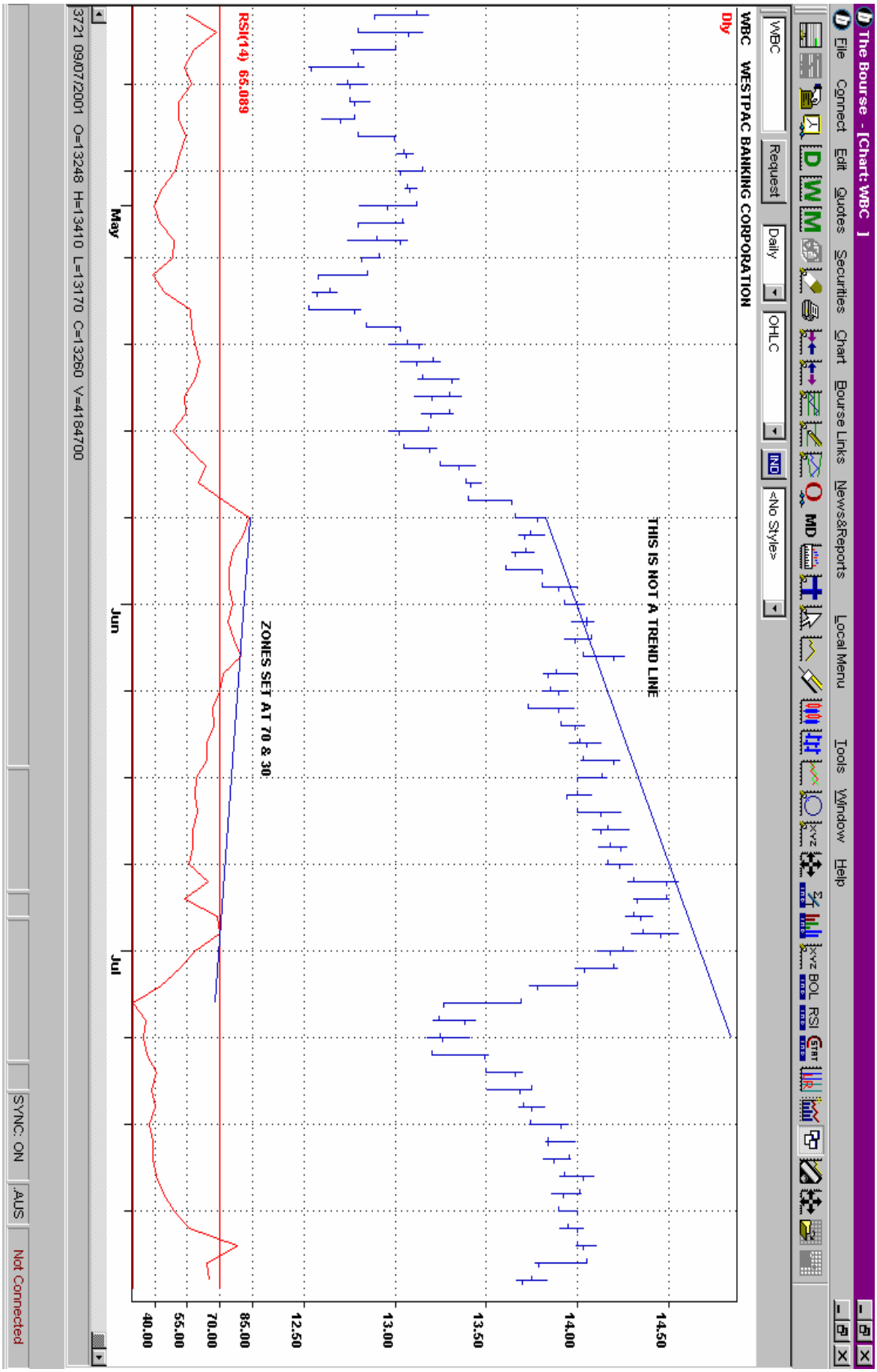
CONVERGENCE—PRICE MOVES SOUTH
RSI MOVES NORTH

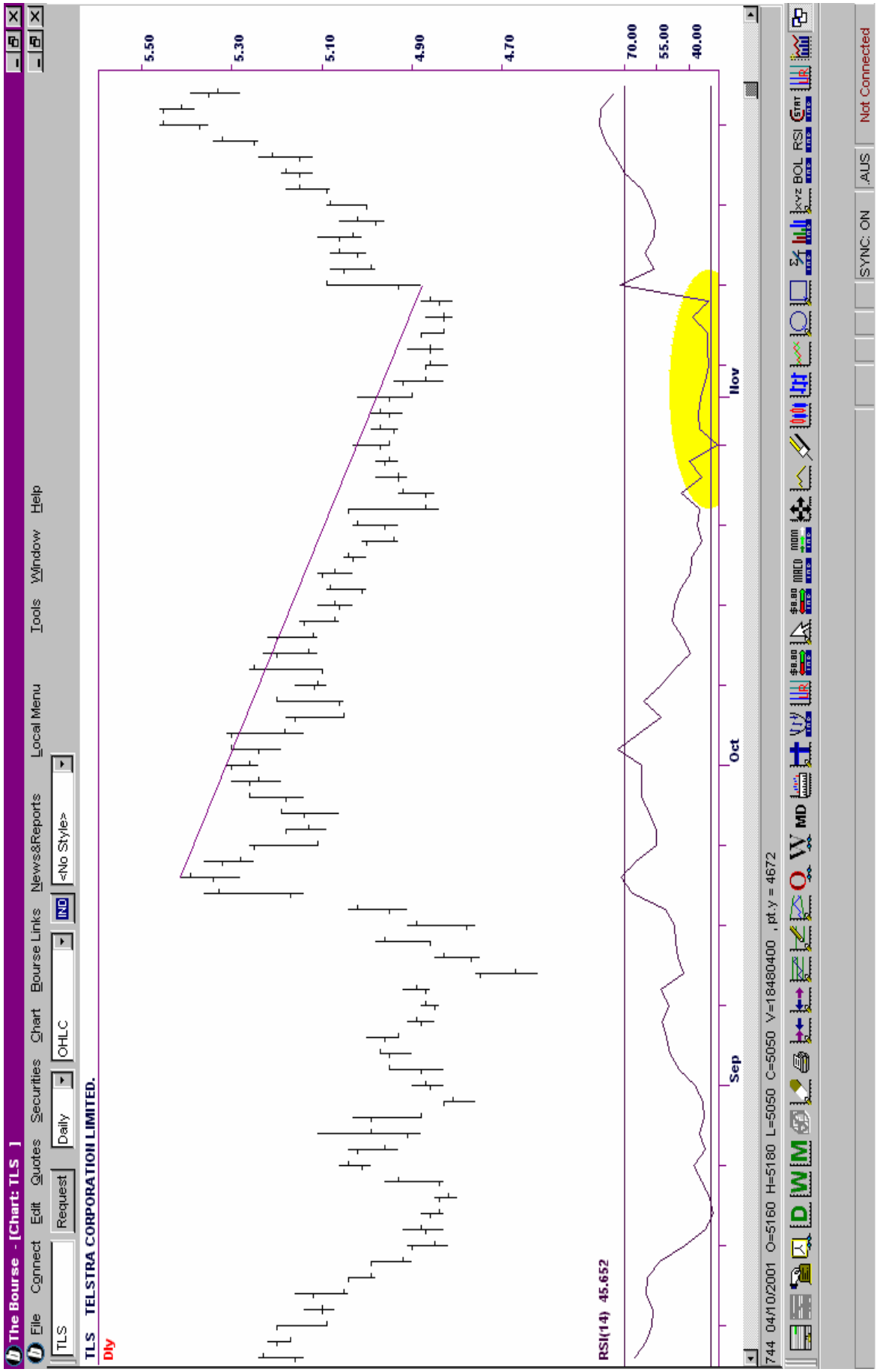












Module Fourteen

Volatility and Bollinger Bands

Stock Volatility

It is important to understand the volatility of a particular stock, before you enter a trade. Simply put, volatility refers to the fluctuation of the share price, with regard to actual price movement and the time it takes to move.

A highly volatile stock is one that has regular and dramatic, peaks and troughs such as Rio Tinto. Points to remember when trading a highly volatile stock, such as News Corp, is that although you may experience extreme profit in a short period, the nature of the beast dictates that your losses can be just as dramatic and just as swift.

As a general rule, the higher the volatility of a stock, the higher the premium, hence the higher the return and the higher the risk. For new traders, stocks with low volatility are generally the best to trade, as they tend to be somewhat more predictable, than those with higher volatility.

Measuring Volatility – There are three (3) measures of volatility and they are:

- Historical Volatility.
- Implied Volatility.
- Future Volatility.

Historical Volatility – is the easiest to understand. Ideally, I suggest buying contracts that have 4-6 weeks to run. You may, however, be forced to purchase contracts with a longer time to run, if you are looking for an open interest of 150 or higher. This is an accepted way of entering a trade, which you may have missed due to a lack of open interest on the shorter contracts.

Historical Volatility

Historical Volatility:

$$\frac{\textit{Highest Share Price} - \textit{Lowest Share Price}}{\textit{Lowest Share Price}} \times 100$$

The following example will clarify what the Historical Volatility represents as a percentage.

e.g. *12 month High = $10.50*
12 month Low = $7.42

$10.50 – $7.42 x 100 divided by $7.42

One thing to remember when buying contracts two or three months out, there will always be a tendency for 'the little guy' to step in should the trade go the opposite way.

For example, you may be inclined to say to yourself, "It still has three months to run, it'll come back." This can be fatal.

The simplest method I have found to determine volatility is to use an indicator called 'Bollinger Bands.'

Bollinger Bands

A market analyst with CNBC by the name of John Bollinger, developed this enveloping type indicator in the 1980's. Since that time the indicator has grown in popularity and is one of the most reliable and common indicators used in charting today.

The basic theory behind the Bollinger Bands is that during a given period, a stock is likely to move between certain price points, or a certain distance from where it is currently. Should the stock move further than the historical average, it is said to be either overbought or oversold.

The Bollinger bands are represented by two solid lines which form an envelope North and South of the stock. These bands vary in distance from a moving average which is added to complete the picture..

Bollinger Bands provide a great deal of information, including a graphical representation of the stock's volatility.

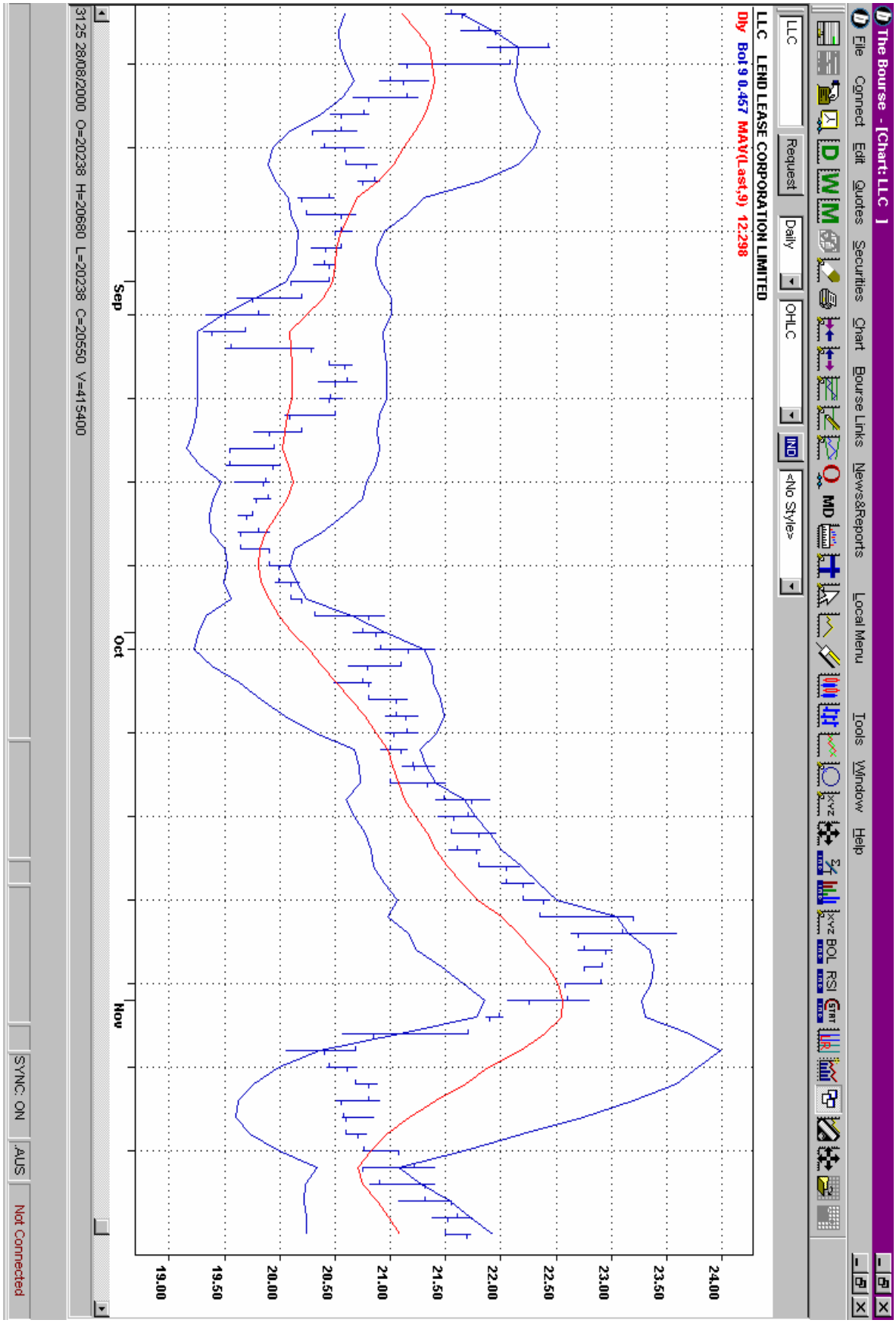
When the stock is in a highly volatile trading period, the bands will flare, or fan out allowing more room for the stock to move. Conversely, when the stock is trading at low volatility, for example, in an eastside consolidation pattern the bands will constrict and move closer together.

Over Bought and Over Sold

While it is common for price bars to remain within the northern and southern limits of the bands, it is possible for the stock to move outside this area. When this occurs it is referred to as overbought for northern movements, and oversold for southern.

Most software programs, and websites for that matter, will display the Bollinger Bands. As mentioned they are applied in conjunction with a moving average. The most common term used in our type of trading will be a 9 Day Moving average and a 9 Day Bollinger Band. Like all indicators, this will vary slightly according to market conditions, although I find a 9 day indicator fairly stable.

It is worthwhile back-testing other terms, particularly for longer term strategies. Some useful terms are 20, 50 and 80 day MAVs and Bollinger Bands.



Bollinger Bands

Using Bollinger Bands:
As mentioned the Bollinger Bands can provide a great deal of information when used correctly and are your number one support tool when it comes to option trading. The Bollinger Bands is helpful both for entry and exit signals.

Should the price bars move or close outside the north or south Bollinger Band it is usually a sign of a strong move which is likely to continue. This can add to SANF upon entry as well as for the first two days of a trade.

Continuing on, should the stock MOVE or CLOSE outside the north or south band AFTER the second day of the move, it is a strong sign the stock is moving into overbought or oversold, and may not be able to sustain this direction. It is a good idea to take some profits, if not exit the trade altogether when this occurs.

Volatility: One of the most significant areas for option trading is the level of Volatility. While there are many ways to calculate, hypothecate, aggregate and guess what the volatility will do, the fact remains that no-one can tell.

The current trading price of a security is a reflection of all that it is known or speculated at any given point. This can change in a nano-second following fresh information.

The easiest way I have found to gauge volatility is simply by looking at the past performance of the Bollinger Bands. When the Bands are close together and hugging the price bars, it is safe to say that the volatility of the stock is low.

During periods of volatility both CALL and PUT option contract premiums will also be LOW. Therefore, it is always preferable to buy contracts when the bands are close and sell when they are wide.

High Volatility: A stock, which has a fast moving share price, will usually be in higher demand, and therefore, the Option Contracts will attract a higher premium. This means although you may have to pay more for your contract, if you have correctly selected your entry signal, your profits will also be higher.

It is important to note that on wide bands, the contract premiums will be high for the direction of the move the opposing contracts will be relatively inexpensive. This is not a good enough reason to gamble, however, it can be handy for trading Channels or Backing patterns.

Bollinger Bands

The major reason I find the Bollinger Bands the most reliable indicator of volatility is because they offer a visual representation rather than a mathematical formula. The term used will dictate how much historical information is included and this will vary depending on which trading plan you follow. A nine day term is useful for shorter term trading, whereas a larger figure would be more appropriate for investing purposes.

Each day the ASX will calculate an 'implied' level of volatility, ie., an amount of price movement that could be reasonably expected based on recent history. For example, if a stock is trading at $9.50 and it's average movement over the past couple of weeks is 32 cents per day, this is the range you would expect for today, without being overbought or oversold.

Bollinger Rules:

1. The northern and southern Bands act as dynamic support and resistance levels for the stock
2. Should the stock move outside the bands on the first or second day of your trade, it offers additional SANF and suggests the move is likely to continue.
3. Should the stock move outside the bands *AFTER* the first or second day, it is wise to either take some profits or exit the trade altogether as it implies a reversal situation.
4. When the price bars are hugging either the northern or southern Bands, it suggests the stock is moving effortlessly and therefore likely to continue its path.

5. The best time to take profits is when the stock is still going in the direction you want it to and the Bands are wide. Don't wait for the move to stall, or the change in sentiment may erode your profit.
6. The middle band – moving average – can act as a wavy support and resistance line.
7. When the stock is above the MAV it is likely to stay above it, and when it is below it is likely to stay below it. This may sound obvious, however, we are looking for a definite 'break' from north to south or vis a versa.
8. As the volatility rise, the bands will begin to widen, as it falls, the bands will squeeze in. It is ideal to buy on tight bands and sell on wide bands as quite often your entry signal will be evident before the volatility rises.
9. After you have entered a trade, maximum profits are achieved when the price bars move outside wide bands. This is your ideal profit taking opportunity.
10. To assist in the entry process, use the MAV as a support and resistance line, as well as the Northern and Southern Bands as an indication of volatility levels and strength of move.

REMEMBER!!

This indicator is a guide only. It can not and does not predict the future volatility or price movement of a stock as it is based on historical calculations.

It is also advisable to test various periods for your Bollinger Bands, e.g.

9 days for short term trends
20 days for Medium and a
52 days for longer Term Trends

DO NOT make a trade based on this indicator alone. It must be combined with your entry signals, which are covered in previous modules!

Module Sixteen

Gaps, Moving Averages and Market Depth

Trading Gaps

Information flow around the globe never stops. Because of this, it is quite common to see stocks open at a different level than their previous close. For the purpose of 'retail' investors, you are assured that no trading takes place between these points.

Gapping is quite common in most charts. One of the reasons for this is the sometimes dramatic effect that international markets have on the open of our market here in Australia. While gaps are common, they can also provide significant assistance to our established entry signals. It is important to note that Gaps should not be over emphasised or used as entry signals alone.

Gaps are important for traders because they are generally seen as a very powerful signal, which indicates a change in the market sentiment. However, the importance of a Gap will depend to a large degree, on where it is on the chart and how it fits into the other indicators, such as Volume and BB's.

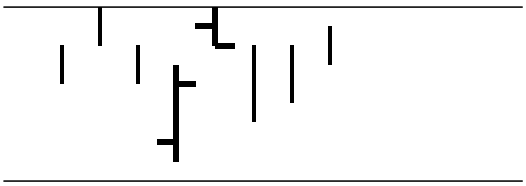
Some Gaps occur when extremely powerful news hits the market overnight. Traders then queue up to place their orders and the subsequent demand (for buying or selling) will push the prices beyond the previous days range.

A Gap is said to be 'filled' or 'closed' when subsequent price action reverses through the Gap. There are numerous types of Gaps that you need to be aware of, because each has different implications in the market. I will only cover the three that concern us the most;

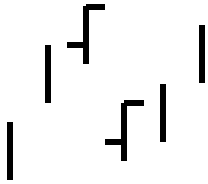
Breakaway, Continuation and Exhaustion Gaps

Gaps

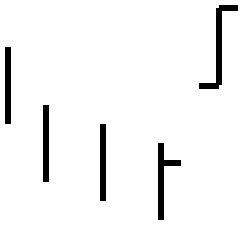
1. Common Gap: As the name suggests, a common gap occurs all the time and will quite often become evident on light volume and the stock will rarely react either positively or negatively to it.



2. False Gap: This Gap may occur when the stock goes ex-dividend. This means the share price will drop the equivalent amount of the dividend, that has just been paid out. This on it's own is not enough to support a trade.



3. Breakaway Gap: A Breakaway Gap operates exactly as the name suggests. It is where the price breaks out of a trading range on heavy volume. A breakaway gap can indicate a new direction for the stock.



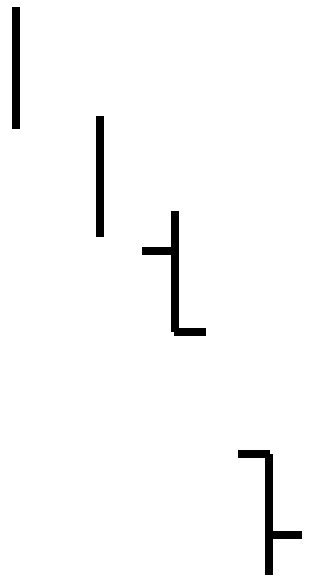
It is important to note the volume associated with this type of gap. The heavier the volume the more likely it is that the move will continue and there is less chance of he gap being filled.

Gaps

4. Continuation Gap: A Continuation Gap is most likely to appear during a strong move. It adds to the SANF and can even deliver profits overnight.

   A Continuation Gap most often occurs midway through the existing trend. This type of Gap also tells you that the market is likely to continue on its present course for some time yet.

   In a Bull Market, the gap is bullish and indicates a strengthening market.

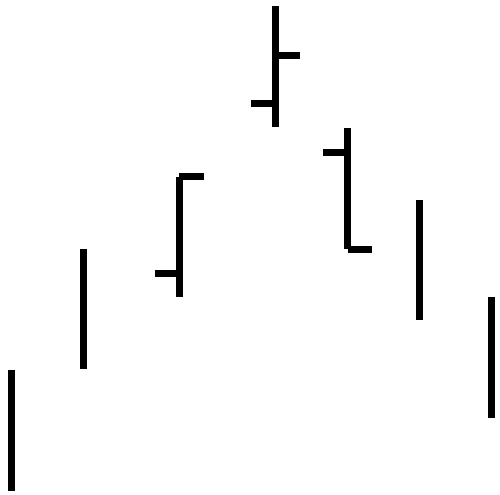


Conversely, in a down trend the continuation gap can be seen as a sign of a continued weakness in the market.

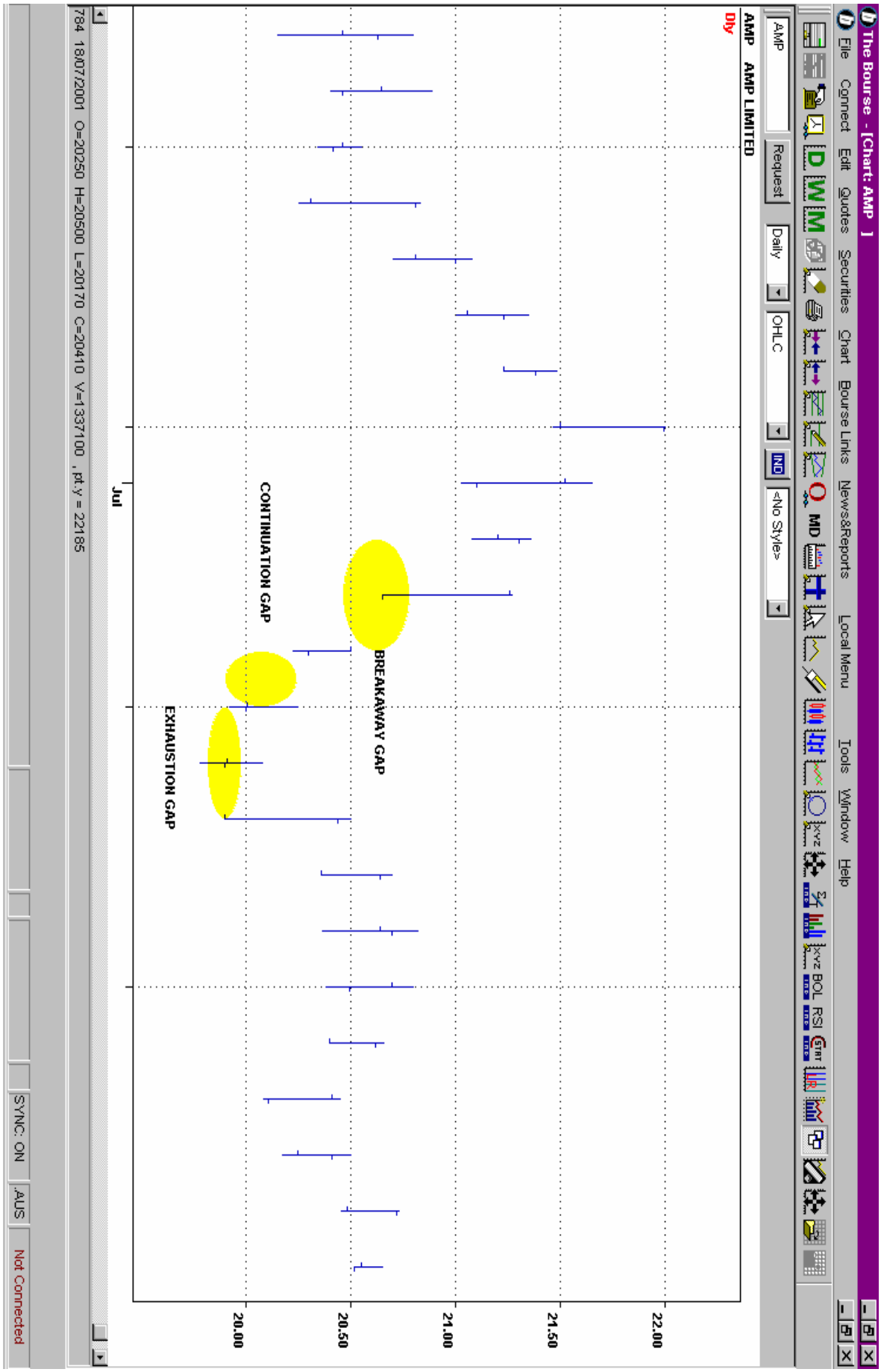
Gaps

5. Exhaustion Gap: An exhaustion gap is an important warning signal as it may be your first indication that your move is coming to an end.

It is likely to occur after both a continuation gap and a break-away gap, have been identified in the trend. Exhaustion gaps are filled almost immediately, which is a good clue that the prices are not able to continue in that direction. The trend is therefore losing momentum.



It is important to note that an exhaustion Gap will look like a continuation gap, although the reversal of price will FILL the GAP. Should you identify more than one continuation gap, it will pay to watch the price closely. I find by taking profits after the second or third continuation gap, my SANF (and my trading bank) increases.



Moving Averages

A moving average is a longer-term indicator, which are calculated on the daily closing price. As you have seen previously, the Moving Average forms the centre line of the Bollinger Bands. It is probably the most widely used indicator of all, and can even be used as a sole means of determining entry and exit signals. I personally use it as support to my other analysis. Although I know traders who use variations of this one indicator with great success.

The greatest advantage of the moving average is that it provides a smooth linear representation of the primary trend. A straight forward moving average simply adds up the prices for a given period, then divides the total by the period used to give a running total. You will notice that by doing this, each day has two separate effects on the actual line. The first when it enters the equation, and the second when it drops out of the equation.

I prefer to use an 'Exponential' version of the moving average, which bears more significance to the most recent data, and less to the previous. For option trading, the most recent data is always the most important and while it does not effect the picture too dramatically, it can be the difference between entering a trade, or waiting for confirmation.

Moving Averages are suitable for analysing and determining trends and can be used on their own, or in combination with more than one moving average. There are three types of moving average:

a. Simple
b. Exponential
c. Weighted

I have found that a nine days moving average gives the greatest support to short term trading, although like any indicator it is wise to try varying terms and back test for yourself.

Moving Average Crossover

Another powerful way to use the moving average is to combine both a fast and a slow moving average to determine change in direction. For example, by using a three Day Exponential moving average and a nine day Exponential moving average, it is quite common for the three day to turn and cross the nine days BEFORE the price.

I know of traders who use a combinations such as 12/20, 20/52, 20/80, 52/80 etc. The combinations are endless and every trader must develop their own 'groove.' My advice is to use what works for you and discard what doesn't. Otherwise, before you know it your screen will be filled with lines and squiggles, and will soon become useless for determining entry signals.

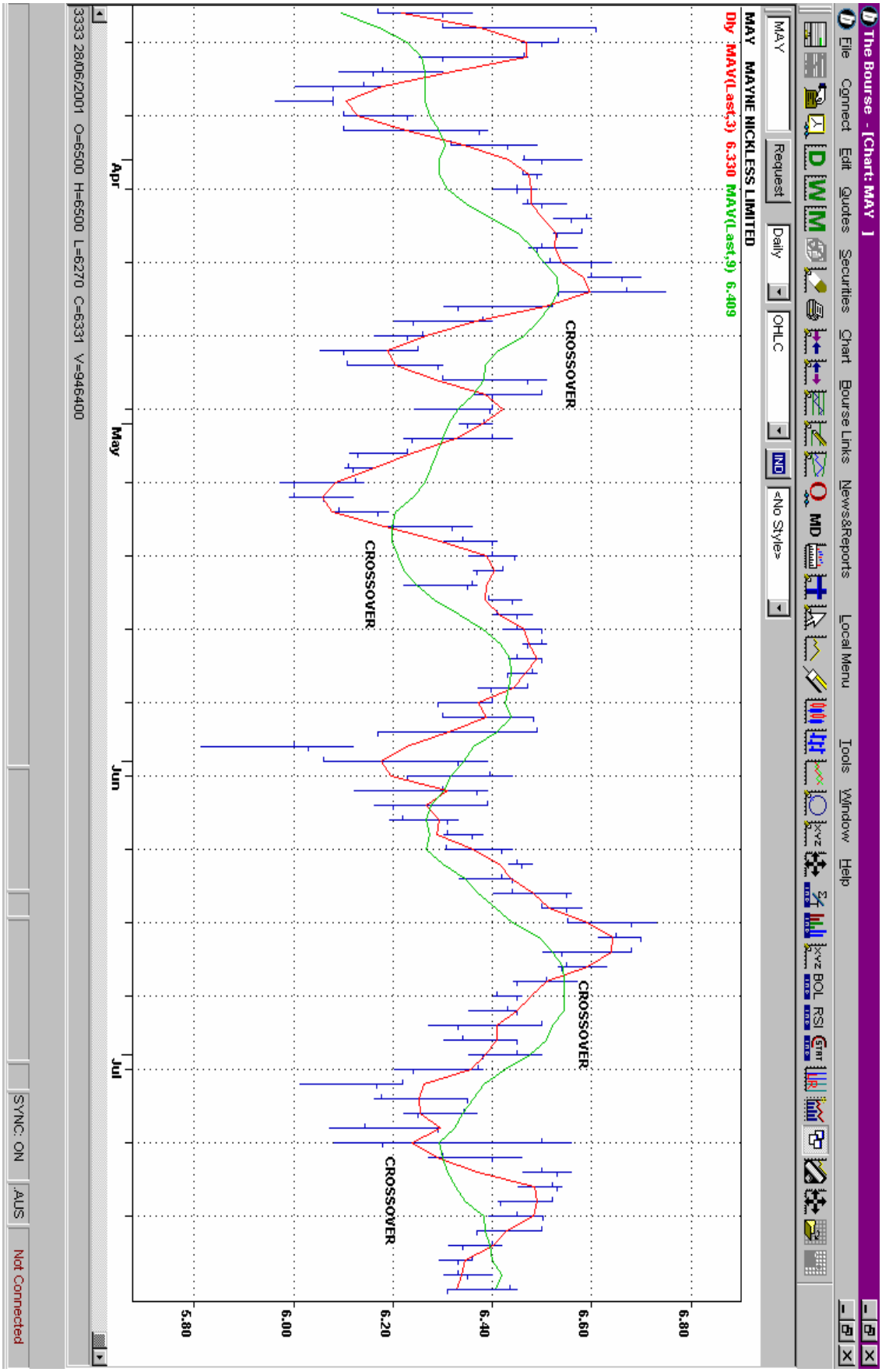
After teaching thousands of people my trading methods, the most common mistake I find is 'Analysis Paralysis.' If you want to gather enough information from the chart to create cash-flow from trading, then KEEP IT SIMPLE.

The rule 'he or she who trades with the most indicators wins', definitely does not apply. My greatest measuring tool is cash at bank and if you succumb to the common mistake of 'know all' you are destined to entrance large audiences with your brilliant commentary. However, you will have so much supporting evidence to both buy and sell, you will spontaneously self combust

When a fast moving average crosses ABOVE the slow moving average, it is a sign of a BULL market.

When the fast moving average crosses BELOW the slow moving average, it is a sign of a BEAR market.

When the price bars move NORTH or SOUTH of the fast and the slow line, this adds strength to the probability of an impending Direction reversal.

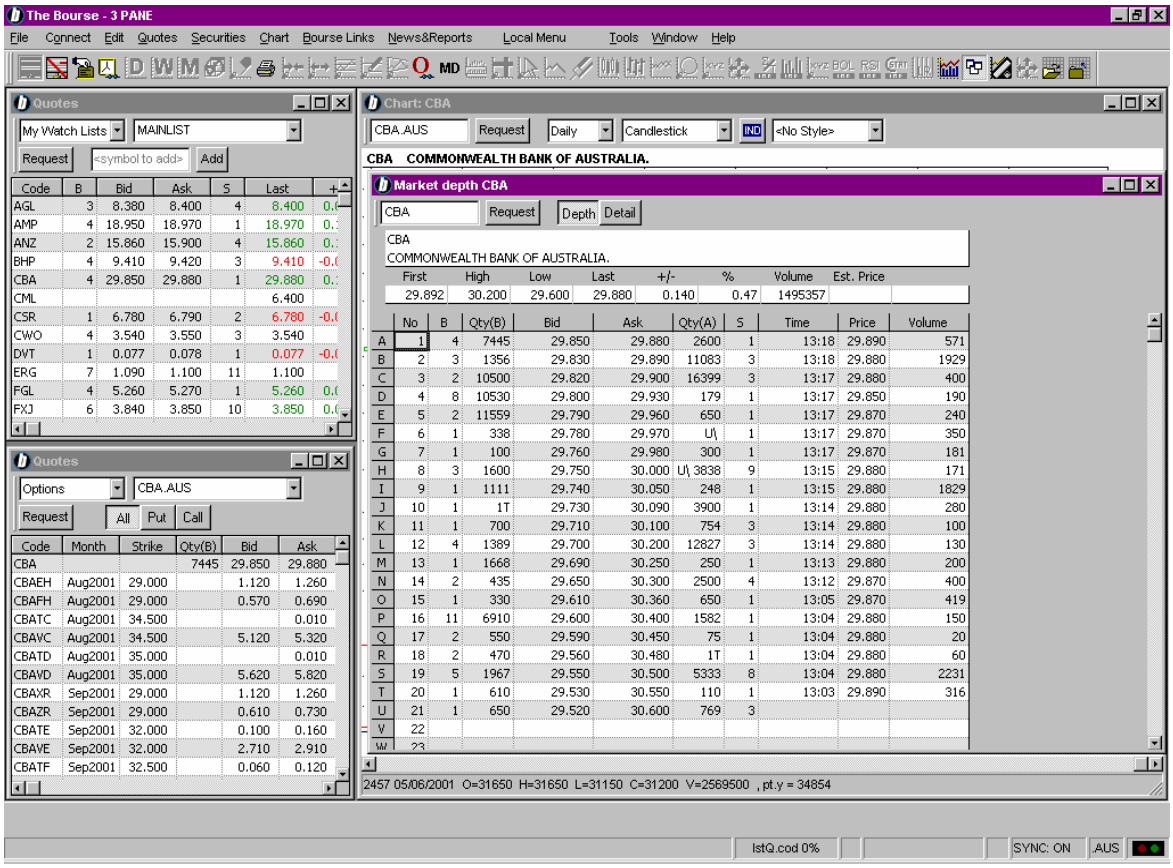


Market Depth

You can use Market Depth to see the amount of Buyers (Bid) and Sellers (Ask). If the amount of sellers is much higher than the amount of buyers, the price will probably go down, and supply will exceed demand.

Therefore, you can say that if the amount of buyers exceeds the amount of sellers, the price will probably go up as demand will be exceeded. This can vary greatly throughout the day and should only be used as a confirmation tool in conjunction with our other indicators.

I have found relying too heavily on the MD can lead to bad decisions as a retail trader does not have access to the screen our brokers use and therefore, you can never be certain exactly who is buying or selling and who is bluffing. It is handy to check for any anomalies such as undisclosed orders, or significant VL's based on price.



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