

FEBRUARY 2004 ISSUE

- 2 Editor's Note**
- 3 Contributors**
- 4 Chat Room**
- Inside the Market: By Jeff Ponczak**
- 5 Financial exchanges embrace demutualization**
An increasing number of exchanges are moving toward a for-profit, shareholder-based business structure.
By Keshia Green
- 8 Prop firm shuts down**
Worldco, once one of the leading proprietary trading shops, has closed and filed for bankruptcy. What will this mean for the industry?
- 8 SEC changes rules on married puts**
Traders who use married puts will now have to deal with the uptick rule.
- 9 Mutual fund probe continues**
The SEC and the state of New York continue to find instances of wrongdoing in the mutual fund industry.
- 9 Quick Scalps**
- 10 New Products**
- 11 Trader's Bookshelf**
A review of Brett N. Steenbarger's *The Psychology of Trading: Tools and Techniques for Minding the Markets*.
By John Saleeby
- 11 New releases roundup**
- Technology for Traders**
- 13 Software Screening: MidCast Pro**
By David Bukey
- 15 Product Review: The Trader's Organizer**
By Kiara Ashanti
- Trading Strategies**
- 16 Technicals meet fundamentals in the earnings flag**
How to spot entry points after surprising earnings announcements, and what to expect after you place the trade.
By Thomas N. Bulkowski
- 20 S&P tendencies around the monthly employment report**
Analyzing the S&P to find out if the Thursdays before employment reports offer any insights into Friday's trading.
By Thom Hartle
- 23 Branching out with short funds**
"Short funds" allow you to hedge positions and sidestep active trading restrictions in the mutual fund market.
By Damian Campbell
- 27 ETF Snapshot**
- 28 Trading System Lab: Glitch Index**
- 30 Ask the Specs**
Catching the public leaning the wrong way, or "How to Make 1.5 Million Percent in the Stock Market."
By Victor Niederhoffer and Laurel Kenner
- Futures Watch**
- 32 What's ahead for the Chicago exchanges?**
The demutualization process for the Chicago Board of Trade is currently held up in court, but there's much more to the story than that.
By David Obuchowski
- 32 Eurex moves closer to launch**
Eurex announced a regulatory agreement and a governance structure as it readies for its scheduled Feb. 1 start.
By Jeff Ponczak
- 33 CBOT rolls out new trading system**
The Chicago Board of Trade began trading some products on its new eCBOTDirect electronic trading platform.
- 35 FBI currency investigation pays off**
A sting operation netted nearly 50 arrests in connection with currency fraud.
- 35 Volume Update**
- 36 Fast Fills**
- 37 Futures and Options Basics**
- Overnight futures trading**
Can you trade all night these days? Should you? A primer on overnight futures trading.
By Kira McCaffrey Brecht
- 39 Futures and Options Trading System Lab**
Keltner Classic System
- 41 Futures Snapshot**
- 42 Active Trader Interview**
Linda Raschke keeps up the pace
A day in the life of short-term trader Linda Bradford Raschke.
By Mark Etzkorn
- 50 The Face of Trading: Markets on call**
By Kira McCaffrey Brecht
- 51 Market History: Presidents Day**
Find out what the market typically does around Presidents Day weekend.
By David Bukey
- 54 Trading Basics: Avoiding wash-sale washouts**
Trading the same stock repeatedly can affect your tax returns. We take the mystery out of the IRS's wash-sale rule.
By David Bukey
- 56 The Business of Trading**
Trading for your retirement
Trading your retirement-plan assets is allowable, although there are some restrictions you must deal with.
By Robert A. Green, CPA
- 59 After Hours**
- 60 Trade Diary**

On the JOB

Who would have thought trading was real work?

Well, pretty much anybody who's tried to do it for a living — and succeeded — proving again the reality of trading is a different breed of animal than what you usually read about or see on TV.

In early November, I spent a day with trader Linda Raschke and watched as she operated her online trading room, made trades and analyzed the markets. It was a long day. She was already working when I arrived at her office 90 minutes before the NYSE open, and she was not yet done when I left around 9 p.m. ET

Given Raschke has been in the business for nearly 25 years, the long hours are not the result of inefficiency or lack of knowledge; it's just the routine she's developed over the years — her job (although, no doubt, she was slowed down somewhat that day by having to explain things to the outsider in her office).

"Linda Raschke keeps up the pace" (p. 66) details some of the conversations from that visit. Raschke's approach can be summarized as applying a wide range of research and historical testing on a discretionary basis based on years of experience. In fact, a large part of the discussion revolved around the importance of experience, both in extracting extra value from trading ideas and in coping with the psychological challenges of the markets.

Raschke is a popular speaker, and she's a good teacher. She's probably best known for her short-term S&P futures trading, although her work encompasses a wider range of markets and styles. Among the practicalities she stays on top of are the latest technology and trading platforms. Given developments in the futures industry over the past few months, one has to wonder how Raschke will be executing trades five years from now.

At the end of a record year for trading volume, machinations in the futures industry are fast and furious as the German all-electronic Eurex futures exchange continues to move forward with its plan to launch a U.S. exchange as soon as February or March.

"What's ahead for the Chicago exchanges" and "Eurex

moves closer to launch" (p. 50) detail the latest in the continuing counter-offensive mounted by the Chicago Mercantile Exchange and the Chicago Board of Trade to disrupt the Eurex's progress (done in the guise of questioning things such as the Eurex's regulatory loopholes) and buy themselves more time to position themselves competitively against the German operation's expected lower costs. You can't blame the Merc and the Board for playing a little hardball — a fight is a fight, after all — but as mentioned previously on this page, it's somewhat amusing to watch the self-proclaimed bastions of free markets fight so hard to prevent competition in their own backyard. (And, surprise, it seems the Eurex reached into their own bag of legal tricks when the Merc in the past tried to expand its presence in Europe.)

In the Necessity-is-the-Mother-of-Invention department, one of the most compelling aspects of this drama is the prospect of a genuine merger between the longtime rival Chicago exchanges — something that two years ago had about as much

chance of seeing daylight as an Adam Sandler Oscar acceptance speech. The logistics of pulling off such a unification boggle the mind (which members would get access to the most favorable washroom facilities?), but establishing a closer relationship of some kind is likely the most competitive thing the Board and Merc can do.

Mark Etzkorn, Editor-in-chief



The reality of trading is a different breed of animal than what you usually read about or see on TV.

THIS MONTH'S Contributors

▼ **Victor Niederhoffer** has specialized in trading futures and options since 1979. After studying statistics and economics at Harvard (B.A., 1964) and the University of Chicago (Ph.D., 1969), and teaching at the University of California, Berkeley (1967-1972), he founded Niederhoffer, Cross and Zeckhauser Inc. In 1980 he founded Niederhoffer Investments, which for many years was one of the top-ranked hedge funds. He began managing money for offshore clients in February 2002, investing his own money *pari passu* with the fund. He is author of *Education of a Speculator* (John Wiley & Sons, 1996) and *Practical Speculation* (John Wiley & Sons, February 2003).

▼ **Laurel Kenner** co-authors a widely read CNBC Money column, "The Speculator," with Victor Niederhoffer. Their book, *Practical Speculation*, won praise from leading traders and academics. Kenner began her journalism career in 1983, and was chief North American stock markets editor at Bloomberg News from 1995-2000.



▼ **Thom Hartle** is a private trader and president of Market Analytics Inc. (www.thomhartle.com). In a career spanning more than 20 years, Hartle has been a commodity account executive for Merrill Lynch, vice president of financial futures for Drexel Burnham Lambert, trader for the Federal Home Loan Bank of Seattle and editor for nine years of *Technical Analysis of Stocks & Commodities* magazine.

▼ **Damian Campbell** (Damian@CampbellEquityTrading.com) is the president of Campbell Equity Trading, an investment management company. His Wall Street experience includes seven years of market research, institutional trading, securities trading and retail sales. Campbell publishes a free newsletter called the Campbell Equity Trading Report which focuses on using mutual funds for high-yield, low-risk market appreciation; readers can sign up on the web at www.CampbellEquityTrading.com.

▼ **Thomas N. Bulkowski** (tbul@hotmail.com) is a private investor and author of *Encyclopedia of Chart Patterns* (John Wiley & Sons, 2000) and *Trading Classic Chart Patterns* (John Wiley & Sons, 2002). Before earning enough from his investments to "retire" at age 36, he was a hardware design engineer working at Raytheon on the Patriot air defense system and a senior software engineer for Tandy Corporation.



▼ **John Saleeby** is head of stocks and futures trading for Gargantuan Financial, a St. Louis-based private hedge fund.

▼ **Robert A. Green** (info@greentrader.com) is a CPA. His company, GreenTrader Tax.com, consults traders on tax solutions, reviews or prepares their tax returns, and sets up business entities and retirement plans. GreenTraderTax.com also specializes in hedge fund creation and management, and offers trader tax guides and trade-accounting software. For more information, visit www.greentradertax.com or call (212) 658-9502.



▼ **Kira McCaffrey Brecht**, a Chicago-based financial writer and technical analyst, has been writing about the markets for 12 years. Posts during her career include Chicago bureau chief at *Futures World News*, technical analyst at Bridge News and market analyst at MMS International.

▼ **Volker Knapp** has been a trading system researcher for more than 15 years. He is president of the VTAD (the German branch of the International Federation of Technical Analysts) and co-founder of Wealth-Lab Inc. He was also a professional hockey player and coach.

▼ **Dion Kurczek** (dion@wealth-lab.com) is a private trader, software engineer and trading system researcher. In 2000 he founded Wealth-Lab Inc. and launched an interactive trading system development laboratory on the World Wide Web (www.wealth-lab.com). His firm produces trading-system development and back-testing software for traders.

▼ **Kiara Ashanti** is a Florida-based writer, editor and private trader. He has been in the financial industry for the last seven years and trading the last four.

Mark your calendars

I find your “News and Numbers” online list of reports quite useful and very much appreciated. But one way to make it better would be to list the report times next to each report, rather than in a separate location. It would make the calendar much easier to read. As a trader I want to know the exact time the report is released so I can anticipate the possible market response (time-wise) at a glance.

— Ed



Hmm...Not a bad idea, Ed. We've updated the "News & Numbers" box on our home page (www.activetradermag.com) to include report release times. Also, if you click on a report, you'll get a page that shows the previous release number, the consensus estimate and (after the announcement) the latest number.

Ferretting out futures

What articles are there discussing how to select a futures brokerage? What articles are there on trading options on futures? If you don't have any articles, what sources might you suggest I try?

— Donald Pickering

We featured an Online Broker Guide in the September 2003 issue. It lists various resources and features for different brokerages, including futures clearing merchants (FCMs). After doing some preliminary research, it's a good idea to visit a company's Web site to see if they have a downloadable demo of their trading platform. One size does not fit all. Try out all the freebies you can.

We've published numerous option strategy articles; the principles that guide equity option trading hold true for futures options as well — a call is a call, a put is a put, a strangle is a strangle, etc. (One thing to watch out for in futures options is liquidity: Not all futures options are heavily traded, and the bid-ask spreads can be quite large.) The Web sites of various

futures exchanges also contain educational material on options.

You can browse the contents of back issues on our Web site, as well as search for specific articles through our online store.

More on volume

I just bought the December issue of *Active Trader* and read the article Thom Hartle wrote called “Following through in the S&Ps.” I really enjoyed the article and it gave me some ideas about tweaking and testing what he wrote about.

But I have a major problem with how he came up with the statistics on the up/down volume percentages. I have been keeping a spreadsheet of the advancing/declining issues and volume for more than three years and I get up-volume percentages a lot more than you showed in your article. Your data shows the first time the up volume is in the 50- to 59.99-percent range was January 2003. I show the first day in that range is Aug. 29, 2002, with many more occurring in the following months. Is there something else that isn't mentioned in the article that you're looking at?

— Eric Wagner

Thom Hartle replies:

What is not specifically addressed in the article — an oversight on my part — is that the volume percentages were sorted from lowest to highest when I grouped them. I wanted to see if there was any tendency for how much the market moved based on the percentage volume ranking within the group. Did the market move more if the number was closer to 50 percent than to 59 percent? The charts suggest it doesn't matter. Therefore, the reference in Figure 1 and the Jan. 13, 2003, reading for the up volume was 50.26 percent, which was the lowest (No. 1), and the reading for April 10, 2003, was 59.91 percent, which was the highest (No. 37) for the group.

Yes, Aug. 29 was the first dominant up volume in the 50- to 59-percent range in the entire data period. But the reading was 51.38 percent for the day — higher than 50.26 percent, and the second lowest for the 50- to 59-percent group.

Questions about an article or trading issue? Send them to editorial@activetradermag.com. *Active Trader* reserves the right to edit letters for clarity and length.

Goodbye members, hello shareholders

Financial exchanges embrace demutualization

BY KESHA GREEN

Financial exchanges, which have long operated as the ultimate members-only clubs, have recently discovered the benefits of opening their doors to outside investors. And in an increasing number of cases, the exchanges are betting that demutualization, a move from a member-owned to a shareholder-owned structure, will boost coffers even more than consolidation or technological improvements.

Many exchanges have changed or are in the process of changing from a non-profit, member-based arrangement to a for-profit, shareholder-based organization. Technically, demutualization features a separation of ownership and trading rights, where membership seats or equity convert to shares.

The potential benefits of demutualization are crystal clear when one considers the success of the IPO launched by the Chicago Mercantile Exchange (CME), but perhaps more murky in terms of self-regulatory issues and long-term economic effects.

Specific reasons driving demutualization vary by exchange. However, the main impetus comes from the potential to make additional profits. Whether an exchange uses demutualization as its first step toward an IPO, as a way to position itself as an attractive acquirer or acquiree, or as a method toward streamlining operations, the end result is the same. Capital needs must be met, particularly in the case of traditional exchanges.

Electronic Communication Networks (ECNs), such as Island, have more access to larger pools of capital because they are typically owned or financed by publicly traded companies. Exchanges are usually restricted to gleaning money from members through transaction fees. Such limitations hinder exchanges from competing effectively with these relatively new challengers.

Fortunately, exchanges can look to another industry for clues on how effectively demutualization can work. Barbara Remmers, an assistant finance professor at Virginia Tech, has observed "a wave of demutualization in the life insurance sector" starting as early as 1995.



"What it has in common with the stock exchanges is that it is a global phenomenon," she says, "and that it's happening in a compressed period of time, as opposed to spread out over decades."

In both cases, demutualization increases the potential pool of capital suppliers.

"[The owners] don't have to be customers," Remmers says. "They can be anyone out there with money. And when outside investors are owners, as opposed to customers, you can have freely trad-

able shares. So you don't get customers, in the case of stock exchanges, being over-invested in one [instrument]. Their worries about their own capital investment may make them want to employ safer than optimal strategies in the exchange."

Who's who in demutualization

Before 1998, no exchanges were publicly traded and few were for-profit. Yet near the end of 2002, there were 10 listed exchanges and at least 15 demutualized exchanges worldwide, according to a World Federation of Exchanges (WFE) member survey.

The CME became the first publicly traded U.S. financial exchange on Dec. 6, 2002. Other U.S. exchanges followed the CME's lead in demutualization, although none have gone through with an IPO. The International Securities Exchange (ISE), the first fully electronic options exchange, demutualized May 1, 2002. The Philadelphia Stock Exchange (PHLX) and the Nasdaq are in the final stages of the demutualization.

While demutualization usually begins with a plan and ends with SEC approval, the process varies among the exchanges because of their different goals. Some exchanges extend demutualization into a larger business strategy, tantamount to a complete structural overhaul with the goal of an IPO in the near future. Other exchanges use demutualization simply as a recapitalization tool, but with more long-term IPO possibilities. If an IPO is not specifically announced in a demutualization plan, it is still typically a topic of discussion.

The Merc makes it work

The CME's demutualization planning began in 1998, says Craig Donohue, who became the exchange's CEO on Jan. 1.

"It wasn't just a demutualization strategy, it was also a business strategy," Donohue says. "And that whole process

took about a year and a half. During that time we were spending a lot of time with our members, talking with them, educating them and convincing them that if they followed our vision and our leadership, we would succeed."

It was time well spent, as 98.3 percent of the CME's membership voted to approve the demutualization of the U.S.'s largest futures exchange. The exchange finally demutualized in 2000, and the IPO two years later raised about \$117.5 million. By the end of 2002, CME's stock jumped 25 percent from its IPO price of \$35 to \$43.66 per share. In early December 2003, it was trading around \$69.

"I think we had members who understood two key things," Donohue says. "The first is that the exchange marketplace is undergoing a very radical change in terms of consolidation and the move toward electronic trading. And, deregulation has brought new competitors into the marketplace, many of whom are not traditional mutual organizations or membership clubs, but rather for-profit companies.

"The second point is the CME was in such a strong position to succeed in terms of equitizing the value of the organization and creating shareholder value," Donohue continues. "Because this is a very successful institution, they saw tremendous growth potential in our diverse product line, the success we've had with electronic trading and the fact we have a vertically integrated business model and a fully-owned clearing house. Therefore, we could effectively execute a growth strategy that would create enormous value for them as shareholders."

Nasdaq tries to break parental ties

The steps for the Nasdaq's demutualization are unique because the stock market has geared all of its efforts toward breaking away from its parent company, NASD. In 2001 and 2002, a separate public company was created, and there was a private placement of shares. Nasdaq stock currently trades on the OTC bulletin board.

The final stage for the Nasdaq's demutualization would be attaining exchange status (currently the NASD is the

exchange and the Nasdaq is just a "stock market"). Its exchange application has been on file with the SEC since 2000, and the Nasdaq remains "cautiously optimistic" about the prospect of approval.

"Both the NASD and the Nasdaq believe the best structure is one in which we are separate organizations," says Ed Knight, the Nasdaq's general counsel. "We now are subject to the full set of rules all other public companies are subject to, but the NASD still has a controlling interest in Nasdaq and the exchange application, when approved, would eliminate that controlling interest.

"The NASD is our regulator," Knight adds. "It would be like if the Food and Drug Administration owned Pfizer. It is just not a healthy relationship. We think we've created an organization that meets all the standards to be an exchange and separately govern itself."

The Nasdaq has also previously made clear its intentions for an IPO, although those plans are on hold.

PHLX and ISE: Aiming for capital injections

The ISE demutualized only two years after it began as an options exchange. Steve Sears, director of research and corporate affairs, attributes the move to the ISE's positioning strategy.

"An advantage of demutualization is the ability to raise capital without having to rely on members," he says. "The ability to access the capital markets provides ISE with a broad base to leverage as ISE enhances its growth. Another benefit of demutualization is the ability to sell additional trading rights without diluting the members' stake in the exchange."

Raising funds is not integral to the ISE right now, according to Sears.

"We can finance all our operations," he says. "There's no business need to alter the present corporate structure."

The ISE's focus was on the separation of trading rights from ownership rights, which was accomplished by creating two classes of stock. Class A shares represented ownership in the ISE. Class B shares represented trading rights, separated into three more classes.

But while demutualization is a busi-

ness change, it's not a primary driver for growth, Sears says.

"Trading systems, innovations and speed of execution are aspects more related to growth."

The PHLX, the first securities exchange in the United States, has a more dire need to raise capital.

"As a member-owned corporate structure, third parties are reluctant to form alliances," says Ben Craig, director of strategic services. "There's a need for more flexibility. After demutualization, we would be in the right kind of position to have those [alliance] discussions.

"We have a number of assets we can't leverage on our own capital resources," Craig adds. "We'd like to maximize in-house assets that need the capital and obtain marketing resources that we don't have internally."

One in-house asset is the Philadelphia Board of Trade, the exchange's futures subsidiary. The PHLX would like to make that market more active and possibly position it as an electronic exchange by using external capital, according to Craig.

"We don't think it's right to go to members to get capital when we've had external interest about that asset," he says.

He describes the PHLX's demutualization plan as being very "vanilla," since the exchange has avoided "reinventing the wheel" by instituting many major corporate or structural changes.

In October 2003, the exchange's board of governors approved the demutualization plan. Members approved the plan on Nov. 25, and the exchange hopes to complete the process by the first quarter of 2004. However, the timeline depends on SEC action. The PHLX doesn't intend to pursue a public offering in the near-term — not even in the next three years — but it is a possibility, Craig says.

Member benefits

With exchanges giving IPOs the "possibility" designation, how do the individual exchange members benefit from demutualization?

Professor Demmers offers the consolidation scenario.

"If you are a member-owner in a mem-

ber exchange that's ultimately going to fail, you'd like to demutualize before [that happens]," she says. "At least you could get some stock that you can quickly sell as opposed to being a person who forever has an ownership interest that can't be sold."

In the case of the PHLX, demutualization will allow broader access to the exchange, which may result in greater value and lower fees for traders. Before demutualization, the PHLX had 504 seats. After demutualization, the number of market participants will be unlimited, Craig says.

"The seat owners are going to be the shareholders of the corporation — 100 percent," he says. "We plan to implement a permit program, where all members will receive a permit after paying a monthly fee for the ability to trade."

Then, permit revenues could pass to the trader, which might prompt the exchange to lower fees.

"For the shareholders, what they have today is a seat that has declined in value, as [is the case] at all exchanges," Craig says. "The shares we intend to offer are a vehicle for them to achieve appreciation based on third-party capital, which will reflect on how well the exchange operates going forward."

Regulatory issues

Most exchanges are quick to claim strict compliance to regulatory statutes. However, the affect of demutualization on regulatory issues is still questionable,

whether the mandates are enforced internally or externally.

After demutualization, "the control exerted by the owners switches from the members to these outside investors," Demmers says. "And their interests aren't necessarily the same as the members' interests. So, there you can have some for better, some for worse — but there are different effects on operations of the exchange because of the fact outside investors are now owning it."

Another concern, albeit slim, is risk. While it's highly unlikely a stock market will default, there is one finding that shows up continually in empirical studies — mutual companies are safer than stock companies.

"We see that finding in the insurance and banking industries," Demmers says. "When the mutual organizations demutualize, they can incur more risk. There is concern over whether risk may increase for stock exchanges because of demutualization."

Also, there is the question of whether deregulation resources will increase or decrease. In the case of the CME, the exchange increased investment in regulation after its demutualization, according to Donohue.

"It's just that being a public company constitutes an extra incentive to be extremely good at what we do as regulators," he says. "Obviously, if we didn't do a good job, it would have an immediate impact in terms of our investors, research

analysts and ultimately our stock price."

Wait and see

How much exchange members trust their leadership can positively or negatively affect the ultimate successful execution of a demutualization plan. For example, the CME had solid membership backing because it pushed to educate its members about the plan and the members' positive outlook of the exchange's track record.

"The pork-belly contract, during the 1960s, with our cattle contract, was the mainstay of what we did," Donohue says. "And the membership supported the leadership of the exchange to basically create financial futures. I think what happened throughout the course of all that history is our membership, most of whom has been around for that entire period of time, saw the capabilities of the leadership of this institution."

The PHLX, with its 214-year history, hopes to duplicate the CME's level of membership support for its plan.

Even so, the jury's still out on how far certain exchanges are willing to go to gain some extra capital, how much friction will result between outside investors and members over internal regulatory issues, and how much monetary impact this rash of demutualizations will eventually have on the global economy. 🐷



©2004, Active Trader Magazine

Out of business

Prop firm shuts down

Another sign the good old days are gone forever occurred in mid-October: WorldCo, a New York-based proprietary trading firm, closed its doors and filed for bankruptcy.

During the bull market, WorldCo was one of the leading prop firms in terms of number of traders and trading capital. However, a dwindling client base and declining revenues led to the shutdown.

WorldCo traders were required to put up a certain amount of money before trading. WorldCo made money by the commissions generated from the traders and also took a small percentage of the traders' profits.

During the market boom, when traders were making dozens of trades per day and riding the Nasdaq wave to huge profits, WorldCo's business model allowed it to thrive and flourish. But as trading volume fell off and fewer traders were able to make a profit, WorldCo was unable to keep up with its expenses. It's unclear how many traders were still at WorldCo when it closed down, although many of them have since moved over to other proprietary firms.

Many traders had money on account with WorldCo, and the firm's bankruptcy leaves the status of those funds in question. The company has said it will try to refund as much money to traders as possible, although its first obligation is to its creditors — landlords, data vendors, etc.

Industry impact

While the bankruptcy could be considered a "black eye" to proprietary trading, some involved in the industry think it could serve as a warning to traders.

"I would not be surprised if more firms went out of business," says Bob Bright, co-founder of Bright Trading, a Las Vegas-based prop firm with more than 40 branches nationwide. "A lot of firms are undercapitalized and being led by people who aren't really traders."

Andrew Fishman, executive vice president of Schonfeld Securities, knows newcomers to the prop trading industry may worry that what happened to WorldCo could happen to other firms.

But, different proprietary firms have

different agreements — in some instances, the prop firm puts up all the money and takes a significant portion of profits. In others, a firm requires an initial deposit and takes a monthly fee but returns a higher percentage of profits.

For instance, Schonfeld's Fishman says the firm paid its traders for profits they had earned years earlier — in some cases millions of dollars — even if a trader had current losses greater than what was earned, and even if the firm was losing money.

"Traders do not deposit any money with us, so they are not going to be putting any capital up," Fishman says.

What traders should know

While the deferred compensation used by Schonfeld may work because traders at Schonfeld are classified as employees, that's not always the case. In many instances, traders at a prop firm are members of a Limited Liability Company (LLC).

"In some cases, deferred compensation is a term that is bandied about but has no meaning," says Robert Green, an accountant who specializes in trader tax issues and a regular contributor to *Active Trader*. "It is a disguise term for a reserve. Firms say they have huge capital — \$10 or \$15 million — and everybody has 10:1 leverage. But if everyone has 10:1, and

traders are losing money, which has been the case the last few years, that capital has been stretched very thin.

"So while firms are telling traders to take deferred compensation because it's a good thing for taxes, they really are saying that they need the capital left in the firm because it is needed for other traders. In effect, it's like a pyramid scheme."

Green says if traders are being misinformed as to why their money is being withheld, they may be victims of fraud and could file a class-action suit against the firm. In any event, he thinks traders need to be more observant before they agree to any contract.

"You should take with a grain of salt what you hear from management," he says. "You should look for tell-tale signs of financial weakness, ask these firms to declare what the true capital they are trading is and account for it without smoke and mirrors and blanket statements. Every prop trader needs to have a lawyer represent them and look at their agreements and put pressure on the prop firms to not have those agreements be so one-sided."

Signs of financial weakness would include an unusual amount of traders leaving the firm, the closing of branch offices and leverage suddenly being cut dramatically. Green says traders have a right to examine a firm's audited financial statement. 

SEC changes rule on married puts

In what may be the first of several changes involving the existing short-sale rules, the SEC in mid-November announced it was concerned with a loophole in the uptick rule.

"Married puts," in which a trader simultaneously buys a stock and a put option, has never been subject to the uptick rule.

In fact, the SEC admits married puts are a legitimate hedging strategy and says it does not want to discourage their use.

However, the SEC is concerned with certain transactions involved with married puts, particularly:

- The purchase of at- or in-the-money puts right at expiration;

- The purchase of an equivalent number of shares to the option purchase;
- The sale of the stock once the married put is acquired; and
- The repeated use of a facilitator that allows the initial purchaser to enter a short-sale in the stock, which often nets out the position, and any fees associated with the facilitator.

The SEC believes married puts with the above characteristics are sham transactions — the subsequent sale of the stock portion can be viewed as an effort to drive down the price of the stock and increase the value of the put. Therefore stock sales when a position is accompanied by a put will now be subject to the uptick rule. 

Mutual fund probe continues

A \$50 million fine levied against Morgan Stanley in mid-November is the most significant monetary penalty to date in the mutual fund investigation being conducted by both the SEC and the New York State Attorney's Office.

The SEC fined Morgan Stanley for two specific reasons. The firm promoted certain funds more than others after accepting a fee from the fund companies. Morgan Stanley then gave its sales staff incentives for purchasing shares of these select funds.

Additionally, Morgan Stanley did not inform its customers that larger purchases (\$100,000 or more) of certain mutual fund shares came with a higher fee, and that fee could negatively affect the returns of the fund.

The \$50 million will be placed in a "Fair Fund" and will be distributed to Morgan Stanley customers who were charged excess commissions for purchasing "preferred" funds.

A few days later, the SEC filed suit against Pilgrim Baxter & Associates, charging the company with fraud and breach of contract in conjunction with market timing of certain funds. As has been the case in many previous allegations against mutual fund firms, Pilgrim is charged with allowing a hedge fund run by Pilgrim executives to trade mutual funds after hours, in violation of SEC law.

This type of short-term trading makes it difficult for portfolio managers to effectively manage the assets of the fund.

Mutual fund company Putnam agreed to wide-ranging changes earlier in November after the SEC found that several of its employees engaged in self-trading of some funds. The changes deal with internal compliance and the restructuring of the company's board of trustees.

Just before Thanksgiving, Security Trust Co. — an intermediary between funds and retirement plans, institutions and financial advisers — was charged with hooking up with Canary Capital Partners in a scheme to trade mutual funds after hours. Canary Partners was one of the first fund companies charged with violations.

In the midst of all the charges, the House of Representatives overwhelmingly passed a law designed to confront mutual fund abuses, and the SEC presented its own reform suggestions in early December.

Among the new rules in the House law include a provision that mutual funds could — although it is not mandatory — charge more than a two-percent fee in an effort to discourage short-term trading. However, any mutual fund legislation will not be discussed by the Senate until Congress reconvenes after its winter break.

As of late November, 11 major mutual fund companies had either been charged, were under investigation or had executives quit under fire. ☎

QUICK SCALPS

SHUFFLING THE DECK

▼ Nasdaq is reclassifying its stocks according to the FTSE Global Classification System (GCS). The GCS is comprised of 10 economic groups, 36 industrial sectors and 102 sub-sectors. It is already used extensively in Europe, Africa and Asia, and it will allow Nasdaq-listed securities to be easily analyzed worldwide.

NEW NYSE BOSS THINKS FLOOR IS STILL SPECIAL

▼ Although NYSE interim chairman John Reed has some changes in mind for the Big Board, none of them include the specialist trading system. Reed's proposal to members includes significantly slashing the size of the NYSE board, which currently consists of 27 members. And, he will suggest the jobs of chairman and CEO be split up into two different positions. However, Reed believes the specialist system — which has come under heavy scrutiny lately as many specialist firms have been fined for illegal trading that cost customers millions of dollars — adds value to the exchange and should be kept. Reed also steered clear of the controversy surrounding his predecessor, Richard Grasso, who resigned under fire after it became known he was eligible for almost \$200 million in deferred retirement bonuses. Reed's plan was widely accepted by NYSE members, although the SEC and Congress think it does not go far enough.

CASH MONEY

▼ Archipelago received a \$125 million investment in November from venture capitalists General Atlantic Partners. That's the largest infusion of capital the exchange has received since some of the top brokerage houses on Wall Street pumped almost \$200 million into the then-fledgling entity in 1999. The money will be used to create a new Web site through which market data products will be sold and to gain an increased share of the nearly 250 stocks listed on the Archipelago Exchange.

NEW RULES

▼ The SEC in early November approved the Nasdaq's corporate governance rules. The rules are designed to strengthen listing standards by enhancing disclosure and transparency. Among other things, the rules will require a majority of a Nasdaq-listed company's board to be independent directors, strengthen audit committees and require non-U.S. companies to comply with heightened disclosure standards. The new rules must be implemented no later than October.

WE DON'T WANT IT, YOU TAKE IT

▼ With a deal with investment firm GTCR Golder Rauner all but dead, the Nasdaq reached an agreement to sell the embattled American Stock Exchange to the AMEX's 864 members. Earlier in the year, GTCR Golder Rauner had agreed to buy the AMEX for \$110 million, but that deal fell through. Published reports indicate the new deal extends for seven and a half years an existing \$50 million loan to the AMEX from the Nasdaq. And, the Nasdaq will loan as much as \$17.5 million in new capital to the AMEX. However, rumors still abound that the Nasdaq will seek to merge with an existing exchange. The Philadelphia Stock Exchange is the most likely candidate, although Philadelphia is in the middle of a demutualization process that must be completed before any deal takes place.

I DIDN'T KNOW THAT

▼ A quartet of studies by the Securities Industry Association (SIA) revealed some interesting tidbits about the industry. For starters, at large firms (8,000 or more employees), 27 percent of those classified as "executive management" are either women or minorities, up seven percent from 2001. Those groups represent 33 percent of investment banking positions and 27 percent of trading positions.

Also, 46 percent of investors surveyed thought the upcoming year will be "good" or "very good" for investing, an increase of 17 percent from 2002 and the highest level since 2000. In 2002, more than 84 million individuals owned stock, a number that has almost tripled since 1980. Those individuals represent almost half of U.S. households.

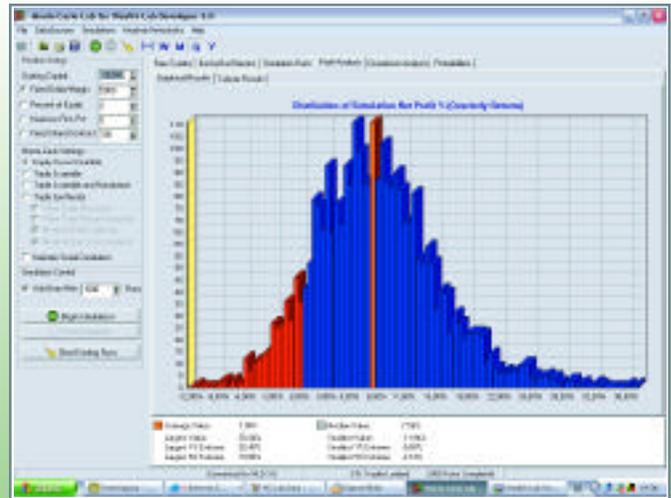
And, the U.S. securities industry is on pace to earn record profits in 2003. Profits for NYSE firms are expected to exceed \$22 billion, more than triple last year's numbers, and more than \$1 billion greater than the record figures of 2000. Revenues for 2003 should reach more than \$150 billion, more than \$90 billion off 2000's record figures.

SHARING SUPERMONTAGE

▼ The Instinet and Island ECNs agreed in November to participate in Nasdaq's SuperMontage trading platform. Their participation is scheduled to begin in January immediately following the consolidation of the ECNs' two order books. "We are committed to exposing our customers' orders to as much liquidity as possible and improving the marketplace for all investors," says Alex Goor, an executive vice president at Instinet. Additionally, the Nasdaq says it will use the Instinet SmartRouter technology to give its members access to enhanced routing services.

NEW Products

▼ **Wealth-Lab Inc.** recently released Monte Carlo-Lab (MC-Lab). This companion product to the Wealth-Lab Developer 3 (WLD3) trading software performs randomized Monte Carlo simulation analysis on historical trading system results. After testing a portfolio of stocks or futures with WLD3, traders can load the historical simulation results directly into MC-Lab and execute thousands of randomized simulations. The product offers a variety of choices to produce new randomized equity curves based on the historical equity curve or trade history. MC-Lab outputs reports and graphs showing the profit/loss and drawdown ranges of the randomized runs. This information can be used to determine the probability of achieving different profit objectives. Traders can also change the settings to quickly see the effects of different position sizing options on the simulation outcomes. For more information visit www.wealth-lab.com.



▼ **Xpresstrade LLC** has launched a new Web site dedicated exclusively to currency trading. The site, www.xtfx.com, explains the structure of the FX market, the mechanics of trading currencies via the Internet and the differences between Forex, stocks and futures. It offers free, real-time, streaming Forex quotes and charts, as well as daily in-depth fundamental and technical analysis of the world's major currencies. Visitors can take advantage of live, real-time chats with FX specialists and register for a free FX demo account.

▼ **Townsend Analytics** now offers the complete BRUT Book. The BRUT ECN is an alternative trading facility that provides both institutional and broker/dealer order flow with its BRUT Book. BRUT ECN Book information is displayed in RealTick's MarketMaker windows and is available for free to all users who subscribe to the RealTick Pro Plus level of service. Visit www.realtick.com and www.ebrut.com for more information.

▼ **Rina Systems** has announced a new Web site, www.tradestationzone.com, designed to be an e-commerce exchange for active and technical traders who use TradeStation and related products and services. Users can exchange opinions, participate in forums and ask questions regarding a product, service or vendor. Products on the site include software, hardware, systems, signals, indicators, data, books and videos. Services include newsletters, advisories, seminars, workshops and custom software development. Anyone can become a member, use available resources, submit a publication, review a product/service or join a discussion group. Participation and membership in TradeStation Zone.com activities is free. Visit the site for more information.

▼ **TradeMaven** offers an order execution and management software designed for both beginning and experienced traders. TradeMaven features include the ability to paper trade and place actual trades using the same interface, an integrated trade journal, proprietary indicators, an integrated order assistant, the ability to record and playback market action, and automatic stop and limit orders. TradeMaven traders can also

collaborate with other users in real time. For more information visit www.trademavenllc.com.

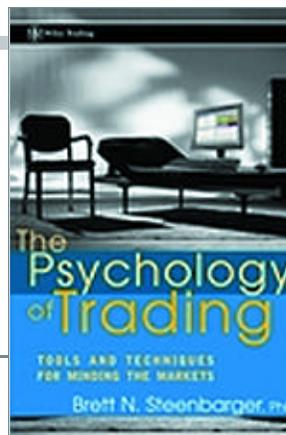
▼ **OptionsXpress**, an online options and stock brokerage, has added GainsKeeper to its online services and obtained a promotional discount from GainsKeeper for its customers. By using GainsKeeper, traders can calculate tax liabilities resulting from trading activities in their brokerage accounts. GainsKeeper also automatically alerts them to the impact of wash sales and other events that can affect taxes. OptionsXpress customers can use this tax lot accounting service by downloading historical transactions into GainsKeeper. GainsKeeper's system then automatically updates the cost basis of positions to reflect wash sales and corporate actions, such as mergers and splits, leading to accurate capital gains calculations throughout the year.

▼ **Field Financial Group** has introduced a free pivot point calculator on its Web site. The software tool calculates Classical Pivot Points — S2 (second support level), S1 (first support level), P (pivot point), R1 (first resistance level), R2 (second resistance level) — for any market and on any time frame. Other tools are also available. Visit www.fieldfinancial.com for more information.

▼ **eSignal** version 7.5 is now available and features news from Dow Jones NewsPlus and AFX News, more advanced charts and full integration with eSignal Market Scanners. This latest version offers market depth from the Chicago Mercantile Exchange and Chicago Board of Trade; the NYSE Open Book with the New York Liquidity Quote; and a means of viewing the bid/ask for each FOREX contributor. eSignal 7.5 has more intraday history than previous versions with six months of data. Options traders will find new daily histories of options, including the open, high, low and close values. The update also offers new technical studies, including Kase StatWare, Bollinger Band Tool Kit and Jan Arps' Sigma Bands. For more information on all the latest features visit www.esignal.com/esignal/features.

The Psychology of Trading: Tools and Techniques for Minding the Markets

By Brett N. Steenbarger
 John Wiley & Sons
 Hardcover, 330 pages
 \$39.95



REVIEWED BY JOHN SALEEBY

The Psychology of Trading: Tools and Techniques for Minding the Markets is an interesting psychologically oriented trading book. The author, Brett N. Steenbarger, Ph.D., is a clinical psychologist and associate professor at SUNY Medical University in Syracuse.

The book is organized as a series of case studies of medical students who seek the counsel of Dr. Steenbarger, who recounts their dilemmas and his suggested solutions. He then analogizes a student's problem to characteristics that might plague one's trading.

The book's main theme is "the real market you're trading is the market called Self." To this end, Steenbarger provides an exercise to identify your constructive and destructive characteristics. He suggests maintaining a journal of all trades and your state of mind while placing each one. This allows you to see both the good and bad characteristics that are battling for control of your personality and, consequently, your trading. The key is to foster the "good personality" to control decision making. The author believes a destructive personality trait can be quickly changed once it is identified.

Although the book avoids platitudes, such as discipline and

planning make a successful trader, it falls short of the rigorous studies and statistical analysis characteristic of a scholarly work. Nonetheless, the author's approach of utilizing the problems of medical students to address various trading pitfalls is unique. Also, the book gives the reader a framework for developing a psychological alter ego to assist in becoming a better trader.

While the book's episodic nature keeps its subject matter fresh, there is a lack of cohesiveness from chapter to chapter. There are many pieces of meat for the reader to sink his or her teeth into, but at times it seems as if there is no skeleton holding the pieces together. However, the author does a fine job in the last chapter of recapitulating his major points.

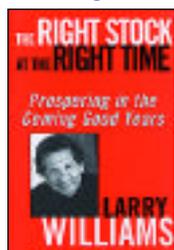
Some readers might be disappointed by *The Psychology of Trading* because it provides almost no insight into the market and doesn't offer typical "rules for success." Essentially this is one man's synthesis of student counseling with his own trading experience. But I think this book is above average and contains some insightful and useful points for traders. I recommend it. 📌

John Saleeby is a St. Louis-based trader and hedge fund manager. For more information see p. 10.

New releases roundup

The following are summaries of recently published trading-related books.

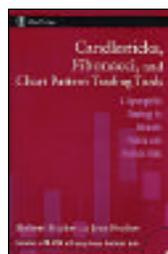
The Right Stock at the Right Time: Prospering in the Coming Good Years



By Larry Williams
 John Wiley & Sons, 2003
 Hardcover, 223 pages
 \$27.95

Williams believes a bear market doesn't have to lead traders to adopt a pessimistic approach. The book argues the path to positive and profitable trading is through recognizing and utilizing historical patterns. By using stock prices from 1854 to present, Williams talks about finding the market bottom and riding the expected upswing. The book outlines trading fundamentals, from key market patterns to investor sentiment, that can help traders gauge potentially lucrative opportunities.

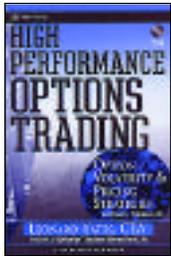
Candlesticks, Fibonacci, and Chart Pattern Trading Tools: A Synergistic Strategy to Enhance Profits and Reduce Risk



By Robert Fischer and Jens Fischer
 John Wiley & Sons, 2003
 Hardcover, 256 pages
 \$89.95

Robert Fischer and his son, Dr. Jens Fischer, explain their new trading approach that merges three analytical tools: candlestick charts, Fibonacci applications and three-point chart pattern analysis. The book begins with a discussion of trading psychology and investor behavior before delving into descriptions of how investors can use the aforementioned tools. ACD-ROM is enclosed, allowing readers to try out the ideas using the WINPHI charting program.

TRADER'S Bookshelf



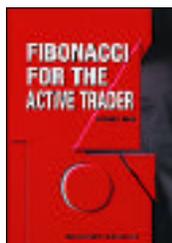
High Performance Options Trading: Options Volatility & Pricing Strategies

By Leonard Yates, CTA
John Wiley & Sons, 2003
Hardcover, 221 pages
\$69.95

The author outlines options strategies geared toward beginning and intermediate traders. Yates provides details on options language, single- and multi-option spread strategies, volatility and various options trading tools. The book also includes an educational CD.

Fibonacci For the Active Trader

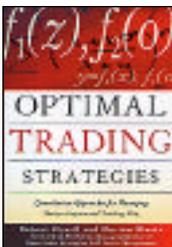
By Derrik S. Hobbs
TradingMarkets Publishing Group, 2003
Hardcover, 221 pages
\$49.95



Hobbs covers the basics, specifically how Fibonacci can help traders find support and resistance levels and identify potential reversals. The majority of the book is devoted to seven Fibonacci-based strategies.

Optimal Trading Strategies: Quantitative Approaches for Managing Market Impact and Trading Risk

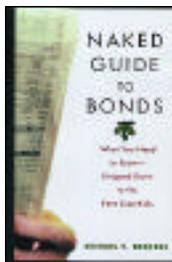
By Robert Kissell and Morton Glantz
AMACOM, 2003
Hardcover, 382 pages
\$69.95



Kissell and Glantz discuss their evaluative process for trading-related decisions by using extensive financial theory, statistical models and examples. This book covers methods to estimate transaction costs, develop optimal trading strategies, and manage market impact and trading risk. It also features advanced concepts such as the Efficient Trading Frontier (ETF) and the Capital Trade Line (CTL), along with trader-focused techniques for optimization and economic fair value computation (FV).

Naked Guide to Bonds: What You Need to Know — Stripped Down to the Bare Essentials

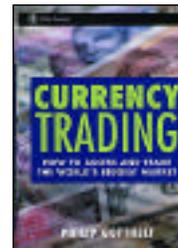
By Michael V. Brandes
John Wiley & Sons, 2003
Hardcover, 242 pages
\$29.95



Brandes focuses on covering bond fundamentals in a simple manner, using a minimalist approach to explain key points about bond types, common economic influences, evaluation strategies and portfolio management for the individual investor.

Currency Trading: How to Access and Trade the World's Biggest Market

By Philip Gottself
John Wiley & Sons, 2003
Hardcover, 304 pages
\$69.95



Gottself provides an introduction to the foreign exchange (FOREX) market by discussing misconceptions about three major concepts: money, currency and foreign exchange. He uses real-world examples and case studies to cover topics such as the parity principle, interest rates, forecasting and currency scams. Gottself presents his book as a way for readers to develop their own conclusions about trading currencies, rather than having to rely solely on the advice of "experts."

Advanced Swing Trading: Strategies to Predict, Identify, and Trade Future Market Swings

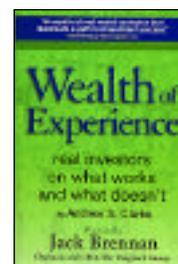
By John Crane
John Wiley & Sons, 2003
Hardcover, 219 pages
\$69.95



Crane, trader and co-founder of Traders Network, offers the "Action/Reaction" trading theory as a way for investors to capitalize on swing-trading opportunities. A combination of price levels, timing methods and confirmation patterns illustrates the author's approach to market forecasting. Key components of this theory include Action/Reaction lines and the Reaction cycle, which features a trendline-based price projection technique (with derivations from the Andrews Pitchfork tool).

Wealth of Experience: Real Investors on What Works and What Doesn't

By Andrew S. Clarke
John Wiley & Sons, 2003
Hardcover, 217 pages
\$24.95



Six hundred "ordinary" investors responded to a Vanguard Group survey, providing the investment insights for Clarke's book. Personal accounts of the respondents' investing pitfalls and triumphs provide a different look at ways to devise investing programs. Some topics cover how investors can diversify and allocate assets, make investment selections with the right benefit and trade-off ratio, and track portfolio performance.

— Compiled by Kesha Green



Software SCREENING: MidCast Pro for the Pocket PC Phone Edition

REVIEWED BY DAVID BUKEY

Several financial software providers now offer real-time stock quotes and charts that can be delivered directly to a trader's wireless technology, but accessing the latest market data usually requires constant manual updating.

In response, HillCast Technologies Inc. has unveiled its MidCast Pro software for personal digital assistants (PDAs) that automatically updates stock prices so traders can get streaming, real-time quotes just about anywhere. (See "The mobile trader," *Active Trader*, October 2003, p. 24, for an overview of recently available wireless products and services.)

MidCast Pro stands out from other financial PDA software in two ways: It is the only wireless program that currently supports streaming quotes, and it runs on more than four dozen wireless devices, including BlackBerrys, Palms, Pocket PCs, Web-enabled phones and hybrid "smart phones" that combine cell-phone functionality with a PDA's processing power.

MidCast's ability to run on a variety of newer PDAs does come at a price: Its main features vary depending on which handheld device you use, and certain features are available only at the expense of others. So keep in mind certain features discussed here may not work on your PDA; alternately, there may be others not covered here that are supported by your handheld device.

For example, the version of the software we used, T-Mobile's Pocket PC Phone Edition, allows you to scroll through a list of news headlines and select an article to read, while BlackBerry's version of the software does not have this feature. Also, Palm and BlackBerry PDAs don't include links to various online brokers' Web sites like the Pocket PC Phone Edition does, but certain Java-based Palm and Blackberry devices can display a candlestick day chart with 30-minute bars that the Pocket PC can't.

Data and network service

MidCast offers two data feeds. Streaming quotes from the Island electronic communications network (ECN) are available for a one-time fee of \$14.95 to \$49.95, depending on the type of handheld device, or users can upgrade to an enhanced data source that features Nasdaq, NYSE, AMEX, OTC, index, currency and mutual fund quotes for an additional \$29.95 monthly fee.

MidCast Pro supports a variety of wireless services, from the General Packet Radio Service (GPRS) and Code Division Multiple Access (CDMA2000) networks that provide dial-up-comparable speeds of 30 to 75 Kilobytes per second (Kbps), to slower, more widely available service that processes data less than half as quickly. (Our Pocket PC came equipped with a GPRS wireless connection.)

SOFTWARE SUMMARY

Product: MidCast Pro

What it is: Wireless real-time, streaming quote software with charting, news and trading links.

Who it's for: Stock traders

Company: HillCast Technologies Inc.

906 East 5th Street, Suite 210

Austin, Texas 78702

Phone: (512) 474-4644

Fax: (512) 485-3052

Web site: www.hillcast.com

Price: \$14.95 to \$49.95 for Island ECN data, depending on the device; additional \$29.95 monthly subscription fee for Nasdaq, NYSE, AMEX, OTC, currency and mutual fund data. 30-day free trial.

Upside: The wireless real-time streaming data feed is the first and only dynamic quote service offered for PDAs. MidCast can run on a variety of handheld devices.

Downside: High network traffic and trade volatility can cause frequent disconnects from MidCast's server. Features depend on the individual capabilities of each PDA model and aren't clearly detailed on HillCast's Web site.

System requirements (recommended): Internet-compatible wireless handset; 30k - 700k of memory pending handset & software version; J2ME, .NET Compact framework pending software version.

MidCast also works with Bluetooth, a limited-range radio frequency that can link PDAs, cell phones, computers and printers, and Wi-Fi, a wireless standard that allows users to share a broadband Internet connection through a home network or public "hotspot" ("Going wireless," *Active Trader*, March 2003, p. 24).

Features

Watch list. MidCast Pro's main screen is a watch list of about a dozen user-defined symbols, constantly updated through a connection to MidCast's server. You can display up to 14 columns of data, including symbol, tick (a trending indicator), price, change from yesterday's close, volume, trade size, trade time, exchange, bid/ask, daily high/low and open/close. Only four or five columns can be displayed at a time, but you can scroll side to side and up and down for additional information and symbols. Adding and deleting symbols and columns is easy and the watch list can handle roughly 40 symbols before its performance suffers.

Figure 1, opposite page, is a watch list of mostly Nasdaq stocks. The first column, the tick indicator (T), uses green or red arrows to show if the stock is trending higher or lower. The tick indicator also displays a bell icon if there are breaking news headlines for the symbol. Figure 1 shows Dell is trending lower and QQQ and SPY have recent news headlines.

Figure 1's four remaining columns display each stock's symbol, latest price, change from yesterday's close and volume. A

stock's price and daily change are highlighted in green or red if its last trade is above or below its previous price. There are several symbols in Figure 1 such as QQQ, SPY and MSFT whose prices are highlighted in green even though the stock is down for the day, indicating they have begun to tick higher after an initial price drop.

The latest quotes for each symbol in the watch list stream by in ticker format at the bottom of the screen. The streaming ticker also notifies you when a symbol hits a daily high or low and remains in place in each of MidCast's four menus (quotes, alerts, news and trading).

Charting. Figure 2 (far right) shows a tick-by-tick, four-minute price chart of Microsoft Corp. with corresponding volume. Each of the 14 price and volume items available in the watch list also appears on the chart screen. The trend indicator (upper right) tracks the price movement of the last eight trades, displaying a solid green or red bar if the last trade was up or down. Hollow bars represent unchanged prices and are green or red depending on the last price change. A drop-down menu allows you to plot different symbols without having to leave the chart screen.

MidCast Pro does not offer historical charts, so if you are interested in more detailed charts, check out software from Semotus Solutions (www.semotus.com) or WolfeTech Inc. (www.wolfetech.com). These products don't offer streaming quotes, but they can plot symbols in a variety of time frames with up to five years of historical data.

Alerts. MidCast's alert options are detailed and easy to configure. You can set an alert based on breaking news, price, bid/ask, and volume changes for any symbol in the watch list and it will pop up onscreen or be sent to you via short message service (SMS) or e-mail. You can manually enter values at which an alert is triggered or MidCast will calculate an alert's percentage change in price, bid/ask and volume.

News. HillCast Technologies has partnered with ComTex News Network Inc. to provide real-time headlines and articles from over 66 sources for any stock symbol you choose. For each symbol, you can browse roughly a dozen news headlines and read each article in full. MidCast also makes it simple to copy and paste an article into a text editor such as Pocket Word so you can read it offline.

Trading. The trading menu offers secure wireless links to six brokerage Web sites (CyberTrader, Ameritrade, E*Trade,

FIGURE 1 STREAMING WATCH LIST

MidCast's wireless streaming quotes distinguish it from other PDA software. This watch list tracks 10 frequently traded stocks.



FIGURE 2 REAL-TIME CHART

This four-minute, real-time chart of Microsoft (MSFT) lists price and volume data. The trend indicator (upper right) tracks the price action of the last eight trades.



Fidelity, Charles Schwab and Scottrade) or places a call to your broker at the push of a button. (HillCast plans to provide seamless trading through its own order management system with a selected online broker, but the technology is not in place yet.)

Performance

You can't expect wireless networks to transmit data as quickly and reliably as desktop, real-time data feeds, but MidCast Pro performed surprisingly well. We measured MidCast's data stream against eSignal version 7.2 running on a digital subscriber line (DSL) — an unfair comparison because DSL transmits data at least 10 times as fast as our GPRS wireless connection. MidCast missed some trades and didn't update as quickly, but wasn't that far behind eSignal's data feed.

MidCast's update response time hinges on how busy its network server is and can slow down during peak market hours. Of course, MidCast's refresh rate for individual stocks varies, depending on how often each stock trades.

In theory, MidCast Pro can stay connected to its server and provide streaming quotes for hours at a time, but the program may disconnect as network traffic increases. However, you can reconnect without restarting the program.

Bottom line

MidCast Pro takes advantage of the latest wireless networks to bring streaming quotes to an impressive array of handheld devices. Other third-party financial PDA software may offer other useful features, such as historical charts, but can't compete with MidCast Pro's real-time updating capability. It's worth a look if you have the recommended hardware and a quick wireless network service in place. 📶



Product REVIEW: The Trader's Organizer

BY KIARA ASHANTI

Traders of different stripes rarely agree about anything, but the benefit of recording and analyzing past trades in a "journal" is something about which short-term, long-term, systematic and discretionary traders tend to concur.

The Trader's Organizer is an electronic trading journal developed by Dr. Alexander Elder. Devotees of Elder's books (*Trading for a Living* and *Come into My Trading Room*) know he is a serious advocate of maintaining a trading journal. Elder has created a software version of a journal (available at www.elder.com; 800-458-0939) he believes all traders should keep. It's a good tool for short-term stock traders as it automates several trade-tracking tasks and allows you to monitor your ongoing performance. But it has a few limitations and drawbacks for other kinds of traders.

The Trader's Organizer works as an Excel spreadsheet add-on (see Figure 1, below). However, it isn't something most traders could put together themselves; it uses nearly every function Excel provides. Entering your trade data is a bit quirky; you cannot import data from your brokerage account so you must enter each trade manually. However, it shouldn't take more than 15 minutes to learn how to navigate the program.

The program first asks for basic parameters such as account balance, commission costs and your per-trade and per-month risk levels. This is simple stuff, but one of the software's limitations appears quickly. The maximum per trade risk allowed in the program is two percent.

This restriction highlights Elder's biases and assumptions regarding money management. This is fine for students who

follow his ideas lockstep, but annoying for any experienced traders who have been doing fine with their own money management rules. It's certainly wise to keep risk low, but it's also restrictive to prevent traders from using different values.

The rest of the Organizer is set up to record and view all current and past trades. Further choices such as Equity Curve, Equity Chart and Performance provide charts that monitor your performance and account growth or decline.

In addition to the journal, the program comes with a useful tool called the Trade Size Calculator. This nifty device automatically calculates how many shares of a given stock you can purchase given your money management rules.

One thing missing from the program is a place to record the reason you entered a trade. This may have been cumbersome to add to the program in its current format, but it's a notable omission. Recording numbers is useful to a point, but they ultimately only show the score, so to speak. The reason you're in a trade is important, as is the reason you get out.

Plus, this program is only for stock traders. Futures, options or currency traders will have to look for a more flexible trade journal program, or make one themselves. Hopefully, future versions of the program will allow you to customize it for different trading instruments.

The Trader's Organizer costs \$99. If you're not trading stocks, or if you're a stock trader comfortable with a risk threshold above two percent, don't bother. However, if you use tight stops and make a lot of trades, it makes recording all those positions and monitoring your trade performance much easier. **1**

FIGURE 1 TRADER'S ORGANIZER: ELECTRONIC TRADE JOURNAL

Trader's Organizer is an Excel add-on program that allows you to record trade data and monitor different aspects of your performance.

The Trader's Organizer															Today is: Tuesday, October 14, 2003			
Today's Trades															Trading Functions		Utility Functions	
New Trade Entry			Exit Trade			Partial Trade Exit			Ctrl-Shift-N Enter New Trade			Ctrl-Shift-T Go To Top of Daily Equity Sheet						
JAN FEB MAR APR MAY JUN			JUL AUG SEP OCT NOV DEC			Ctrl-Shift-X eXit Trade			Ctrl-Shift-E Export Organizer Data			Ctrl-Shift-I Import Organizer Data						
Ctrl-Shift-P Partial Trade Exit			Ctrl-Shift-D Delete Trade			Ctrl-Shift-V Display Version (Splash screen)												
August 2003																		
Cash Balance					Account Value					Risk Management								
Beginning Cash Balance \$50,000.00					Beginning Account Value \$50,000.00					Max Risk Per Trade 2.00% (\$1,000.00)								
Equity Gain/Loss \$9,976.00					Equity Gain/Loss \$9,976.00					Max Monthly Loss 6.00% (\$3,000.00)								
Net Monthly Cash Flow \$0.00					Net Monthly Cash Flow \$0.00					Prior Risk \$0.00								
Ending Cash Balance \$59,976.00					Ending Account Value \$59,976.00					Current Month Loss \$0.00								
Current Month Trade Risk \$0.00					Current Month Total Risk \$0.00													
Trade Identification & Status			Trade Entry Data				Trade Updates			Trade Exit Data				Calculate				
Trade No.	Ticker Symbol	Status O/C	Type L/S	Date In	Position Size	Entry Price	Comm. & Fees	Slippage	Stop Price	Current Price	Date Out	Exit Price	Comm. & Fees	Slippage	\$ Risk	Alerts	Equity Gain/Loss	
1	DELL	C	L	06/10/03	500	10.00	12.00	0.00	9.50		08/10/03	30.00	12.00	0.00			9,976.00	
2																		
3																		
4																		
5																		
6																		

Source: Trader's Organizer (www.elder.com)



Technicals meet fundamentals IN THE EARNINGS FLAG

Everyone's seen stocks jump after surprisingly good earnings news, but it often seems as if the move is over before there's a chance to get in the market.

Here, a professional trader explains a chart pattern that can be used to exploit post-earnings price moves.

BY THOMAS N. BULKOWSKI

Some chart patterns work so well you want to keep them quiet so you can profit from them before the rest of the world finds out and takes away the

edge. The earnings flag is a pattern I discovered a few years ago and have traded since. The following analysis is the first study of the pattern's performance.

You might think that because I am disclosing the pattern here, it probably doesn't perform well enough to keep quiet. That may (or may not) be true, but it doesn't mean you should throw the pattern onto the trash heap.

The earnings flag gets its name

because it appears after an earnings announcement and takes the shape of a flag or pennant. Both patterns represent consolidations: A flag forms as a rectangle attached to a staff; a pennant forms as a triangle. In a rising price trend, these flags or pennants usually slope downward, but they may form horizontally or even (rarely) tilt upward. Figure 1 shows two examples: The August pennant has a horizontal appearance and the November pennant has a downward slant.

The August pattern is an almost perfect example of what to look for in an earnings flag. On the day of the earnings announcement, the stock reacted by soaring higher. (On rare occasions, the up move will be delayed by a day — be suspicious if the reaction takes longer.) The rally usually continues in straight-line fashion for a few days and then stops. At this point the stock consolidates and retraces a portion of the gain, typically in the manner shown in Figure 1, before resuming its rise. A buy signal occurs only when price confirms the pattern by closing above its high.

Pattern hallmarks

Favorable earnings flags have several notable characteristics. Table 1 (right) contains identification guidelines for the pattern, based on daily price data.

First, earnings flags that appear within existing uptrends produce the best results. Trying to trade a good earnings report in a falling stock market usually means reduced profits or an outright loss.

When the earnings announcement occurs, be ready for a sharp price rise,

FIGURE 1 EARNINGS FLAG AND PENNANT

Earnings flags are consolidations that can take the form of both rectangular flag formations (which are bounded by parallel trendlines) and triangular pennant patterns (which are bounded by converging trendlines). Here, two pennants appear after surprisingly good earnings announcements. The first is more horizontal; the second slopes down, against the trend.



Source: Proprietary software (Thomas Bulkowski)

but also be aware most earnings announcements are not followed by such enthusiastic moves. The post-announcement rally is usually quick; it generally takes less than a week for price to reach the flag's highest high (which can be part of the staff as well as the subsequent consolidation days). In Figure 1, for example, the August pattern's high occurred nine days after the earnings announcement, while the staff was the high in the November pattern. Although it will eliminate the vast majority of announcements, avoid earnings announcements that do not result in large initial up moves.

Do not trade unconfirmed patterns — that is, those that are not validated by a close above the pattern high. (They may be prime trading candidates, but this study did not incorporate them.) Finally, be careful about trading after an up gap because of the risk the stock will quickly collapse after you buy, filling the gap.

In the earnings flag example in Figure 2, price zips higher for five days (with an up gap between the first two bars) then retraces; the trendlines defining the top and bottom of the down-sloping flag are roughly parallel. Next, the stock resumes its up move, confirming the pattern a day after piercing the flag's upper trendline. After that, price tries to make a new high but stalls out in mid-August before falling to point A. Such retracements after a quick rise should be allowed for. In this case, the retracement closed the gap before price climbed again, ultimately making the July 2003 high above 72 (not shown).

Failed patterns

What do pattern failures look like? Look at the November pattern on the right of Figure 3. Price gapped higher after the earnings announcement and continued rallying for four days. Price then started to correct at the point a flag or pennant would typically appear — except this time it doesn't happen. The correction or consolidation has irregular borders instead of the parallel or converging upper and lower trendlines of a flag or pennant. The stock eventually tumbles below 26. This pattern is not an earnings flag because price never closed above the pattern top.

The July pattern also does not qualify as an earnings flag because of lack of

TABLE 1 IDENTIFICATION CRITERIA FOR THE EARNINGS FLAG PATTERN

Criterion	Requirement
Time frame	Daily
Preceding price action	The best performance comes from patterns found in rising price trends.
Event	Surprising quarterly earnings. (Subsequent price action determines if the results were "surprising" to the market.)
Pattern shape	Price shoots up — sometimes gapping higher — and continues rising, usually for several days (but can be as few as one day). Price then consolidates, usually forming a pennant or flag consolidation before the rally resumes.
Confirmation	Always wait for price to close above the highest high in the pattern, or pierce the flag-pennant trendline boundary, before trading.

FIGURE 2 GAP AND FLAG

This is an example of a typical earnings flag, where two parallel trendlines contain the flag's price action. As consolidation patterns, earnings flags represent a pause in an up move before a potential resumption of the trend. In this case, the post-earnings up move contained an up gap that was eventually filled at point A.



confirmation. Price never closed above the highest high of the flag, but point A invalidated the pattern even sooner by closing below the pattern's low (the day earnings were announced).

The logic behind this rule is simple: Retracements usually conform to a Fibonacci ratio — that is, they retrace 38, 50, or 62 percent of the preceding rally. A correction of 100 percent or more means you're losing money if you don't have a stop in place. In this case, the failure of price in August to rise above the July flag

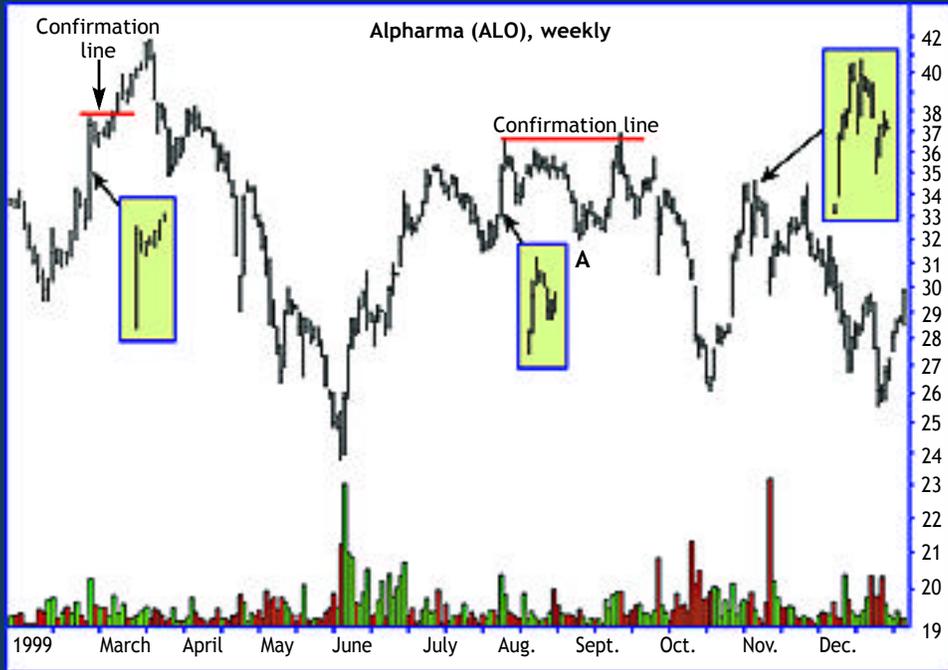
high was a good clue to abandon the trade.

The March pattern in Figure 3 is valid. There was a large trading range the day earnings were announced followed by a bowl-shaped correction. After confirmation, price rose 11 percent before topping out.

Figure 4 emphasizes the need to wait for confirmation and how dangerous gaps can be. Price gapped higher on the earnings announcement, then formed a flag and moved lower. Instead of revers-

FIGURE 3 CONFIRMING THE PATTERN

An earnings flag is confirmed when price closes above the high of the pattern, or above the pattern's upper trendline. However, most patterns that form after earnings surprises don't confirm and should not be traded. On this chart, only the March pattern is a valid earnings flag. The other two failed to close above their respective highs.



Source: Proprietary software (Thomas Bulkowski)

FIGURE 4 THE DANGER OF GAPS

Be especially wary of an up gap the day earnings are announced. Because gaps represent very strong momentum, a stock will often quickly reverse and close all or part of the gap, resulting in a huge loss. Waiting for confirmation and using stops solves this problem.



Source: Proprietary software (Thomas Bulkowski)

ing again to the upside, the stock kept tumbling, eventually reaching a low of 16.25 in October. However, by waiting for confirmation, you would have avoided a loss.

Figure 5 shows an earnings flag that performed well. Traders, perhaps correctly anticipating a good earnings report, pushed the stock higher starting on Oct. 10, almost two weeks before the earnings announcement. (Such rallies before an earnings announcement should make you wary of placing a trade. If everyone thinks good earnings will be announced, how much of a surprise can it be?)

In this case, however, the stock was able to rally even higher. Price climbed after the announcement and formed a flag pattern. Less than two weeks later, price broke out above the top of the flag and soared higher, eventually reaching a high of 46.81 in late November. This is the way an earnings flag is supposed to perform.

These examples have shown what earnings flags look like on a chart. Analyzing performance statistics can improve trading performance by understanding how often the pattern tends to succeed and the size and duration of the typical moves that follow.

Pattern stats

Table 2 shows the statistics gathered on the earnings flag for this study. Seventy-three patterns were identified in 50 stocks beginning in 1995, but the majority appeared in the last three years because of limitations in the database. There were not enough patterns from the bull market to separate and compare performance for bull and bear conditions. Of the 73 patterns, 19 were followed by distinct trend reversals (from down to up), while 54 (74 percent) resulted in continuations of uptrends.

The three failure rates are comparatively high. Fourteen percent of the patterns failed to rally more than five percent (measured from the confirmation or breakout price — the highest high in the pattern — before a 20 percent downturn, measured from high to close); 26 percent of the patterns didn't gain more than 10 percent. However, 25 percent of the patterns

resulted in rallies larger than 45 percent.

From the day the earnings announcement occurred, price reached the pattern high an average of five days later (six days total). The average rise was 19 percent, measured from the close the day before the earnings announcement to the pattern high. It took another 16 days to climb to the breakout level, which gives some indication of typical flag width (less than two weeks, on average).

The average post-pattern gain was 31 percent, with a duration of approximately two months (63 days) from the breakout to the maximum gain. Considering that 44 of the patterns came from a bear market and only 29 from a bull market, this average gain isn't too bad.

These numbers imply you should select only earnings flags in a rising price trend, and wait for confirmation before buying. Watch price closely; if it shows weakness, consider selling (use other tools to determine if a trend change is in the offing). If price drops below the low of the earnings announcement day, exit your position.

Also, watch for small gaps between the earnings announcement and the prior day. Gaps have a tendency to close quickly, and those patterns with gaps do not have better performance

statistics than those without gaps.

The best post-breakout gains emerge from patterns that rally approximately 19 percent from the close the day before the announcement to the pattern high. The 17 patterns in this category had an average post-pattern rally of 47 percent. (However, analysis of a larger number of sample patterns might change these statistics.)

Closing position

The least appealing aspect of the performance statistics was the relatively high failure rates. However, these numbers are probably high because many samples came from a bear market.

That doesn't mean you can buy and hold, though. In turbulent times, even an exceptional earnings report may gap the stock up for only a few days before price tumbles. Trade carefully. When the trend conditions are favorable, trading confirmed patterns and managing positions based on performance statistics can yield good results. 📌

For information on the author see p. 3.

Additional reading

Books by Thomas Bulkowski:
Encyclopedia of Chart Patterns (John Wiley & Sons, 2000)
Trading Classic Chart Patterns (John Wiley & Sons, 2002)

Active Trader articles:

- "A different breed of scallop," January 2004, p. 32
- "The three rising valleys pattern," December 2003, p. 28
- "Pipe bottom reversals," November 2003, p. 28
- "Grabbing the bull by the horns," September 2003, p. 46
- "Head-and-shoulders bottoms: More than meets the eye," August 2003, p. 32
- "The high-low game," July 2003, p. 28
- "Tom Bulkowski's scientific approach," September 2002, p. 32

TABLE 2 PERFORMANCE STATISTICS FOR THE EARNINGS FLAG

Description	Statistic
Number of patterns studied	73
Followed by reversal	19
Followed by continuation	54
5-percent failure rate	14%
10-percent failure rate	26%
15-percent failure rate	36%
Rises over 45 percent	25%
Average gain	31%
Days to ultimate high	63
Reversal performance	23%
Consolidation performance	34%
Days to event high	6
Rise from day before announcement to flag high	19%
Days to breakout from event high	16

FIGURE 5 TEXTBOOK FLAG

This is good example of an earnings flag, but it also occurred more than a week after the market began buying in anticipation of a good earnings announcement. This pattern confirmed and was followed by a profitable move, but overly anticipated earnings can sometimes doom a trade because a rally is already priced into the stock by the time earnings are announced.





S&P tendencies around the MONTHLY EMPLOYMENT REPORT

The employment report is probably the most closely watched monthly economic announcement, and it usually offers traders plenty of volatility. This analysis provides clues about the market's tendencies the day before and after employment report releases.

BY THOM HARTLE

The first Friday of each month typically marks an increase in volatility when, at 8:30 a.m. ET, the U.S. Department of Labor releases its Employment Report. Market players anticipate the report days in advance, and the report is usually the focal point of the week for short-term traders.

The report, which most people simply interpret as a monthly update of the U.S. unemployment rate, consists of two major studies that discuss the outcomes of two distinct surveys. The first is a survey of approximately 60,000 individual households, from which the unemployment rate is estimated. The second survey queries businesses (more than 300,000) rather than individuals. This survey results in statistics such as the "nonfarm payroll" number, the average work week and average hourly earnings.

Although the general public is probably more aware of the unemployment rate, informed traders understand the "nonfarm payroll" number is the more important employment statistic. Nonfarm payroll reflects the number of jobs that have been added or lost to the economy, as reported by the businesses

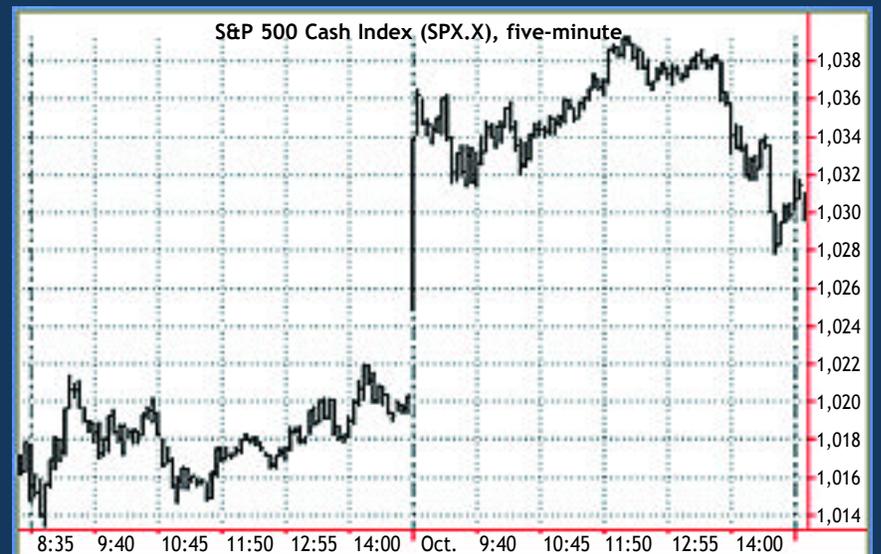
that create or eliminate those jobs, and, as such, is a more accurate barometer of the state of the job market than the unemployment rate.

However, it is not the actual employ-

ment numbers reported by the government that affect the market, but rather the numbers relative to the estimate bantered about by the financial media, economists and gurus prior to the report

FIGURE 1 JUMPING ON THE NUMBER

The employment report released on Oct. 3, 2003, resulted in a strong up move on the open in the S&P 500 cash index.



Source: TradeStation

release. The sharp opening up move in the S&P500 cash index on the day of the Oct. 3, 2003, employment release (see Figure 1) shows the kind of reaction that can accompany these numbers.

Popular perception

One of the most common observations regarding employment number releases is the expectation for the day before a report (Thursday) to be a quiet trading session, as traders supposedly take a wait-and-see attitude to the imminent news.

To find out if there are any tendencies for the market to behave in a particular way from the day before employment releases to the day after them, the following study examines the daily trading ranges of employment Fridays, the preceding Thursdays and the subsequent Mondays (see Figure 2) to quantify the impact of the reports. The study was conducted on continuous S&P 500 E-Mini futures (ES) prices — including the overnight session data — because this market is open when employment numbers are released one hour before the cash market opens. The observation period spanned January 1998 through September 2003 and encompassed 69 employment reports.

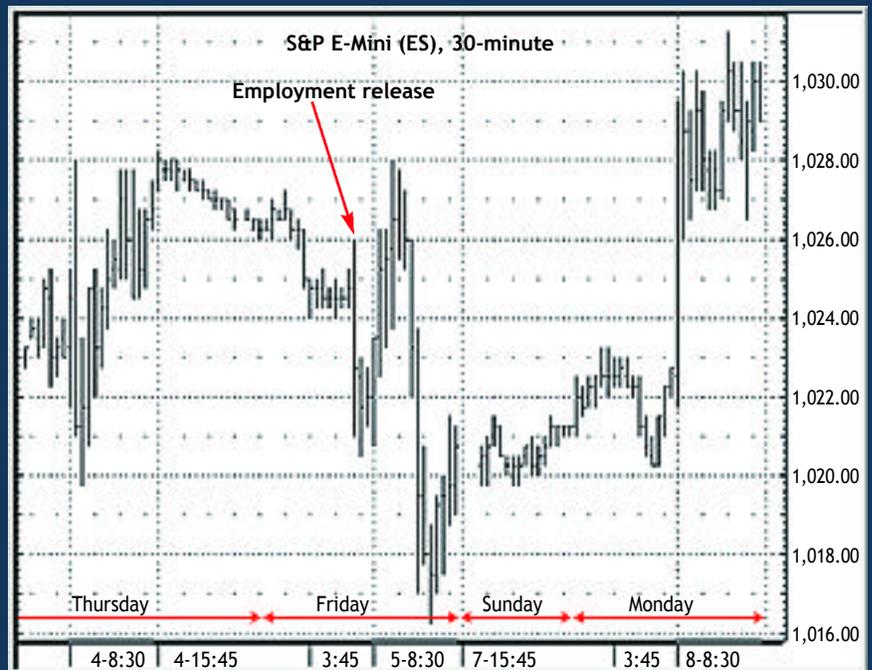
Daily trading ranges

During the analysis period, the average daily S&P E-Mini trading range was 23.21 points. If we start by assuming the employment number causes many short-term traders to sit on the sidelines on Thursday, make plays on Friday, and then possibly exit or reverse on Monday, we would expect to see a difference in the average range if these days are removed from the calculation. However, the adjusted average range was 23.19 points, indicating there are other factors driving the market on a daily basis.

Sorting all the daily ranges for these days into three groups, beginning with the lowest range (5.25 points) up to the highest range (134.25 points), revealed the bottom third had an average range of 13.81 points (5.25 points minimum range to 17 points maximum); the middle third had an average range of 20.79 points (17.25 minimum to 25.25 maximum); and

FIGURE 2 EMPLOYMENT-REPORT PRICE ACTION

The employment report, which comes out the first Friday of every month, can affect the market both before and after it is released — but not always the way people expect. This chart shows the trading in the S&P E-Mini (ES) futures, including the overnight session.



Source: CQG, Inc.

TABLE 1 AVERAGE E-MINI S&P FUTURES DAILY RANGE (JANUARY 1998-SEPTEMBER 2003)

Breaking down into thirds the average daily ranges of all days except Thursdays, Fridays and Mondays around employment releases provides benchmarks for what could be considered high-range, average-range and low-range days in the S&P E-Mini from January 1998 to September 2003.

Day	Average range	Minimum range	Maximum range
All	23.19	5.25	134.25
Bottom	13.81	5.25	17.00
Middle	20.79	17.25	25.25
Top	35.60	25.25	134.25

Source: CQG, Inc.

the top third had an average range of 35.60 points (25.25 minimum to 134.25 maximum). These ranges are summarized in Table 1 (above).

Now let's see how the ranges of employment-related Thursdays, Fridays and Mondays compare to these figures.

Before, during and after

Table 2 compares the average ranges for Thursdays before employment, employment Fridays and the following Mondays. Pre-employment

Thursdays had an average range of 21.44 points (8.25 points minimum and 48.25 points maximum). Because these Thursday figures fall right in the middle group of all trading ranges (as shown in Table 1), it appears anticipating a slow day ahead of an employment number was not supported by the evidence in this observation period.

For Friday release days, the average range jumped to 27.03 points, with a minimum of 7.75 points and a maximum of 77 points. This places the average

TABLE 2 THURSDAY, FRIDAY AND MONDAY RANGES (EMPLOYMENT RELEASES)

Analyzing the average ranges for the Thursdays, Fridays and Mondays connected with monthly employment releases shows Thursday's and Monday's ranges fell within the middle third of daily ranges from Table 1, while Friday's – report release day – fell within the top third of ranges.

Day	Average range	Minimum range	Maximum range
Thursday	21.44	8.25	48.25
Friday	27.03	7.75	77.00
Monday	21.49	8.00	61.00

range for employment Fridays in the top third of all ranges for the review period, and confirms that volatility tends to increase on employment release days.

The Mondays after employment reports had an average range of 21.49 points, with a minimum of eight points and a maximum of 61 points. These figures indicate Monday, like Thursday, was more of a typical day during this period.

A second look

So far, the data doesn't seem particularly illuminating. Scratching beneath the surface, however, provides additional information. Do employment Fridays always have wider trading ranges than their preceding Thursdays? No. Of the 69 employment releases, only 43 (62 percent) of the Fridays had larger ranges than Thursday (see Table 3).

One issue to consider is whether Thursday's range hints at what to expect on Friday. Of the 26 times Friday had a smaller range than Thursday, the average range for Thursday was 25.47 points (14.25 minimum and 48.25 maximum). For Fridays with larger ranges than Thursday, the average range for Thursday was 19.01 points (minimum 8.25 and maximum 33.50). There were

only eight Thursdays with ranges larger than 25 points that were followed by employment Fridays with even larger ranges. This implies the market properly anticipated the employment release on Thursday when the range for that day was up approximately 25 points or more.

The post-employment day tendency was similar. When an employment Friday had a range smaller than Thursday's, the following Monday's range was wider than Friday's 18 of 26 times (69 percent). Of the eight times Monday's range was smaller, the difference between it and Friday's range was between -1.00 and -17.00 points. Of the 18 days Monday's range was larger, the minimum range was 0.25 points and the maximum was 30.25 points.

As mentioned previously, Monday ranges were, on average, smaller than employment Friday ranges. Also, Mondays following Fridays that had ranges wider than Thursdays, had smaller ranges than Fridays 31 of 43 times (72 percent), with the difference between Friday and Monday being between -0.50 points and -52 points.

What the market is saying

This analysis indicates the market both

anticipates and reacts to employment reports through the expansion of the average range on the preceding Thursdays and subsequent Mondays.

The two most interesting points are, first, Thursdays before employment reports are not, contrary to popular belief, necessarily low-volatility days. Second, if Thursday's range is unusually large, there appears to be a high likelihood the market has already factored in, or discounted, the news.

The market's movement on Thursday might force many traders to commit before the number is released on Friday. For example, say the market is advancing on Thursday and a trader is short in anticipation of a negative reaction to Friday's employment report. The market could hit the trader's risk point, forcing an exit. Another trader may have committed to a long position ahead of Friday if the market was making a substantial up move. Come Friday, both these traders have already done their buying, so they do not represent any additional long-side fuel for the market.

Another interesting tendency is the Monday range expansion after Fridays with smaller ranges than Thursday.

Practical application

Although the discrepancy between the actual employment numbers and the estimates should ultimately set the stage for how the market reacts in the short term, the patterns outlined here can be incorporated into many short-term trading strategies.

For example, one practical idea would be to consider setting smaller profit targets for day trades on employment Friday if Thursday's range was more than 25 points, because in these cases Friday is likely to have a smaller range.

If Friday's range is less than Thursday's, expect a more volatile day on Monday than Friday. This could be an incentive to hold on to a profitable position at the close of an employment day in anticipation of renewed momentum on Monday. 

TABLE 3 THE THURSDAY CLUE

When Thursday's range was, on average, 25.47 points or more, employment report Friday had a smaller range. The opposite was true when Thursday's range was 19.01 points or less.

Thursday average range	Thursday minimum range	Thursday maximum range	Friday range
25.47	14.25	48.25	Smaller than Thursday's
19.01	8.25	33.50	Larger than Thursday's

For information on the author see p. 3.



BRANCHING OUT with short funds

The mutual fund industry is increasingly tightening restrictions on frequent trading. Inverse or “short” funds allow you to protect yourself against downside risk – or take advantage of sell-offs – without being subject to fund-trading limitations.

BY DAMIAN CAMPBELL

The turn of the century marked the end of the longest and strongest bull market in U.S. history. Mutual funds reaped the benefits of heightened public interest in the stock market, increasing the number and type of their funds to feed the seemingly endless demand.

However, studies over the past 30 years have shown the majority of mutual funds have not performed any better than the stock indices against which they have been measured.

In the bear market that began in spring 2000, buy-and-hold investors who had previously been rewarded for sitting on their hands or buying on dips were subjected to large, sustained losses in their personal brokerage, IRA and pension accounts. The mutual fund explosion abruptly stopped and fund outflows gained momentum. Many funds closed or consolidated their assets with other funds. As a result, many private investors who felt burned by the market have been in no hurry to get back in.

The buy-and-hold strategy is based on the assumption markets will rise over the long-term. History supports the profitability and advantages of this approach, which include low transaction costs, deferred capital gains and minimal account maintenance. The disadvantage — the loss of capital sustained in down periods — was all too apparent in the recent bear market. A five-year chart of Fidelity’s Magellan Fund (see Figure 1) illustrates the devastation that can occur during extended downturns. The buy-and-hold return for this five-year period was a paltry 1.3 percent.

Over the past year, though, the market staged a turnaround and fund inflows picked up, a phenomenon aided by historically low interest rates that offered no growth or income in safe-haven, interest-bearing accounts.

The challenge now for many gun-shy investors and traders is to find a way to use mutual funds to participate in an uptrend-

ing environment while limiting downside risk during periods of market weakness. Inverse or “short” mutual funds potentially fill the bill.

Mutual fund trading and market timing

Market timing in mutual funds consists of attempting to buy funds at market lows and returning to cash during corrections (mutual funds cannot be sold short). The elusive key to this strategy is reliably identifying market tops and bottoms.

Different technical and quantitative methods are typically used to time the market. For example, a simple 252-day (one-year) moving average crossover system (buying when price crosses above the moving average and selling when it crosses below it) would have protected most of the Magellan Fund’s gains in the 1990s, while getting you reinvested again near the bottom of the bear market. The total gain for the period shown in Figure 1 would have been 51 percent, not counting the inter-

FIGURE 1 ROUGH RIDE

This five-year snapshot of the Fidelity Magellan fund highlights the periodic drawbacks of the buy-and-hold approach.



est received for the 2.5 years the investment was safely out of the fund and in an interest-bearing account. Of course, during another period this system might perform far less effectively.

Frequent-trading penalties

The 252-day moving average crossover system would not have been subject to any regulatory trading constraints because of the low number of signals it would have generated over the five-year period.

A more aggressive frequent-trading strategy, however, could run into one of several fund-trading restrictions. Some mutual funds impose “redemption fees” on investors who hold their positions for short periods of time. For example, a fund might impose a two-percent redemption fee on shares sold within 60 days of purchase. These fees are returned directly to the fund itself (and thus to the fund’s long-term shareholders) to offset the costs resulting from short-term trading. Also, many funds limit the number of round-trip transactions a shareholder may make during a particular time period — for example, four round-trip trades per year.

Most funds allow their shareholders to exchange shares of one fund for shares of another fund in the same fund family. But some funds modify this privilege to deter frequent trading by delaying the exchange or requiring a three-day settlement period between the sale and subsequent purchase.

There is a way around these penalties, though. Instead of selling the mutual fund position during a period of market weakness, you could buy an inverse or short fund in an amount sufficient to offset the risk of decline.

Short funds: Hedging and trading alternative

Short funds usually have a direct inverse relationship to an underlying market index and have no frequent-trading restrictions. Thus, buying one of these funds is equivalent to selling its long-side counterpart, and there are no limits to how often you can trade them. Examples of this type of fund and their parent indices are shown in Table 1.

TABLE 1 SHORT FUNDS

Short funds are designed to have a direct inverse relationship with an underlying (“target”) index or market. Purchasing one of the S&P 500 short funds, for example, would be equivalent to selling the S&P 500 index. The “x2” designation means the fund is leveraged and will have twice the volatility as its target index.

Fund	Target index
SOPIX, USPIX (x2), RYAIX, RYVNX (x2), POTSX	Nasdaq 100
BRPIX, URPIX (x2), RYURX, RYTPX (x2), PPSX	S&P 500
PDOSX	Dow Jones Industrial Average
BEARX, PBRGX, GRZZX	Russell Midcap Growth
SHPIX, POSSX	Russell 2000
CPCRX	Russell 1000
RYJUX 30-year	Treasury Bond

Glossary

Best-fit index is the most appropriate passively managed collection of stocks against which to measure the performance of a given mutual fund. Best fit signifies the index that provides the highest **R-squared** value, which is how closely a fund tracks an index. An R-squared of 100 means that all (100 percent) of a fund’s movements are explained by changes in the index.

Beta reflects a fund’s sensitivity to market movements. The beta of the benchmark index is 1.00. A fund with a beta of 1.15 should rise 15 percent more than the benchmark index in rallies and fall 15 percent more in downturns.

The **Ease of Movement** value determines the rate at which the price of a security is changing by analyzing the amount of volume. The formula is:

$$\text{Ease of Movement Value (EMV)} = \left(\frac{(\text{High} + \text{Low}) / 2}{(\text{Prev High} + \text{Prev Low}) / 2} \right) / \left(\frac{\text{Volume}}{\text{High} - \text{Low}} \right).$$

We’ll illustrate how to use these instruments to hedge a long mutual fund position. The steps required for initiating and managing the trade are:

- Choose the primary (long) fund;
- Choose the appropriate inverse hedging (short) fund;
- Calculate the “hedge coefficient”; and
- Establish the buy-sell signal parameters.

We’ll use an example based on the Russell 2000 index, which is an index of small-cap stocks. First, we’ll select a no-load small-cap fund that has a best-fit index to the Russell 2000, an R-squared of 75 or above, and a beta greater than 0.75. (For a definition of these terms, see “Glossary,” above. These parameters also are available at MorningStar.com under “Risk Measures.”) To achieve the maximum hedging benefit, choose primary funds that outperform the market indices during uptrends. The small-cap funds are usually the most volatile and therefore the best vehicles for this type of trading.

Assume you are long Perritt Capital Growth Fund (PRCGX), which is classified as a “Small Blend” fund. Although it is a no-load fund, it has a two-percent redemption fee designed to discourage frequent trades. The best-fit index of this fund is the Russell 2000 index. Therefore, an appropriate inverse fund for hedging purposes would be SHPIX (refer to Table 1). We will assume we are preparing to initiate this investment on Jan. 1, 2001.

The next step is to find the proper number of short-fund shares to hedge the position’s risk. The goal is to provide optimum protection for the fund during times of general market weakness, while not penalizing the fund’s outperformance over the index when the market is rising. Accordingly, we are interested only in the size of the draw-down — not its standard deviation. The lookback period you use to determine this should encompass at least two complete up-down cycles in the fund.

Balancing act

In this case we will work with a 252-trading-day period (Jan.

TABLE 2 THE SHORT-FUND EFFECT

The trade summary of using an inverse fund as a proxy for selling illustrates the effect of hedging a long-side fund position.

Date	PRCGX Share	PRCGX Investment	Signal	SHPIX Share	Hedge Coeff.	Hedge Trades	Hedge Profit/Loss Per Trade	Hedge Total	PRCGX + Hedge
1/2/01	11.07	10,000.00	Sell	32.52	1.07	10,700.00			10,000.00
1/11/01	12.02	10,858.18	Buy	32.36		10,648.01	-51.99	-51.99	10,806.18
2/20/01	12.96	11,707.32	Sell	32.40		12,526.83		-51.99	11,655.33
4/10/01	12.09	10,921.41	Buy	34.48		13,329.63	802.80	750.81	11,672.22
5/30/01	14.43	13,035.23	Sell	31.05		13,947.70		750.81	13,786.04
6/4/01	14.86	13,423.67	Buy	29.84		13,400.61	-547.09	203.72	13,627.39
6/12/01	14.99	13,541.10	Sell	30.50		14,488.98		203.72	13,744.82
6/13/01	14.98	13,532.07	Buy	31.09		14,768.36	279.38	483.10	14,015.17
6/14/01	14.69	13,270.10	Sell	31.10		14,199.01		483.10	13,753.20
6/29/01	15.16	13,694.67	Buy	30.83		14,072.35	-126.65	356.45	14,051.12
7/3/01	14.93	13,486.90	Sell	31.18		14,430.99		356.45	13,843.35
10/11/01	13.00	11,743.45	Buy	35.25		16,316.30	1885.32	2,241.77	13,985.22
10/30/01	13.73	12,402.89	Sell	35.21		13,271.09		2,241.77	14,644.66
11/1/01	13.93	12,583.56	Buy	34.80		13,117.49	-153.61	2,088.16	14,671.72
1/14/02	15.54	14,037.94	Sell	30.88	0.93	13,055.28		2,088.16	16,126.10
3/1/02	15.40	13,911.47	Buy	30.53		12,908.59	-146.69	1,941.47	15,852.94
4/1/02	17.07	15,420.05	Sell	29.74		14,340.65		1,941.47	17,361.52
4/10/02	17.38	15,700.09	Buy	29.52		14,238.77	-101.88	1,839.59	17,539.68
4/25/02	17.58	15,880.76	Sell	29.61		14,769.11		1,839.59	17,720.35
4/30/02	17.62	15,916.89	Buy	29.06		14,493.36	-275.74	1,563.85	17,480.74
5/6/02	17.60	15,898.83	Sell	29.74		14,785.91		1,563.85	17,462.68
5/9/02	17.46	15,772.36	Buy	30.08		14,957.99	172.09	1,735.93	17,508.29
5/10/02	17.46	15,772.36	Sell	29.66		14,668.29		1,735.93	17,508.29
5/14/02	17.53	15,835.59	Buy	28.84		14,265.14	-403.15	1,332.78	17,168.38
5/20/02	17.25	15,582.66	Sell	29.88		14,491.87		1,332.78	16,915.44
8/19/02	14.15	12,782.29	Buy	36.42		17,661.87	3170.00	4,502.78	17,285.08
8/26/02	14.28	12,899.73	Sell	36.37		11,996.75		4,502.78	17,402.51
10/16/02	13.76	12,429.99	Buy	39.24		12,940.84	944.10	5,446.88	17,876.87
11/11/02	14.30	12,917.80	Sell	37.81		12,013.55		5,446.88	18,364.67
11/14/02	14.47	13,071.36	Buy	36.68		11,655.33	-358.22	5,088.65	18,160.02
12/9/02	15.06	13,604.34	Sell	35.82		12,652.03		5,088.65	18,692.99
1/3/03	15.30	13,821.14	Buy	35.42	0.50	12,509.03	-143.01	4,945.65	18,766.79
1/17/03	15.15	13,685.64	Sell	36.66		6,842.82		4,945.65	18,631.29
3/14/03	14.30	12,917.80	Buy	38.22		7,134.89	292.07	5,237.72	18,155.51
3/31/03	14.91	13,468.83	Sell	37.83		6,734.42		5,237.72	18,706.55
4/02/03	15.06	13,604.34	Buy	37.15		6,614.34	-120.07	5,117.64	18,721.98
5/20/03	16.31	14,733.51	Sell	33.83		7,366.76		5,117.64	19,851.16
5/22/03	16.53	14,932.25	Buy	33.21		7,230.44	-136.32	4,981.33	19,913.58
6/23/03	17.93	16,196.93	Sell	31.41		8,098.46		4,981.33	21,178.25
6/27/03	18.19	16,431.80	Buy	30.87		7,961.27	-137.20	4,844.13	21,275.93
7/1/03	18.39	16,612.47	Sell	30.15		8,306.23		4,844.13	21,456.60
7/2/03	18.38	16,603.43	Buy	30.32		8,352.21	45.98	4,890.10	21,493.54
7/17/03	18.85	17,028.00	Sell	29.70		8,514.00		4,890.10	21,918.11
7/24/03	19.19	17,335.14	Buy	29.42		8,434.34	-79.67	4,810.44	22,145.58
8/4/03	19.17	17,317.07	Sell	30.14		8,658.54		4,810.44	22,127.51
8/12/03	19.50	17,615.18	Buy	29.48		8,468.89	-189.65	4,620.79	22,235.97
9/25/03	20.72	18,717.25	Sell	28.25		9,358.63		4,620.79	23,338.04
10/06/03	21.75	19,647.70	Buy	26.29		8,707.91	-650.72	3,970.07	23,617.77
10/22/03	22.37	20,207.77	Sell	26.77		10,103.89		3,970.07	24,177.84
10/28/03	22.76	20,560.07	Buy	25.68		9,689.93	-413.95	3,556.12	24,116.19

1, 2000, to Dec. 31, 2000). The maximum drawdown percent (MDD%) is the maximum percentage you would have lost during the period if you bought at the high and sold at the subsequent low. In this case, the maximum drawdown percent for the primary fund, PRCGX, was -33.0 percent. An opposite parameter called maximum upside percent (MUS%) for the SHPIX short fund must then be calculated.

The MUS% is the maximum percentage you would have gained during the period by buying at the low and selling at the subsequent high. Changes in the inverse hedge fund are presumed to occur at the same time as, but in an opposite direction of, the MDD% of the primary fund. For SHPIX, in this time period, the MUS% was 30.9 percent.

Next, the hedge coefficient is calculated by dividing the MDD% by the negative MDD% for SHPIX (-33.0 percent / -30.9 percent = 1.07). As a result, whenever a hedge is required, the amount invested in the primary fund, PRCGX, will be multiplied by the hedge coefficient (1.07) to determine the dollar amount of SHPIX to buy. In this case, you would buy \$1.07 of SHPIX for every \$1 of PRCGX.

It is appropriate to recalculate the hedge coefficient at regular intervals because of changing market conditions and possible fund management or strategy adjustments. In this case, the coefficient was recalculated at the beginning of each year, but it could also be recalculated at the time of each new sell signal. (It should also be noted that because SHPIX was nonexistent during the early years of this illustration, its share price was extrapolated backwards by applying an inverse ratio from the Russell 2000 index. Short funds are relatively new — no short funds for the Russell 2000 were around then.)

Illustrating the approach

To illustrate how buying a short fund can substitute for selling the primary fund, we'll show the results of a simple timing system based on the Ease of Movement (EMV) indicator (see "Glossary"). The indicator and its system is not the focus of the study, and as seen in Figure 2, this system is not highly opti-

mized; it produces a fair number of whipsaw trades, particularly at market peaks.

A buy signal occurs when the EMV is positive; a sell signal when the EMV is negative. Table 2 shows the results of this system — buying SHPIX hedge (on margin) whenever a sell signal is generated — from 2001 through 2003. (Brokerage and margin fees are not included in this analysis.) All trades are placed the day after the buy/sell signal is generated.

Figure 3 is a percent-change chart that compares the performance of the Russell 2000 (9-percent gain), buying and holding PRCGX (106-percent gain with a maximum drawdown of -27 percent), and buy-and-hold of equal amounts of PRCGX and SHPIX (33-percent gain with a minimal drawdown).

However, the best performance (158 percent gain with a maximum drawdown of -5.1 percent) is achieved through buying and holding PRCGX coupled with timed SHPIX hedges. Rather than focus on the final percentage gain, note the differences between the timed and non-timed PRCGX investment at September 2001 (+36 percent) and October 2002 (+63 percent). Overall, drawdown (risk) is greatly minimized and the bulk of the gains are preserved.

Added flexibility

The past five years have been a rollercoaster ride for the average mutual fund investor, encompassing the end of a strong bull market, three years of a severe bear market and, finally, one year of recovery.

Currently, investors are understandably hesitant to commit themselves entirely to the market's vagaries, but they also find themselves forced from the cash sidelines because of historically low interest rates. This ambivalence could be removed by having a market-timing strategy that would allow bull-market profits to accumulate and decrease drawdown risk during periods of market weakness. Unfortunately, many funds have various constraints on frequent trading that include redemption fees and short-term-trading penalties.

Instead of trading completely in and out of mutual funds with a timing system, traders can buy higher volatility small-cap funds and apply inverse-index mutual fund hedges at appropriate times. These hedges are calculated to neutralize the drawdown risk while capturing the superior appreciation inherent in the higher volatility of these funds. 🌀

For information on the author see p. 3.

Late trading

Mutual funds have been in the news recently because of alleged fraud on the part of fund managers, most notably because of a practice known as late trading.

A complaint filed by State's Attorney General Eliot Spitzer with the Supreme Court of New York alleges Canary Capital Partners, a New Jersey hedge fund, was allowed to place trades well after the market close. To use Spitzer's analogy, this amounted to "betting today on yesterday's horse races." For more information on the mutual fund allegations, see "Mutual fund probe continues" on p. 18.

FIGURE 2 TIMING IN THE MARKET

A simple strategy based on the Ease of Movement oscillator was used to trigger trades.

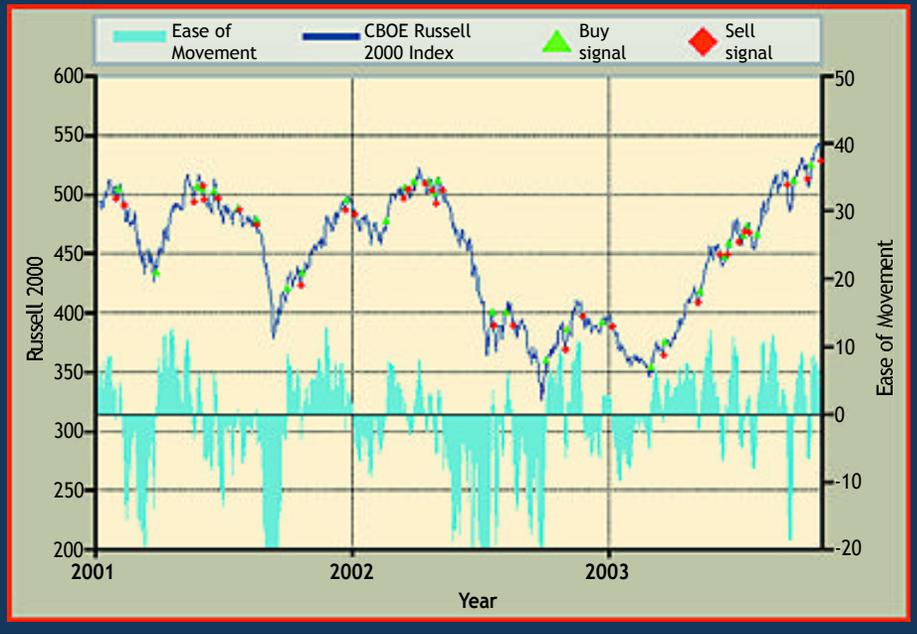
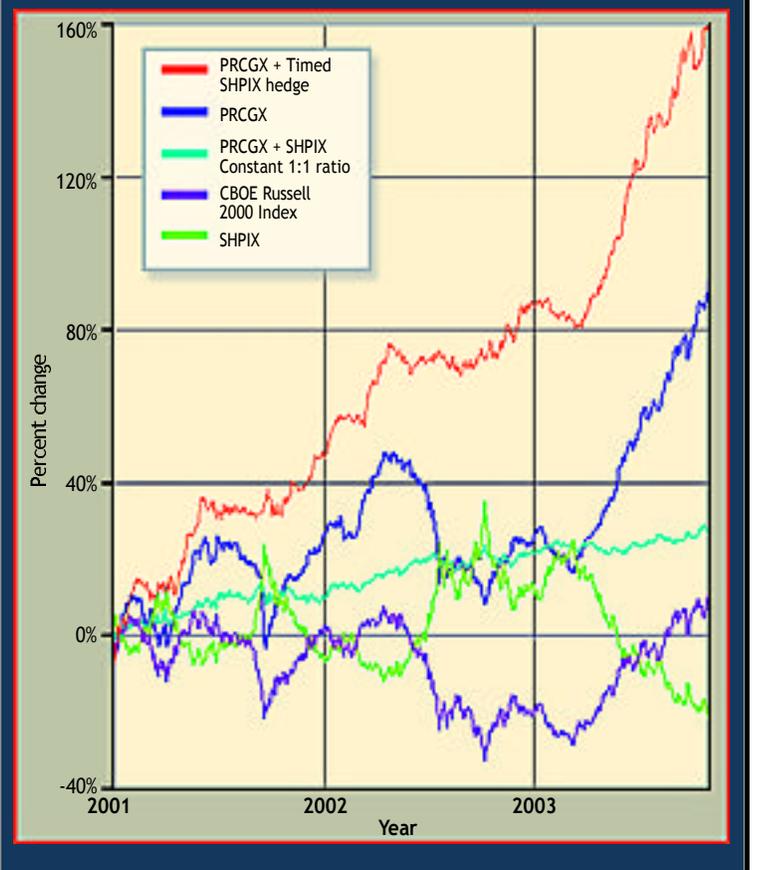


FIGURE 3 PERFORMANCE COMPARISON

The short-fund hedging technique outperformed both the fund and the target index.



ETF Snapshot

Date: Dec. 5, 2003

The following table summarizes the trading activity in the most actively traded ETF contracts. The indicator readings are NOT trade signals. They are intended only to provide a brief synopsis of each market's liquidity, direction, and levels of momentum and volatility. See the legend (right) for explanations of the different fields.

Instrument	Sym	Sector/Market	Type	Vol	STT	ITT	LTT	Trend%	Vltly%	OB/OS
Nasdaq 100	QQQ	Index	Trust	81.5M	▼	▲	▲	0.26	0.53	N
S&P 500 Index	SPY	Index	Trust	34.2M	▲	▲	▲	0.74	0.19	N
Semiconductor	SMH	Technology	HOLDR	11.0M	—	▲	▲	0.41	0.76	N
Japan Index	EWJ	International	iSHARE	6.9M	—	▲	▲	0.02	0.07	N
Dow Jones	DIA	Index	Trust	5.0M	▲	▲	▲	0.47	0.27	N
Russell 2000 Index	IWM	Index	iSHARE	3.4M	▲	▲	▲	0.61	0.22	N
Financial Sector	XLF	Financial	SPDR	1.9M	—	▲	▲	0.54	0.02	N
Oil Services	OIH	Energy	HOLDR	1.4M	—	—	▲	0.10	1.00	OB
Biotech	BBH	Biotech	HOLDR	1.1M	—	▼	▲	0.00	0.12	N
S&P Midcap 400	MDY	Index	Trust	1.1M	▲	▲	▲	0.81	0.75	N
Retail	RTH	Retail	HOLDR	789.1	▼	—	▲	0.19	0.98	OS
Russell 2000 Growth Index	IWO	Index	iSHARE	716.8	—	▲	▲	0.54	0.22	N
Materials Sector	XLB	Materials	SPDR	541.8	▲	▲	▲	1.00	0.73	N
* EAFE	EFA	International	iSHARE	522.4	▲	▲	▲	0.78	0.19	N
Nasdaq Biotechnology Index	IBB	Biotech	iSHARE	511.6	—	—	▲	0.08	0.10	N
Brazil Index	EWZ	International	iSHARE	463.0	▲	▲	▲	0.71	0.15	OB
Russell 1000 Growth Index	IWF	Index	iSHARE	444.7	▲	▲	▲	0.56	0.58	N
Software	SWH	Technology	HOLDR	432.6	—	▲	▲	0.20	0.10	N
Technology Sector	XLK	Technology	SPDR	362.3	▲	▲	▲	0.34	0.31	N
Russell 1000 Value Index	IWD	Index	iSHARE	360.0	▲	▲	▲	0.89	0.31	N
S&P 500 Index	IVV	Index	iSHARE	352.7	▲	▲	▲	0.78	0.12	N
Energy Sector	XLE	Energy	SPDR	285.5	▲	▲	▲	0.58	0.93	OB
Russell 2000 Value Index	IWN	Index	iSHARE	230.2	▲	▲	▲	0.76	0.12	N
Broadband	BDH	Broadband	HOLDR	223.8	—	▲	▲	0.17	0.19	N
Russell 3000 Index	IWV	Index	iSHARE	194.3	▲	▲	▲	0.73	0.39	N
Consumer Discretionary Sector	XLY	Consumer Discretionary	SPDR	182.9	—	▲	▲	0.69	0.73	N
Canada Index	EWC	International	iSHARE	168.4	▲	▲	▲	0.78	0.54	OB
S&P SmallCap 600 Index	IJR	Index	iSHARE	166.8	▲	▲	▲	0.78	0.42	N
** TeleBras	TBH	Telecom	HOLDR	128.7	—	▲	▲	0.41	0.03	OB
United Kingdom	EWU	International	iSHARE	115.0	▲	▲	▲	0.85	0.59	N
Total Stock Market Vipers	VTI	Index	Viper	108.2	▲	▲	▲	0.68	0.41	N

* Europe, Australasia and the Far East ** Brazilian telecom

This information is for educational purposes only. Active Trader provides this data in good faith, but cannot guarantee its accuracy or timeliness. Active Trader assumes no responsibility for the use of this information. Active Trader does not recommend buying or selling any market, nor does it solicit orders to buy or sell any market. There is a high level of risk in trading, especially for traders who use leverage. The reader assumes all responsibility for his or her actions in the market.

Legend:

Sym: Ticker symbol.

Vol: 30-day average daily volume, in thousands (unless otherwise indicated).

STT: Short-term trend direction. Trend is up/down if a short-term moving average (MA) is above/below the value of the moving average one month ago and price is above/below the current MA. If both conditions are not met, there is no trend.

ITT: Intermediate-term trend direction. Trend is up/down if an intermediate-term MA is above/below the value of the moving average three months ago and price is above/below the current MA. If both conditions are not met, there is no trend.

LTT: Long-term trend direction. Trend is up/down if a long-term MA is above/below the value of the moving average nine months ago and price is above/below the current MA. If both conditions are not met, there is no trend.

Trend%: The percentile rank of the current trend strength reading compared to those of the past three months. (In other words, a reading of .09, or 9%, means only 9 percent of the readings over this period were lower than the current reading.)

Vltly%: The percentile rank of the current volatility reading compared to those of the past three months. (In other words, a reading of .75, or 75%, means 75 percent of the readings over this period were lower than the current reading.)

OB/OS: Whether a 10-day momentum indicator registers the market as overbought (OB), oversold (OS) or neutral (N). Note: Overbought and oversold signals are NOT trade signals. They are warnings that upside momentum is high or low (compared to the market's recent activity) AND MAY REMAIN SO FOR AN UNDETERMINED AMOUNT OF TIME.



Glitch Index

Markets: Stocks.

System concept: This system was inspired by the more successful stock systems that have appeared in the Trading System Lab. These strategies share a common timing technique — they attempt to take advantage of minor extreme price movements.

This system detects when price has deviated significantly from its norm by measuring how far it moves above and below a “detrended” simple moving average (SMA). The resulting indicator is called the “Glitch Index,” which represents the percentage move price has made above or below the detrended SMA. The theory is price will move back to its norm, and we can profit by taking advantage of the temporary deviation. The formula for calculating the Glitch Index is:

$$\text{Glitch Index} = (\text{Diff}/\text{Closing Price}) * 100$$

where,

SMA = 30-period simple moving average

Diff = Closing Price – SMAMult

RocSMA = Rate of Change(SMA) * 0.1 + 1

SMAMult = SMA * RocSMA

The system buys when the Glitch Index goes below -2 and sells when it swings back up above +2. However, the system will not enter a long trade if the highest Glitch Index value within a 30-bar period is greater than 5. This prevents the system from entering when prices snap back from an extremely overbought level, such as a blow-off at the top of a strong bull rally.

The color of the Glitch Index (GI) indicator bars (Figure 1) helps illustrate what the system is doing. Light green bars indicate a GI greater than 5, which means long trades are forbidden for the next 30 bars even if an entry signal occurs. Dark green bars indicate a GI of greater than 2 (the sell zone). Red bars indicate areas that are within the “no sell” zone (GI < -5), while dark red bars indicate the buy zone (i.e., GI < -2). The system does not sell short.

Rules:

Entry

1. The Glitch Index must be less than -2.
2. The highest Glitch Index reading within the last 30 bars must be less than +5.
3. If these two conditions are met, buy the next bar at the market.

Exit

1. If the Glitch Index is greater than +2, exit next bar at the market.

Money management: Each trade was sized to equal 6 percent of the current account equity.

FIGURE 1 SAMPLE TRADES

The system goes long on a Glitch Index reading of less than -2, as long as a reading above +5 (dark green bars) has not occurred in the past 30 days.

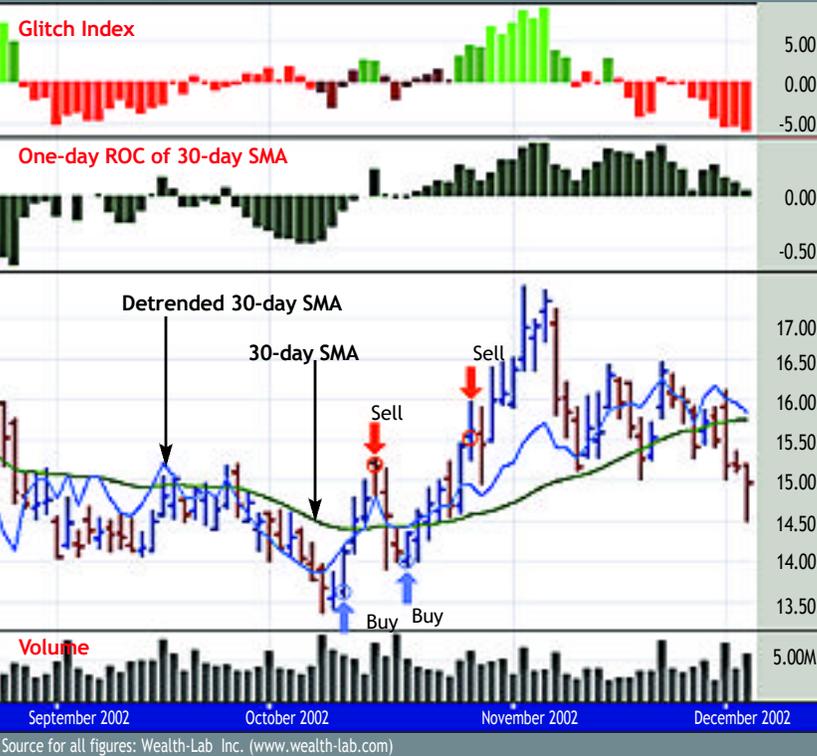
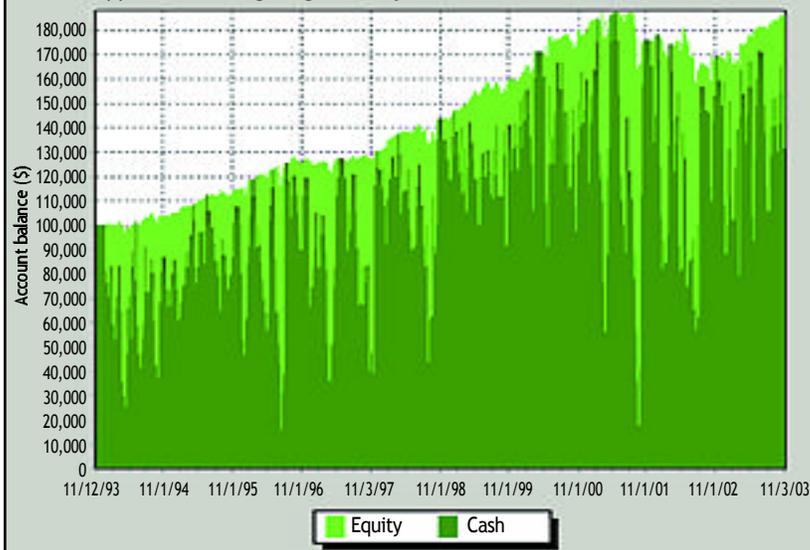


FIGURE 2 EQUITY CURVE

The last two years have been difficult, but the system managed to approach new highs again this year.



Starting equity: \$100,000 starting capital. Deduct 1 cent per share commission per trade (round turn).

Test data: The system was tested on the Active Trader Standard Stock Portfolio, which contains the following 18 stocks: Apple Computer (AAPL), Boeing (BA), Citigroup (C), Caterpillar (CAT), Cisco (CSCO), Walt Disney (DIS), General Motors (GM), Hewlett-

Packard (HPQ), International Business Machines (IBM), Intel (INTC), International Paper (IP), JP Morgan Chase (JPM), Coke (KO), Microsoft (MSFT), Sears (S), Starbucks (SBUX) AT&T (T), Wal-Mart (WMT).

Test period: November 1993 through November 2003.

System results: The equity curve in Figure 2 results shows the system returned 86.98 percent in 10 years, and was in the market only about 25 percent of the time. The annualized return of 6.41 percent is acceptable, and many funds would be happy with this performance. The low exposure of the system indicates there is still room to increase the position size and squeeze out more performance.

The system, which is long-only, had a better than 70-percent winning percentage on nearly 600 trades. Maximum drawdown in this period was only -19.28 percent, while buy and hold experienced a devastating -66.30-percent maximum drawdown.

Monte Carlo simulation: Before trading a system, you should understand its inherent risk. One method to gauge this is a Monte Carlo simulation, which uses a set of historical trading system results, such as an equity curve or a list of trades. A number of randomized simulation "runs" (at least 1,000) is generated. Each run randomizes either the equity curve data or the underlying trades to create a new equity curve and performance result set. This new result represents a potential outcome of the system based on the historical trading dynamics and has its own unique net profit and drawdown.

A Monte Carlo analysis can answer questions such as:

- What is the largest loss I can expect from the system within a one-year period?
- What is the system's expected average monthly profit and drawdown?
- What is the chance the system will generate a loss over a specific time frame?

STRATEGY SUMMARY

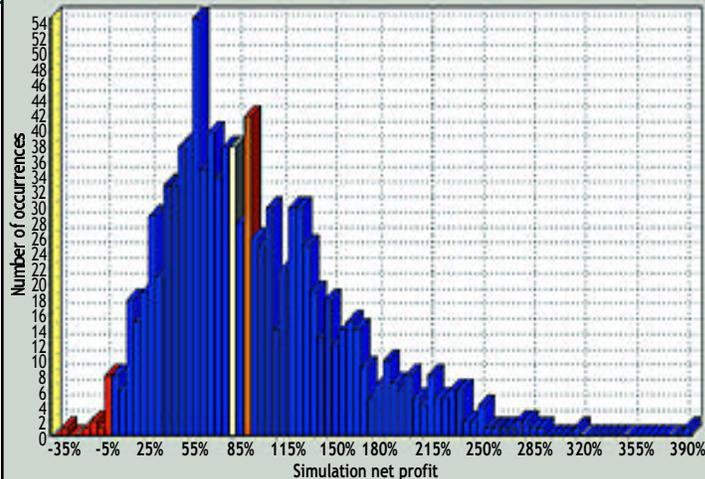
Profitability		Trade statistics	
Net profit (\$):	85,985.00	No. trades:	592
Net profit (%):	85.98	Win/loss (%):	70.78
Exposure (%):	23.59	Avg. gain/loss (%):	1.84
Profit factor:	1.65	Avg. hold time:	17.54
Payoff ratio:	0.73	Avg. profit (winners) (%):	5.98
Recovery factor:	2.37	Avg. hold time (winners):	12.89
Drawdown:	-\$36,306	Avg. loss (losers) (%):	-8.19
Max. DD (%):	-19.28	Avg. hold time (losers):	28.80
Longest flat days:	565	Max. consec. win/loss:	37/8

LEGEND: Net profit — Profit at end of test period, less commission • Exposure — The area of the equity curve exposed to long or short positions, as opposed to cash • Profit factor — Gross profit divided by gross loss • Payoff ratio — Average profit of winning trades divided by average loss of losing trades • Recovery factor — Net profit divided by max. drawdown • Max. DD (%) — Largest percentage decline in equity • Longest flat days — Longest period, in days, the system is between two equity highs • No. trades — Number of trades generated by the system • Win/Loss (%) — the percentage of trades that were profitable • Avg. profit — The average profit for all trades • Avg. hold time — The average holding period for all trades • Avg. profit (winners) — The average profit for winning trades • Avg. hold time (winners) — The average holding time for winning trades • Avg. loss (losers) — The average loss for losing trades • Avg. hold time (losers) — The average holding time for losing trades • Max. consec. win/loss — The maximum number of consecutive winning and losing trades

Disclaimer: The Trading System Lab is intended for educational purposes only to provide a perspective on different market concepts. It is not meant to recommend or promote any trading system or approach. Traders are advised to do their own research and testing to determine the validity of a trading idea. Past performance does not guarantee future results; historical testing may not reflect a system's behavior in real-time trading.

FIGURE 3 MONTE CARLO SIMULATION

The distribution of the net profits of 1,000 Monte Carlo simulation runs shows the average value is 94.91 percent (orange bar), the median value is 83.06 percent (gray bar).



- What is my chance of realizing a 20-percent profit using a position size of 5 percent of equity as opposed to a fixed position size of \$5,000 per trade?

There are several ways to run a Monte Carlo analysis. In this case, we used an "equity curve scramble" method, which populates a new equity curve one bar at a time. For each bar, a random bar of the original equity curve is selected, and the bar-to-bar percentage return is applied to the randomized equity curve.

This method can effectively capture the dynamics of the historical testing period, including price shock events, because the effects of multiple positions reacting to events is captured in the original equity curve and translated to the randomized equity curves.

Figure 3 shows a distribution of net profit from all of the Monte Carlo simulations. The distribution is compiled over the entire historical testing period. More than 98 percent of the Monte Carlo runs resulted in a net profit. This analysis supports the idea that the Glitch Index is a robust system that performs well over time.

Bottom line: The Glitch Index system is conservative and achieves good results considering the low exposure and low drawdown. The system was created in May 2001. It has seen some rough times since then, but has recently approached new highs.

— Dion Kurczek of Wealth-Lab Inc.

PERIODIC RETURNS

	Avg. return	Sharpe ratio	Best return	Worst return	Percentage profitable periods	Max. consec. profitable	Max. consec. unprofitable
Weekly	0.13%	0.78	5.96%	-11.19%	51.92%	8	9
Monthly	0.53%	0.91	5.62%	-8.96%	68.60%	9	2
Quarterly	1.58%	0.97	6.90%	-10.81%	73.17%	10	3
Annually	6.57%	1.07	12.26%	-6.14%	80.00%	7	2

LEGEND: Avg. return — The average percentage for the period • Sharpe ratio — Average return divided by standard deviation of returns (annualized) • Best return — Best return for the period • Worst return — Worst return for the period • Percentage profitable periods — The percentage of periods that were profitable • Max. consec. profitable — The largest number of consecutive profitable periods • Max. consec. unprofitable — The largest number of consecutive unprofitable periods

Trading System Lab strategies are tested on a portfolio basis (unless otherwise noted) using Wealth-Lab Inc.'s testing platform. If you have a system you'd like to see tested, please send the trading and money-management rules to editorial@activetradermag.com.

BY VICTOR NIEDERHOFFER AND LAUREL KENNER



*Where's the edge in the market?
Holding onto your shirt while others are throwing in
the towel.*

Q: You two advocate the buy-and-hold philosophy, yet you often say the best way to make money in the market is to wait for a decline, buy to the extent of your bank balance, wait a week and sell out. How do you reconcile these two conflicting pieces of advice?

Laurel: The conflict is more apparent than real. We'll start with why both strategies are good, and then take up the question of how to best combine them.

Many investors gave up on buy-and-hold during the 2000-2003 market crash, and we'll no doubt take some shots for saying it still makes sense. As with all of our other trades, we base our opinion on empirical results — or, as we like to say, on counting.

The one investment book we recommend to all traders and investors, *Triumph of the Optimists*, by Elroy Dimson, Paul Marsh and Mike Staunton (2002, Princeton University Press), shows every major stock market in the world returned some 1.5 million percent during the 20th century. No other class of investments came anywhere near those results.

No comparable survey of global markets had ever been done; therefore, every trader and investor must take *Triumph* into account when formulating a basic approach to the market.

When we cite *Triumph's* results, people typically object that it makes no sense to look at market results over a century. Our response is that you may not be around in a century, but your children and grandchildren will. Furthermore, if the market's basic drift is a 1.5-million-percent upward direction, you need to factor in that powerful force in your own trading. That's why all shorts die broke.

People also argue the circumstances of the 20th century were exceptionally favorable to the market. Yet the 20th century suffered through two world wars, inflation, depression, central planning that stifled the economies of much of the world, and countless disruptions to trade. We see no reason why the market should not overcome the inevitable adversities of the pres-

The market moves between booms and busts, and the public is always leaning the wrong way during these times.

ent century and deliver similarly stellar results for buy-and-hold in the next 100 years.

Can you improve on buy-and-hold? Sure you can. My collaborator beats the market with great consistency when he stays out of Southeast Asia, and I'll turn the podium over to him.

Vic: In my first book, *The Education of a Speculator*, I had a table showing what happens in the market after declines. The data covered the years 1987-1996. I have since updated the study, and extended it through 2003. Tables 1 and 2 (below) show the results.

Results from 1987 show after a decline of 7.5 points in the S&P 500 index, the average move in the S&P the next day was +1.4 points. In the subsequent seven years, from 1997 through 2003, the average move the next day was 2 points. As the typical move after any day is only 0.1 point, a trader who judiciously waits for opportunities to collect an extra point or two can substantially outperform the index.

Both results are highly significant from a statistical standpoint, with a probability of chance occurrence of less than 1 in 10,000 in each case. In both periods, 55 percent of the observations were up.

I performed the same study with Dow Jones Industrial Average data for the 70 years before 1987, with similar results.

Laurel: We can't resist quoting one of our favorite passages in

TABLE 1 S&P MOVES ON DAY AFTER DECLINES (1987-1996)

	Move in S&P next day		
	Average points	% up	Number of occasions
After decline of 7.5 points	1.39	55%	31
After rise of 7.5 points	0.88	60%	30
After any day	0.12	52%	2,154

Source: Niederhoffer, *Education of a Speculator*

TABLE 2 S&P MOVES ON DAY AFTER DECLINES (1997-2003)

	Move in S&P next day		
	Average points	% up	Number of occasions
After decline of 7.5 points	2.00	54%	499
After rise of 7.5 points	0.09	49%	511
After any day	0.10	51%	1,980

Source: Niederhoffer Investments

market literature. It is from an 1887 book by Henry Clews, *Twenty-Eight Years in Wall Street*:

But few gain sufficient experience in Wall Street to command success until they reach that period of life in which they have one foot in the grave. When this time comes, these old veterans of the Street usually spend long intervals of repose at their comfortable homes, and in times of panic, which recur sometimes oftener than once a year, these old fellows will be seen in Wall Street, hobbling down on their canes to their brokers' offices.

Then they always buy good stocks to the extent of their bank balances, which they have been permitted to accumulate for just such an emergency. The panic usually rages until enough of these cash purchases of stock is made to afford a big "rake in." When the panic has spent its force, these old fellows, who have been resting judiciously on their oars in expectation of the inevitable event, which usually returns with the regularity of the seasons, quickly realize, deposit their profits with their bankers, or the overplus thereof, after purchasing more real estate that is on the up grade, for permanent investment, and retire for another season to the quietude of their splendid homes and the bosoms of their happy families.

Vic: The reason this kind of method holds up is the market moves between booms and busts. The public is always leaning the wrong way during these times. This helps oil the vast machinery of Wall Street: the brokers, the analysts, the market makers, the managing directors, the data vendors, the skyscraper architects, the electricians.

How to reconcile this with buy-and-hold? Everybody should keep a reserve for opportunistic investments — or, if you have no reserves, to increase the leverage of your investments at various times. The big declines provide opportunities to "expand the overplus" of your bank deposits.

However, I would disagree with Henry Clews in one respect: Rather than putting the overplus into real estate, I'd recommend putting it into a good equity index fund.

Laurel: If you can make just 3 or 4 percentage points a year above and beyond the usual buy-and-hold by buying in panics, that amounts to a tremendous increase over time. 📈

Have a question about trading? Trader Victor Niederhoffer and financial writer Laurel Kenner, co-authors of Practical Speculation (John Wiley & Sons, 2003), provide practical and hard-hitting answers. Send questions to gbuch@bloomberg.net.

For more information on the authors see p. 3.

Is there a match in the cards?

What's ahead for the Chicago exchanges?

BY DAVID OBUCHOWSKI

Remember when the Chicago Board of Trade and the Chicago Mercantile Exchange were enemies? It seems so distant. Now, the two futures exchanges are partners in a common clearing link, and they are also partners ... in court.

The two exchanges are fighting a lawsuit by Eurex stating they are in violation of the Sherman Act. In short, that means *both* exchanges are being accused of being an illegal monopoly — an apparent contradiction. Nonetheless, they are fighting the charges together and have partnered in Washington to convince Congress it should prevent the impending arrival of Eurex's U.S. exchange.

Beyond the current common efforts, the CBOT is in another struggle of its own — demutualization (i.e., switching from a membership-based ownership structure to a shareholder-based ownership structure. For more information, see "Financial exchanges embrace demutualization," p. 5).

The CBOT has been trying to convert to "for-profit" status, but the minority members (i.e., all exchange members who do not have full seats) don't like the plan. That's not surprising, considering minority members, which comprise four of the five classes of memberships at the CBOT and account for 75 percent of the CBOT's trading activity, would receive only eight percent of the profit (according to the original plan).

The minority members sought a court injunction to prevent a vote on demutualization, and they got it. The case is currently pending.

However, it's almost as if the minority membership's injunction against the for-profit move is on the back burner.

At the forefront for the CBOT, of course, is keeping the Eurex out (for as long as possible) and fighting off an anti-trust suit — basically, the CME's agenda.

This draws into question the idea the CBOT is positioning itself to be taken over by the CME.

No one will go on record about the possibility, and attempts to reach the CBOT for comment were unsuccessful.

However, the scenario screams for recognition. If — or more accurately, when — the demutualization of the CBOT occurs, sources close to the situation say that will be one of the first steps leading to the acquisition of the CBOT by the CME.

The CME has already successfully demutualized, launched an IPO and has the highest futures trading volume of any exchange in the United States. However, it — and the CBOT — is threatened by the Eurex, the No. 1 volume futures exchange in the world.

With its electronic (i.e., no trading floor), ECN-like way of hosting trades, the Eurex is poised to steal business away from the Chicago exchanges because of its lower costs. And while the CME and CBOT continue to protest the Eurex's arrival, it's clear they both see Eurex as an imminent threat — one that could be here as soon as February.

The two exchanges that have long dominated the U.S. futures industry are now faced with new competition that could potentially relegate them to second or third place. Of course, if the two exchanges merged, that would change everything.

And let's not forget the disagreement within the CBOT membership. The two



sides can't seem to agree on whether to go for-profit and abandon the membership system. And, even if they did agree on that, they still can't seem to decide on the distribution of profits.

The CBOT was once an exchange that some thought might go public. Now, with all the infighting and the threat from Eurex, that doesn't seem like such a concern.

The CME, though, *is* already traded publicly. It has all those issues ironed out. It does more volume than the CBOT, and it already clears trades for the CBOT.

Wouldn't it make sense, then, that the CME would be seeing the CBOT as less of an enemy and more of an opportunity? Likewise for the CBOT?

"That's what's kind of happening behind the scene," says a source with close ties to both the CME and CBOT.

How long the scenario remains behind the scene remains to be seen. ☹

CME, CBOT still fighting

Eurex moves closer to launch

BY JEFF PONCZAK

While the Chicago exchanges testified before Congress in early November in an attempt to block Eurex's U.S. Futures Exchange, Eurex moved closer to its goal of launching its U.S.-based entity by its Feb. 1 target date.

Eurex signed a regulatory services contract with the National Futures Association (NFA), an independent organization that will provide trade practice surveillance, market surveil-

lance and membership background checks for Eurex.

"In addition to our own market supervision, the NFA will serve as a policing organization for our markets that will ensure our members follow all the exchange rules," says Peter Reitz, a member of the Eurex executive board. "They will also ensure all customers are treated fairly in our markets. That means they will specifically look at any illegal or suspicious trading activities in those markets."

The NFA board approved the deal

later in November by a 16-2 vote. The agreement is for three years, with an automatic one-year renewal. While the NFA provides self-regulatory functions for many futures exchanges, it rarely does so to the extent it will for Eurex. The NFA has previously regulated BrokerTek and the Merchants Exchange at this level, but Eurex CEO Rudolf Ferscha is confident it is the right firm for the job.

"The NFA has been operating in these markets for a very long time," he says. "They have been surveying the whole breadth of the activity in derivatives. They know all the steps down to the end customers extremely well. They have a deep resource and know-how in that sphere. Many exchanges choose to do those services themselves, but we thought it would be good if we could offer an independent partner to make sure there was no issue whatsoever with us not having the full quality of the U.S. marketplace in that regard."

Eurex also announced its plans for a governance structure. The U.S. Futures Exchange board of directors will consist of 12 members, which Ferscha says will include "a broad spectrum of industry participants."

The board will have at least half its openings filled by FCMs, arbitrage firms, proprietary traders, investors and independent clearing firms. According to Ferscha, the majority of directors will be U.S. citizens living in the U.S.

"We would anticipate some Germany-based board members," he says. "But the European board of directors will have no veto power over the U.S. board."

At the same time Ferscha was in Chicago discussing the NFA and the membership structure, the Chicago exchanges were on Capitol Hill testifying before Congress.

Chicago Mercantile Exchange chairman Terry Duffy voiced concerns about the Eurex exchange application in three different areas — payment for order flow and internalization, market integrity and cross-border regulatory concerns, and unfair competitive practices.

"Eurex U.S.'s application is an empty shell," Duffy says. "It omits important facts concerning how it will handle critical regulatory, clearing, settlement and financial responsibilities and the contracts it will trade."

Duffy claims Eurex's plan to give rebates only to the 10 firms creating the most volume is a blatant attempt to seek payment for order flow, and he fears Eurex's claim that U.S. products could be cleared in Europe and vice versa brings up some concerns about regulating two different markets.

He also finds it ironic that while Eurex claims the U.S. exchanges are fearful of new competition, Eurex did all it could to prevent the CME from putting a Globex terminal in Germany.

Chicago Board of Trade chairman Charles Carey echoed those concerns and also criticized what he sees as a potential lack of transparency in the Eurex model. European exchanges sometimes use a "call-around" market that allows brokers to trade away from a centralized marketplace.

Carey says this causes customers to get "opaque prices" away from the best price.

"This system has great potential for conflicts of interest that give preferred customers favored pricing and disadvantage average customers in the market," Carey says.

Both the CME and the CBOT have also questioned Eurex's proposed transatlantic clearing link, which they say is not mentioned anywhere in the Eurex application.

Michael McErlean, director of the U.S. Futures Exchange, represented Eurex at the Congressional hearings.

"U.S. Futures Exchange will operate as a U.S. company, located in the U.S., staffed by U.S. employees, acquiring services from U.S. service providers and subject — in all respects — to the same U.S. regulatory framework that is applicable to all U.S. futures exchanges."

In response to Duffy's contention the application was an "empty shell," McErlean said some information has remained confidential because of its sensitive nature, but added the original application was more than 2,000 pages long.

McErlean added that the payment scheme was no different than volume discounts given by U.S. exchanges, and that it would help create an efficient and

liquid marketplace. He also said the U.S. system would be fully electronic, although he did not discuss the "call-around" system.

As for the transatlantic link, McErlean confirmed Eurex's plans to create one, but says it was not included in the application because certain hurdles must be cleared before it can be considered.

Also present at the hearing was James Newsome, president of the Commodity Futures Trading Commission — the regulatory body that ultimately will decide on Eurex's application. While Newsome said there is no target date for a decision, his testimony was generally favorable toward Eurex.

"The Commission's regulations do not require that an application for

designation as a contract market include all future clearing plans that may be contemplated," Newsome says. "Because we can consider only the proposal contained in the application, the Commission's review of the clearing component of the application is currently proceeding strictly on the basis of the proposed clearing services agreement with The Clearing Corporation."

Newsome adds that incentives aimed at generating trading volume "have long been viewed as acceptable by the Commission," and that the CFTC has been given broad power to punish anyone breaking U.S. law concerning the futures market, even if the rule-breaker is located overseas.

In any event, Ferscha is still committed to beginning Feb. 1. He has no concerns about the quality of the application and says that in the four-week comment period, there was not a single comment from a customer or user that highlighted any major or potential problem.

"However, there were dozens, if not hundreds, of pages of complaints by competitors — particularly two competitors — who have lots of things to worry about with our application," Ferscha says. "That speaks for itself." ☐



A Direct hit

CBOT rolls out new trading system

The Chicago Board of Trade began to sever its remaining ties with Eurex on Nov. 24 when it switched its electronic trading platform on certain products from Eurex's a/c/e system to one powered by EuronextLiffe.

The remainder of the products switched over Jan. 2.

"The new system should provide us greater opportunity within our markets and will lead us to expanded opportunities in terms of trading new products," says Brian Durkin, senior vice president of trading operations for the CBOT.

Durkin says the new system, which will be called eCBOTDirect, is better for three reasons — functionality, speed and flexibility.

The new platform has a much greater ability to handle spreads than a/c/e, which was limited to three-month spreads. Anything other than that had to be treated as a separate product. eCBOTDirect can handle eight different futures spreads and 32 different options spreads.

And, eCBOTDirect eliminates the one-second delay, or "netting" that plagued the a/c/e system. Durkin believes the real-time capabilities of the new system will increase volume dramatically.

"Up until this past year, all data was netted by two seconds," Durkin says. "We were able to get that down to one second, and immediately after that we saw a huge volume increase in our Dow

product. Once the netting was cut in half, that market information coming out stimulated additional trade."

Plus, member firms are able to develop their own front ends, which allows them to add their own particular bells and whistles. EuronextLiffe has already worked with 53 firms who chose that option.

Additionally, while the a/c/e platform operated over 64K lines, eCBOTDirect uses T1 lines. That will cut down on processing time and will allow users to send more messages.

"This functionality has never been deployed in the U.S. before, so there is a lot for traders to learn," says Bob Ray, vice president of business development. "It's a dramatic increase in terms of what you can trade and how you can trade it, especially in the options markets."

The new system also employs two different algorithms — a price-time algorithm and a pro rata algorithm. A price-time algorithm fills orders on a first-come, first-served basis. A pro rata algorithm looks at all the composition of orders in the marketplace and disperses those on an even basis.

There is also a pro rata with priority algorithm in which traders providing stronger levels of liquidity will get a higher quantity of the positions available at



that price. In other words, if a market participant increased the bid from 5 to 6 and the rest of the market follows, the participant who initially improved the price will get a more significant portion of the size available at that price.

"Price-time works well for front-month treasuries," Durkin says. "However, for our options complex and for some of our less liquid products, the pro rata algorithm is better."

The new system will also allow each product one extra hour of trading, although the opening time will be scattered over various products, with about a one-minute delay between the opening time of various products. Durkin says that allows the system to maintain an orderly marketplace.

The CBOT already trades 85 percent of its financial futures electronically, so the most significant volume increase on eCBOTDirect should come in options. Less than one percent of financial options are traded electronically.

"We are committed to an integrated trading platform," Ray says. "We don't anticipate a huge explosion initially, because it will be a function of the marketplace getting used to having this kind of sophisticated functionality. But I think it will grow." 🕒

Getting stung

FBI currency investigation pays off

While participants in the foreign exchange market claim the “Wild, Wild West” image once bestowed on the industry is a thing of the past, events like the one that occurred in late November show all the gunslingers haven’t been removed just yet.

The FBI raided several Wall Street currency brokers in an 18-month sting operation that netted almost 50 arrests. Most brokers arrested were charged with fraud. In some cases, the defendants allegedly convinced retail investors they were putting money into a multi-million

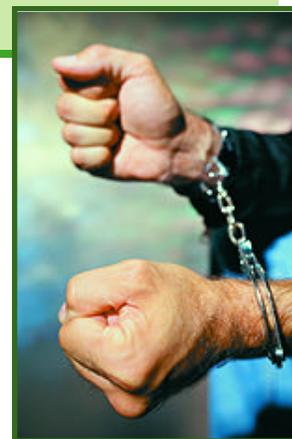
dollar foreign exchange trade. In reality, retail investors are not allowed to participate in those types of deals.

According to the FBI, one of the main scams involved a scheme known in the industry as “Points for Cash.” Currency traders at large institutions allegedly engage in rigged trades that purposely result in losses for an employers’ accounts and profits for the co-conspirator. In return, the counter parties provided cash kickbacks, including cash stuffed in envelopes delivered in diners, according to court papers.

In just a few months, the investigation

uncovered more than 120 such trades totaling more than \$650,000.

Currency traders at JP Morgan Chase, Societe Generale, UBS Warburg Dillon Read, Dresdner Kleinwort Benson and Israel Discount Bank were arrested, along with a former member of the Fed’s Foreign Exchange Committee, three practicing attorneys and numerous officers of various publicly traded companies. ☪



Volume update

Single-stock futures

After strong September numbers, daily volume in October fell significantly on both NQLX and OneChicago. Both exchanges saw a record volume decrease.

The NQLX’s average daily volume dropped 69 percent to 1,506 contracts – the largest monthly decrease in exchange history. With a total monthly volume of 6,943 contracts, the iShares Russell 2000 was again the top volume contract. The QQQ, Juniper Networks, Metro Goldwyn Mayer and Wal-Mart rounded out the top five volume contracts.

OneChicago’s average daily volume fell 73 percent to 3,156 contracts – also a record decrease. General Electric topped the list with 5,420 contracts traded, followed by Altria Group, SBC Communication, DIA and PeopleSoft.

Chicago exchanges

The Chicago Mercantile Exchange (CME) and Chicago Board of Trade (CBOT) enjoyed another strong month, as year-to-date volume rose 14 percent and 32 percent, respectively, compared to the same period in 2002.

The CME saw its interest rate products, led by Eurodollar futures, trade 20.1 million contracts – the largest October volume ever for the product group. Globex volume rose 47 percent year-to-date compared to the first 10 months of last year and comprised 46 percent of October’s total volume.

E-mini Russell 2000 futures (509,058) and E-mini S&P MidCap 400 futures (150,619) set monthly volume records.

The CBOT eclipsed its all-time volume record (set in 2002) by trading 381.6 million contracts year-to-date, a 32-percent rise over the same period last year. In addition, monthly volume records were set in five product groups: soybean, Mini-sized soybean, soybean meal, soybean oil and wheat futures.

New York exchanges

New York Mercantile Exchange volume as of Nov. 1 was off .2 percent from 112.2 million contracts in 2002 to 111.9 million this year. The New York Board of Trade had another strong month as year-to-date volume was up 17 percent to 20.6 million contracts.

Options

Strong October volume numbers propelled the International Securities Exchange (ISE) to within 5 percent of the Chicago Board Options Exchange’s (CBOE) overall volume lead. The ISE also closed within 5 percent in July before the CBOE pulled away over the next two months. The ISE remained the No. 1 volume exchange for equity options.

The CBOE claimed 32 percent of all options volume, or 28.64 million contracts, in October. The ISE traded 27 percent of the volume, or 27.14 million contracts. Year-to-date totals for the ISE increased by 77 percent from the same period in 2002, while CBOE’s year-to-date volume rose 16 percent. ☪



● ● ● ● ● ● ● ● FAST FILLS

GOOD FOR GOOSE, GOOD FOR GANDER

▼ If Eurex is going to have a presence in the United States, the Chicago Mercantile Exchange thinks turnabout is fair play. In early November, the CME announced a new pricing plan for European customers and a plan to add communication hubs. Under the plan, proprietary trading firms and trading arcades located in Europe will have prices for contracts traded on Globex cut by as much as 73 percent. The new fees on Eurodollar, E-Mini and foreign exchange futures and options will be 44 cents per contract. And, the CME will add six new communication hubs in major European cities, adding to the London hub created in 2001.

WE HARDLY KNEW YE

▼ BrokerTec, an all-electronic futures exchange that tried to compete with the Chicago Board of Trade in fixed-income products, ceased operations in late November. BrokerTec, which had the financial backing of several leading investment banks, was at the end of its second year of operations when it shut down, primarily because of declining volume. While there was speculation a few months ago that Eurex was interested in buying BrokerTec rather than going through the process of applying for exchange status, there were no rumblings in the days after BrokerTec's announcement.

WHAT A COINCIDENCE!

▼ The Chicago Mercantile Exchange and the Chicago Board of Trade have donated more money in 2003 to members of Congress than ever before. Through Sept. 30, the CME had given more than \$325,000 to various congressmen – more than General Motors, and 79 percent more than the exchange had given in any previous similar time frame. The CBOT gave \$169,000, an exchange record for the first nine months of an election cycle.

PART II

▼ The Chicago Board Options Exchange continued its rollout of its hybrid trading system CBOEdirect HyTS in late October. The second phase of the rollout creates several opportunities for increasing liquidity among members and market makers and also has a more efficient order facilitation. More than 325 option classes are trading through the hybrid system, representing more than 90 percent of U.S. equity trading volume.

TCC TCB WITH OCC

▼ The Clearing Corporation (TCC), which recently agreed to clear trades for Eurex's U.S. entry, also entered into a clearing agreement with The Options Clearing Corporation (OCC) to provide post trade execution services for futures contracts. The agreement pertains to futures markets affiliated with options exchanges that clear through OCC. The agreement runs for three years.

HELLO, DALIAN

▼ The Chicago Board of Trade signed a Memorandum of Understanding with the Dalian Commodity Exchange (DCE) in Dalian, China, to pursue cooperative and potential joint business initiatives between the two exchanges. Under the agreement, the two exchanges will share information on market and product development and potentially work toward developing markets for new derivative products. The DCE is the largest futures exchange in China.

DOES THAT MEAN PLUMBERS ARE ELIGIBLE?

▼ The CME in mid-November announced new corporate governance plans, including a Market Regulation Oversight Committee that will be made up entirely of non-industry members. The CME also said it would make sure its audit, compensation and governance committees were comprised mainly of independent members. The exchange also plans to change the structure of its board of directors to include seven non-industry representatives – three more than currently serve.

TIMBER!

▼ Timber Hill, one of the largest options market makers, announced in late November it was closing its specialist division at the American Stock Exchange and would stop trading on the AMEX by the end of 2003. The firm said it wanted to focus its attention on exchanges with a greater electronic presence. Timber Hill had 40 floor traders in 2000 but only nine in late 2003.

THAT'S A LOT OF HEDGING

▼ Despite an SEC investigation and a fair amount of negative attention, the hedge fund industry continues to boom. Almost \$25 billion of new money was invested in hedge funds in the third quarter of 2003, almost twice the amount of the second quarter. For the year, more than \$45 billion has been invested, a new record. In 2002, only \$16.3 billion was invested the entire year.

IF THEY START TRADING CASTOR OIL, GO SHORT

▼ The world's first exchange for essential oils trading was launched in Sydney, Australia, in early November. Comdaq EOE is supported by the Anglo-Indian technology company Comdaq and backed by a series of private investors. The initial markets will be on tea tree oil, an Australian native plant, although the exchange intends to introduce other contracts.

OVERNIGHT futures trading

Overnight trading sessions have become an increasingly common part of the futures landscape. Should you trade these periods or include them in your analysis?

BY KIRA MCCAFFREY BRECHT



When the closing bells mark the end of open outcry trading at the various U.S. futures exchanges, they do not necessarily signal the end of trading in many futures contracts for that day.

Most high-volume U.S. futures markets, ranging from Chicago stock index and interest rate contracts to New York crude oil futures, trade for several hours in “overnight” electronic trading (in some cases, trading begins less than an hour after the day session closes). During this time traders can initiate new positions or close out existing ones.

At the Chicago Mercantile Exchange (CME), for example, virtually all futures contracts are traded electronically overnight on the Globex trading system. For information on specific Globex contracts and trading hours see www.cme.com/files/GLOBEX_HoursInsert.pdf.

In late November 2003, the Chicago Board of Trade (CBOT) launched a new electronic trading platform called

“eCBOTDirect.” Most of the exchange’s financial futures contracts and agricultural contracts can be traded via this system. For more information on specific trading hours, see www.cbot.com.

In New York, the New York Mercantile Exchange (NYMEX) offers electronic trading on an after-hours basis on virtually all its energy and metal contracts through its Internet-based ACCESS electronic trading system. For hours, see www.nymex.com.

The New York Board of Trade (NYBOT) does not currently offer overnight electronic trading on coffee, cocoa, sugar, orange juice or cotton futures.

There are two aspects of overnight trading to address: whether to include night-session data in your analysis, and whether the overnight session offers any unique trading advantages or risk.

Getting the data

Generally, overnight electronic futures data is offered by price quote vendors at no extra charge to subscribers. Day session and night session data is typically distinguished by different ticker symbols.

For example, eSignal customers interested in NYMEX crude oil data can look at CLZ3=1 (December 2003 crude oil futures — evening electronic session only), CLZ3=2 (December 2003 crude oil futures — pit session only) or CLZ3, which represents a “composite” of both the pit session and the evening ACCESS trading activity.

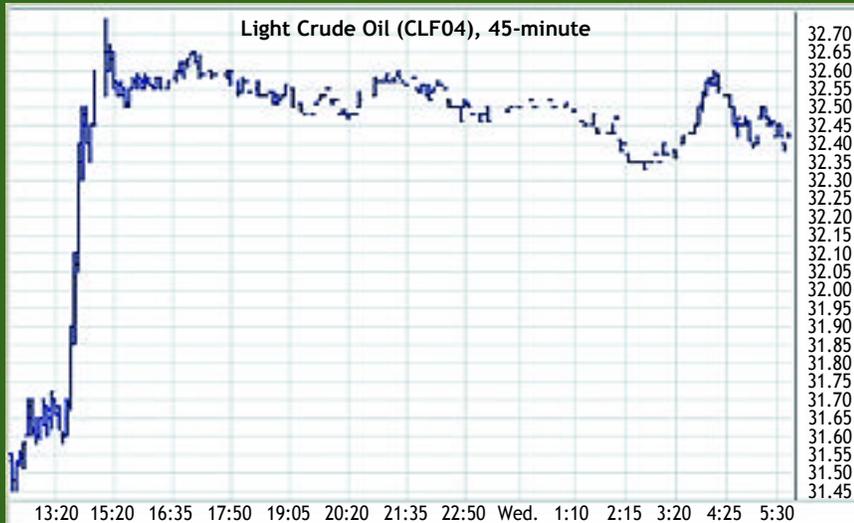
“If there are multiple trading sessions, there will be multiple symbols to define them,” says Jim Hamann, data quality control analyst at FutureSource in Lombard, Ill., which offers a number of retail quote packages. The company uses a similar set of three symbols to represent pit trading, electronic trading and composite data.

Traders can chart their choice of pit session, electronic or composite price data across all time frames on most analysis platforms. Historical data is also segregated for the three different symbols.

“Many people need session-specific content,” says an eSignal spokesman. “Traders need to explore their charting software and data collection feed to determine the symbols, which signify the different sessions.”

FIGURE 1 NIGHT AND DAY

The narrow range and spotty trading in the crude oil evening session illustrate the limitations and dangers of overnight trading. Although only the final portion of the day session is shown here (left), its range dwarfs that of the night session, when prices drifted in a roughly 25-cent sideways channel.



Source: FutureSource.com

For some of the “mini” futures contracts, which trade exclusively on an electronic platform and have no open outcry at all, eSignal has synthetically created a symbol that tracks action solely during the hours the big contract is trading. For example, on eSignal, the “ES Z3=2” symbol represents E-Mini S&P trading from 8:30 a.m. to 3:15 p.m. CT, which are the trading hours in the full-size S&P open-outcry pit.

“Many customers said the evening electronic [session] is just noise,” which was the impetus to create the synthetic symbol, says the eSignal spokesman.

For this reason, many traders still ignore the night session entirely, analyzing day-session data exclusively. Figure 1 is a five-minute chart that shows trading in January 2004 crude oil futures from the end of the Tuesday, Nov. 19, day session into the evening session. Trading activity dropped off noticeably during the overnight session.

Tonight is really tomorrow

The U.S. futures exchanges define evening electronic sessions as belonging to the next day’s trading day. For example, Sunday evening electronic trading in T-bond futures would belong to Monday’s session and is included in Monday’s settlement action. The same goes for evening crude oil trading in New York. Monday’s session “begins” during Sunday evening trading and settles with the close of the Monday day session.

Each session of the CME’s exclusively electronic E-mini S&P contract session officially begins at 3:30 p.m. CT (except on Sunday) and settles at 3:15 p.m. the next day. The overnight session for the full-sized S&P contract ends at 8:15 a.m. CT, 15 minutes before the day session opens, but this simply represents a temporary suspension of trading, not an official close. Accordingly, Tuesday’s trading actually begins at 3:30 p.m. CT on Monday and ends at 3:15 p.m. on Tuesday.

“Tuesday’s session is defined by the end of the day, when the settlement price occurs,” says FutureSource’s Hamann.

To analyze or not to analyze

Even though volume is much lighter in overnight electronic trading sessions, many analysts and traders do incorporate evening-session price action in their research and charting. Tom Pawlicki, financial futures technical analyst at Refco, LLC in Chicago, routinely studies the “composite” symbols of the S&P, T-bond and Dow futures markets he watches.

Pawlicki has found that relying on the composite price bar for T-bond futures gives him more accurate support and resistance price levels, and fewer misleading gaps between bars, which he says often turn out to be “meaningless.”

Also, he has found that a price high or low set during the evening electronic session will be a price point to which the market returns to test at a later time.

“The market treats the overnight high as the high for the day,” Pawlicki says. “Sometimes there is only a couple of ticks difference (between the overnight high and the pit session high), but when the market tests an old high, it generally equals the high set in the night session.”

Overall, Pawlicki has found markets such as the S&P, Dow and T-bond futures contracts “respect” the price action that occurs overnight, and utilizing the composite symbol offers better technical analysis reference points, including work with Fibonacci retracements and trendlines.

FIGURE 2 COMPARING TOTAL TRADING TO THE DAY SESSION

The top chart reflects the combined day (pit) session and the overnight (electronic) session in crude oil, while the bottom chart shows only the day-session data. Although the charts are very similar overall, there are noticeable differences between certain bars.

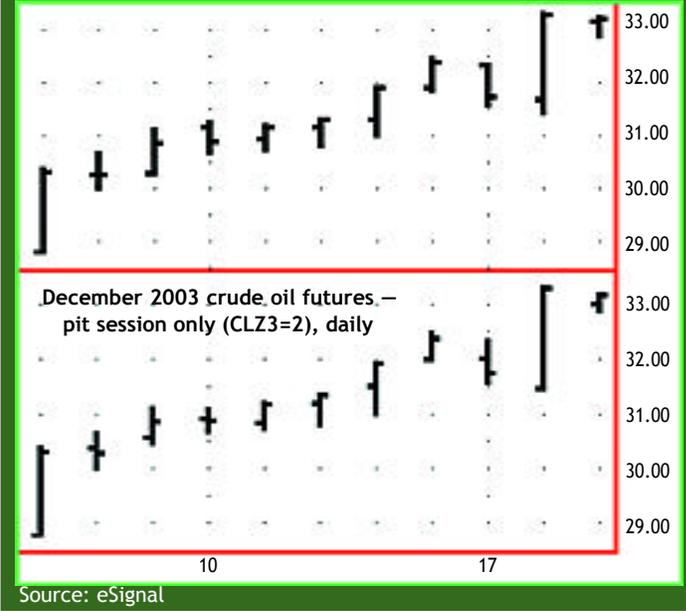


Figure 2 compares daily bars of the pit-traded crude oil contract with those that reflect both pit and overnight trading.

Practicalities: Volume talks

John Bollinger, president of BollingerBands.com, advises traders attempting to determine whether or not to incorporate night session data into their analytical work to consider the concept of the “price-setting mechanism.”

For example, he notes, “the price of IBM is set primarily during the NYSE main session — that’s where the largest number of people who care about IBM focus on it. If it is German bunds, the price-setting mechanism is during the German day session.”

So, whether a trader is trying to determine the importance of overnight action in natural gas futures, gold futures or S&P futures, Bollinger argues, “people need to get that central concept straight in their minds for whatever they are trading.”

Overnight electronic trading action “needs to be related to events in the main session, in order for the technician to be successful,” Bollinger concludes.

It’s important to understand that because night-session trading is generally thin, bid-ask spreads can be much larger than they are in the day session, and getting in and out of trades without giving up too much can be challenging. Be sure to check the overnight volume figures for any markets you are interested in, and watch the trading during that session to see if trading is practical.

Overnight trading sessions can be useful, especially if you know in advance a price point at which you want to buy or sell. But because of the typically lower volatility and volume (big moves and heavy trading mostly occur when a huge news event rocks the markets), overnight trading does not usually offer many intra-session trading opportunities. Beginners, especially, should be wary. 📌

For information on the author see p. 3.

Keltner Classic System

Market: Futures.

System concept: Can a trading technique that was developed and published in 1960 still make money in today's markets? Yes, as long as the technique is based on a set of simple rules that captures the market's dynamics.

Chester W. Keltner published his "Keltner Channel" technique in the book *How to Make Money in Commodities* in 1960. Keltner Channels are similar to the more familiar Bollinger Bands, in that they consist of a middle line and an upper and a lower band that encompass most price action. Price moves above or below the bands indicate strong momentum in that direction.

The middle line is a 10-bar simple moving average (SMA) of the bar's typical price ($(\text{Close} + \text{High} + \text{Low}) / 3$). The upper band is the middle line plus the 10-day moving average of the High - Low, while the lower band is the middle line minus the 10-day moving average of the High - Low.

Keltner's method of using his bands was very simple: Buy when price closes above the upper band, and reverse and go short when price closes below the lower band. This is a trend-following approach that is always in the market — a true reversal system. The area between the upper and the lower bands provides some space for prices to move without generating numerous whipsaw signals.

Rules:

Long trades

1. Enter long when price crosses above upper Keltner Channel.
2. Exit long when price crosses below lower Keltner Channel.

Short trades:

1. Enter short when price crosses below lower Keltner Channel.
2. Exit short when price crosses above upper Keltner Channel.

Money management: Two-percent (approximately) of account equity risked per trade. We accomplish this by determining the initial exit level of the trade based on the opposite Keltner band value. For example, if prices cross above the upper band the system goes long, and the initial exit price is the lower Keltner band. We buy the number of contracts that would result in a two-percent loss of equity if the position is closed out at that lower Keltner band level.

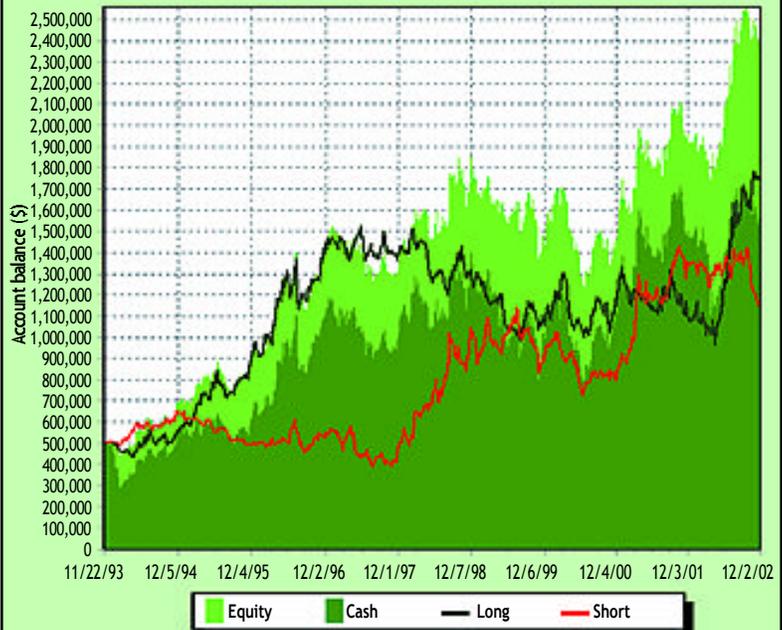
Starting equity: \$500,000. \$20 deducted for slippage and commission per round turn.

Test data: The system was tested on the *Active Trader* Standard Futures Portfolio, which contains the following 19 futures contracts: DAX 30 (AX), corn (C), crude oil (CL), German bund (DT), Eurodollar (ED), Euro Forex (FX), gold (GC), copper (HG), Japanese yen (JY), coffee (KC), live cattle (LC), lean hogs (LH), Nasdaq 100 (ND), natural gas (NG), soybeans (S), sugar (SB), silver (SI), S&P500 (SP) and 10 year T-Notes (TY).

This month's system testing was performed using weekly historical data (from Pinnacle Data Corp., www.pinnacledata.com) rather than daily data. Weekly prices are less noisy than daily prices, and many trading systems perform better on the weekly time frame for this reason. Later, we will compare the results of the system using daily data.

FIGURE 1 EQUITY CURVE

The system was profitable on both the long and short sides, with some moderate volatility and drawdown periods.



Source for all figures: Wealth-Lab Inc. (www.wealth-lab.com)

FIGURE 2 DRAWDOWN CURVE

The maximum drawdown of around 30 percent was significant, but the system recovered from all drawdowns relatively quickly.



Test period: September 1993 until December 2002.

Test results: The results reflect the Keltner Classic's trend-following nature. The winning percentage is low (only 37.81 percent), but the average profit for winning trades (14.7 percent) is much higher than the average loss for losing trades (6.92 percent). This is reflected in the "Payoff Ratio" of 2.12.

Trend-following systems typically produce more losing trades than winners, but a good system will offset the smaller losses by catching major trends, thus achieving an overall profit. This implies a good trend-following system should hold winning trades longer than losing trades. In this case, winning trades were held for an average of 38.5 weeks, while losing trades lasted only 12.40 weeks.

By letting the profits roll and cutting the losses short, Keltner Classic was able to deliver a very respectable annualized gain of 18.78 percent during the historical testing period of 10 years. There were two losing years during the period, with losses of -3.4

FIGURE 3 SAMPLE TRADES (WEEKLY)

The system catches and rides a long trend in crude oil.



percent and -8.11 percent. The two best years had returns of 59.21 percent and 40.10 percent.

Daily vs. weekly: A second test using the same system rules on the same time period — but using daily data instead of weekly — resulted in a net loss of -80.24 percent. Why such a dramatic difference? To help answer this question we can examine one of the large winning trades on the weekly scale and examine the system's performance during that same period on daily data.

Figure 3 shows a long trade in crude oil that was held for 75

FIGURE 4 DAILY TIME FRAME

Using daily price data on the same test period resulted in more frequent whipsaw trades and negative returns.



weeks. The contract price during this period appreciated nearly 100 percent, and a one-contract position returned nearly \$12,500.

On daily data, the system traded a total of 15 times (eight longs and seven shorts) during the same period. Only five of the 15 trades were winners, and one contract would have netted \$3,380 during this period.

By using a weekly time frame the system was able to catch a long trend and avoid the noise and whipsaws on the daily time frame.

Bottom line: Keltner Classic, although published 40 years ago, proves to have potential as a long-term trend-following system on the weekly time frame. Consider testing your systems on weekly data. You will sometimes find this results in less noise and better performance.

— Dion Kurczek and Volker Knapp of Wealth-Lab Inc.

STRATEGY SUMMARY

Profitability		Trade statistics	
Net profit (\$):	1,866,139.00	No. trades:	439
Net profit (%):	373.23	Win/loss (%):	37.81
Exposure (%):	62.72	Avg. gain/loss (%):	1.25
Profit factor:	1.36	Avg. hold time:	22.27
Payoff ratio:	2.12	Avg. profit (winners) %:	14.70
Recovery factor:	3.01	Avg. hold time (winners):	38.50
Drawdown		Avg. loss (losers) %:	-6.92
Max. DD (%):	-33.39	Avg. hold time (losers):	12.40
Longest flat days:	140	Max. consec. win/loss:	8/11

LEGEND: Net profit — Profit at end of test period, less commission • Exposure — The area of the equity curve exposed to long or short positions, as opposed to cash • Profit factor — Gross profit divided by gross loss • Payoff ratio — Average profit of winning trades divided by average loss of losing trades • Recovery factor — Net profit divided by max. drawdown • Max. DD (%) — Largest percentage decline in equity • Longest flat days — Longest period, in days, the system is between two equity highs • No. trades — Number of trades generated by the system • Win/Loss (%) — The percentage of trades that were profitable • Avg. gain — The average profit for all trades • Avg. hold time — The average holding period for all trades • Avg. gain (winners) — The average profit for winning trades • Avg. hold time (winners) — The average holding time for winning trades • Avg. loss (losers) — The average loss for losing trades • Avg. hold time (losers) — The average holding time for losing trades • Max. consec. win/loss — The maximum number of consecutive winning and losing trades

Disclaimer: The Trading System Lab is intended for educational purposes only to provide a perspective on different market concepts. It is not meant to recommend or promote any trading system or approach. Traders are advised to do their own research and testing to determine the validity of a trading idea. Past performance does not guarantee future results; historical testing may not reflect a system's behavior in real-time trading.

PERIODIC RETURNS

	Avg. return	Sharpe ratio	Best return	Worst return	Percentage profitable periods	Max. consec. profitable	Max. consec. unprofitable
Weekly	0.38%	0.86	10.72%	-13.05%	56.14%	8	9
Monthly	1.63%	0.87	16.80%	-13.23%	59.09%	5	4
Quarterly	4.88%	0.86	27.38%	-20.33%	56.76%	3	3
Annually	20.37%	0.94	59.21%	-8.11%	77.78%	3	1

LEGEND: Avg. return — The average percentage for the period • Sharpe ratio — Average return divided by standard deviation of returns (annualized) • Best return — Best return for the period • Worst return — Worst return for the period • Percentage profitable periods — The percentage of periods that were profitable • Max. consec. profitable — The largest number of consecutive profitable periods • Max. consec. unprofitable — The largest number of consecutive unprofitable periods

Trading System Lab strategies are tested on a portfolio basis (unless otherwise noted) using Wealth-Lab Inc.'s testing platform.

If you have a system you'd like to see tested, please send the trading and money-management rules to editorial@activetradermag.com.

FUTURES Snapshot

▲ 0.75 ▲ 512.68 ▲ 3 ▼ MCM2 ▼ 510.00 ▼ 0.80 ▼ COMEX ▼ 158.50
▲ 0.0021 ▲ JYM2 ▲ 0.8042 ▲ 0.0031 ▼ USM2 ▼ 102.7/32 ▼ 9/32 ▼ CLND2 ▼ 24

Date: Dec. 5, 2003

The following table summarizes the trading activity in the most actively traded futures contracts. The indicator readings are NOT trade signals. They are intended only to provide a brief synopsis of each market's liquidity, direction, and levels of momentum and volatility. See the legend (right) for explanations of the different fields.

Market	Sym	Exch	Vol	OI	STT	ITT	LTT	Trend%	Vtly%	OB/OS
S&P 500 E-Mini	ES	CME	592.40	479.80	▲	▲	▲	0.85	0.05	N
Nasdaq 100 E-Mini	NQ	CME	282.30	265.70	▼	▲	▲	0.27	0.14	N
Crude oil	CL	NYMEX	93.60	157.90	—	—	—	0.06	0.86	N
10-yr. T-note	TY	CBOT	91.30	795.00	▲	—	—	0.15	0.27	N
Eurodollar	ED	CME	68.90	664.20	▲	—	—	0.06	0.15	N
5-yr. T-note	FV	CBOT	68.80	681.90	▲	—	—	0.38	0.12	N
Corn	C	CBOT	56.60	157.70	▲	▲	—	0.80	0.22	N
Eurocurrency	EC	CME	50.40	110.70	▲	▲	▲	0.84	0.19	OB
S&P 500 index	SP	CME	48.80	540.60	▲	▲	▲	0.85	0.05	N
30-yr. T-bond	US	CBOT	45.50	374.60	▲	—	—	0.17	0.44	N
Gold	GC	NYMEX	45.40	134.60	▲	▲	▲	0.66	0.51	OB
Mini Dow	YM	CBOT	44.50	41.50	▲	▲	▲	0.58	0.20	N
Natural Gas	NG	NYMEX	37.80	55.10	▲	—	▲	1.00	1.00	N
Soybeans	S	CBOT	35.30	75.00	—	▲	▲	0.07	0.19	N
Russell 2000 E-Mini	MR	CME	25.20	28.60	▲	▲	▲	0.61	0.20	N
Heating oil	HO	NYMEX	23.10	44.30	▲	▲	—	0.20	0.95	N
Unleaded gasoline	HU	NYMEX	21.40	42.00	—	—	—	0.17	0.41	N
Sugar	SB	NYBT	17.80	120.90	▲	—	—	0.85	0.27	N
Japanese yen	JY	CME	17.50	140.90	▲	▲	▲	0.19	0.03	OB
Wheat	W	CBOT	17.30	42.20	▲	▲	—	0.76	0.46	N
Silver	SI	NYMEX	14.70	50.00	▲	▲	▲	0.73	0.25	OB
Canadian dollar	CD	CME	14.40	74.60	▲	▲	▲	0.24	0.66	N
Nasdaq 100 index	ND	CME	13.90	82.00	▼	▲	▲	0.27	0.20	N
Swiss franc	SF	CME	13.70	61.70	▲	▲	▲	0.66	0.85	OB
Soybean meal	SM	CBOT	12.40	40.30	▼	▲	▲	0.07	0.02	OS
Soybean oil	BO	CBOT	12.00	38.50	▲	▲	▲	0.32	0.00	N
British pound	BP	CME	10.90	65.00	▲	▲	▲	0.73	0.24	OB
2-yr. T-note	TU	CBOT	10.60	121.90	—	—	—	0.41	0.34	N
Copper	HG	NYMEX	9.70	58.70	▲	▲	▲	0.54	0.71	OB
Dow Jones Ind. Avg.	DJ	CBOT	8.10	34.70	▲	▲	▲	0.59	0.17	N
Mexican peso	ZG	CME	7.20	35.40	—	▼	▼	0.25	0.10	N
Coffee	KC	NYBT	7.10	24.60	—	▲	▲	0.33	0.32	N
Live cattle	LC	CME	7.00	33.30	—	▲	▲	0.37	0.00	N
Cotton	CT	NYBT	6.60	43.30	▼	▲	▲	0.00	0.49	N
Aussie Dollar	AD	CME	5.90	58.20	▲	▲	▲	0.89	0.02	OB
Lean hogs	LH	CME	4.10	16.50	▼	▼	—	0.57	0.00	N
Cocoa	CC	NYBT	3.20	13.30	▲	—	▼	0.12	0.00	OB
Nikkei 225 index	NK	CME	3.00	27.40	—	—	▲	0.21	0.00	N
Russell 2000 index	RL	CME	1.80	21.80	▲	▲	▲	0.61	0.31	N
Fed Funds	FF	CBOT	1.50	45.30	—	—	▲	0.11	1.00	OS
LIBOR	EM	CME	1.50	15.70	▼	▼	—	0.74	0.69	N
400 Midcap	MD	CME	1.50	14.30	—	▼	▼	0.44	0.71	N
Orange Juice	JO	NYBT	0.80	15.40	▲	▲	▲	0.81	0.71	N

This information is for educational purposes only. Active Trader provides this data in good faith, but it cannot guarantee its accuracy or timeliness. Active Trader assumes no responsibility for the use of this information. Active Trader does not recommend buying or selling any market, nor does it solicit orders to buy or sell any market. There is a high level of risk in trading, especially for traders who use leverage. The reader assumes all responsibility for his or her actions in the market.

Legend:

Sym: Ticker symbol.

Exch: Exchange on which the contract is traded.

Vol: 30-day average daily volume, in thousands.

OI: Open interest, in thousands.

STT: Short-term trend direction. Trend is up/down if a short-term moving average (MA) is above/below the value of the moving average one month ago and price is above/below the current MA. If both conditions are not met, there is no trend.

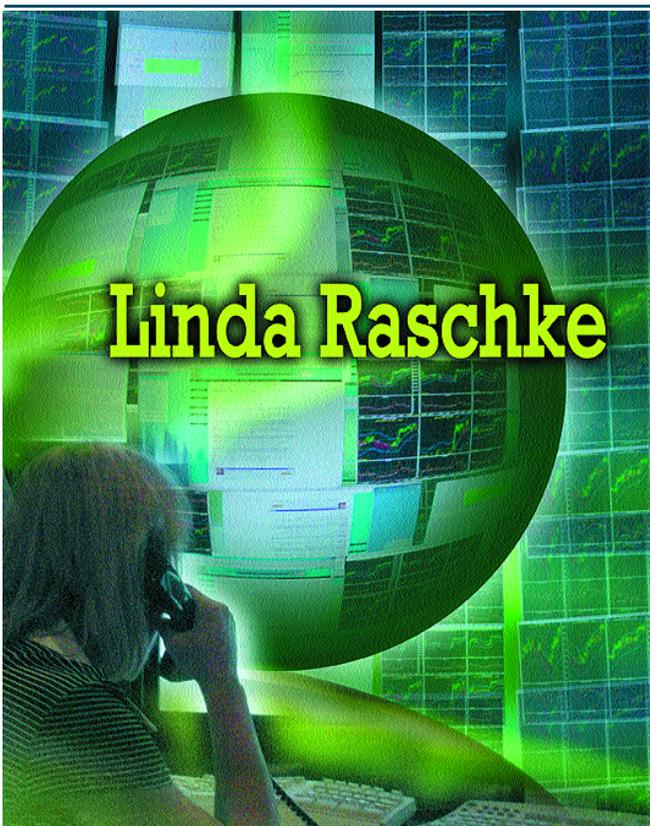
ITT: Intermediate-term trend direction. Trend is up/down if an intermediate-term MA is above/below the value of the moving average three months ago and price is above/below the current MA. If both conditions are not met, there is no trend.

LTT: Long-term trend direction. Trend is up/down if a long-term MA is above/below the value of the moving average nine months ago and price is above/below the current MA. If both conditions are not met, there is no trend.

Trend%: The percentile rank of the current trend strength reading compared to those of the past three months. (In other words, a reading of .09, or 9%, means only 9 percent of the readings over this period were lower than the current reading.)

Vtly%: The percentile rank of the current volatility reading compared to those of the past three months. (In other words, a reading of .75, or 75%, means 75 percent of the readings over this period were lower than the current reading.)

OB/OS: Whether a 10-day momentum indicator registers the market as overbought (OB), oversold (OS) or neutral (N). Note: Overbought and oversold signals are NOT trade signals. They are warnings that upside momentum is high or low (compared to the market's recent activity) AND MAY REMAIN SO FOR AN UNDETERMINED AMOUNT OF TIME.



Linda Raschke

keeps up the pace

We spend a day with Linda Raschke and learn about her trading style, daily market regimen and the challenge of riding a horse in a circle.

BY MARK ETZKORN

"Stick an offer out there at 59.25...wait, just offer them out at 59."

Linda Raschke momentarily interrupts her discussion of time frames to put in an order to sell (at 1,059.00) a long scalp position in the E-Mini S&P futures. It's early afternoon and she has spent nearly every minute of the last six hours in the same chair, splitting her time between monitoring charts, posting commentary and trade alerts for subscribers in her online trading room, and trading.

When her order is in the market, Raschke picks up the conversation where she left off.

"When you're scalping, you have to remember the shorter the time frame, the higher the noise level," she says. "And the higher the noise level, the more back-and-fill the market will have and the greater the odds that if you're trailing a stop, your stop will be hit. So for scalp trades, I don't use trailing stops and I exit in one piece.

"You have to recognize how much edge you're giving up just by having the bid-ask," she continues "You'll always do best when you're scalping if you're more conscientious about initial trade entry. It's important to try to buy on the bid and sell on the offer more than 50 percent of the time. That might mean you buy on the bid when you enter and you exit at the market, or vice versa."

Raschke can talk non-stop about trading, often using a ver-

bal short-hand born of years of immersion in her field.

"On a longer time frame, when the power of the trend or momentum is behind you, initial trade location is not nearly as critical," she says. "You put the trade on because you're playing for a longer ride — the most important thing is to not miss that trade. With a trend-following system, for example, maybe 30 percent of the trades are really good and you can't afford to miss those."

Raschke has been a fixture in the trading industry for years as a popular speaker and sometime author (see "Linda Raschke: Top trader keeps it simple," *Active Trader*, August 2000, p. 56). Although she is 23 years into a career that has encompassed everything from floor trading to money management, she does not appear to be heading into an early retirement. Between her personal trading, Web site (www.lbrgroup.com), online trading rooms and occasional seminars and conferences, she's plugged into the markets virtually around the clock. Although Raschke is probably known mostly as a short-term S&P 500 futures trader, she is active in several time frames, markets and trading styles.

In early November 2003 I spent a day in Raschke's trading office. Our conversations took place when she wasn't making trades, attending to her online trading rooms or comparing notes with her staff and fellow traders.

A day in the life

The day begins (for me) a little before 8 a.m. ET, more than 90 minutes before the New York Stock Exchange open. Raschke's home and office are in south Florida's horse country — an interesting blend of rural casualness and suburban modernity. Most of the homes are less than a dozen years old, but many of the local roads are intentionally unpaved to make them more amenable to riding. Miles of crisscrossing white horse fence bracket the multi-acre properties in the area, most of which have built-in stables; many, like Raschke's, also have riding arenas on the grounds.

After saying hello to Raschke's three horses, we walk around back to the office that extends off the back of her house and flanks a pavilioned swimming pool. The trading room is, like her house, airy with high ceilings and filled with sunlight from windows on three sides. One set of doors opens onto the pool and patio; the other opens onto the stables and riding grounds beyond.

Two tiers of computer monitors blanket adjacent walls and a large ViewScan atomic clock perches in the corner where the walls meet. The trading "desks" are large wooden tables on which sit phones, a laptop, printers, keyboards, notebooks, mice (the computer kind) and, occasionally, a long-haired cat (the mammal kind). Two dogs, one big and laconic, the other small and energetic, also wander in and out of the room. Some semi-tropical greenery decorates different corners of the room.

There is no TV — no obligatory financial news station droning in the background. Early in the morning music is playing, but for most of the day the room is filled mostly with the quiet hum of computer drives and air conditioning (it's early November but the temperature still creeps into the low 80s), punctuated by bursts of typing, Raschke's observations about trading and the occasional phone call.

Raschke occupies the chair by the patio door; to her left is her assistant, Harry Devert, who manages the online trading room with Raschke and works various trade orders throughout the day. Before the open, she gives all her computer screens the once-over, checks in with staff (including Dan Chesler, who lives close by, and others in Chicago, New York and Pennsylvania), looks over her analysis and prepares comments for today's trading session.

Price behavior, probabilities and market relationships

After posting her pre-opening comments in the trading room, Raschke talks about her trading principles, day-to-day approach to the markets and the difference between discretionary and mechanical trading.

"Everything I do is based on actual chart points," she says. "I'm always looking at the swing highs or the swing lows. I never calculate Fibonacci numbers, Gann retracements, artificial pivot points or other things like that because I've never found any edge or any statistical significance from testing them.

"But I can quantify chart points," she notes. "I can quantify and test something like, 'If the market made new momentum lows and there's a reaction up by half an ATR (*average true*

range), what are the odds the market will trade below that low?' I can determine there's, say, a 68-percent probability of that happening."

AT: *Do you use any kind of market or stock selection process along with patterns or strategies?*

LBR: Yes. One way to find good potential long-side stock candidates, for example, is to identify the up-trending stocks with the best relative strength at the beginning of a quarter.



Linda Raschke, Harry Devert and Dan Chesler.

A better word to describe it might be the stocks that are "best bid," or "most well-bid." I look at the number of days stocks trade from low to high and how steady their bids are for the two-week period. In other words, I want to see only shallow retracements. So it's not necessarily the stocks that are up the highest percentage the first two weeks.

Every quarter the institutions seem to have a theme, and there's an element of crowd behavior — nobody wants to be left behind. So if Abby Cohen, or one of the other powers that be at a particular time decide drug stocks are in, they all have to own drug stocks in their portfolios because they're afraid of underperforming each other. It's really blatant.

The stocks — and I stick to the big-cap stocks in our database — that are best bid in the first two weeks tend to stay the strongest throughout the whole quarter. That group or sector is in vogue, so to speak.

AT: *What's an example of a pattern you use in trading?*

LBR: Here's an interesting one based on a *failed* pattern: If today has the widest range of the past four days and an up close, the odds the low of the bar will be taken out in the next two days is the least-probable scenario.

We came up with a great little system based on that: If you see a wide-range bar with a lower close or a higher close and the high or low of that bar is taken out within two days, it's a signal.

If there was a down-closing wide-range bar and the market takes out the high of that bar within two days, it's a buy signal,

because that's the least-probable scenario — it occurs maybe 20 percent of the time. And when the least-probable scenario plays out, there's a very powerful reason why.

AT: *Even though you emphasize the primary role of price action, you still seem to use indicators in certain roles.*

LBR: You have to put indicators in context. They're background information — never the primary reason for a trade.

That said, you can use indicators to objectively scan and rank things. I can create a list of the markets or stocks with the lowest ADX (*average directional movement index — a trend strength indicator*) values on a daily basis, for example. Indicators also allow you to see something very quickly (*she pulls up a chart*). My eye can see a rally in an oscillator, price resistance at the moving average and a little bear flag. If I just look at a plain bar chart, I can't put the price action into context as fast. Indicators can help you process the information a little more quickly.

AT: *But something like that still won't be as objective or mechanical as something like the wide-range bar scenario, which has a definable probability associated with it, right?*

LBR: Absolutely. It is easier to quantify patterns with range functions than it is with indicators, which are derivatives of price. We evaluate the market in terms of whether there is a high-probability scenario unfolding or if the market is doing the *least-probable* thing, which is valuable information in and of itself.

Sometimes the aberrations and changes in historical relationships are the most powerful signals you can get. For example, if I have 80 years of data that shows a P/E range like this (*she draws a hypothetical range*), and suddenly it changes to this (*she draws a large shift out of the range*), I always want to go with that move. There's always a very powerful reason a market changes a relationship.

The same goes for seasonal patterns or any kind of aberration. I always want to go in the direction of the aberration or adverse move. Every trader I know has had to adapt to a different environment or different market.

Remember during the Gulf War when every 50-cent jiggle in crude oil would move the S&P futures five points? It was a leading indicator. And in the late '90s, there were those five Nasdaq stocks that would always lead the S&P by five minutes or so — all you had to do was watch these stocks to get a good four or five points in the S&P futures.

Today, the asset allocators since the beginning of 2003 have been overweighted in small-cap stocks. The small-cap indices were the first to make new highs and new momentum highs — they have been leading all the way up. I don't think the marketplace has caught on to this so much. For the past four months, the small-cap indices have been our leading indicator for the S&P.

Which goes back to the issues recognizing relationships and experience. Your edge comes in comparing one thing to another: What's the relationship between the S&P and the TICK, between price and an oscillator and so on. When the TICK runs up +1,000 but the S&P only moves up two points, I'm going to be very careful. But if the S&Ps run up 10 points in that same scenario, I definitely want to buy the first pullback.

Remember when the yield curve broke out of its historic

range and began to flatten out so much? Everyone was saying, "Oh, it has to go back." Wrong! You always want to trade in the direction of the new highs or new lows in a relationship. That's what blew out Long-term Capital Management (*a high-profile hedge fund headed by a collection of financial academics and other "experts" that collapsed in the late 1990s*).

Mechanical systems

Raschke uses the word "system" regularly, and she has volumes of historical test results and other research at her disposal. Nevertheless, she's no systematic trader.

AT: *Have you ever been a completely mechanical trader?*

LBR: The closest I ever came was trading a certain system 100-percent mechanically. I barely lasted two weeks — the system generated 10 trades per day. The best success I've had is having someone else do the trades for me.

There's such a small edge in mechanical systems. People don't understand a trend-following system, for example, might go flat for two to three years. You need to be able to trade a lot of systems and a lot of markets [to make mechanical trading work].

Let's say I initiate a long position here on a breakout (*she points to a the top of a wide-range bar on a chart*) with a mechanical system and I'm going to trail a stop at the lowest low of the past seven bars, so if the market moves up I'll keep raising the stop. And say if I test this out, it has a positive expectation — but not a huge one — in every market and every year. But because my initial stop is way down here at the bottom of a bar with an extreme range, the distance between my initial trade location and my risk point is pretty wide.

What I've found with the majority of mechanical systems is they only test out well if you use a very wide stop. If you try to use a conservative stop, you'll get chopped to pieces. The only exceptions are some S&P scalping systems, but with those you're dependent on having a very high win-loss ratio — which you can only get on a very short time frame, playing for a very small objective.

AT: *It seems like you're talking about different approaches, though, not necessarily right or wrong, in terms of using a mechanical system. Because isn't it valid to say, "I'm willing to assume the increased risk of the wide stop based on the system's projected reward?"*

LBR: Of course. But there's something else to consider. Let's say this system has a win-loss ratio of 60 percent. You think, "Hmm, not bad."

But that's horrible, because the odds of getting five consecutive losers at some point out of a sample size of 200 or so is around 90 percent. So I know if I trade this system religiously I run an incredibly high risk of having five losers in a row — with a large per-trade risk. How much leverage do you think I'm going to use on a system like that? Minuscule.

It's not that it's not a worthwhile trade idea — maybe it is — but the fact that I have large trade risk combined with high odds of five losers in a row means I'm going to have to trade this pattern across 20 markets [to make it viable].

On the other hand, consider a little scalping pattern that has a 92-percent win ratio and shoots for a 75-cent profit in the S&Ps. The odds of getting five losers in a row are much more

remote. I can trade 10 times more leverage on that system than I could the first one.

Ultimately, understanding how to use leverage is what makes the difference between the average Joe Schmoe and a superstar trader.

Momentum and volatility

One of the indicators Raschke references when discussing the concept of momentum is a two-period rate of change (ROC), or momentum — the difference between the current close and the close two bars ago. This leads to a discussion about the relationship between momentum, volatility and looking at markets on more than one time frame.

AT: *What's the significance of the two-period ROC?*

LBR: Typically, after two strong readings in an uptrend, [a pull-back will occur].

AT: *What constitutes a strong reading?*

LBR: One that's greater than the readings over the previous three to four weeks. It sort of depends on the individual mar-

ket and environment, but three to four weeks is a rough way to quantify it.

(She pages through different charts to find an example.) Here (she counts off the ROC readings): one, two — and there's the pull-back.

This shows up even better on a more volatile index, such as the Nasdaq.

In this case, the market has to test [the previous high] and form a divergence (See Figure 1). We're in a trending market; before this can really break down, this has to tick up one more time. You can see the market made really good momentum highs here, pulled back, and there were two trading days from high to low — so I have to look for this to go up one more time.

It might fail — it could gap up one more time and come down. If it had opened flat and made an early push down I would have tried the long side, only because the market had traded from high to low for two days, and there is such a strong tendency for a market to alternate trading from high to low, then from low to high. That's far more powerful in the equity markets, and especially in the index futures, than it is in the cash commodity markets or some individual shares.

Individual stocks can be more trendy.

You can see six consecutive days of trading from low to high in an individual stock. That would be extremely rare in the S&Ps.

AT: *In this case, you were talking about looking for one more move to the upside —*

LBR: Normally my directional bias would be to the upside, just based on the momentum analysis. However, I've found the ability to predict a directional bias based on the momentum work drops off dramatically in certain types of volatility conditions.

An extremely volatile selling climax will mess up the readings on the first reaction. In general, bull and bear flags (short-term consolidations that typically lead to a continuation of the preceding uptrend or downtrend, respectively) work in normal market conditions. But a bear flag, for example, will fail after a volatility extreme like a V-spike reversal because the market will likely make a spike and ledge (move horizontally) instead of making a good retest back down. So, shorting the reaction after a V-spike reversal is a sucker's play. Flags will also fail when there's no volatility.

That's why all these people who develop and sell systems based on directional oscillators like RSI and stochastics...if you test those things out, they're worthless. What they're trying to do is look for a bull or bear flag, which will work in this type of environment but will fail at an extreme volatility high and

FIGURE 1 MOMENTUM BUY-DAY SETUP

The two-period ROC had made new momentum highs at the end of October and the market had corrected downward, trading from high to low for two days. According to Raschke, on the morning of Nov. 3 this indicated a buy-day setup. The two-period ROC was poised for a retest of its most recent momentum high, and new price highs were expected on the reaction up. If the market had opened flat or gapped down, it would have been an immediate buy. In this case, the market gapped higher (see inset) and a long trade was entered on the first small pullback (in the S&P futures).



Source: Aspen Research

also in a contracting volatility environment.

There are a million ways to identify a continuation pattern such as a flag. But unless you incorporate a volatility filter into your system, you're not going to have any statistical edge, at least not one I would trade.

It doesn't matter how good a particular pattern seems to be. Even our Short Skirt system, which is based on a short-term

Trend days are typically followed by consolidation days, which are trading-range days during which the market tests back and forth.

AT: *What are signs a trend day may be setting up?*

LBR: Three different types of conditions tend to precede a trend day. First, there's a significant degree of range contraction.

You can measure that by simply seeing narrow-range price bars, such as an NR7 day, which is a bar with the narrowest range of the past seven bars. [Trader] Toby Crabel wrote about it in his book.

Second, you can get a trend day after a large opening gap: It could be a large gap down and a trend day up, a large gap up and a trend day down, or a large gap up and a trend day up.

A large gap means one side is caught off balance. When a market comes out of an equilibrium level — such as at these points when there have been inside bars and narrow ranges, or low ADX readings on an hourly chart, or a chart consolidation like a triangle — that's what causes "positive feedback" loops. There's the interaction of people getting stopped out, people initiating new trades — the whole nine yards — so you'll get a stronger move.

Finally, if the market is just approaching new 20-day highs or lows, these points tend to be magnets or key chart levels that will accelerate price action.

AT: *So does today (Nov. 3, 2003) qualify as a trend day?*

LBR: We have the conditions for a potential trend day. To confirm a trend day, you can look for two things. One thing Toby Crabel mentioned was a very large 15-minute bar to open the trading session

FIGURE 2 TREND DAY ALERT

One of the things Raschke says indicates the potential for a trend day is an opening 15-minute bar greater than the opening 15-minute bars of the past seven days, an observation she attributes to trader Toby Crabel.



continuation pattern that tests out with a 68-percent win-loss ratio on a mechanical basis, is improved by taking volatility into account. If I simply [stop trading the pattern] after we've had a big move, it will eliminate the system's drawdown periods.

Trend days and range days

After a large up move on the open, the stock market is essentially trading horizontally in the morning, which leads to a debate whether the day will shape up to be a trend day.

AT: *More than once you've mentioned "trend days" and "range days." How do you define these?*

LBR: A trend day opens on one end of its range and closes on the opposite end, has range expansion, and makes a steady pattern of higher highs and higher lows, or vice versa, throughout the day. In the index futures, there are two or three trend days a month.

(see Figure 2). Looking at today's first 15-minute bar in the Nasdaq 100, it was not a very large bar, so this would not give us an early jump on identifying a potential trend day. Sometimes the market will open with a big bar down or up, and you know to just go for it.

AT: *How do you quantify a "big bar?"*

LBR: You can determine the threshold of significance yourself, depending on how aggressive you want to be — whether you compare it to the past five opening 15-minute bars or the past 20. You can quantify this type of thing a zillion different ways — you can use a percentage function, or make a comparison relative to the previous n bars, just like a volatility breakout system.

So, we can scan our database and find the stocks that had the largest 15-minute bars relative to the 15-minute bars of the past two weeks. (She pulls up a list of stocks using a program called

Insight.) There were a lot of Naz shares. If I were trading stocks, this list has the ones I'd want to go with.

Then you can add volume: Which of those stocks have had a significant increase in volume in the first 15 minutes relative to the past two weeks? That's an extremely significant little nugget.

AT: Does the placement of the close in the preceding bar have any implications for a trending move the next day — if it closed extremely high or low, for example?

LBR: I don't care that much about a day that closed on its high or low. I'm more interested in how the market behaves after the first 30 minutes of trading. A lot of the pension funds and institutions tend to stand back a little in the first 30 minutes and watch the market settle in to get some confirmation.

The other things we look for in terms of a higher trending day include a volume increase — which we don't have today, but we have to keep in mind today is a Monday, usually a lighter-than-normal volume day.

Then, is there good leadership — are IBM, Microsoft, Intel, GE looking good? Next, I want to see a degree of trendiness between say, 10 and 10:30 or 10:45 a.m. I want to see a steady pattern of higher highs and higher lows after 10 o'clock. If I see that pattern I know it will appear in the afternoon, too.

The last and most important thing is that I want to see trend in the market breadth — the difference between advancing issues and declining issues. (*She pulls up a screen showing the TICK indicator, which is the difference between the number of NYSE stocks trading up on the day minus those trading down on the day.*) Right now you can see breadth is really strong — +1,400. But what you *really* want to see is improvement in breadth from here. You don't want to see the market gap up on strength and see the breadth number deteriorate, or go flat. [If there's no improvement] in volume or breadth, the market is more likely to stay within a trading range. If that's the case, I'll be in more of a scalp mode and just play for small wins — a point or two, or even less.

But if I see volume, trend in the breadth and strong money flows, I'll play for a big target. I'm looking to hold that position until the end of the day, or add to the position during the day, or maybe hold part of it overnight.

Another thing to look for on a trend day is program activity — buy programs on a trend day up. You see that in the TIKI (*the Dow equivalent of the TICK*). Any time these guys fire off the baskets — which they all do now — everything is so highly indexed, it's going to include the Dow stocks, so you'll see the TIKI at +24, +26.

Something I'll almost always do the day after an NR7 day is bracket stops around the early morning range. When I tested this out about five years ago, it didn't matter whether you bracketed the first 45 minutes range or the first hour's range. If there's going to be a trend day, you're going to catch it.

Execution and performance

When discussing her online trading room, Raschke mentions one of her goals is to communicate the importance of the trading process, and the reality of dealing with things such as errors and unexpected market developments. She talks about missing a trade setup she has been watching develop.

"To me, it's a bigger crime to miss a trade I've been monitoring — I have to put on at least a small position at the market just on principle," she says. "I'd rather try and be wrong than not put the trade on at all. So if I feel like I'm not doing it at an advantageous trade location, I'll reduce the leverage to a minimum, but I'll still make the trade.

"It hurts my confidence if I don't at least try," she continues. "If you don't follow through, you'll start holding back — like a golfer who won't really swing freely because he's afraid he'll hook or slice. In any performance endeavor, if you start holding back a little bit, it blocks you and messes up your game. You've still got to go for it even if you know the odds of a winner aren't going

The green and red dotted lines mark daily highs and lows, highlighting the fact the market had traded from high to low the previous two days and setting up the potential for a long trade. After exiting an early-morning buy scalp off a higher low on Nov. 3, the market resumed its downtrend.



to be *quite* as high, but it's something you've been watching and monitoring."

In this case, Raschke is referring to a long trade in the December 2003 Eurocurrency (ECZ03) futures that set up in the aftermath of two successful short trades the previous week (see Figure 3).

LBR: Now, I've already caught this market moving to the downside two days in row. So this morning I'm thinking, "OK, I like playing the downside because it's rewarding me, but we've already had two down days in a row. Let's see if there's upside potential."

Let's look at what happened here. The market rallied up to the retest — I think it hit 92 or 93 on this little pop — so it could easily turn back down. At the very least, then, I want to pull a stop up to breakeven.

What I'll do is stick an offer out there — always try to make the market take your offer out first, because there's always that edge in selling on the offer and buying on the bid. If it isn't hit within the next two or three minutes, I'll get out at the market.

AT: *How do you gauge how much time a trade like that needs?*

LBR: The time frame I'm trading on and my objective. Think in terms of how long it takes for an average swing, up or down, to form on a certain time frame. Let's say you're working on a 10-minute time frame. What's the average up swing or down swing going to be — 30 minutes or so? It might be longer, but this gives you an approximate window to work within.

In this case, I wasn't playing for a big target because overall, the market is in a trading range — it's not like I have trends on multiple time frames behind me — and I do know the short-term momentum has been to the downside because the downswings have been larger than the upswings. That's really what I try to do, by the way — I just want to trade in the direction of the most recent greatest swing on my time frame.

And there's some common sense. If you're on a one-minute time frame, you're not going to hold the trade for an hour.

AT: *You've said in the past you usually enter a position all at once. Is that still true?*

LBR: If I'm trading on a longer time frame, I might put part of the position on initially and then work a bid to see if I can get a better average price. Or, I'll work a bid on half the position but have a buy stop higher in case I don't get filled on the limit order so I don't miss out. In other words, I'll bracket an entry.

AT: *Earlier, we were looking over your notebooks of market tendencies, patterns and test results. You mentioned the challenges of using mechanical trading systems, but you still seem to have a systematic bias — you reference different statistics regarding the probabilities of this or that pattern. But ultimately, what you actually do in the market appears to be discretionary.*

LBR: Everything I do is discretionary, and I'll be the first to admit that with experience you just get to be a better tape reader. But you still have to start with a framework or structure. You see people who get frustrated after trading only three or

four months (*she pauses and shrugs*)...It's like anything. If you're a radiologist and you read x-rays for five years, you're going to develop a better feel for things than if you'd only done it for three months. That's why every doctor has to do an internship or residency for two or three years.

People don't realize it's the same thing in the markets. Even if you're trading 100-percent mechanically, there are so many nuances to execution and organization, and so many things in the market that can go wrong. How do you handle adverse gaps, and gaps through your stops, for example?

Experience counts for a lot in this business. It's a survival game. If you can persevere and endure for that first two or three years, then you're there. If you do it for a year and get frustrated and quit because you're not profitable — well, that happens to a lot of people.

If you don't know the rules of the game, you don't know what to look for. My former husband used to be a baseball player, and when we'd watch a game he'd say things like, "He's going to throw the ball low and inside, and here's why..." and sure enough, the pitcher would do it. In the market, if you know what to watch for, it makes a world of difference.

Another example is my sport, dressage, which I've been doing for 16 years. It's sort of the equivalent of gymnastics with horses. You try to build up strength, flexibility and suppleness. It can take a long time — six years — to train a horse up to a higher, competitive level, and even longer for the individual rider. I still feel like an amateur in many aspects because for 16 years I've tried to ride a perfect circle with the proper bend in the horse. So I can sympathize with people who are newer to trading.

To the untrained eye watching a horse prance around looks cool, but there's no way to tell a good horse from a bad horse. But after you've watched it a while, you can see how a certain horse holds himself — he's relaxed, his moves are rhythmic, his tail isn't swishing, his ears are perked forward, which means he's happy and listening to his rider. When you can appreciate all the nuances, you can enjoy watching the sport because you know what to look for.

It's like that with the market. I know what to look for, I have my own road map and I know how to read it, which is another important point: It's not like there's a right or wrong way as long as what you are doing translates down to the bottom line! Some people like to look at trading in the context of Elliott Wave, or cycles or something else.

AT: *But from your experience, don't you think there are some things that are completely irrelevant or erroneous as far as trading approaches or ideas go?*

LBR: If a trader is consistently profitable using a particular methodology, that's what's important. If an approach is not valid or is based upon erroneous assumptions — or even more importantly, it is simply not executable on a real-time basis — then it's worthless because it will not translate down to the bottom line.

Analysis and preparation

Raschke spends a great deal of time each evening analyzing the

markets and putting together a game plan for the following day (which she posts on her Web site). Among other things, she logs the closing prices and two-period ROC for each market, notes any significant volatility conditions, and records market internals such as breadth oscillators and put-call ratios. When reviewing her nightly regimen, she re-emphasizes the importance of using filters and putting information in context.

AT: *What do you do after the close or in the morning to prepare for the upcoming trading session?*

LBR: The two most important things to look at when you do your analysis at night, or when looking at a system, chart pattern or indicator, is to put it in a context.

First, consider the volatility condition. For example, if a market has already made an exceptionally large move and has entered into a consolidation — has started forming a trading range — you would use certain strategies and trade management.

Or, if the market just formed a long consolidation and just made its first breakout, there might be more runaway-type moves, which will mean looking for different kinds of patterns and entry techniques.

The second context is the higher time frame. I put more emphasis on multiple time frames than I did 10 or 15 years ago. By consulting multiple time frames you know you'll either be trading with the trend or taking advantage of a dominant technical pattern such as a key test.

I might be making my trades based on a daily chart for stocks. If I'm looking at the daily chart I'm always going to put it into the context of the weekly technical structure: Are there weekly sell divergences I need to be aware of? Or is there a broader weekly bull flag forming?

Likewise, in the S&P futures, if I'm looking at a one- or five-minute chart, I want to know if the market is already at the end of a run and perhaps needs to consolidate on a longer time frame. Are we in the middle of an overall trading range? Or did we just break out and make new momentum highs on the five-minute chart for the first time, in which case I can be a little more aggressive?

AT: *What are you trying to figure out in terms of your after-hours analysis? What do you want to determine for the next day's trading?*

LBR: You need to concentrate on having one trend for the day. For example, say I'm looking to short natural gas because it had such and such a setup, therefore I'm expecting it to trade from high to low, or close lower than it opened. If someone gave you just that one piece of information about a market every day, think how much easier it would be to trade. You wouldn't have to worry so much about your initial trade location, for example.

I think people get too caught up in looking at one-minute or five-minute charts. The majority of the time markets like beans, gold or natural gas are going to trend off their opening prices — more so than the S&Ps, which have more trading range days.

I don't want to understate the importance of the short time frames there, because the S&Ps futures have more range and volatility, and you can trade them on such a short time frame.

But you have to think about getting the main idea right each day for each market. What's the "play" for the day?

AT: *Do you think this kind of approach can give you potentially misleading biases, such as refusing to sell because your analysis indicated today was going to be an up day?*

LBR: You can pretty much tell right away if you have the right game plan or not [in a market]. I might find out I don't have the right game plan, so I just don't touch that particular market.

I might set up four to 10 short-term swing trades each night, and maybe half of those will fall perfectly into our laps. Others we'll miss, but we almost always make one to three trades a day in another [futures] market, in addition to different stocks.

Parting thoughts

The sun has set before we leave the trading room. Raschke offers suggestions as to what traders can do to get and keep themselves on a profitable track.

"You have to add things, explore everything and find what works for you," she says. "Start out by doing one thing and one thing only — trading a bull flag, for example — and do it well. Then add a simple filter, such as looking at a higher time frame."

That advice might frustrate some. Less-experienced traders often crave hand-holding more than anything, but self-reliance is at the heart of trading progress. The next bit of advice may even be harder for some people to swallow.

"Forget about making money, just get proficient at execution," she says. "Because when you start, you can be nervous and you can freeze up. And with practice, the emotions that accompany trading subside."

She also warns against getting spread too thin or distracted by markets or situations with less potential.

"After you strip everything away, how do you maximize your efficiency?" she asks. "You have only one pair of eyes, no matter how many screens you have. You can only manage so many positions, so go where the volatility and volume are. Spend your time, money and resources in markets where you can ultimately move size. You need liquidity. Once you're consistent, the goal should be to increase your size."

It's almost five hours after the close when Raschke wraps things up, but she still has to put in time later to create the game plan sheet for tomorrow.

As I gather my things, she talks about how important the mental game of trading is, and what she refers to as "rituals" — the various exercises and disciplines she practices every day to maintain her confidence and equilibrium and keep her on track in the markets.

"After 20 years, I still brainwash myself."

Next month: More on Raschke's indicators and trading strategies and techniques.



The Face of TRADING

Markets on call

BY KIRA MCCAFFREY BRECHT



Name: Dr. Henry Yu

Age: 47

Lives and works in: Toms River, N.J.

One of Dr. Henry Yu's biggest frustrations is that he's not always at a computer screen when the market is making a big move. As a full-time physician, Yu's "day job" makes it a challenge for him to trade the E-Mini S&P futures intraday.

"I get upset when I miss a great run," he says. "The hardest thing is juggling this and my work."

However, despite his busy daily practice, Yu still manages to monitor trades between patient appointments. Yu maintains a trading setup in his medical office. He sets alarms on the computer, which page him if a futures contract or a stock he is interested in trading hits a certain price. Once he's finished with a patient, he can check in on the markets.

However, on the first Friday of the month, when the U.S. Department of Labor releases its employment report — usually a big market mover — Yu clears his schedule so he can be at his computer at release time. Generally, Yu also tries to free time to trade between 9:30 and 10:30 a.m. and 3 and 4 p.m. ET.

Yu notes similarities between working in medicine and trading, particularly the importance of paying attention to detail and adhering to a disciplined approach.

"When you examine a patient you have to do a thorough job, from head to toe," he says. "There's a certain set of rules to follow, and the discipline in the work is very important."

Like many other people, Yu first got involved in trading toward the end of the major bull market in U.S. stocks. He initially bought and sold "high-flying stocks like Cisco and Sun Microsystems" on an intraday basis, through a full-service brokerage.

"I caught the bull by the tail and made a lot of money in the last two months, without really knowing what I was doing," Yu says. While his profits allowed him to buy a new Porsche, once the bull market began to crash into a bear, Yu realized his trading strategy was a little uncertain and after several months of losses, he stepped away from the markets.

One of Yu's grateful patients, an investment advisor who had successfully survived a liver transplant, introduced him to Jeff Manson, a trader and advisor, who convinced Yu to take another look at the markets. Yu spent three days with Manson watching and learning his trading system. From there, Yu

began studying further. He purchased a mechanical trading system (Software Solutions' Entry Point software), which he now relies on in his trading.

Outside of trading: Yu is an internist, in a group practice with three other physicians.

Trading method: Yu relies on his trading software and says there is no discretion in the methodology. He applies the software both to stocks, for one- to three-month position trades, and his intraday futures trading. Yu utilizes a stock list from Software Solutions, which he receives every two weeks, to help determine which stocks to trade.

The software is designed to trigger buy/sell signals, which capture the middle third of a market's move, according to Yu. He will screen stocks from that list against *Investors Business Daily* criteria, searching for uptrending growth stocks with EPS ratios above 80 from an industrial group. He also checks potential stocks on Knobias.com to learn about current earnings and company news. In his intraday futures trading, Yu generally puts on two to four trades per day in the S&P E-Mini.

Worst trading experience: Yu finds that his worst trading occurs when he is "stressed out" about other aspects of his life and sits down at the computer and starts trading "just to get his frustration out."

He has learned that "if I had just traded the chart and followed the [system], I would have been fine."

Most important lesson: "One of my biggest problems is that as a physician I'm used to giving orders and I'm never wrong, until after the fact," Yu says. "I've found that I will stay in my trades longer than I should. You need to cut your losses short."

The best thing about trading: "The freedom. You don't have to answer to anybody. If you are wrong, you have no one to blame but yourself," Yu says. He also points to the ease of the electronic trading as a big plus, with no more phone calls to brokers waiting to hear about fills.

When not trading: Yu enjoys fishing.

Recommended reading: *Investors Business Daily* Web site and books, Knobias.com, and the smart money sector tracker industrial browsers on www.marketwatch.com.

This article is not intended as an endorsement or non-endorsement of any specific software or brokerage. It is intended simply to relate the experiences of a trader who uses a purchased system to trade.

Trading setup

Hardware: Pentium IV PC, 80 GB hard drive, 1Ghz RAM, two 21-inch monitors.

Software: TradeStation for stocks, RealTick for futures. Also, Entry Point software by Software Solutions.

Internet connection: Cable modem

Brokerage: Trend Trader LLC (direct access).



Presidents Day

Sifting through the data to discover potential trading opportunities around this market holiday.

BY DAVID BUKEY



It doesn't attract much attention in analysis circles, but Presidents Day, which is observed on the third Monday in February, is one of only nine holidays for which the stock market closes each year.

The holiday falls in a traditionally weak month sandwiched between two months with traditionally bullish returns: February is near the bottom of the pile in terms of average monthly S&P return with an anemic .07-percent gain over the past 25 years (September is the only month with a worse average performance: a -1.18-percent loss). January is one of the strongest months of the year, and March has posted a relatively bullish 1.05-percent average gain during the same period. (See p. 83 for additional reading about seasonal trends.)

To see how the market behaved before and after Presidents Day, we analyzed the 25 years of daily S&P 500 price data from 1979 to 2003, focusing on the average daily performance of the 20 days surrounding Presidents Day, from 10 (trading) days before the holiday to 10 days after it.

Daily performance

Figure 1 (right) shows the 25-year average returns for each of these days. For example, day -10 represents the average return on the 10th day prior to Presidents Day and day 10 is the average performance of the 10th day following it.

The market posted average declines the two days before and three days after the holiday (days -2 to 3), but then rallied the second week after the holiday (days 4 to 10), with day 6's -.02-percent loss the only down day in this period.

The five-day period from the second day before Presidents Day to the third day following it (days -2 to 3) contains

the most consecutive losses (five) for a total of -.61 percent. The four-day period from day 7 to day 10 consists of successive average gains for a .78-percent cumulative return.

Table 1 compares each day's average and median, or middle, value and lists the difference between the two figures. The "Probability" column contains the percentage of times the market moved in the direction (positive or negative) of the average move. The final two columns show the largest individual up moves and down moves for each day.

Comparing average and median returns is useful because an extremely large or small number in a data set can skew the set's average value higher or lower; the median is less susceptible to this influence. For example, the median value in the data set 1, 2, 3, 4, 25 is 3, but its average is 7; the final number of the set is much larger than the first four and

skews the average higher.

In this case, the differences between the average and median values are fairly small — only eight of the 20 days are more than .10 percent apart. However, several of the median values (highlighted white) either contradict the sign (positive or negative) of the average return or are zero, in which case the averages returns should be considered less reliable.

For example, day -10 has an average return of -.04 percent but a median return of +.28 percent. This .32-percent discrepancy suggests a few disproportionately negative returns have skewed the average lower than the median. This is also reflected by the day's low probability (40 percent) of a down move (negative return). The other similarly highlighted days have comparable statistics.

Price moves (positive or negative) are more significant when combined with a high probability of a move in that direction (a high "winning percentage").

FIGURE 1 PRESIDENTS DAY MARKET BEHAVIOR

The market lacks direction around Presidents Day. A five-day sell-off between days -2 and 3 reverses at day 4 and the market then climbs into the second week following the holiday.

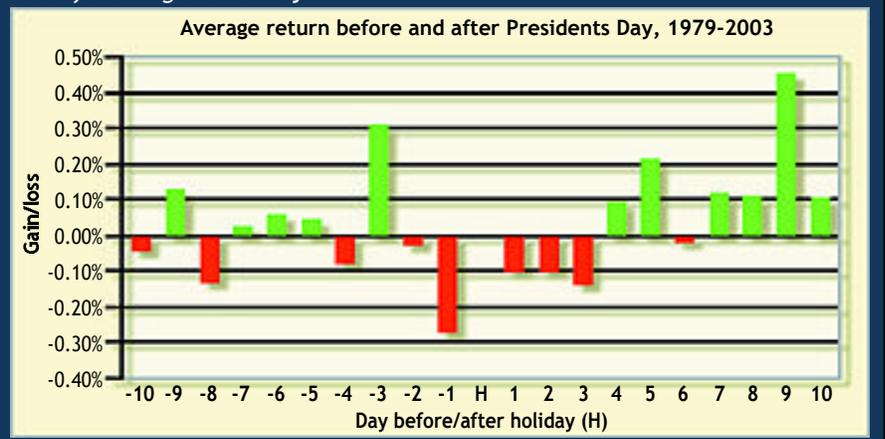


TABLE 1 DAILY MOVES

The largest average moves (positive or negative) also have the highest probability of a move in that direction.

Day	Average return	Median return	Difference	Probability	Max.	Min.
Day -10	-0.04%	0.28%	0.32%	40%	2.14%	-2.47%
Day -9	0.12%	0.14%	0.02%	56%	1.23%	-1.41%
Day -8	-0.13%	0.00%	0.13%	52%	1.94%	-2.08%
Day -7	0.02%	0.00%	0.02%	44%	1.72%	-1.85%
Day -6	0.06%	0.20%	0.14%	64%	1.49%	-2.10%
Day -5	0.04%	0.04%	0.00%	56%	2.57%	-2.24%
Day -4	-0.08%	-0.02%	0.06%	56%	1.07%	-2.22%
Day -3	0.31%	0.30%	0.01%	68%	1.96%	-1.27%
Day -2	-0.02%	-0.14%	0.12%	56%	2.49%	-1.45%
Day -1	-0.27%	-0.40%	0.13%	72%	2.14%	-3.04%
Day 1	-0.10%	0.09%	0.19%	48%	2.07%	-2.40%
Day 2	-0.09%	-0.14%	0.05%	64%	1.63%	-1.85%
Day 3	-0.13%	-0.32%	0.19%	64%	1.91%	-1.55%
Day 4	0.09%	0.03%	0.06%	52%	2.09%	-1.68%
Day 5	0.21%	0.23%	0.02%	60%	2.66%	-1.84%
Day 6	-0.02%	-0.07%	0.05%	56%	1.90%	-1.58%
Day 7	0.12%	0.11%	0.01%	60%	1.76%	-1.43%
Day 8	0.11%	0.10%	0.01%	52%	1.23%	-1.32%
Day 9	0.45%	0.37%	0.08%	80%	2.26%	-0.57%
Day 10	0.10%	-0.06%	0.16%	44%	2.04%	-1.27%
Average:	0.04%	0.04%	0.00%		1.92%	-1.78%

Table 1 shows the three largest daily price moves (up or down) also had the highest winning percentage (blue highlighted rows). Day 9 had a .45-percent average gain and an 80-percent probability of being an up day; day -3 had a .31-percent gain and a 68-percent chance of being an up day; and day -1 had a -.27-percent loss and a 72-percent chance of being a down day. Also, the median returns for these days did not contradict the average returns.

Best-performing periods

Another way to look at the data is to analyze multi-day price moves around the holiday.

Table 2 shows the largest average

price moves for 20 different time windows — i.e., the largest one-day price move, two-day price move, through the largest 20-day price move — and lists the specific periods that produced them.

We analyzed both average gains and losses, but the table shows only gains because each period's largest price move was to the upside. For example, day -1's -.27-percent loss was smaller than day 9's .45-percent gain and the four-day loss from day -1 to day 3 was less than the four-day gain from day 7 to 10 (-.59 and .78 percent, respectively).

The table includes each period's average and median returns, the difference between them and the "benchmark" return for each period, which is the aver-

age S&P return over the same-length period between 1979 and 2003. The table also lists each period's per-day return (average return divided by the number of days), probability of gains and largest individual up moves and down moves.

For example, the largest 10-day average return (.72 percent) occurred from the day after Presidents Day to the 10th day after the holiday (days 1 to 10). The period's average return is .41 percent higher than its median and is nearly twice as large as its benchmark return of .40 percent. The 10-day period's .07-percent per-day return was larger than the one-day benchmark gain of 0.04 percent and it had a 60-percent chance of producing a positive return.

Table 2 shows the average and median values for the different time periods are fairly close — only six of the 20 periods are more than a quarter-percent apart. However, these six discrepancies (the five-, six-, 10-, 11-, 12- and 16-day periods) stand out because 19 of the 20 average gains are less than 1 percent and a difference of a half-percent represents a wide swing from the average.

The shortest periods tended to have the largest per-day returns. The top four per-day returns range from the four-day period's (days 7 to 10) .19-percent daily gain to day 9's .45-percent gain. These per-day gains also outperform the one-day .04-percent benchmark gain by the widest margin: The four-day period's daily returns are nearly five times as large as its benchmark and day 9 outperforms this figure by .41 percent.

The best-performing periods of four days or less also had the best chances of gaining ground. The four-, three- and one-day periods post gains 76, 72 and 80 percent of the time, respectively. The other 17 periods not only have smaller per-day gains, but less than a 70-percent chance of positive returns. The two-day period (days 8 and 9) is the only exception to this rule with the second largest per-day return of .28 percent and 64-percent chance of an up move.

The past 10 years

To see if the 25-year tendencies have changed at all in more recent history, we also performed a separate analysis of the 10 most recent years. Figure 2 (left) shows the average daily gains of the 10 days before and after Presidents Day from 1994 through 2003.

The most notable difference between Figure 1's 25-year period and Figure 2's 10-year period is the average performance on the day before Presidents Day

FIGURE 2 PRESIDENTS DAY, 1994-2003

In recent years, the loss on the day before Presidents Day has intensified.

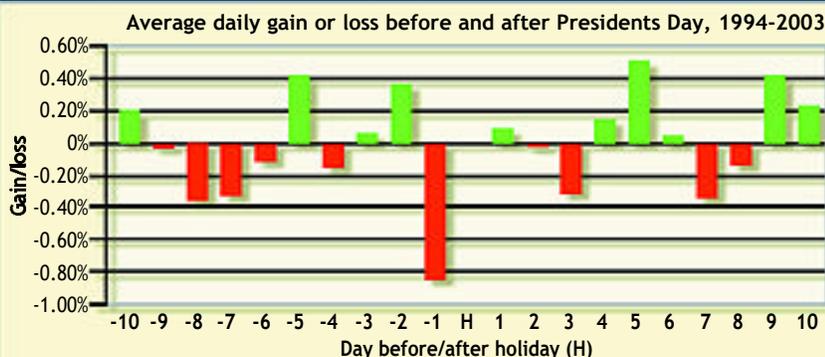


TABLE 2 BEST-PERFORMING PERIODS

The shortest time periods tend to have favorable characteristics (larger per-day returns and higher probabilities of gains).

Period length	Days	Avg. return	Median return	Difference	Benchmark return	Per-day return	Probability	Max.	Min.
1 day	9	0.45%	0.37%	0.08%	0.04%	0.45%	80%	2.26%	-0.57%
2 days	8 to 9	0.56%	0.72%	-0.16%	0.08%	0.28%	64%	2.17%	-1.84%
3 days	7 to 9	0.68%	0.87%	-0.19%	0.12%	0.23%	72%	3.13%	-2.61%
4 days	7 to 10	0.78%	0.73%	0.05%	0.16%	0.19%	76%	4.01%	-2.75%
5 days	5 to 9	0.87%	0.32%	0.55%	0.20%	0.17%	56%	5.69%	-2.23%
6 days	5 to 10	0.97%	0.29%	0.68%	0.24%	0.16%	68%	5.87%	-2.21%
7 days	4 to 10	1.06%	0.95%	0.11%	0.28%	0.15%	56%	6.74%	-2.41%
8 days	3 to 10	0.92%	1.03%	-0.11%	0.32%	0.12%	68%	5.09%	-3.41%
9 days	2 to 10	0.83%	0.60%	0.23%	0.36%	0.09%	56%	6.51%	-2.93%
10 days	1 to 10	0.72%	0.31%	0.41%	0.40%	0.07%	60%	4.50%	-4.62%
11 days	-1 to 10	0.45%	0.00%	0.45%	0.44%	0.04%	48%	4.64%	-6.42%
12 days	-3 to 9	0.64%	1.36%	-0.72%	0.48%	0.05%	64%	5.09%	-6.42%
13 days	-3 to 10	0.74%	0.82%	-0.08%	0.52%	0.06%	64%	6.40%	-5.87%
14 days	-4 to 10	0.67%	0.78%	-0.11%	0.56%	0.05%	60%	7.52%	-6.68%
15 days	-5 to 10	0.70%	0.62%	0.08%	0.60%	0.05%	68%	6.72%	-5.58%
16 days	-6 to 10	0.76%	0.23%	0.53%	0.64%	0.05%	56%	6.82%	-6.84%
17 days	-7 to 10	0.79%	0.90%	-0.11%	0.68%	0.05%	56%	6.49%	-7.42%
18 days	-9 to 9	0.68%	0.73%	-0.05%	0.72%	0.04%	64%	6.35%	-8.87%
19 days	-9 to 10	0.78%	0.71%	0.07%	0.76%	0.04%	56%	6.03%	-8.34%
20 days	-10 to 10	0.75%	0.90%	-0.15%	0.80%	0.04%	60%	7.66%	-8.01%
Average:		0.74%	0.66%	0.08%			62.60%	5.48%	-4.80%

Note: The average returns of multi-day periods may be inconsistent with the sums of daily averages due to rounding.

(day -1). In Figure 1, the day prior produced a modest -27-percent down move — the third-largest average daily move. In Figure 2, the average loss grew to -.83 percent, larger than any other average daily move in the 10- or 25-year period.

Figure 3 shows the year-by-year gains and losses on the day before Presidents Day and shows the probability of losses on this day has also increased in recent years. Overall, there was a 72-percent chance of losing ground in the entire 25-year period, but in the past 10 years that probability increased to 90 percent, including a string of 11 consecutive losses between 1992 and 2002. Whether this means a continuation of this trend is

more likely than a return to the more moderate statistics of the 25-year period is open to debate. However, the price action during this period in any given year will help determine the advisability of acting on these probabilities.

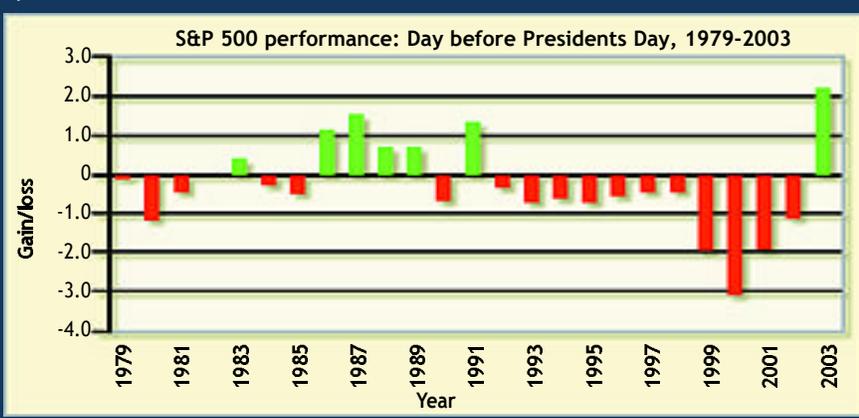
Trade ideas

The tendency for the day before Presidents Day to be a down day suggests the possibility of selling short on the day prior and immediately covering the position the following day. Similarly, the strength of the ninth day after Presidents Day implies going long on the close of day 8. These moves are smaller than the five-day average loss between

days -2 and 3 and the four-day gain from day 7 to 10 in Figure 1, but they have larger per-day returns and higher chances of moving in the desired direction. These daily trends could also be used as entry or exit signals or the basis of a longer swing trade if current market conditions support it. Ⓢ

FIGURE 3 MARKET BEHAVIOR ON THE DAY BEFORE PRESIDENTS DAY, 1979-2003

The market typically falls on the day before Presidents Day. Note the string of 11 consecutive losses between 1992 and 2002.



Additional Active Trader reading

- "Playing the seasonals," November 2000, p. 86
- "Ben Warwick: Taking the Quantitative View," February 2002, p. 62
- "Mark your calendars: Stock market seasonality," September 2002, p. 96
- "Memorial Day and the stock market," June 2003, p. 42
- "Fourth of July market behavior," July 2003, p. 30
- "Trading system lab: May-October system," July 2003, p. 42
- "Market history: Labor Day and the stock market," September 2003, p. 86
- "Legends of the fall," October 2003, p. 38
- "Thanksgiving and the stock market," November 2003, p. 76.
- "Analyzing end-of-year stock market patterns," December 2003, p. 82.



Avoiding **WASH-SALE** washouts

The wash-sale rule can be tricky to interpret, but active traders must understand its basic tenets. Find out how to identify wash-sale situations and handle the consequences — or avoid the issue altogether.

BY DAVID BUKEY

Closing a losing trade may be painful, but it gives you a tax advantage — deduct the loss and reduce the burden of other taxable capital gains. However, if you trade the same stock repeatedly, you may not get this tax benefit right away.

According to the wash-sale rule, you cannot immediately take a tax loss if you purchase, or replace, the same stock position 30 days (calendar, not trading) before or after the initial sale. The wash-sale rule's purpose is to stop traders from claiming a tax deduction while maintaining a long-term stock position by repeatedly opening and closing a trade on a short-term basis. The wash-sale rule doesn't usually affect buy-and-hold investors, but it can make preparing tax returns a nightmare for active traders who may trade hundreds, if not thousands, of times a year.

Despite common misunderstanding, the basic wash-sale guidelines are fairly straightforward. To claim a tax loss, you must not purchase "substantially identical securities" within a 61-day window — 30 days before the sale, on the sale date or 30 days after it.

For example, if you bought 100 shares of IBM at \$125 in January 2002 and sold it at \$100

on March 1, 2002, you could have deducted the \$2,500 loss realized on that date. But if you believed IBM was poised for a rebound and bought 100 shares at \$105 on March 25 — only 25 days after the sale — you violated the wash-sale rule and couldn't claim the tax loss. You continued the stock position by replacing the original shares and claimed a tax deduction at the same time.

The wash-sale rule also applies to short sales. For example, if you sold short and covered your position at a loss and sold



Additional *Active Trader* reading

"Year-end tax planning tips," December 2003, p. 86

"Eat what you want...just take care of your taxes," January 2003, p. 94

"Get a head start on your tax planning," December 2002, p. 92

"Get what you deserve," October 2002, p. 92

"Taking the sting out of losses," September 2002, p. 100

"Staying in the game," June 2002, p. 94

"Different markets, different tax rules," May 2002, p. 94

"Take control of your taxes," February 2002, p. 96

the same stock short again within 30 days of ending the original trade, you have violated the rule.

Substantially identical or not?

Much of the confusion surrounding the wash-sale rule involves the IRS's definition of substantially identical. The wash-sale rule is clear when buying back common stock of the same company, but it is much less concrete about replacing common stock with other types of securities.

The IRS considers options, warrants and preferred stock (if its characteristics are similar to common shares) as substantially identical to common stock, but not commodities or futures contracts (including option and wide-based index futures). However, single-stock futures and narrow-based index futures contracts are considered substantially identical to their underlying securities. The S&P 500 is an example of a broad-based index, while narrow-based indices represent specific sectors such as biotechnology or energy.

Bonds offered by the same issuer with the same interest rate are substantially identical to each other, but those issued by different authorities or the same authority at different rates are not.

The rule is less clear about trading in tax-advantaged accounts or trading mutual funds. Can you avoid the wash-sale rule by selling stock at a loss in a taxable account and repurchasing it in a tax-deferred Individual Retirement Account (IRA) within 30 days? Are two similar S&P 500 index funds offered by separate firms substantially identical?

Pushing the boundaries of the wash-sale rule sounds tempting, but common sense and a conservative interpretation will keep you out of trouble. Kaye Thomas argues on his tax-education Web site, www.fairmark.com/buystock/wash.htm, that repurchasing stock in an IRA within 30 days of a tax loss in a different taxable account violates the wash-sale rule because the trades are directed by the same person (you). Similarly, because the performance of two S&P 500 index funds will likely mirror each other, the funds are probably substantially identical.

Wash-sale deferral

If a trade triggers a wash sale, the tax-loss deduction can't be immediately claimed and is deferred to the cost, or *basis*, of the replacement stock. For example, if you bought 100 shares of IBM at \$125, sold them at \$100 and bought them back at \$105 within 30 days of the sale, the disallowed \$2,500 loss is added to the cost of the new shares ($\$10,500 + \$2,500 = \$13,000$). For tax purposes, it's as if you purchased IBM at \$130 a share.

The tax-loss benefit is postponed until you sell the replacement stock. If the new shares are sold before the end of the year and there are no similar purchases of IBM within a 61-day window of the final sale, the wash-sale rule's tax effect is canceled out.

For example, assume you made those three trades in 2002 and sold the new shares at \$80 on Dec. 12, 2002: The tax loss is \$5,000 ($\$13,000 - \$8,000$). This is the same amount as if the two losses occurred without the wash-sale rule (the first loss = \$2,500, or $\$12,500 - \$10,000$; the second loss = \$2,500, or $\$10,500 - \$8,000$).

However, if you held the new shares into 2003, or if additional purchases within 30 days of the Dec. 12 sale violated the

wash-sale rule, the original \$2,500 tax loss would be deferred into 2003.

The wash-sale rule also changes the holding period of the replacement stock to include the purchase date of the original stock sold and prevents a long-term loss from becoming a short-term loss. Because short-term losses are deducted from short-term gains that are taxed at higher rates than their long-term counterparts, claiming a short-term loss might give you an unwarranted tax advantage.

Avoiding the wash-sale rule

Traders can render the wash-sale rule irrelevant by electing Section 475 mark-to-market (MTM) trader status. Because all securities will be "marked to market" at the end of the year, the distinction between realized and unrealized gains and losses disappears along with the wash-sale rule's effect.

The full consequences of the MTM election require more in-

FIGURE 1 ONLINE WASH-SALE RESOURCES

These tax-education Web sites and software programs will help you identify potential wash-sale conflicts in your trades.

IRS Publication 550

www.irs.gov/pub/irs-pdf/p550.pdf (p. 52)

General information

www.greentrader.com/EducationCenter/GTTRecWashSale.shtml

www.fairmark.com/buystock/wash.htm

www.turbotax.com/articles/FAQonWashSales.html

www.tradersaccounting.com/wash-sale-rule.asp

www.fool.com/taxes/2000/taxes001006.htm

Software

GainsKeeper (www.gainskeeper.com)

GTT TradeLog (www.armencomp.com/gtttradelog)

depth treatment, and selecting the election shouldn't be treated lightly — trader status can only be changed by IRS consent. (For more information about the wash-sale rule and MTM accounting, see "Additional reading," opposite page.)

Longer-term traders and investors can avoid wash-sale headaches by not trading the same stock within 30 days of a tax-loss sale and selling any replacement stock by the end of the year. Also, they can consider trading futures contracts that are similar to their original investments (i.e., buying an S&P 500 futures contract to replace SPY, the S&P500 tracking stock).

Other resources

GainsKeeper and GTT TradeLog are two software applications that identify wash sales and automatically adjust the replacement stock's basis. These programs, combined with the Web resources listed in Figure 1 (above), can help determine if the wash-sale rule applies to your trades and how to sidestep it in the future. 



Trading for YOUR RETIREMENT

Many traders want to actively trade their retirement plan accounts. For some it's a bad idea, for others it's a nice way to benefit from tax-deferred cumulative returns. However, there are limitations to what you can do with a retirement account, so take some time to learn the rules before actively trading your retirement plan.

BY ROBERT A. GREEN, CPA



Many traders, especially those who lost most or all of their money during the bear market, have been looking for new capital to take advantage of opportunities in the recent bullish stock environment.

Some traders may join proprietary trading firms to gain access to a firm's trading capital and get leverage of 10:1 or more. However, prop traders need to be licensed and many prop firms require capital deposits of \$25,000 or more.

Other traders might be interested in raising capital from friends, family and others to form their own hedge fund. This allows them to benefit from using other peoples' money, but without exceptional trading skills they are likely to disappoint themselves and their clients.

Trading retirement plan assets is another option. This can be a lucrative approach for seasoned, profitable traders as long as they stay clear of excessive costs, ERISA (Employee Retirement Income Security Act) violations and IRS penalties.

Trading your retirement plan assets may not be a prudent decision, regardless of your skill level. Under IRS and

ERISA law, certain retirement plan assets must be invested with caution and an aversion to risk. Remember, you are relying on these assets for your retirement, when you'll likely have no other sources of income other than social security and your portfolio.

Need, not greed

If an aggressive return on trading capital is 25 to 50 percent, a trader needs capital of at least \$200,000 to generate income of \$100,000 — the amount many traders need to cover their living and business expenses. Certainly, the past few years have been tough for traders and investors. For many, the last resort for capital is retirement plan assets.

It's not easy to take money out of your retirement plan and put it in your trading account. Most qualified retirement plans do allow for loans. You can use the loan proceeds to fund your taxable trading accounts. However, IRAs are not qualified plans and they do not allow loans. If

you take money out of your plan before retirement age, it is considered an "early withdrawal" and is subject to regular income tax plus a nasty excise-tax penalty of 10 percent.

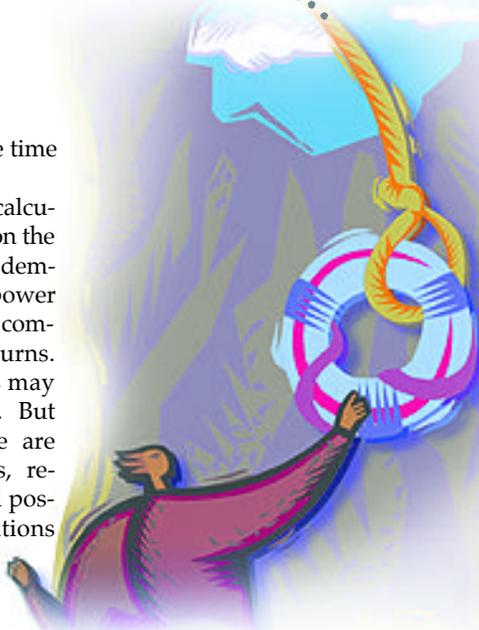
There are some exceptions to this; search the IRS Web site at www.irs.gov to learn more.

Keep it in

There is a way to have access to your retirement plan assets without paying taxes and penalties on early withdrawal. If you leave the money in your retirement plans and trade it within the account, all the trading gains you generate are tax-deferred. Although the money will be taxed upon distribution, you will be paying the same tax rate you would if you traded securities in a normal account (although the tax laws and rates may

change by the time you retire).

Financial calculators found on the Internet can demonstrate the power of tax-free compounded returns. The numbers may impress you. But beware: There are many pitfalls, restrictions and possible violations you need to be aware of.



Brokers take a pound of flesh

Because of the significant competition in the brokerage space, commissions are as low as they have ever been. However, that's not necessarily the case when it comes to retirement plan accounts.

Plus, different brokerages have vastly different rules when it comes to the number of allowed trades and other terms and conditions. Some of the restrictions are based on ERISA and IRS rules, and others are simply the policies of the brokerage.

We have stated in the past that Mini 401(k) plans are the retirement plan of choice for traders, but most brokers still do not offer this product. Mutual fund companies offer Mini 401(k) plans, but most traders prefer a retirement plan they can trade.

ERISA — what it is and why should you care

The Employee Retirement Income Security Act (ERISA) of 1974 is administered by the U.S. Department of Labor (DOL). ERISA was designed to better protect employees' retirement plan assets. Previously far too many companies abused their retirement plans for the benefit of management and shareholders, leaving employees to suffer. For more information, visit www.dol.gov/dol/topic/retirement/erisa.htm.

Before ERISA, companies could purchase only their own stock in their retirement plans. Under ERISA, companies are not allowed to invest all retirement plan assets into any one stock. And, the amount that any single position takes up in the plan cannot exceed 25 percent. Company administrators have a fiduciary duty to diversify investments and manage risk.

This rule presents a problem for many traders. Is active trading in an ERISA-covered retirement plan a violation of the plan diversification rules?

Because there is no clear guidance or case law on this question, each case should be evaluated individually with a CPA or tax attorney specialized in ERISA and tax regulations.

Good news about IRAs

Individual retirement accounts (IRAs), including traditional IRAs, Roth IRAs, Rollover IRAs and education IRAs, are not covered by ERISA. Therefore, they are not subject to ERISA plan diversification rules. However, you still may be subject to rules established by your broker, and you will definitely be subject to certain tax restrictions.

SEP IRAs and Mini 401(k) are covered by ERISA if they are set up on the company level; if they are established individually, they are not subject to ERISA rules. Retirement plans that include third-party employees are covered by ERISA for the protection of those employees. But plans for individuals are allowed to fend for themselves without government oversight and protection.

Be an individual

Previous Business of Trading articles

have advocated individual-level plans for traders, with the Mini 401(k) as the first choice and SEP IRAs as a fallback if you miss the deadline date for establishing a Mini 401(k). See "A special 'K,'" *Active Trader*, February 2003, p. 96, and "Year-end tax planning tips," *Active Trader*, December 2003, p. 86.

To have the opportunity to fund a tax-deductible retirement plan, you need to form a simple legal entity. This provides you with earned income, which is essential to funding a retirement plan.

The entity pays you a fee (the fee is considered earned income) and the trader establishes a retirement plan on the individual level. This means the trader is not subject to the ERISA 25-percent plan diversification rules.

A conservative approach

A good approach to the 25-percent rule is to business trade only 25 percent of the plan and conservatively invest the remaining 75 percent in bonds, mutual funds and other non-stock investments.

These recommendations are based on research of ERISA and DOL court cases. The DOL raised the stock investing argument in a few litigations. However, our attorney's opinion is that a high concentration of plan investments in stocks is prudent for a fiduciary and not an ERISA violation, and there is support in the ERISA case law for day traders to self-direct plan investments.

If there is a will there is a way

Consider the following example of trading in an ERISA plan: A trader is actively trading 100 percent of the plan assets but may not be in violation of the 25-percent rule. He trades 10 stocks on a daily basis and does not keep any positions overnight.

The trader hedges his positions and monitors risk very closely. This trader is diversified and is consistently profitable.

The spirit of the 25-percent rule calls for risk management and diversification. It does not specifically state active trading is prohibited. This trader is very

.....

If you want to actively trade your retirement plan, try to do so in a non-ERISA account. If you do have an ERISA account, trade only 25 percent of the assets.

.....

diversified and trading with a good amount of risk management.

While there is little question many short-term approaches especially day trading are high-risk activities, a successful trader can argue consistent profitability proves it is not high risk for them. If a consistently losing trader is trading the retirement plan assets, this claim may not hold water.

However, this is based on theory and has not been tested under the law, so proceed with caution.

Consider the reverse example: A consistently losing trader actively trades stocks in his ERISA plan in a very risky manner without the use of stop losses or hedging. An argument can be made that

this trader violated ERISA rules by not diversifying out of risky trading activities.

No self-dealing allowed

The IRS does not allow “self-dealing” between your retirement-plan assets and yourself.

For example, if you actively trade your retirement plan assets (ERISA or not), you may not pay yourself a management or administration fee. That will be deemed an early distribution subject to tax and the 10-percent excise tax. Also self-dealing is a “prohibited transaction,” which is subject to an additional 15-percent tax.

In most cases it’s also self-dealing to invest your retirement plan assets into

your own hedge fund. Your retirement plan may not be a partner in your trading entity. You can’t sell securities from your taxable accounts to your retirement accounts.

For more information see “The Dos and Don’ts of IRA Investing” by Robert Preston at www.aicpa.org/pubs/jofa/apr2000/preston.htm.

No trader tax benefits

Even if you have resolved all the ERISA and tax issues surrounding trading your retirement plan, keep in mind that doing so does *not* qualify you for trader tax status. Only trading a taxable account can do that. You need trader tax status in order to deduct all your trading business expenses.

Without trader tax status, all your expenses are matched to your retirement plan income, which is tax-deferred. That means your expenses are also tax-deferred. It will be difficult (although not impossible) to keep appropriate records so that when you retire and take taxable distributions, you can reduce that income by the deferred expenses. An administrator will not allow you to record those tax-deferred expenses in the retirement account.

To protect against deferral of your expenses, gain trader tax status on at least a small taxable trading account. Within reason, you can allocate all your business expenses to the taxable account and not be stuck with any expense deferral. You will then get the best of both worlds.

Bottom line

If you want to actively trade your retirement plan, try to do so in a non-ERISA account. If you do have an ERISA account, trade only 25 percent of the assets (or consult with an expert on ways around the 25-percent rule). Finally, find a brokerage that offers restrictive commissions and few restrictions on trading retirement accounts. 

For information on the author see p. 3.

Within the rules?

Consider this scenario. A trader has \$200,000 in a taxable trading account and \$400,000 in an IRA account. He trades both accounts, using day- and swing-trading methods. His brokerage, however, limits some trading in the IRA.

Because of the trader’s activity in the regular account, he has trader tax status and reports his \$30,000 of trading business expenses, including interest expense on his taxable accounts, on his individual tax return Schedule C (Profit and Loss from Business).

The trader enjoys a 50-percent return (\$100,000) on his taxable account and a 40-percent return (\$160,000) in his IRA. He reports his \$100,000 taxable gain on Form 4797 (as a mark-to-market trader, he is eligible to use this form). His net taxable trading income (gains less expenses) is \$70,000, which is enough to cover his living expenses.

He does not make any early withdrawals from his IRA.

It is unlikely the IRS will pay much attention to these circumstances; however, could it argue the trader invested in his own business activity, did self-dealing or had any prohibited transactions? Under current law, this trader is operating in a gray area.

Nonetheless, the trader has a solid defense. He is a sole proprietor, so his IRA did not buy stock in his own trading company. And, he did not transfer any more to a taxable trading account. His IRA did not pay any of his trading business expenses (his broker wouldn’t allow it anyway), and all expenses are deducted on his taxable trading business.

He carried on a trading business in his taxable accounts and his net business taxable income was sufficient to cover his living expenses. He used his trading skills to trade his IRA with full asset diversification, liquidity and risk management.

The Lemonade Stand

Sometimes, everything you need to know about business you learn on the playground.

Little Billy closed the cash box at the end of another successful day at the lemonade stand.

"Life is good," he thought, "especially when you're the only game in town."

Mikey whose family moved to town about a year ago, smiled back. He had helped Billy's business take off by delivering the lemonade to kids all over the playground. Before Mikey came along, the kids had to visit the lemonade stand.

As they walked home together, Billy had something he had to get off his chest.

"Mikey," he said. "I've decided I don't need you anymore. I'm going to hire someone else who will work cheaper and faster."

Mikey heard what Billy said but didn't respond initially. There had been talk around the playground for quite a while that this was going to happen. Mikey had to admit there was a little part of him that was glad it was happening.

"Well, thanks for the opportunity," he said. "Best of luck to you."

The next day, Mikey announced he was going to start his own lemonade stand. Billy saw him on the playground and wished him luck. "I've had competition before," he thought. "And I've always come out on top."

However, there was already a buzz around the playground in anticipation of Mikey's addition to the lemonade scene. Everyone knew Mikey, in his old neighborhood, had the best and most successful lemonade stand for miles around. This was in part because he sold a popular product at a reasonable price. Another

reason for his success was the same delivery system that made Billy's operation such a winner.

All the kids figured Mikey would be able to make lemonade that tasted as good as Billy's since they had worked together so closely. And Mikey would certainly charge less.

It'd never been a secret that Mikey thought Billy charged too much. Heck, Billy probably wouldn't deny that — after all, he was the only game in town, so he could pretty much charge whatever he wanted.

In the days that led up to the new stand, Billy was mostly quiet. If he saw Mikey in the playground, he would say hello or perhaps stop to chat briefly about the new swing set.

However, their casual but friendly relationship came to an abrupt end the day Mikey announced his specific plans for his new lemonade stand: He would use the exact same recipe as Billy, charge a lower price and enhance his delivery system to make it even easier for kids to get lemonade.

When Billy got word of Mikey's plan, he was bamboozled. Sure, he figured Mikey would be a formidable competitor, but he had no idea just how formidable. Cheaper prices *and* easier access? For years, he had ruled the roost, but now his position was threatened. What could Billy do?

For starters, he told anybody who would listen how flawed Mikey's plan was. "He's not playing by the rules!" he cried. "He's going to bribe people to buy



his lemonade!"

But Billy wasn't just speaking out — he was also preparing just in case Mikey really started selling lemonade. He lowered prices, changed his delivery system and even hooked up with Tommy, who sold peanut butter and jelly sandwiches at the other end of the playground. Usually, Billy and Tommy couldn't agree on anything, but they began working together to prevent Mikey from starting his lemonade stand.

Nobody else besides Billy and Tommy seemed to have any kind of problem with Mikey. The other kids in the playground were more concerned with the latest kickball game than anything else, and they were thrilled that a new competitor gave them a choice of where to buy their lemonade.

There was virtually nothing they or anybody else could do to stop Mikey from opening the lemonade stand.

Everybody on the playground hoped Billy would eventually quit his whining and focus on his own business. After all, there were a lot of thirsty kids out there, and a lot of lemons to be squeezed. **!**

ON THE JOB



A misstep – and a missed opportunity – in gold shows why it’s all in the execution.

Trade

Date: Friday, Nov. 7, 2003.

Entry: Long December 2003 Gold futures (GCZ03) at 382.20.

Reason(s) for trade/setup: After sliding to almost 372.00 on Oct. 17, December Gold rallied more than \$20 over the next week, peaking on Oct. 24. The market then seesawed lower until Nov. 3 (the first trading day of the month) at which point it began to consolidate with a slightly upward bias (four of five higher closes). The low of the spike-bottom reversal day on Nov. 7 marked a successful test of the support level implied by the Nov. 3 low and the high close set up the possibility of additional upside movement.

Initial stop: 380.30, which is 40 cents below the previous day’s close of 380.70. This level was chosen because the low of the entry day was 376.50, and placing a stop just below this price (which would be a natural retracement level — a test of the previous day’s low) would have represented too large a risk. In this case, placing the stop below the previous day’s close would liquidate the position if the market made a second consecutive lower close.

Initial target: 389.00, or 20 cents below the close of the Oct. 24 swing high.

Update (Nov. 10): The market rallied strongly today, closing at 386.70. To prevent this trade from turning into a loss, the stop was moved up to 382.90, 40 cents below the day’s low.

Result

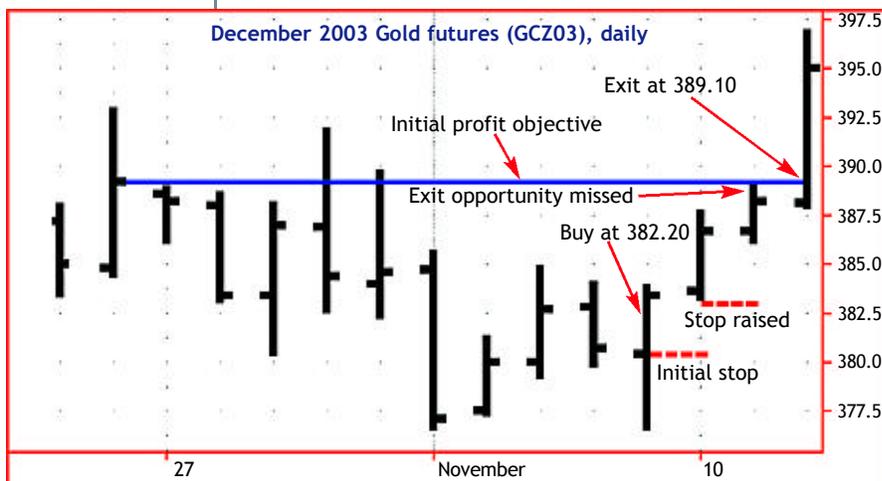
Exit: 389.10.

Reason for exit: Initial profit objective reached.

Profit/loss: +6.90 (1.81 percent).

Trade executed according to plan?
No.

Lesson(s): The market reached the profit target on Nov. 11, but we did



Source: eSignal

not exit according to plan. Strong early trading (and a bad trade print at 390) led us to believe the intraday upside potential was greater than we initially thought, so we raised the target to 390 — and missed our exit point. The market made a high of 393.30 before selling off to close at 388.20.

Because the closing price was below the resistance level that provided the initial target, it seemed possible the market could move lower. We decided the position had to be liquidated as quickly as possible the next morning (Nov. 12) — regardless of what the market was doing. A few minutes after the open, the contract was trading right around 389.00, and we got out at 389.10.

Of course, the market proceeded to rally another eight points in the next few hours, but this is incidental, considering the market could have sold off and erased virtually all open profits because we failed to adhere to the trade plan. Maybe leaving additional profits on the table is just punishment. 🙄

Note: Initial targets for Trade Diary trades are based on conservative evaluations of either a price pattern’s historical performance or technical targets, such as the nearest chart-based support or resistance level. However, trades are established as reactions to market behavior; initial price targets are flexible, and are most often used as points at which some portion of the trade is liquidated to reduce the position’s open risk. The initial (pre-trade) reward-risk ratios are conjectural by nature.

For a second installment of the Trade Diary, go to p. 61.

Trade summary									
Date	Future	Entry	Initial stop	Initial target	Initial reward/risk	Exit	Date	P/L	Actual reward/risk
11/7/03	GCZ03	382.20	380.30	389.00	3.57	389.10	11/12/03	6.90 (1.81%)	3.63

TRADE **Diary**

How can you tell if buying a sell-off is timing a healthy pullback or catching a falling knife?

Trade

Date: Tuesday, Nov. 11, 2003.

Entry: Long the December 2003 Nasdaq 100 E-Mini futures (NQZ03) at 1,407.00.

Reason(s) for trade/setup: Historical testing indicated the Nasdaq tended to rally after corrections such as the one that occurred over the three most recent days, including the entry day. We will go long on logic the market is pulling back and will resume its uptrend.

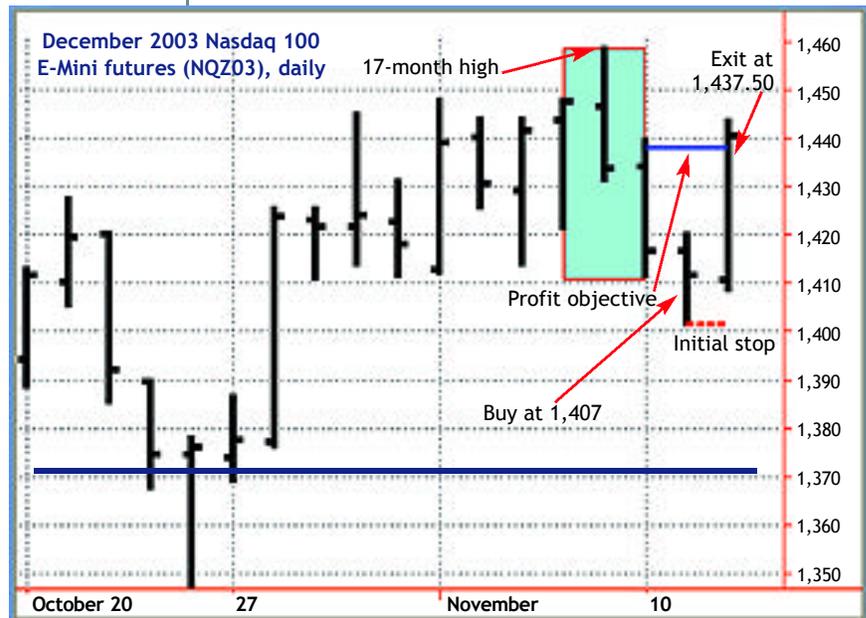
This stance was based on analysis of two patterns, the first of which reflected the S&P 500's status as of Nov. 10: a 17-month high reached the week before (on Nov. 7, in this case), followed by a decline of at least 0.75 percent in the five days following this recent market high. Of the 30 times since 1993 these conditions existed, the market had a fairly strong tendency to rally over the next five trading days. The lowest probability of a gain (60 percent) was in the third day after the pattern; the rest of the days had probabilities of 70 percent or higher. A second analysis of the Nasdaq 100 pattern, shown in the three highlighted bars (ending the next day, Nov. 11), produced similar statistics.

Although this trade is in the direction of the market's historical uptrend period (November to May), this bullishness was balanced by the fact that the Nasdaq was up nearly 40 percent at the time of the trade; some correction would seem in store by the end of the year. However, short-selling opportunities have been shortsighted for most of 2003.

The trade was entered after the market sold off in early trading, stabilized and traded sideways for several hours, suggesting selling pressure was easing. (The market ended up rallying at the end of the day to close near the middle of the day's range.)

Initial stop: 1,402.00 (1.50 below the low of the day).

Initial target: 1,437.50, which is 2.00 below the high of the previous day's wide-range down bar. If the current drop is simply a pullback, the market should recoup most of the losses of this bar in a relatively short period of time. At that point, part of the position can be liquidated and the stop raised to protect profits, or the entire position can be sold and re-established.



Source: TradeStation

Result

Exit: 1,437.50.

Reason for exit: Initial profit objective reached.

Profit/loss: +30.50 (2.17 percent).

Trade executed according to plan? Yes.

Lesson(s): In contrast to the first installment of the Trade Diary (see p. 96), we followed the script on this trade, exiting the position at the target level even though this market (like gold) looked like it could go higher at the time of the exit (approximately 2:40 p.m. ET on Nov. 12).

We exited the entire position instead of just part of it. Because of the upward reversal's strong momentum, a small correction at the close or next day's open would not be unexpected, and would offer the opportunity to re-enter the market. When you capture a fast, strong move like this one, it's a good idea to cash in at least part of your position. 📌

Trade summary									
Date	Future	Entry	Initial stop	Initial target	Initial reward/risk	Exit	Date	P/L	Actual reward/risk
11/11/03	NQZ03	1,407	1,402	1,437.50	6.1	1,437.50	11/12/03	(2.17%)	6.1