

Choose your instruments

By Daryl Guppy

It took real skill to lose money in the market in 2006 through to 2007. Now it will take real skill to make money in the market in 2008.

This is the year of the Rat, but it is also the year of the bear. The weakness in the US market, shown in the rounding top pattern in the DOW Index has impacted on regional markets. For the first-half of this year traders focus on methods for trading short and for short term trading using warrants and CFDs. They will also consider how to use derivatives to benefit from rally recoveries.

Many people ask, "Which is the best sector – gold, oil etc?" This is the wrong question to ask. In a broad market retreat all sectors are effected, but some more than others. The key question to ask is "Which is the best instrument to use to take advantage of a developing opportunity?"

This is a very different market to the market we have traded in the past three years. It calls for very different skills and approaches. Traders who have become legends in their own minds as they confused success in a bull market with trading ability and skill received a very rude wake-up call. Survival now depends on our ability to recognise change and apply the appropriate trading activity to benefit from the changed conditions. Traders have been protecting profits in ordinary stocks from October through January. With the accumulated cash they now examine methods to trade the short side of the market.

The most dangerous point in any trade is the entry. This is the point where we have the maximum risk because the trade may fail. A price move in the wrong direction takes us out of the trade. In stock trading there are three methods for controlling this risk. In order of importance, they are:

- Financial risk calculation. This is the standard calculation using entry price and the distance to the stop loss price. When the stop loss price is hit, the trader loses

2% of his total trading capital, the trade is closed.

- Logical chart support. The probability of a successful trade is increased when the financial risk calculation is combined with a logical chart based support level. This is where we expect prices to pause before developing a new trend.

- Opportunity analysis. We use our analysis methods to identify stocks with a higher probability of moving as we anticipate. Trading success depends upon the financial and chart based risk control. The success rate of the opportunity identification can be as low as 55% in a bull market. Traders will still make good money if they follow the first two conditions with discipline in a bull market.

These methods must be modified when we trade CFDs or warrants. The order of importance is reversed. It becomes much more important to identify the opportunity balance correctly. We need a much greater balance of probability that the trade will move in our preferred direction. An adverse move in a CFD is magnified by the margin leverage. Lack of price movement in our favour becomes a liability in a warrant trade because of the impact of time decay.

In a derivative trade the other usual risk management features – financial and chart stops – are like safety belts. We really plan not to have to use them because the quality of our driving – our opportunity selection – must be better to ensure we are not going to crash.

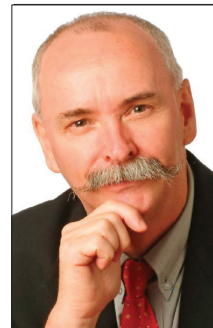
This is the most important difference between trading derivatives and trading stocks. The risk management in a derivative trade starts with our own actions and with a good identification of the strongest trade opportunity. We expect the trade to quickly move in our favour and not to test the stop loss levels. By taking only those trades with a very high probability of success we reduce the incidence of whipsawing.

Many traders have grown accustomed to less precise entry methods in the bull

market. They could use almost any method for trade entry, and the general bullishness of the market carried prices higher. The validity of their entry methods and the validity of their entry analysis was never truly tested. It can be summarised by the way these traders handled a stock that fell after they made the entry. "Its ok. It will bounce back" they said. And most times they were correct because the bull market minimised the consequences of their mistakes. Many traders came to believe that these 'mistakes' were a natural part of good trading.

The bear market applies a harsh test to all these entry methods. Sloppy entry methods will result in large losses in derivative trading. We use volatility based entry methods with the count back line and trend analysis.

People lose money when the market falls. They also lose their nerve and they are more reluctant to enter the market again when a recovery develops. After a strong fall the market takes much longer to recover. The nature of the trend behaviour changes. The nature of trading opportunity also changes so the old trading methods require modification. Bear markets are a time for education and time to learn from people who really trade the market for a living.



ATIC
SINGAPORE
www.theATIC.net

*Daryl Guppy appears regularly on CNBCAsia and is known as "The Chart Man". He is an equity and derivatives trader and author of many trading books including *Trend Trading* and *The 36 Strategies of The Chinese For Financial Traders*. Daryl will speaking at the Asia Trader & Investor Convention (ATIC) in Singapore, which will be held on 1 – 2 March at Suntec City Hall 401. For more information, please visit www.theATIC.net.*

For Smart Investor readers, obtain your complimentary ticket to the Asia Trader & Investor Convention by completing a short survey at www.theatic.net/surveysg!