To Trade or Not to Trade … That Is the Question

By Sunny J. Harris

The stockbroker's credo resounds in my ears: "Just buy and hold. That's all that works for the long term." Average in by buying when the market is down. Average in by adding to your portfolio on a regular monthly schedule, regardless of what the market is doing. I listened to that advice for years. But, somehow I doubted it, thinking there must be a better way.

In the face of several back to back losing years in the stock market, one has to wonder whether buy and hold might not be a losing strategy overall. The pundits are worried; the public is worried; and the traders are worried. The question may not just be what and when to trade, but whether to trade at all. And, if you are aging, will the market recover before you have to retire?

Is there a better way? Or, is that all there is? Early in my trading career I wondered whether market timing could improve a portfolio's results over the buy-and-hold approach. So, I did what any good scientist would do: set up an experiment, test and measure.

For purposes of this article, we will use the Dow Jones 30 Industrial Average (DJIA, $INDU, or Dow) and the NASDAQ Index (QQQ) as proxies for "the market." One could argue that the Dow Index contains only 30 stocks, and that it is representative of large, established companies, and that the NASDAQ was largely the focus of trading activity over the past several years. Nevertheless, we have historical data on the Dow for many, many years and it is widely used as an indicator of economic health. The main argument against using the NASDAQ as a proxy would be that it is representative of small, speculative stocks and is highly volatile. I argue for using both, because that's what the world does! During feverish, speculative mania, investors and traders all over the world turn to the stocks in both these indexes for trading opportunities, hoping to make their fortunes.

Clearly, if you started buying in 1982, at the beginning of the lengthy bull market run, you would have faired well. Buying the Dow on January 1, 1982 at 882, and holding throughout all ups and downs to the present, you could close your position today at 12,582, for a neat little profit of 11,700 points. Assuming you had held 100 shares, you would have netted a tidy $1,170,000 in the intervening 29 years. One-hundred shares, originally purchased at 882, would have cost you $88,200. Your return, then, would be approximately 11% per year over the 29 year period. That's hard to beat.

Figure 1—The Dow Over the Very Long Term (since 1982)

Figure 2—The NASDAQ OEX Over the Very Long Term (since 1993)

But, what if you weren't around in 1982? Or, what if you weren't interested in trading at that time in history? Chances are you heard about trading as the bubble expanded in the dot-com boom, and you fell into the clutches of one of the purest motivations for trading: greed. Two emotions rule the markets—fear and greed—and these two emotions come heavily into play at market tops and bottoms. So, for purposes of examining the question (to trade or not to trade) let's say you decided to become a trader on January 1, 2000.

The DJIA closed the year 1999 at 11,497; the NASDAQ closed the same year at 792. Had you used the buy and hold approach from January 1, 2000 to now (June 30th, 2011), you would have made a measly 11,497 - 12,414 = 917 points on the Dow and 792 – 587 = -205 points on the NASDAQ, for a loss. If you had bought 100 shares (the same way you made 11% per year in the previous example), you would have made $91,700 in 11 years on the Dow and lost $20,552 on the NASDAQ respectively. Combining the two and dividing by 11 years, you would have only made $6,468 per year.

What happened? After a long, long bull market run, we finally entered a long overdue bear market. Bear markets are healthy for the economic cycle and continued growth of the economy in the same way that forest fires are healthy for the environment. We entered a cleansing period, and prices are normalizing during this phase.

But, as traders we need to know: is there any way to negotiate around in a bear market and not lose your shirt? The answer, of course, is yes, if you traded from both the long and short sides on the way down, or if you were psychic and went short at the top and were still holding your short position until the market turned back up. As a more practical solution, I mark important pivot points with a yellow highlighter and then calculate the potential profit from each long and short position. (Actually I created an indicator that I call PHW and it automatically does the calculations, because I got tired of doing it by hand.) Knowing that it would be impossible to catch all the turning points, we need to take a practical percentage of the ideal and work with that lesser goal. Over the years I have found that it is possible to achieve 40% of the ideal, but rarely more. So that's the figure I use for PHW—40% of the ideal.

Figure 3—PHW™ calculates the ideal maximum possible profit

Had we been able to catch all of the ideal moves, both long and short, from the beginning of January 2000 to present, the PHW indicator shows that we could have made a maximum ideal profit of $156,450 on a single contract. Now, let's buy our 100 shares and the ideal total becomes an astounding $15,645,000. But, remember, it's impossible to catch all the highs and lows, so we estimate our goal to be 40% of the ideal—that is $62,580. That's certainly better than losing the $1,231.47 in the buy-and-hold scenario!

Now we have answered the first of my critical two questions when it comes to analyzing a trading instrument, be it bond, stock, index, or futures. Where is the money? It's pretty clear that while buy and hold is not the answer over the 18 months around 2008, that trading in some (as yet unidentified) time frame holds promise.

Many traders, especially new ones, approach the chart with all the big guns wide open. In other words, they put a wide variety of indicators and/or systems on the chart and hope that the more technology they add to the situation, the more likely they are to capture profits. By my analysis, that is probably the least likely approach to capturing real-time profits. While

indicators on charts look great with the benefit of hindsight, when you are reading a chart as it is forming, from the blank right-hand side (aka the hard right edge), it is very difficult to tell what the market might do next. So, that brings us to our second question: How Do I Get Some? (Money, that is.)

Knowing now that there is money to be made going long and short in the otherwise choppy market presented in Figure 3, we must now, with clear, Zen-like thinking, determine what approach will least confuse the issues and net us something close to the 40% PHW number we calculated.

This approach is backwards to the new traders' approach of slamming the chart with indicators until they find something that they like. I like to leave the yellow dots indicator on my chart while I am conducting the "how do I get some" research. In fact, I like to leave the dots on while I am trading, as well, to remind me to examine just how close I am getting to the ideal. The problem now becomes one of finding an indicator or pattern that gives us close approximations to the yellow dots. In fact, if we find an indicator that gives more signals than the ideal, that's okay too. We can always weed out extraneous signals with filters and pare back to the optimal dots configuration.

The first approach I always examine is a simple moving average strategy. Let's put two simple moving averages on the chart and visually inspect just how close their crossovers approximate the yellow dots. Just in case you are not familiar with this approach, two moving averages can be used to generate a signal when one crosses over the other. When the fast moving average crosses downward over the slow moving average it is considered a sell signal; when the fast moving average crosses upward over the slow moving average it is considered a buy signal. The default values for the fast and slow averages are generally 9 and 18 respectively, so that's where we will start.
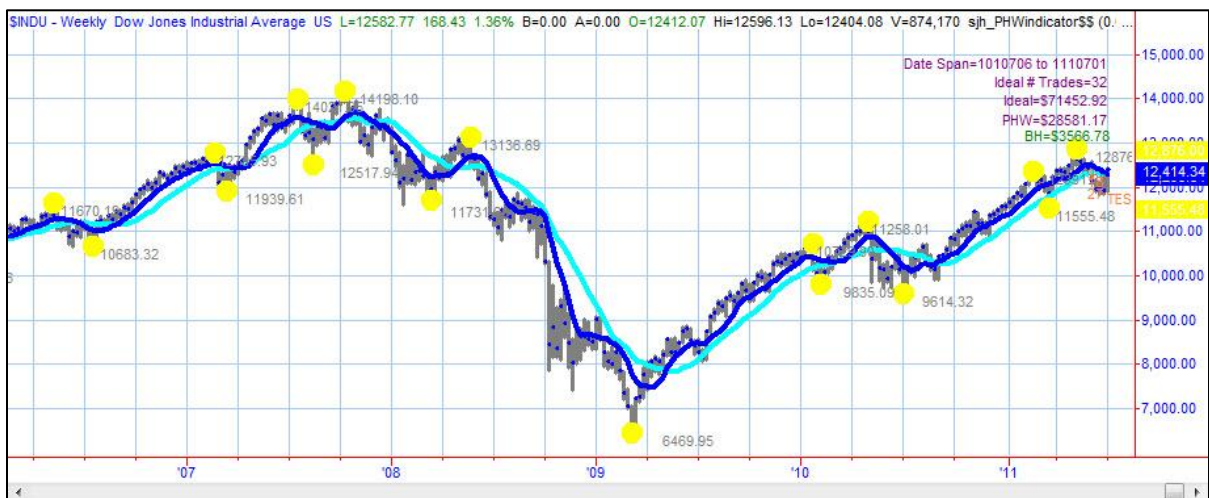

Figure 4—Simple moving averages with 9 and 18 for input values

A quick visual inspection will tell you that while the moving averages follow price nicely, and at first the crossovers look pretty good, a closer look shows that the crossovers are a bit

late. We can change that. By trying them on for size, we can select a combination of two moving averages that do a better job of catching the turns. One trick to getting nimble feedback at the pivot turns is to get the two moving average parameters very near to each other. For instance, I tried 9 and 11 as the inputs and found that the chart much more nearly approximates the turns, without leaving quite so much on the table. You can experiment with these inputs in your software either visually, or if you have sophisticated software like TradeStation, MetaStock, MultiCharts, Genesis Navigator, or NinjaTrader by using their optimization features.

Next comes the question, what shall we do during sideways periods when market action seems to produce nothing but losing trades? The moves in these periods of congestion are usually smaller than in trending markets, and by the time a reversal is signaled through the moving average, the move is nearly over. The end result of this dilemma is buy signals at tops and sell signals at bottoms. What we would rather do is avoid the whipsaw altogether, or to scalp small moves through channels by selling at resistance and buying at support. But, how do we know when we are in a channel versus when we are in a trend?

Simple! There is a wonderful indicator created in the 1970s by Welles Wilder, called ADX. This is the Average Directional Movement Index. Many people misread this indicator, or avoid it altogether because it seems complicated. As a quick-start, the ADX very simply says that we have a trend when the ADX indicator is moving upward, and we don't have a trend when the ADX is moving downward. That's all you really need to know: trend or no trend.

Figure 5 shows the ADX (with an input value of 14) and the moving averages 9 and 11. Now if you compare choppy, sideways periods on the price chart with the ADX indicator below it, you will see that ADX is generally moving downward during choppy times. It is then that you would want to bring out your support and resistance measurements, or avoid trading altogether. (That was what I meant earlier when I said we could use a filter; in this case the ADX is the filter.)

Figure 5—Moving Averages (9,11) and ADX(14)

Figure 6—Sunny's Proprietary Dynamic Moving Average

A trading strategy really should not be much more complex than this. Simple strategies tend to work into the future; complex strategies tend to fail in changing market conditions. The simpler you can keep your concepts, the more success you are likely to experience.

For my own trading, I long ago developed my Dynamic Average indicator. It occurred to me that markets are always changing, and while 9 and 11 might be the right combination of inputs for the indicator under current conditions, they might not be the right numbers in a few weeks or months with the market moving sharply upward, or in sideways congestion. One way to approximate this ever-changing scenario would be to re-optimize your strategy every week, or even every day. With that effort, you would be chasing last week's market character with each optimization. Rather than re-optimizing, it occurred to me that I could ask the market how fast it was moving. I call this "speed." If the market averages a one point range this week, then the speed is one; if the market averages a five point range this week, then the speed is five, and so on. When the market is moving fast we want a set of averages that are close together and will turn quickly when the market turns. Inputs like the 9 and 11 used earlier would be ideal for fast moving markets. Yet, when the market slows down and gets into congested, sideways periods, we want the averages to get out of the way and not to cross over each other—and especially not several times. So, in congestion we want moving average input values like 10 and 30. That way the averages don't even come close to each other. Then, as the market changes character and begins to pick up speed, we want the averages to self-adjust and start coming closer together, preparing for a trend, or a trend reversal. That's what I mean by "dynamic."

For ease of reading the signals, I have programmed my indicator to display the difference between the moving averages so that I can readily see when it crosses over the zero line. A cross of the zero line means that the two averages crossed over each other. For even further clarity, when the indicator is red, we are in a sell signal, and when it is green, we are in a buy signal. This indicator is shown in Figure 6. Notice that there are fewer signals (crossovers)

given with the Dynamic Average than with the 9 and 11 simple moving average shown in Figure 5, even using the ADX as a filter. The Dynamic Average does a pretty good job of staying out of its own way. It doesn't trip over its own feet, so to speak.

In my personal trading, I like to use the Dynamic Average to tell me whether I should be long or short, and key support and resistance areas, which are given by my Pennants indicator, to tell me when to execute, or pull the trigger. I'll discuss my Pennants indicator in the next article.