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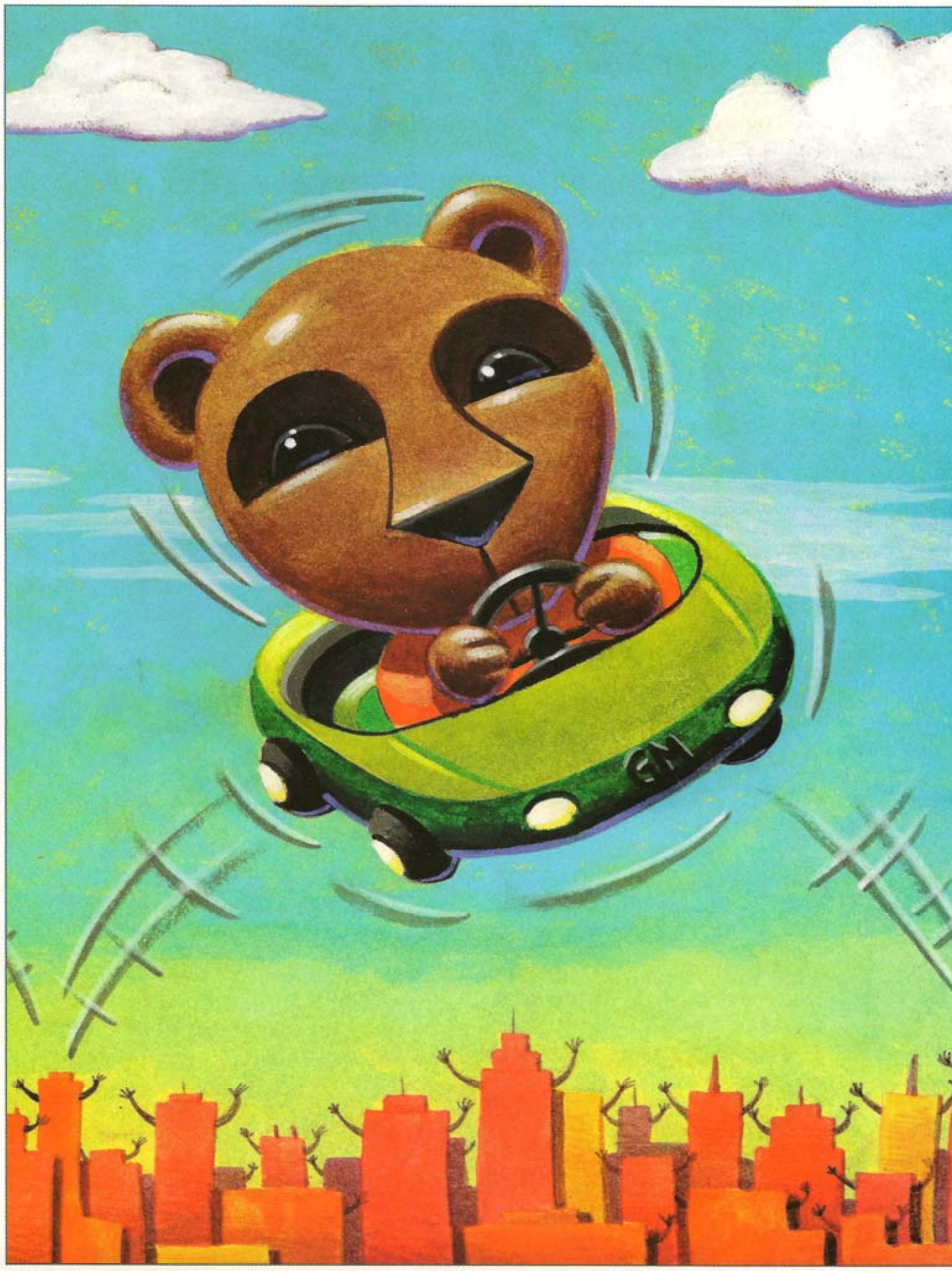

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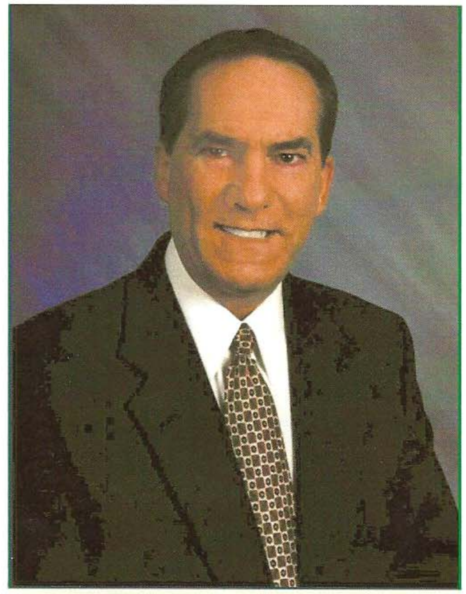
INTERVIEW

The Holy Grail Of Trading Is Within Us

Chuck Dukas Of TRENDadvisor.com

Chuck Dukas is principal in a hedge fund and president of TRENDadvisor.com, a website that provides trading recommendations and educational and training services to better equip the trader to understand the markets and prepare traders to trade independently. He is the author of The TRENDadvisor Guide To Breakthrough Profits: A Proven System For Building Wealth In The Financial Markets, *which is a comprehensive guide to trend analysis and how it relates to trading and investing plans, published by John Wiley & Sons. This interview combined phone and email questions and answers, starting on April 10, 2006, conducted by STOCKS & COMMODITIES Editor Jayanthi Gopalakrishnan.*



Nobody is going to replicate the market as an algorithm since it's all about human behavior.

Chuck, how did you get interested in trading?

From the time I pursued graduate work in finance in the early 1980s, I spent every moment I could working on technical analysis. I spent endless hours and years developing and testing algorithms. I was looking for the holy grail of trading. I know now it exists, but not as a trading system. It lies within us. The holy grail really is the discipline to follow a plan or methodology.

From that I developed the diamond analysis, which was a result of my desire to develop a system with repeatable success for any skill level. Soon I realized I had to record the methodology, which is why I wrote the book.

What, in your opinion, are the most important decisions any trader has to make before placing a trade?

There are some questions you have to answer before you place any trade. The questions are:

1. Do you have a plan for that trade?
2. Will the trade be a long-term trade or swing trade?
3. Will your stop be a hard stop or a mental one?
4. What would the trade look like if it fails?
5. If you're going long, do you have a first objective where you will harvest a portion of the profit?
6. Think of a trader as being a builder of a home. Would that builder construct that home without a set of plans?

Success comes with a blueprint, and the more times you duplicate that design, the more dependable the outcome.

You encourage traders to trade trends. By trends, do you mean long-term trends or short-term trends or both?

Let's assume it is a long-term trade. First, I would establish my risk based on the quality or strength of the trend. What I mean is that if the market is in a bullish phase, the price has to be greater than the 50-period moving average, and the 50-period moving average has to be greater than the 200-period moving average.

What if it's in a bearish phase?

The converse would be the case for a bearish phase. What I found going back 80 years in the Dow Jones Industrial Average (DJIA) is that price stays within a bullish or bearish trend about 67% of the time. I also found that the DJIA is in a bullish phase 45% of the time and 23-24% of the time in a bearish phase. From the weekly chart of the Standard & Poor's 500, I can see that the index went into a bullish phase in January 1995 and stayed there till August 1998, and it occupied that phase for 193 consecutive weeks.

For those investors who take a long-term approach, the monthly chart of the NASDAQ Composite Index entered the bullish phase in January 1991. The price of the index was 414, and it stayed in the bullish phase for nine consecutive years, reaching a high of 5132. In short, trading with the trend keeps you in the meat of the trade.

My work details six phases of price activity, weighing the strength or weakness of the trend. After I identify the phase, I look at the weekly chart for the longer trend and then time the entry based on the daily chart. This approach keeps you in check with the long-term dynamics of price activity.

Often, pullbacks are seen in the daily charts, yet the weekly charts still maintain their trend. If you are a short-term trader, I would determine the strength of the trend based on the daily chart and use an intraday chart for the entry setup.

What are some ways to measure trends?

First, let's define trend. An uptrend is a series of higher highs and higher lows. Over time, faster prices rise in a shorter time frame, which indicates the strength of that uptrend. I use a 60-period high/low channel because that is approximately a quarter of trading data. This indicator then draws the value of the highest high and what it has been for the last 60 periods. We can measure where the current price is relative to whatever the highest high has been for the last 60 periods. When price begins to exceed this high channel, the market is now producing higher highs.

Another useful tool to measure the strength of the trend involves adding the 60-period high and the 60-period low and dividing it by 2. This produces a 50% retracement indicator. This simple indicator displays the middle of the price channel. When you are in an uptrend, we would want to have the price above the 50% retracement indicator, suggesting the trend is still intact.

If an uptrend is a series of higher highs, what does the end of that trend look like? Most traders would say it looks like a series of lows. More accurately, the end of an uptrend can just be an absence of further highs over time.

You use a methodology called the TRENDadvisor, which essentially looks at six phases. Can you tell us about these phases?

The TRENDadvisor diamond aids us in analyzing price behavior as it changes over time. Markets will cycle between bursts of intense price activity and periods of stability. This natural flow of price expansion and contraction cycles through six phases. It acts as a compass for the trader or investor, determining the price strength of the financial instrument to be traded.

The six phases of the TRENDadvisor diamond has two phases that are clearly trending and four where the trend is less evident. The two phases where there is the sharpest price movement over time are called the bullish phase for the uptrend and the bearish phase for the downtrend.

In the progression of market cycles, markets move in a bell curve of six parts. They are:

- ***Part 1:*** The buying process begins
- ***Part 2:*** We see an acceleration of price and volume. Price then plateaus as the buying interest wanes
- ***Part 3:*** Sellers step in and begin to liquidate their long positions
- ***Part 4:*** This sets the stage for an increase in selling activity
- ***Part 5:*** Price then establishes a floor for support as selling pressure dries up
- ***Part 6:*** Once a base is built, it levels out and the cycle repeats itself.

The TRENDadvisor diamond (Figure 1) is broken into two equal sections. Each section measures three phases of price activity. The left side of the diamond is the buy side guiding us through the progression of how uptrends unfold. This includes the recovery phase, accumulation, and bullish phase.

The right side is the sell side, which directs the series of how downtrends develop. This includes the warning phase, distribution, and bearish phase.

Tell us about these phases.

I'll start with the *recovery phase*, which begins as traders who are short decide to cover their positions and investors begin to buy when price is low. As more buyers step into the market, price cycles into the *accumulation phase*, where traders/investors accumulate their long positions as price moves sideways with a positive bias. The *bullish phase* is evidence of demand far outstripping supply. Buying pressure is strong with few sellers. This phase has all the positive characteristics of an uptrend.

Price then cycles to the sell side. The *warning phase* is the first on the sell side. This phase generally sees an absence of buying pressure. Traders who were long begin to liquidate their holdings. Price then stair-steps into the *distribution phase*, at which point selling becomes more pronounced and downtrends become more apparent.

Then price moves into the *bearish phase*, supply outstrips demand, heightened selling pressure ensues, and everyone is trying to sell their stock, which drives prices down sharply. This highlights the progression of price activity as it cycles through the six phases of the diamond.

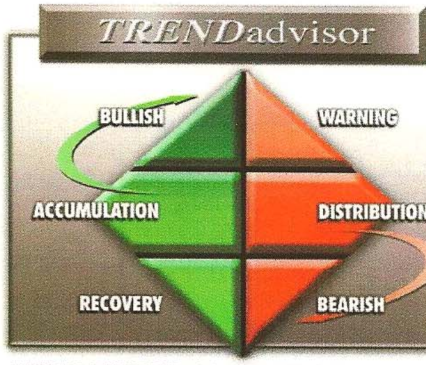


FIGURE 1: THE TRENDadvisor DIAMOND. Here you see the six phases of the trend. The ones on the left side are the three phases on the buy side and the ones on the right are for the sell side.

How does this fit in with taking a trade?

Now that we have defined what a buy-side trade and a sell-side trade are, it is our job as traders/investors to measure the risk associated with each trade. Stock candidates should be chosen based on your plan objective and risk tolerance. You want to deploy your capital with minimal risk and a reward associated with that risk. You want to deploy capital when you can make the most capital. The key to trading is to have a plan or methodology and have the discipline to follow it. You don't want to beat the market, you want to join the market. And trading with the market allows traders/investors the benefits of market momentum.

I use the acronym "MSE," which stands for "market/sector/equity," meaning trade in the direction of the market first, followed by the sector, and then use a top-down approach to those equities meeting your criteria. The market is the engine that pulls along the sectors and the equities. When we have this all in sync, the likelihood of trading success is greatly enhanced.

So is there a best time to enter a trade?

I would say yes. Trading and executing a plan will greatly increase your chances of success. And by following a plan, if you miss the trade today you can be sure that there will be another one tomorrow. Patience and discipline is your best companion. Nobody is going to replicate the market as an algorithm since it's all about human behavior. It's the discipline that people have that will make them successful.

Once you enter a trade, you must know what the trade would look like if it fails as well as what it would look like if it succeeds. It's the power of visualization. We see repetition in the markets, and it's our duty as traders/investors to make informed decisions whether a trade is based on the technicals or fundamentals or both, not on hype or conjecture.

Once a trader is in a trend, how does he know when to exit?

By this point, we have explored various actions that are essential for a successful trade. Even though there are six different phases to a trend, every trend is different so there should be a separate tactic based on each trend.

You would use a different exit methodology when price is expanding fast, like in the bullish phase, compared to when the price is not moving as quickly in the distribution phase. It's not a one-size-fits-all approach. Knowing when to exit is the least-talked-about subject, but it's probably one of the most important.

Anyone can buy a stock. It is pretty easy these days, since it's not necessary to talk to anyone. All you have to do is sit back at the computer and hit the button. In fact, oftentimes people just buy stocks without giving it too much thought.

But then comes the sell part of the equation. The trade you placed could be profitable, it could be a loss, or it could be break even. Given that there are these three possibilities, you have to decide which one to focus your energy on. Exiting a trade should be as easy as entering a trade.

Once a candidate is found, the plan of the trade should be delineated. The entry, stop, exit, and capital to be deployed must be defined. Knowing when to exit a trade should come without fear or greed being involved. If we did our work on the trade, we should know what to expect, and there should be no surprises.

What money management tactics do you use with trends?

In trading and investing, there is usually too much emphasis placed on indicators and setups and too little on the issues of discipline and money management. There are a variety of ways that money management can be utilized in capital deployment.

Like what?

One method is to have full long positions only in instruments displaying the characteristics of the bullish phase. Conversely, you could have full short positions in the bearish phase and less capital exposure in the other phases. This example deploys capital in the safety and strength of the two phases where trend is most prevalent.

Another approach ladders your positions based on the strength of the phase. An investor could choose to build a long-term position in a financial instrument, and the money management model would look something like this: In the recovery phase where price begins to build its base, we would expose a one-third position. As price begins to stabilize and improve, we would increase exposure by adding another one-third position in the accumulation phase. We now have a two-thirds position at risk. As price cycles to the bullish phase where safety and strength are at their optimum, another one-third position is added, bringing the exposure to a full position.

Patience and discipline are your best companion. It's the discipline that people have that will make them successful.

The reverse holds true for those traders/investors who sell short. In that case, we traverse to the sell side. A one-third position is shorted in the warning phase, followed by adding another third position in the distribution phase and the final one-third in the bearish phase. This money management technique deploys dollars based on the strength and quality of the trend.

Why is it crucial for traders to have a methodology?

A methodology is a body of methods and rules that lets you know what to do and when to do it to control risk and harvest profits, and it gives you the discipline for entering and exiting your trades. Everyone who trades needs a methodology, and few have one they consistently apply. If you are actively managing financial assets, you should have criteria for how and why you are buying and how and why you are selling. A simple yet very powerful approach is: Buy and own only stocks or financial instruments that meet the standards of an uptrend.

For those for whom it is appropriate, selling short is another strategy when the criteria meet the components of a downtrend. Simply, a methodology is a blueprint of your rule set coupled with the discipline to execute. You must adhere to the rule set before that trade is entered. Then trading what you see and not what you think or feel will always keep you out of harm's way.

What should a trading plan include?

A well-defined plan increases your chances for success for several reasons. First, it prepares you and gives you a plan on how to deal with losses. Over the years I've coached and trained traders, a common thread of failure I've seen is the absence of a plan on how to take losses and harvest profits. It's inevitable that some statistically significant number of your investments or trades will not work. Given this fact, what must happen to keep losses at a minimum? A trading plan helps you define the amount of money that will be lost in the trade if the stop price is triggered. Second, a good trading plan will help you delineate when and how you will take profits.

What are the elements of a trading plan?

The elements of a trading plan should include but not be limited to:

1. Your objectives and assessing your risk/reward
2. The markets and time frames you are going to trade
3. The maximum number of positions you will hold based on your portfolio
4. How you will deploy your capital and whether all trades will be dollar-weighted
5. What the rule sets will be for the entry/exit and harvesting profits
6. Where your stops will be placed. Will they be a percentage below an entry for a long position, or have you examined where support might be violated to exit that position? If the position is profitable by *X*, will you sell a portion of that position and ladder a stop as price rises?

Periodically, you might need to evaluate and adjust your system or plan. Discipline in trading means acting on your plan when the criteria are met. If you have a plan and no discipline, your success, if any, will come from random factors or pure luck. If you have discipline and no plan, you will not know what to do or when to do it. So as a wise trader once said, "Plan your trade and trade your plan, use stops, and manage your capital appropriately." Those are the keys to a successful trade.

Easier said than done!

Unfortunately, we are not disciplined people. We want to do the same thing over and over again. And until we change ourselves, we will run into the same problems over and over again.

Any last words?

There's a quote that sums it all up, from Jesse Livermore: "There is nothing new on Wall Street or in stock speculation. What has happened in the past will happen again and again and again. This is because human nature does not change, and its human emotion that always gets in the way of human intelligence." Livermore, who is still considered to be the greatest trader who ever lived, said that some 75 years ago, and his words still ring true today.

Thank you, Chuck.

SUGGESTED READING

Dukas, Chuck [2006]. *The TRENDadvisor Guide To Breakthrough Profits: A Proven System For Building Wealth In The Financial Markets*, John Wiley & Sons.

Smitten, Richard [1999]. *The Amazing Life Of Jesse Livermore: World's Greatest Stock Trader*, Traders' Press.

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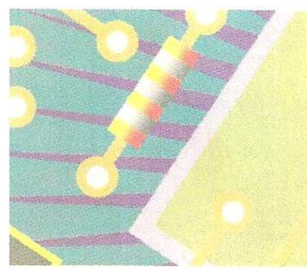

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