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*Nothing in the world can take the place of persistence. Talent will not; nothing is more common than unsuccessful men with talent. Genius will not; un-rewarded genius is almost a proverb. Education will not; the world is full of educated derelicts. Persistence and determination alone are omnipotent. The slogan "Press On" has solved and always will solve the problems of the human race.*

**Calvin Coolidge**

**Pro Trader** is the brainchild of author, trader, and educator, Frank Watkins. After many years holding senior positions in the share market and futures industry, Frank formed Pro Trader in 1997. **Pro Trader** has a rapidly growing membership in Australia and New Zealand, providing quality software, data, education and broking services to its members. Pro Trader is Australia's only TOTAL share market service provider, your one-stop shop for ALL your trading needs.

**ProTrader**  
[www.protrader.com.au](http://www.protrader.com.au)

*Fortune Favours the Informed*

Sales Contact 1300666767

Email: [sales@protrader.com.au](mailto:sales@protrader.com.au)

Broking Contact 1800123015

Email: [broking@protrader.com.au](mailto:broking@protrader.com.au)

# Chapter 1

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## What Will You Need?

This chapter outlines the various items you will need to start trading on the share market. It is by no means an exhaustive list, but defines the basic requirements to trade 'visually' using technical analysis. We have endeavoured to keep this document as generic as possible pointing out alternative sources of product or information, but where **Pro Trader** provides a particular service we will mention it, and of course we highly recommend all our services, especially since it is Australia's only TOTAL trading service. What you will need depends on your level of expertise and familiarity with the market but for a beginner, a basic list is:

- A broker
- Access to stock quotes and charts
- Stock market analysis software
- Stock market data
- Access to quality education and training
- Ongoing mentoring and support

### Your Broker

In order to trade shares you will need a broker with access to an Australian Stock Exchange Member Firm. For this service you will be charged a brokerage fee. Brokerage fees are charged on orders as shares are bought and sold. Brokerage fees vary from broker to broker depending on the service they offer. More recently the advent of online Internet-based brokers has made trading very cheap for those who do not require any particular service or research. You can expect to pay between \$15.00 and \$30.00 per transaction for online broking and between \$50.00 and \$100.00 for the traditional broking service.

***Pro Trader operates a broking service. They may be contacted on  
FREECALL 1800 123015***

## Quotes and Charts

The stock market is an auction system with sellers (The Bears) offering their stocks for sale and buyers (The Bulls) bidding to buy these stocks. The stock market publishes the selling prices and the bid offers constantly throughout the trading day. At any time, while the market is open you may get a quote for either the current buying or selling price for a stock. This is known as a stock quote.

The data generated by price fluctuations due to all this buying and selling may be used in chart form to “visually” track what is happening to a stock’s price over a period of time. This time may be real-time or intra-day where we watch the price movement over the course of the trading day, or end of day or inter-day where we track the price movement over periods greater than one day.

The ability to visually analyse a stock’s behaviour over time is the core of technical analysis. Many factors may interact to affect a stock’s price such as the company’s financial health, market sector, management behaviour or general economic factors to name a few. The technical analyst maintains that the analysis of the interactions of all these factors is far too complex to be reliably used in picking potentially successful stocks. A better approach is to use the end-result of these interactions, the price movement. A stock chart tells the story of a company’s successes or failures through price fluctuations over time.

### Why are charts useful to me as a trader?

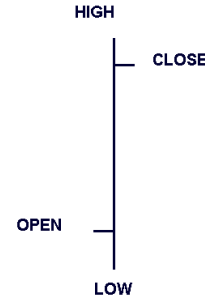
We are all familiar with charts. How many cartoons have you seen with the patient’s chart at the bottom of the bed? A chart is a visual representation of a set of data that allows us to quickly see patterns in the underlying data. Charts allow us to find patterns in prices as the buyers and sellers ebb and flow. It is very difficult to make sense from columns of figures, but the same numbers in a chart format allow us to see what is happening.



## Monthly, Weekly and Daily charts

Each chart comprises a collection of daily price bars – each showing the open, high, low and the closing price.

On a monthly chart, each bar represents one month of trading, so a year of price action is shown in twelve bars, giving us a very long-term picture. Monthly charts can show a ten or a twenty-year low or high but they don't show us enough detail for trading purposes. To view more detail we need to look at weekly or daily charts. Some people use "intra-day charts". Intra-day charts may show price bars that represent one minute of trading.



### Which charts should I use?

Any reasonable software package will allow you to access daily weekly and monthly charts at the click of a button. These charts show more than enough information.

### Should I get real-time quotes and charts?

In recent years some people have come to believe that they need real-time quotes to enable them to pick even the slightest variation in trends. The majority of investors using real-time quotes overtrade and ultimately lose money. Just as monthly charts show too little detail, intra-day charts provide too much detail. Traders have been profitable for centuries, using daily charts.

Most successful traders make their profits from following long-term trends and making their decisions outside trading hours. Decisions made outside market hours and based on chart analysis are logical whereas most decisions made during market hours are based on emotion.

## Software

In order to trade successfully you will need to be able to find good shares for potential trades. As a technical trader, you will need a software package to run your analysis of these shares. There are many software packages to choose from and they vary in price and functionality. An Internet search will find many potential sources. **Pro Trader** develops its own software that is a sophisticated pattern scanning application. It is specifically designed to find rising stocks in any market conditions. A

feature of this software is that using advanced technology reduces the amount of time needed each day to analyse the total market for potential trades. Whichever software package you choose, as a minimum you will need the following computer indicators:

- Simple, Weighted and Exponential Moving Averages
- Moving Average Convergence/Divergence
- On-balance Volume
- A trend line indicator

The package you choose should also have a market scanning ability as without it you will experience great difficulty in finding stocks to trade, and your trading will become very time-consuming.

*To download the free **Pro Trader** software demonstration go to [www.protrader.com.au](http://www.protrader.com.au) and follow the links to the download area.*

## Data Supply

The software package you choose will also need to have its database of stocks updated daily. It is important that you choose a data vendor that has systems in place to make this requirement as simple as possible while maintaining a high degree of data integrity. Like most things, cheap data can often be inaccurate or poorly formatted. Another point to consider is whether your data vendor will be around for the long term. A feature of the data supply business is a high degree of turnover amongst data vendors. The industry comprises a core of larger established vendors with many small cut-price operations continually entering the market and disappearing after a short time in business. It's important that your chosen vendor is reliable and can guarantee data integrity to a high degree. Again, **Pro Trader** may be of help to you in this area.

***Pro Trader** supplies high-quality end-of-day data to its members. This service is included in the membership fee*

## Education

An aspect of share trading is, that to do it well, you are committing to a process of continually improving your knowledge of the subject. The key to profitable trading is a devotion to honing your trading plan and increasing your range of trading experience and education. It is an on-going process and is part of the enjoyment that many traders experience from share

trading. There are a myriad of books on the topic of technical analysis, and share trading in general. You may have heard of, or perhaps even read my first book “*Exploding the Myths: What your broker doesn’t know or won’t tell you*”. This book is an ideal publication for anyone interested in share trading, and has helped thousands of traders avoid the errors and pitfalls that can be costly in the share market.

Another good source of information on the share market is the Australian Stock Exchange (ASX) and in particular the ASX website [www.asx.com.au](http://www.asx.com.au). This is a good source of information on every company listed on the Australian market. The ASX also produce many publications on all aspects of trading and the market in general.

## Ongoing Mentoring and Support

Your first rule should be survival, good education will give you the tools to help you survive and prosper in the share market. No man (or woman!) is an island. We all need a source of constant interaction with our fellow traders. A good source of this interaction is found on the many bulletin boards and website forums. There are hundreds to choose from and you should have no difficulty finding one where the level of discussion reflects your current level of knowledge.

You may find as you progress in your trading that a particular aspect or technique of trading will attract you. It may be Gann trading or Elliot Wave theory, or Darvas Box theory, who knows? The topics seem boundless. It is important that you have some access to experienced traders as a source of advice. This advice should be qualified however, don’t just take anyone’s word at face value. The best forums usually have a well-known contributor or mediator on the site, these are the sites you should use.

*On-going training is a feature of **Pro Trader** membership. The company supplies comprehensive training for its members through web-based multimedia training that is available anywhere, anytime. Pro Trader runs a member-based forum on its website that allows its members to interact and share their experience and trading knowledge with fellow members.*

# Chapter 2

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## You and Your Broker

Your choice of brokers can make or break you! Most beginners have a false expectation of what a broker should be or should do. If you believe that a broker's main role is to make your fortune for you, you will more than likely fail miserably in your attempts to be a profitable investor. Your broker should not be your friend, keep your dealings at a business level.

In order to succeed and constantly beat the market averages you need to follow these guidelines:

- Do-it-yourself and become the best investor that you can.
- Do your own research and make your own decisions.
- Your broker is only there to help you transact your business.
- Develop a trading plan
- Be persistent – always refining your trading plan.

While you will need a broker to transact your orders for you, we would recommend that you are extremely careful about the advice that you accept from others. This includes brokers, newsletters and the media in general. As technical analysts, we believe you should make your own trading decisions based on the price movement and trading volume data, with only minimal fundamental information.

## Types of Orders

### **Start-gain**

A start-gain is a buy order to be transacted once the price has risen to a particular level. You may choose to buy a stock once certain conditions are met. It may be a break of long-term resistance, the penetration of an ascending triangle or the break of a Darvas Box. Whatever the reason, you will only want to buy as prices begin to move upwards. The beauty of a start-gain order is that it can be placed long before the event occurs. A start-gain order also saves pre-empting a buy and then holding for

an indeterminate period while waiting for a break that may never occur. Make sure your broker will take start-gain orders.

### **Stop-loss**

The constant use of a stop-loss has been statistically proven to improve a trader's profitability. ***Do not trade without a stop-loss if you are serious about making money.***

As stop-loss is an instruction given to your broker ordering him to sell your stock "at market" if prices fall to a pre-determined level. Professional investors have been using stop-loss orders for more than fifty years but there is reluctance on the part of many Australian brokers to accept this type of order.

#### **"At market"**

This is an order to sell your stock as soon as possible at the best available price.

#### **Acceptable bids and offers.**

There are minimum bids allowed on share transactions:

- Up to \$0.10 minimum bid = 0.1c
- Over \$0.10 to 50c minimum bid = 0.5c
- Over 50c to \$998.99 minimum bid = 1c

## **Why Use a "Stop-loss".**

As the name implies, the use of a stop-loss helps you to stop losses! There are risks in almost everything we do on a day-to-day basis: crossing a road can be dangerous enough. There are risks owning houses, cars, boats and the like. Overcoming the day-to-day risks is a natural subconscious act. Responsible house and car owners take out insurance policies to minimize potential financial losses. It is almost an automatic reflex action.

Why not take this approach when share trading? No one wins every trade. (Although this must surely be your ultimate goal – there is no point in a heart transplant surgeon being happy with an eight out of ten success rate!) It is the odd losing trade that you need to protect against.

## **How Does a Stop-loss Work?**

Assume you wanted to purchase a stock only if it breaks through a resistance level at \$1.00 per share. What is a reasonable risk to take in an

effort to see whether your decision to purchase is correct? In other words, what is your pain barrier, ten, fifteen or perhaps twenty cents? This is your decision and your decision alone. No one can help you, but let's assume you have chosen to place a stop-loss at 94 cents. This is an instruction to your broker to sell your stock at MARKET immediately the market trades at 94 cents.

So 94 cents is the trigger price that sets off the broker's selling action. By the time the broker goes through the process, the price will probably have fallen lower than the stop-loss price. Your order may be executed at 93 cents, or even lower if there are others selling stock at the same time.

### **Trailing Stop-loss**

A "trailing stop-loss" facility is equally important to lock in profits as stock prices rise. The trailing stop-loss forms an essential part of any trading plan. Again, make sure your broker provides this facility. This simple process requires a review of your stop-loss on a daily basis. Keep raising the stop as the market rises. At some stage the market will turn down, trigger your stop-loss and the stock will be sold. This method overcomes the problem of when to take profits. Let the market decide for you! A trailing stop-loss, along with a plan that defines where to place the trailing stop, is the best way to safely stay in a stock that is trending upwards for a long time. The trailing stop-loss is similar, in some ways, to insurance. You should increase the value of a house and contents insurance policy as the value of your property increases!

### **Percentage value stops**

How do you then choose the price point at which to place the stop-loss? Some so-called experts recommend a percentage stop-loss. This method sounds right but is it? To use a constant 5% of the entry price as a stop-loss is flawed logic; 5% on a 5-cent stock is far too close and 5% on a \$50.00 loss is too much to risk.

**The key to successful stop-loss placement is to have the stop at a level where you do not expect the market to trade. This stop-loss needs to be below a recent price support level.**

In other words, if the stock drops beyond a certain level, it is an alarm bell that something is going wrong with the stock and it's time to get out. You cannot place a stop-loss at a level simply because it is convenient!

### **Dollar value stops**

Talking about placing stops at a convenient level is another suggestion made by “expert” presenters and the same flawed logic applies. You will hear them suggest that you should not risk more than say five hundred dollars on any stock. These people are also the ones who tell you that if you take a \$1500 profit on your winning trades and use a \$500 stop, you have the key to great wealth. If it were that easy, we would have been doing it for the last 150 years.

Unfortunately, even in an upward trend a stock price may fluctuate far too much for a five hundred dollar stop to survive those fluctuations. For instance, you buy 100,000 shares at 10 cents each in a small speculative company; your outlay is \$10,000. A five hundred dollar stop-loss would knock you out of the market at 9.5 cents per share. This could well be within a normal daily fluctuation.

### **Moving average stops**

A sensible way to set stops is to use methods that take into account longer term trends and iron out the effect of daily fluctuations. A moving average is a good practical method to manage risk as well as a sensible way to place stop-loss orders. If the price today is above the average price of say the last thirty days, the trend is up. If the price is below the average price of the last thirty days, the trend is down. Place a stop-loss order at a price level below the level of the thirty-day moving average.

Moving averages were part of a traders tool-kit long before computers came on the scene. These days, the calculation is done for you by any software analysis package, making it a quick and simple operation to find where to place this type of stop-loss.

### **Stops under support**

The safest place to have a stop-loss is under a strong price support level. The trick is to buy stocks just on or just above that support. Assuming that you will place a stop-loss underneath a strong support level, the closer you buy to this support, the lower your risk becomes.

*Professional traders know the value of a stop-loss, but unfortunately, the vast majority of brokers do not offer this vital service. The broking service offered by **Pro Trader** evolved from client demand. It offers a full start-gain and stop-loss service. Trading with a stop-loss is the key to professional risk management in the stock market; **do not EVER trade without a stop-loss in place**. If your broker does not offer this service then get another broker! Pro Trader broking may be contacted on*

***FREECALL 1800 123015***

# Chapter 3

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## Trading Instruments

I am constantly asked, “How do you trade options?” or “Do you use CFD’s or futures?” Let me make three points, very strongly, at the outset.

1. Exchange traded options, CFD’s, Futures and Warrants are all derivatives. They all offer leverage. They were designed for a portfolio manager to hedge his exposure to market risk. Used correctly the returns can be very high. In keeping with the old market adage, “the higher the risk, the higher the return” these derivatives can be extremely costly to the uneducated; buyer beware!
2. Investing in the market is a marathon, not a 100-metre dash. Start your investment career by doing the simple things first, buy shares that are rising and make a profit. When you can constantly make above market average profits in any economic conditions – then and only then – look at harnessing the leverage offered by any of the derivatives.
3. You need to develop a solid trading plan that covers your entry and exits from the market. Once you have generated an entry rule and a particular stock qualifies, you can then decide on whether to buy shares or use an option, warrant or a CFD to take advantage of the anticipated movement. You need to choose the stock first, and then use the trading instrument that best suits your needs.

There is a happy band of “experts” constantly running around the country, running \$2000 or \$3000 weekends courses where you will “learn the secrets of a professional trader”. Unfortunately the vast majority of participants in these courses fail in their trading pursuits.

Be careful, while the potential profits from trading derivatives are real, the downside is that you are exposing yourself to huge risks. Like anything in life, we must walk before we run. Learn to trade equities successfully before moving on to more elaborate, sophisticated trading instruments.

## **Shares**

### **What are Company Shares?**

Shares are documents issued by a company to raise finance. A company worth \$50 million may want to raise \$10 million to fund a project. By doing this it has taken the decision to allow 20% of the company to be owned by members of the public or any other interested purchaser. The company may feel that \$1 per share is suitable and therefore makes 10 million shares available for buyers. By buying a share you become a part owner of that company. Anyone can buy shares in a publicly listed company.

### **Dividends & Share Price**

Earnings from shares are two fold:

1. The value of the share can rise when the performance of the company involved is trading well, subject to a takeover, or may be on the verge of a “new” discovery.
2. A company may choose to pay a dividend. Payment of a dividend in the past is no guarantee of dividend payments in the future.

Aim for capital growth: there is no point receiving a dividend if the share price has halved. A dividend should be treated as a bonus that you receive for owning the right stock at the right time.

### **Contributing shares**

Another instrument is the contributing share, which is similar to an option in terms of leverage potential, but will involve the requirement of holders to pay incremental payments to continue to hold the right to convert it to a fully paid share. Many are issued at a low entry price, and may involve a number of small payments over time, before a final pre-determined amount is paid to fully convert it into a fully paid share.

## **Stock Options**

When companies look at raising fresh capital a number of choices are available. One choice is the listed company option. Listed company options are normally issued at a minimal cost to shareholders and investors as an incentive to participate in a placement of fully paid shares.

This option gives the buyer the right, but not the obligation to convert their option into a fully paid share at a future date, which is pre-determined when the option is issued.

The main features of a listed company option include:

- The underlying security.
- The exercise price.
- The exercise date.

American options provide the holder with the opportunity to convert their option into a fully paid share at an anytime up until expiry, whilst European options can only be exercised at expiry. Both European and American options are actively traded on the ASX and their role as an investment tool is gaining a wider acceptance.

## Exchange Traded Options

### What is an option?

There are *two types* of options:

- Call Options giving their holder the right but not the obligation to buy a specified asset at a specified price at or up to a specified date.
- Put Options giving their holder the right but not the obligation to sell a specified asset at a specified price at or up to a specified date.

### Exchange traded option contracts are standardized in terms of

- Contract volume.
- Expiration dates (mostly up to six months or one year, options with life spans of more than one year are rarely available).
- Exercise prices (usually at least 3 are available for a given expiration date).
- Delivery/settlement procedures.

## Warrants

There are two main categories of warrant

- **Trading warrants** – these are relatively short dated and a high-risk high return instrument.
- **Investment warrants** – are longer dated with a lower risk reward profile.

**Common Warrant features are:**

- An expiry date
- The exercise price
- Each warrant series is offered by an issuer, generally a large financial institution such as a bank.
- Each warrant has an underlying instrument
- The conversion ratio – that is the number on warrants required to convert to one share.

**The risks of trading warrants include:**

- The holders of warrants are exposed to the risk of the issuing institution.
- A warrant is a wasting asset.
- Warrants are very high risk/high return derivatives.
- The possible lack of reasonable bids and offers – meaning that you may not receive “fair value” particularly on the sale of warrants.

## **CFDs**

The latest arrival on the derivatives scene is the equity Contracts for Difference (CFDs), and it is a rapidly growing sector. For the experienced investor CFDs are proving an attractive means of gaining control of individual equities without the need to invest in the physical share.

A CFD is another derivative linked to the underlying share price. You can buy (go long) or sell (go short) the underlying equity. The ability to go short is one of the principal attractions of CFDs as other methods of going short are both expensive and inconvenient. CFDs are what are known as geared or leveraged instruments. In common with all other derivatives, it is possible to hold a position much greater than would be possible by simply purchasing the physical shares. As leverage works both ways, it increases both the potential risk and return. In the case of substantial adverse market movements it is possible to lose all of the money originally deposited and to remain liable to pay additional funds immediately to maintain a margin requirement.

# Chapter 4

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## Your Trading Plan

Strange though it seems, most people will spend more time planning their annual holiday than they will large investment. The general approach promoted by the financial industry and brokers alike is the BHP plan. The BHP plan is simply Buy, Hold, and Pray and throw in some diversification. Beating the market averages requires a more pro-active approach.

A trading plan allows you to revise and improve your performance to a level where you can constantly outperform the market averages regardless of economic conditions. A plan brings consistency and discipline to your trading and ensures correct management of risk. Without a plan you are simply gambling.

There are two key elements to a trading plan. The first element is your entry and exit criteria and the second element is money management.

*I strongly recommend you read the book “How I Made \$2,000,000 In The Stock Market” (1986, Lyle Stuart Kensington Publishing, New York). This book was written by Nicholas Darvas – the man who developed the best and simplest trading plan I have seen. The Darvas method has been incorporated in the **Pro Trader** software.*

### Four Trading “Secrets”

You need to:

1. Know what stock to buy – trawling for trades
2. Know when to buy – entry criteria.
3. Know when to sell – exit criteria
4. Managing risk while holding a stock – money management

### Trawling for Trades.

When seeking a company in which to invest, what are we looking for? What can we rely on to assist with an informed decision? We can forget about using the “tip sheet” type of newsletter or last weeks broker research. This type of research is no more reliable than tossing a coin. If

these methods worked with anything approaching a high degree of success everyone would be wealthy from their share market profits.

Let's assume we are going to use a planned sophisticated approach to stock selection. We also need to make another major assumption. That is we want to purchase shares that have a good chance of rising in value in the near term – not just a possibility of rising at some stage in the future. My view is that when you purchase shares in a company, you are lending the company your funds and you want a reasonable return.

So, we agree that we want to buy stocks that are rising – this is where software comes to the fore. Good software should be able to scan the total ASX database of around 1500 companies and find investing opportunities in literally a matter of seconds.

*The Pro Trader software is specifically designed to perform high speed scanning. There are various scans designed to find rising stocks. The software has several “world firsts” such as the “active trend line tool”, key reversal scans, the trend channel indicator, many pattern recognition scans and the unique Darvas Scan.*

## **Entry Criteria**

There are many ways to enter the market. For many Australians the first taste of the share ownership was their participation in new floats. As successive governments sold off public instrumentalities, Australians rushed to buy shares in the Commonwealth Bank, Telstra and various other companies. Over a million Australians were introduced to trading when the AMP Society de-mutualised. Participation in floats is certainly a method of entering the market. However I am suggesting you look for specific buying criteria that you use time after time to ensure the timing of your purchase has the odds of success heavily in your favour.

In my book “Exploding the Myths” I have devoted a full chapter to entry signals, detailing five tried and proven methods of entering stocks at the right time. Those five entry methods are:

1. Buying once you see a pattern of higher highs and higher lows.
2. Key reversal bottoms.
3. Buying a break of resistance.
4. Buying on support
5. Buying as prices break above moving averages.

## **Exit Criteria**

When do you sell a stock? At what precise moment in time do you choose to ring your broker and tell him to take profits on a particular stock? Or do you just wait and pray. While the Commonwealth Bank float has been more than spectacular, the Telstra and AMP floats have turned very sour. Why are investors still holding shares in these companies? Lack of planning and lack of knowledge!

Unfortunately profit taking is the least thought about area of trading, therefore causing the most problems for a new trader. Most traders find themselves in a situation where they have been in a profitable stock, only to see those profits drift away and turn into a loss. It is unacceptable to hide behind outdated thinking that all you need is time in the market, time for a stock to recover. We can no longer afford to have our capital tied up for years on end in a non-producing investment. I make two strong suggestions:

1. You must have exit rules as part of a trading plan. These rules should be robust enough to cover all eventualities in all market conditions. These rules need to be written down prior to making any investment.
2. Let the market tell you when to take profits. This may seem an odd statement, however with the correct use of what we call a “trailing stop-loss” the market will tell you when enough is enough.

I use five exit signals. Again, these are detailed in the book “Exploding the Myths”.

## **Managing Risk**

Managing risk can be broken into three categories:

1. Market risk
2. Individual stock risk
3. Money management risk

### **Market risk**

Market risk is with us all the time, however as you can see from the table below, it can also be a buying opportunity. Newcomers are often concerned that “the market will crash” when they buy shares. To allay your fears, there were two “great crashes” during the last century one in 1929 and one in 1987, nearly sixty years apart. I’m positive that the next great crash is a long way away and there is an extremely good chance that you will

recognize the signs and avoid any significant losses. Perhaps the table below sums up the best way to look at market risk; it is in fact an opportunity.

<b>Event</b>	<b>Initial reaction</b>	<b>% change one month later</b>
Pearl Harbour Dec. 1942	- 6.5%	+ 3.8%
Korean War June 1950	- 12.0%	+ 9.1%
Cuban missile crisis Oct. 1962	- 9.4%	+ 15.1%
Kennedy assassination Nov 1963	- 3.0%	+ 7.0%
October 1987 market crash	- 34.0%	+ 12.0%
Gulf War January 1991	- 4.3%	+ 17.0%
WTC attack September 2001	- 12.0%	+ 11.0%

### **Individual stock risk**

When purchasing shares, pick a level of risk that is appropriate and place an order to sell the stock should prices fall to that point. In other words, work out how much are you prepared to risk in order to see whether your decision to buy is correct.

A stop-loss is the educated trader's insurance policy. A stop-loss is what lets you go to work each day or play golf without worrying, secure in the knowledge that if your stocks fall to a level beyond the amount you are prepared to risk, your broker will sell the stock.

It sounds simple – and the concept *is* straightforward. In practice, the only difficulty is choosing the sell point. You should always calculate your risk and place your stop-loss order *prior* to purchasing a stock. This is because a stop-loss should be part of your total trading plan, worked out at the same time as you work out how much to invest in the stock and how much profit you plan to take from the investment.

A sound knowledge of how to apply a stop-loss is one of the very first steps towards a profitable trading career. The trick is to minimize trading risks. Most newcomers enter the market on a tip they have picked up from a newspaper, a friend or, surprisingly, a stranger! They do so with little consideration for the risk they are taking.

### **A word of caution on “Blue Chip stocks”**

Owning a blue chip share does not reduce risk. Newcomers are led to believe that purchasing a blue chip share almost assures them of risk free and profitable trading. This is not the case. Blue chip shares are subject to the same large price fluctuations as any other stock.

## **Money Management Rules**

Successful trading is as much about money management as choosing the right stock. If constantly let your profits run and restrict your losses, you will be a profitable investor. Money management is all about:

- How many stocks you will hold?
- How much will you risk on any one trade?
- What portion of your capital will you invest in any one stock?

### **How many stocks will you hold?**

This is an individual choice - I offer the following suggestions as guidelines.

- A \$10,000 account should hold a maximum 4 stocks. The least you want to invest in one stock is \$2500, less than this and brokerage becomes a large consideration. Some newcomers may only have \$2500 spare to begin with – that’s okay, you will need to look after it very carefully and stick to a well defined plan.
- A \$20,000 - \$50,000 account should hold between 5 and 10 stocks. There may be the temptation to diversify and hold 20 stocks with \$2500 invested in each company. Unfortunately diversification alone will not contribute to your success. Far better to specialize and buy fewer stocks, but stocks that are rising in price.
- A \$100,000 account should hold a maximum 10 stocks.

### **How much will you risk on any one trade?**

This is another individual choice and will reflect the amount of money that you have to invest. As a guide I believe the stop-loss that you place at the time of entering a trade will protect at least 90% of your capital. You need to find trades where the stop-loss can be placed below a recent support level but within 10% of that entry price.

### **What portion of your capital will you invest in a stock?**

My belief is that you should invest an even amount of your funds into each stock. There is little point investing \$5000 into one stock and \$3000 into another based on the belief that one stock will perform better than another.

People that trade in that manner are usually reliant on stories or fundamental analysis. The better a story is told, the more money they will invest. Logic should tell you that this is not going to work. If you are operating from a plan with strict entry rules, logic will tell you that your chances for success are the same with each stock.

# Chapter 5

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## Your First Trade

### The Moment of Truth!

Nothing can actually prepare you for the moment when you are about to make your first purchase. It's rather like the first time you drove a car – pretty nerve wracking and you would probably been happy to accept a bit of help. Before you place an order to purchase your shares, you need to run through a checklist.

- How many will you purchase?
- What is the cost?
- What brokerage rate will you pay?
- What is your risk?
- At what point will you “breakeven?”
- Will you pyramid a winning position

For the purpose of this example, let us assume you are going to trade in lots of \$2500. The particular share you are going to buy is trading at \$1.00, and your brokerage rate is \$60.00.

### Calculating the Breakeven Level

The breakeven level is easily calculated, but some traders make the simple mistake of not including all the costs incurred in the trade. It is essential that both the entry **and** exit brokerage fees are included in the cost. The total cost for the trade is then:

Total trade cost = (Parcel size \* stock price) + entry brokerage + exit brokerage

For example suppose we wish to enter a trade at a price level of \$1.00 with entry and exit brokerage of \$60. If our parcel size is 2500 we have a total cost of:  $(2500 * \$1.00) + \$120 = \$2620$

### Optimising the Breakeven Level

The task of optimising the breakeven price level is achieved by finding a minimum breakeven level for the trade. Given that the brokerage

costs and the stock price may be taken as fixed for entry to the trade, the breakeven level may only be optimised by carefully adjusting the parcel size

The breakeven level is calculated by dividing the total cost by the parcel size:

$$\text{Breakeven level} = \$2620/2500 = \$1.05$$

The stock must at least reach this level before we achieve a no loss situation. Any exit price below this level will result in a losing trade. If we increase the parcel size to 5000 shares the total cost is now:

$$\text{Total cost} = (5000 * \$1.00) + \$120 = \$5120$$

The breakeven level is now:

$$\text{Breakeven level} = \$5120/5000 = \$1.03$$

As can be seen from the preceding examples, an increase in parcel size results in a lower breakeven level. We reach a profitable level sooner, if we trade a larger parcel. However, the trade off is an increase in capital required to fund the trade and a greater capital risk level within the trade. Care must be taken to balance this risk and optimum parcel size for the trade. A common mistake made by novice traders in the rush to complete their first trade, is to buy a small parcel of “penny dreadful” shares with no realistic possibility of even covering brokerage costs let alone reaching a breakeven level!

## **Analysing the Trade**

Now that we have optimised the parcel size with the maximum size permitted by our trading rules and the limits of our trading account, we are now in a position to estimate the likely success of the trade. We should now stop and ask ourselves some questions such as:

*Analysing the past performance of the stock, does a significant rise beyond the breakeven level seem possible?*

*Is this a realistic possibility or are we merely gambling on an unlikely event?*

Taking the time to do this simple homework will prevent us entering unrealistic or potentially unprofitable trades

Managing a successful trade is a balance between good risk management and good money management. A common error is to attempt to reduce the trading cost by using cheaper broking services such as online brokers, but this is a foolish economy. The benefits provided by broking services offering stop-loss facilities far outweigh the higher brokerage cost.

A better strategy is to employ the simple money management technique outlined and optimise the trade.

## Placing Your Order

Once you have found a stock and your breakeven analysis deems it a viable trade, what next? Your first actions should be to place an order to purchase the stock once your buy criteria has been met and **at the same time**, place an initial stop-loss to exit the trade if the stock trades at a price just below an unacceptable level.

## Managing Your Trade

A key aspect of trading is the use of a trailing stop-loss to manage trading risk. Let us assume that we are now engaged in a trade. We've placed our order and an initial stop-loss. The stock price is moving upwards - what next? All we can do now is adjust the stop-loss level. This is done with the caveat that we may **NEVER** lower the stop-loss level, so all we may do is move it up. Where we move it to is the issue, and this is determined by the price movement.

As soon as realistic we want to move the stop-loss to our breakeven level. If our initial risk level was 10%, we move our stop up so as to maintain this maximum risk level. Remember, this was the risk level that was acceptable when we formed our trading plan, so we should stick to our plan and maintain this maximum risk level. Once the stop reaches the breakeven point we have a no-lose trade. Always remember that once the price starts to move upwards, if we don't move our stop-loss up also, we are increasing our risk level; all positive price movement is not just changing numbers, it is your money. If the price rises and you do not move your stop, you are exposing more and more of your capital to the market.

## Pyramiding the Position

Pyramiding the position is also a part of a good trading plan. Traditionally we are taught to diversify our investments to dilute our risk. We may have some high performing stocks, and some stocks that are poor performers, but everything should average out in the long run. In my opinion this is nonsense. What we are doing is attempting to reduce risk by accepting mediocre performance. With the risk management provided by the trailing stop, we are refusing to accept poor performance since we will "stop out" of these trades. The stop-loss and market movement will combine to "separate

the wheat from the chaff". My philosophy is to only accept minimal losses and compound profits.

## Conclusion

I wrote this book to give the novice an overall picture of what is needed to get started in the share market. It is not a definitive text by any means, and I would recommend that you read as much on this topic as you can. In general, the more information and education you have at your disposal the better. However, I will temper these remarks with a word of caution. As in most areas of life if something sounds "too good to be true" it probably is. I do not wish to be overly cynical, but I'm afraid that where money is concerned, and in particular in the share market, from time to time charlatans and conmen abound. There is always the latest "get rich quick" seminar guru with a sure-fire method to make you millions. My advice is to be careful. There is no substitute for good risk management techniques, good software and most importantly, good education.

I wish you all the best in your trading endeavours and I hope it rewards you with the financial benefits your efforts deserve.

A handwritten signature in black ink, appearing to read 'Frank Watkins'. The signature is stylized with a large, sweeping loop on the right side and a sharp point on the left.

Frank Watkins.

### **Other Books by Frank Watkins**

*Exploding the Myths: what your broker doesn't know or won't tell you!*

*Darvas Box Trading: Legacy of a Super Trader*

Contact Pro Trader Sales 1300666767; Email [sales@protrader.com.au](mailto:sales@protrader.com.au)

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