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How to get started in active trading & investing

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New York Times Bestselling Author

How to Get Started in Active Trading and Investing

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This book is dedicated to my beautiful sons, Zachary D. Nassar and Weston S. Nassar.
I am very proud of you both!

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FOREWORD

As a long-time Commodities trader, I have attended many symposiums and events on the topic of "making money in the market." Usually within a half hour of listening to a presentation, I get bored with the speaker and just get up and leave because the information tends to be all theory without actual trading experience behind the information. David Nassar is one of the few who keeps me thoroughly intrigued.

My firm, MBF Clearing Corp, is the largest clearing firm on the New York Mercantile Exchange (NYMEX). I have been trading since I was eighteen and teaching others for almost that long. In 2002, I authored the book, *The Logical Trader, Applying a Method to the Madness*. After the book was published, I began conducting a series of trading seminars and live trading demonstrations in which I invite a select few to join me at the NYMEX. David Nassar is one of the rare and few worthy of speaking at our highly sought-after events on Wall Street. Great traders are hard to find and those who can transfer their knowledge to others are even harder—David is one of those people.

I have a large team of proprietary traders who trade my money, as well as customers who rely on me for quality information. My role is to continually help them to be successful, therefore, quality information is at a premium. The problem is, finding quality information is rare. The first time I listened to David, I was immediately impressed with his views of the market and his methods of trading them. I knew he was focused on the same basic principles of the market that I have been trading and teaching about in the futures markets for the past 20 years. Working with seasoned pros and other market icons, I can tell you that timeless strategies that have worked on the floor of the exchange are also transferable to virtual screen-based markets. These are methods that few people truly understand because of the jaded views that form due to media influences but that will open the reader's mind to an unobstructed view of how to make money in all markets.

When trading on the floor of the NYMEX, learning to trade is "baptism by fire." You are taught by hanging on to the wing of active traders all around you who are moving large amounts of money in real time. There is little time for theory—only action! Today, the markets are virtual and open to all participants. This creates the opportunity for a structured learning environment that the exchanges did not readily provide. The way I and many others learned to trade on the floor was through harsh reality and experience, which created many casualties among traders. Today that has changed because of traders like David, who can teach how they trade.

Reading *How to Get Started in Active Trading and Investing* was like reading an echo of myself. His obsession with risk management and his approach of combining discrete market trading patterns with market psychology are the same views I have expressed in *The Logical Trader*. If you only read one book this year, read David Nassar's comprehensive guide to the markets. It will teach you how to become your own analyst while acquiring a tremendous fundamental, technical, and psychological background into the markets. This book will be an invaluable trading tool for the day trader, swing trader, and long-term investor regardless if you trade stocks, bonds, or futures contracts. It should be required reading for all traders and investors. It is a rare opportunity to get into the mind of a highly successful trader.

Finally I will state that trading has been the greatest living I could have ever imagined. It has given my family and me tremendous opportunities, while allowing me to follow my passion. My 15-year-old son paid me a father's greatest compliment recently when he stated that he too wants to learn how to trade the markets. I hope David Nassar will be one of his mentors.

Mark Fisher
President, MBF Clearing Corp

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Brian Shannon is our Chief Market Technician and head of Research at MarketWise. Brian, who has a business degree from Merrimack College, has been published in many industry magazines and is a recognized speaker around the country and abroad.

Eric Erickson is a research analyst and instructor at MarketWise who has contributed greatly to the project. Eric has a strong background in mathematics with a degree in physics from Western Washington University. Eric conducts regular online classes, which are very well subscribed to.

John Seckinger is a research analyst and instructor at Market-Wise. John holds an MBA from Regis University.

I also want to thank all the talented and supportive people at TerraNova Trading, LLC. Special appreciation to my partners MarrGwen and Stuart Townsend, founders of Townsend Analytics, Ltd. and the RealTick® trading platform; Chris Doubek, President of TerraNova Trading, LLC.; and Jerry Putnam, CEO of Archipelago® Exchange. I also want to thank my editor at McGraw-Hill, Stephen Isaacs. This is the fifth book I have done with Stephen, and he has always been outstanding. I would also like to thank Jeffrey Krames for his continued support. Appreciation to all the wonderful people at McGraw-Hill who edit, format, and publish the material. Finally, and most importantly, I would like to thank my loving and supportive wife Tracy.

INTRODUCTION

History teaches us many lessons, and it seems the lessons of the market are taught more often by the bear than the bull. During the last bull market cycle, like those that preceded it, the energy was electrifying. The bulls ran through the Streets (Wall Street and Main Street) with the blood of any short sellers dripping from their horns. When the "new economy" was fed to the public by industry spokespeople disguised as CEOs of Internet companies, it was swallowed whole by the media and the trusting public alike. Analysts dove into the fray and were a driving force behind the entire circus act, fooling themselves into believing the garbage they themselves spewed. As long as the market rallied, many analysts were willing to disregard ethics for instant gratification. Most were not motivated by sound research, but by investment banking deals and CEO influences.

Many investors believed they were invincible, racking up thousands if not millions of dollars, but it didn't take long for the self-cleansing mechanism of the market to take its course. The business of trading is Darwinist—survival of the fittest—and most didn't survive. Those who survived were able to dismount the bull and remount the bear, but as industry statistics prove, they are few. Regardless which bull market we describe, the attitudes and results have been nearly the same. Statistics prove that it takes more than a bull market to be profitable. History also proves this. I believe the eighteenth-century mathematician Daniel Bernoulli unknowingly described what it takes to survive the market best—"Human Capital!"

Human capital describes, among other attributes, one's education, talent, and ability to perform. Most people pay too little attention to human capital and too much attention to the ideas and methods of others. As we have learned from the most recent bear market, this diversion is at their own peril. The public took to Internet trading like a fish to water—or should I say a sheep to the slaughter. The analysts and brokers fed investors ideas and the bull market made these players heroes. As such, most participants didn't consider risk. Beginner's luck syndrome quickly developed and most participants did not fully appreciate the risks embedded within the analysis they consumed. New participants tended to be gullible and trusted data fed to them from analysts under the guise that big money equals smart money. But we must not be confused and turn the bear market into a scapegoat for the reasons most investors lose. Luck breaks down with the emergence of a bear market, but bear markets are not to be blamed—the lack of knowing how and when to sell is the reason. Investors who don't know why they bought won't know when to sell. Analysts didn't miss the call to sell. They had no incentive to make it in the first place as Chapter 1 will explain. As a result of this misguided trust the public placed on the analysts, luck quickly ran out and human capital suffered with little personal investment into self-development.

Back in the 1700s Bernoulli introduced another factor of paramount importance that can be applied to today's stock market—The Law of Diminishing Returns. This law states that not all risk can be defined in intrinsic or mathematical terms. Bernoulli discovered that "the utility resulting from any increase in wealth will be inversely proportionate to the quantity of [wealth] previously possessed."* Because wealth is relative to each participant, each person must make their own decisions regarding risk. What may be acceptable risk for one person may not be for another. Therefore Bernoulli's law of diminishing returns reminds us that trading and investing is a very individual endeavor. This historically valid discovery applies today, explaining why successful traders and investors tend to remain profitable. The combination of patience and fear contribute to decision making. Objectively analyzing and waiting for the right trade while relentlessly protecting downside risk are among the best skills a trader can acquire. Decision making at an institutional level where all participants of a fund are subjected to the same risk does not address such personal risk tolerances.

Even objective market analysis does not cancel out all subjective factors, such as fear or the psychological pressures of the market. Like it or not, when you commit your capital, you also commit your emotions. In bull markets, greed too often takes a front seat to fear, but it is a healthy dose of fear that develops discipline—something most investors never learned. I believe that no participant, regardless where they are in their career, escapes the psychological demands of the market! Perhaps the easiest way to describe this is to say that the analysis of markets (stocks, options, bonds, futures, currencies, etc.) are determined by objective considerations (statistical analysis, probability, back testing, technicals, fundamentals, etc.), but the motivation to act on the analysis is personal and influenced by the laws of diminishing returns. Do the potential gains warrant the risk? The conundrum created for many who contemplate these very real issues (consciously or unconsciously) often lead to a form of ambiguity. The way that many people deal with dubiety is to delegate the decision making to others—hence the contradiction. This raises other important questions regarding the risk/reward relationship.

This theory of risk and utility is known as *The Petersburg Paradox*, and was only translated to English in 1954, 216 years after its creation! The only reason it was translated was because the modern-day economist John Maynard Keynes made reference to it in his great work, *Treatise on Probability*. Both published works are readily available and deserving of your study. The salient points and relevance to the market are quite enlightening. Is a millionaire proportionately happier with each additional million dollars acquired? The law says no, and his happiness is only incremental and eventually it diminishes because he is less willing to take risks. The paradox in today's terms is that as you accept the responsibility of doing your own analysis, you begin to understand the very real risks embedded within the markets. Most investors never truly understand this until too late. Investors who rely on others for research perhaps temporarily escape the paradox by not understanding the true risks, but are later punished for their apathy. Bull markets tend to provide a false sense of security and even overconfidence which only sets up the greater fall. Ignorance is not bliss and the delegation of risk management to institutional funds is not the answer that many seek. The oddity can be surmised by stating that while acquiring market knowledge also reveals its risks; equivocating the responsibility to others exposes even greater risks. This is not to say that money should never go into managed accounts, but if these accounts are used, the risks the fund is taking must be fully understood.

Regardless of age, gender, or status, all participants will find the market to be an evolutionary process and challenge every step along the way—an endeavor of relentless demand yet limitless bounty. Therefore, every participant must answer this question about risk. Those who cut corners and hunt for an easy solution to the market have the most to explore and the least to find. Those who accept the responsibility of finding their own path are in a position to achieve success. Research done by others does not account for the individual subjectivity of each person. The confluence of using objective analysis for making decisions and the ability to define individual financial risk is the role you must accept. The act of following research and analysis for which you have had no hand in is clearly the greatest risk. The individual who trades their own capital becomes the trader, the analyst, psychologist, coach, and risk manager. This begins to define both the objective (analytical skills) and subjective (psychological demands) knowledge one must possess in order to be successful. There are no divine answers.

What is certain is that the cash (equities) markets are not a zero sum game. As long as others buy after you do, like in the case of long positions (buy low sell high strategy), or others sell after you do, like in the case of short positions (sell high buy low), many participants can simultaneously make money. Risk is not linear or equal to all participants. Conjointly, institutions want you to react to their analysis because they can tolerate more risk than any individual. Accordingly, the influences they imbue upon the market naturally create reactionary pressures most individuals fall victim to. The market cliché “if they don’t scare you out, they will wear out” comes to mind. The first step is to avoid being the “dumb money” that is bamboozled by this classic market activity by becoming your own analyst and understanding how this activity is manifested in the market. Once this manifestation can be seen through objective data (which will be discovered throughout the text), decisions can be made with predetermined risk that meets your own individually defined parameters. The same firms that employ analysts and brokers produce news that moves and gaps the market. These firms not only help to produce the tsunami of market moving news, but they are better prepared both through prior knowledge and capital wherewithal to “batten down the hatches” and deal with it. This book is an introduction to understanding the forces at play in the market to not only avoid foreseeable risk, but to also gain an edge to compete and win.

An entire generation of traders and investors have been conditioned to follow the analysts’ ratings, research, and brokers. This diversion from the truth is at the expense of building the requisite skills of understanding one’s self and developing the human capital as your own analyst. I draw on history to make an important point; history repeats itself because human nature is not prone to change. The study of the market is the study of human nature, and the past teaches us important lessons that must be applied. In other words—be Market Wise!

David S. Nassar

*See Against the Gods, 1996, pg. 105.

PART I

THE LANDSCAPE

CHAPTER 1

TRADITIONAL WALL STREET—TRUMPERY, TYRANNY, AND TENDENCY

In a rare time of disintermediation whereby money management is flowing to the individual and public domain, there is no better time to understand the economy and the capital markets. In management theory, the *Peter Principal* is a phenomenon that describes a level in which incompetence is obtained. In other words, even after successive promotions, little can be achieved beyond one's abilities. I believe traditional brokerage firms and the analysts that work for them have reached and surpassed this level of incompetence. As stated, big money does not mean smart money, and the journey you are about to embark on will prepare you to understand and deal with the market, to make your own decisions, or at a minimum, prepare you to filter the advice of others before blindly investing.

Countless battles take place each day on Wall Street. In this arena powerful people rely on the public's order-flow to navigate a world of greed, fear, regulations, and even corruption. The markets are populated with large institutions down to small investors. To the uneducated, the markets may seem covered in a blanket of fog where movements are mysterious. Therefore, in order to participate in the financial markets, these uneducated participants pay for a guide to lead them through the fog. There is trust placed in this guide and participants believe they are being led toward their best interests. At times the guide leads participants safely through the shrouded world, but other times the guide leads participants in a way that only furthers their own interests. This analogy too often describes the relationship between the amateur market participant and their money manager or broker. The relationship between an investor and their money manager is a tricky one, taking on different tones in different market conditions.

During a strong bull market, almost every stock's price increases. This is great news for the investor, both big and small. In most cases, if a person invests any money at all in the stock market during this time, they will most likely see a profit. A strong bull market is also where true greed rears its ugly head, tempting those in positions of influence to put their own monetary gain before the masses that trust them to honestly guide them through the fog. As with most things in life, what goes up must come down. When markets decline and the bearish side shines through, people begin to lose the money they have invested. It is at this time that the exceptional greed and corruption at high levels is uncovered, breaking the trust between broker and investor. Investors begin to understand the trumpery or nonsense being fed to them. This in turn causes confidence levels to plummet. During this time of low confidence, market participation decreases and Wall Street searches for ways to gain back the trust of the investor. Typically regulators jump on this opportunity to step in and enact rules designed to bolster confidence. These rules allow the investing public to feel that the corruption has been stamped out and won't happen again. This bull and bear cycle has been repeated time and again throughout the history of the stock market. History is our teacher and lessons can be learned that apply today.

This cycle reaches as far back as the economic boom of the 1920s, and much farther if we exclude regulation. After World War I, the U.S. economy began to rebuild. In the 1920s the use of electricity expanded and consumerism rose. With this rise in consumerism the stock market rose as well. In fact, the market was driven upward in a craze. Most participants made money and little thought was given to regulation, and the theory of the day was a laissez-faire approach to just "let things be." The crash happened near the end of October 1929, when the Dow lost over 39 percent from the high it made in September of the same year. By June 1932 the Dow had lost over 90 percent.

Many investors borrowed money to participate in the stock market rally, and as prices fell, banks collected on loans made to investors who now had holdings worth very little. Many banks also invested depositors' money in the stock market, and the combined result was that banks had large, uncollectible loans and worthless stock. As word spread and panic set in, people tried to retrieve their money as banks failed by the hundreds. This is what modern day fund managers call a "run on money," and it represents a repeatable crowd reaction we still see in the market today.

In response to the great crash, the Federal Government set up the Federal Deposit Insurance Corporation (FDIC) to prevent such disasters from happening in the future. If an FDIC-backed bank failed, then the government would reimburse depositors. The FDIC still stands today.

After the crash in the 1920s and the ensuing depression, there was a consensus that in order for the economy to recover, the public's faith in the markets needed to be restored, similar to the sentiments felt after the stock market decline that began in 2000. In 1933 and 1934 Congress passed two Securities Acts that required public companies to tell the truth about their businesses and required people who trade, buy, and sell securities to put the investors' interest first. The SEC was founded in 1934 to enforce these rules. Notice the pattern—the market goes up and irrational buying takes place, then the market comes down and people lose money and consumer confidence drops, then regulation is enacted to renew the confidence of investors. See Figure 1-1 for a chart of the Dow during this period.

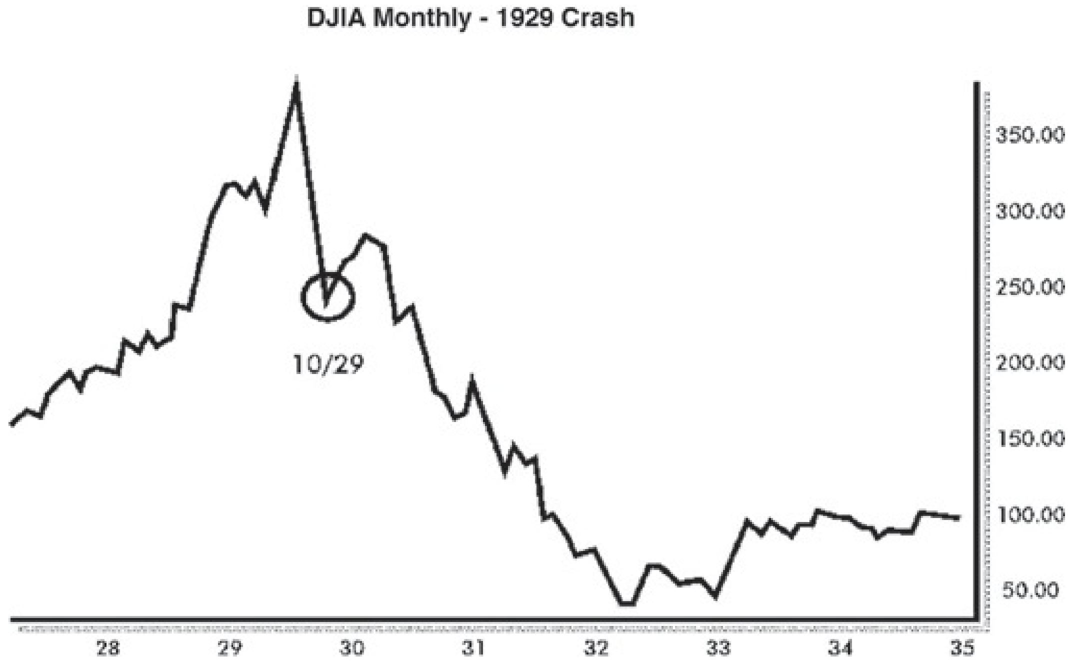

FIGURE 1 - 1 *A chart of the Dow that illustrates the crash of 1929.*

Direct parallels can be drawn to the Internet bubble in the late 1990s. During the 1990s the stock market grew at an unprecedented pace, led higher by high-tech companies. After the market crested and fell, people once again lost money. Regulators asked questions and uncovered information that contributed to falling confidence. The SEC quickly enacted regulations to increase confidence, and the cycle of market activity followed by regulatory intervention. The common denominator that spans the dimension of time is human nature. History helps us understand the problems that occur today by understanding the problems of the past. To link the similarities, we must have an understanding of how things really work in the markets. The first piece of understanding comes from the knowledge of how information is filtered through the market participants of Wall Street.

Success on Wall Street is based on information. It is a world of tyranny, where important information is given to a select few. The majority of amateur market participants base their decisions on fundamental information given to them by brokerage firms or the public companies themselves. It is key to understand how this information is handed down and how it can be altered. To use a metaphor, a long line of participants clamor and compete for market information. We see this information as “market food.” The food chain describes where various participants exist within the information hierarchy. Once this information is received, we must then ask what nutritional value remains. The digestive system of the market operates on a very fast metabolism. These participants include institutions and high producing commissionable accounts that receive the best market food with their commission dollars. As they act on this information, stock prices often discount in value before the public reaches the same information, only now depleted of its nutritional value. In most cases, the public is at the end of the intestinal system, where the “market food” is —well, you can finish the analogy for yourself! But the digestive process describes what the analysts, brokers, and media do with the market food they receive (research and ratings reports) before it reaches the public, who are the last to receive it. Pretty gross, I agree, but I want you to get the message—by the time the market food reaches you, it is not wise to consume it. This explanation illustrates why Wall Street insiders consider the public to be "dumb money." The first step in changing your place in the system is to understand the system itself, and that begins with investment banking.

INVESTMENT BANKING

The first set of relationships to understand are the ones built by a private company that decides to sell their stock publicly. These private companies are located at the beginning of the food chain, where all the relationships start. Initial Public Offerings (IPOs) can be very profitable for the company going public and the investment bank alike. There are a variety of reasons a company may decide to go public. The company may want to use the proceeds from the sale of stock to enlarge their business, pay off debt, or may want to spread risk from the current owners over a larger area. To do this, the company must find initial buyers for the stock they intend to sell. The initial buyers are found through the underwriter. Underwriters are generally institutions that specialize in taking companies public; as a group they are called *investment bankers*. Understanding this process is in your best interest and will set the foundation of knowledge you need to understand Wall Street.

The next step is to understand how financial institutions make money and the relationship of the broker, analyst, and investment banker. This is important to understand because you need to know where their interests lie and if they conflict with yours.

WHY A BROKER CAN MAKE YOU BROKE

A *broker* is an individual, who is licensed to buy and sell securities and has the legal power to act on the behalf of a customer. If someone wanted to buy 1000 shares of stock, they would have to go to a person or firm who has access to the market, and this is a broker. Brokers are in the sales business, and most get paid on a commission basis. Much like a real estate agent, who makes money when a house is bought or sold, each time a stock is bought or sold through a broker, they charge a commission. As long as a transaction is incurred, the broker and the firm they work for gets a commission, regardless of whether their client makes money or loses money. There seems to be an obvious conflict of interest between how a broker gets paid, when that broker is paid to manage an investor's money. Many argue the broker's incentive to do a good job in investment management is to retain and attract customers, and this keeps the interests of the customer and broker aligned. History proves otherwise in many ways, such as churning and poor performance to name a few, because brokers are generally not trained as analysts; they are trained to sell. Even if trained as analysts, their interest and your interest align poorly.

ANALYSTS