LEARNING MADE EASY

2nd Edition

Swing Trading

for dummies®

A Wiley Brand

Identify promising markets and sectors to trade

Figure out how to profit from short-term opportunities

Manage risk at the portfolio and security level

Omar Bassal, CFA

Founder and Managing Director of Shukr Investments

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Swing Trading For Dummies®, 2nd Edition

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Contents at a Glance

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Introduction

Just what is a swing trader? Swing traders hold positions over several days and sometimes for a few weeks. The goal of *swing trading* is to profit from short but powerful moves.

Swing trading differs from the buy-and-hold approach to investing. Long-term investors may hold a security through periods of weakness — lasting weeks, months, or even years — figuring that the tide will eventually turn and their investment thesis will be proven correct. Swing traders don't care for such poor performance in the near term. If a security's price is performing poorly, swing traders exit first and ask questions later.

I wish I could tell you that swing trading is fast and easy and leads to overnight profits that will make you an instant millionaire. Perhaps you have seen ads about a quick path to profits by following a "proven" or "secret" system. Or maybe you've seen a "news story" of an elementary school teacher that became a millionaire trading stocks during her lunch break. These ads and stories are alluring — people really want to believe them.

But I'm afraid the reality is there are no sure-fire ways to instant riches. Swing trading is no different; it won't turn you into a millionaire overnight. Period. Anyone who tells you different is either lying, doesn't know, or has something to sell you. As a beginner in swing trading, you'll likely lose money for a period until you master the ropes and apply the information in this book and other resources. I remember reading several books before I started trading, convinced I could begin as an expert. But I lost money for a period, rediscovering lessons found in the very books I read. There are few teachers better than the pain of losing money.

As you improve, you can expect to achieve investment performance in-line with the overall market and possibly above it. If you reach an advanced level of swing trading, then you may be able to generate 15 to 20 percent annually over time. If that number doesn't impress you, it may be because you're underestimating the powerful force of compound returns: a $10,000 investment growing 20 percent each year will reach more than $383,000 after 20 years — in other words, 38 times your money. One of the most successful investors of all time, Warren Buffett, generated annual returns of about 21 percent over more than 50 years of investing.

About This Book

In *Swing Trading For Dummies*, Second Edition, I introduce you to the strategies and techniques of the swing trader. Moreover, I cover topics given short shrift in some trading textbooks — topics that largely determine your swing trading success. For example, whereas many textbooks focus on chart patterns and technical indicators, this book goes one step further to cover the importance of money management, journal keeping, and strategy planning. Although these subjects are less glamorous than looking at charts, they're actually more important — because even exceedingly skilled chart readers will fail if they devise a flawed system, take unnecessary risks, and don't learn from their mistakes.

Here are some of the subjects this second edition covers:

- **Your trading plan:** A trading plan must outline when you're in the market and when you're not. It must detail your criteria for entering and exiting securities. Your plan should also cover what to do when a trade doesn't work out, as well as how much you risk and how you handle your profits.
- **Popular (and easy) chart patterns to trade:** Dozens of chart patterns appear from time to time in securities' price patterns, but not all of them are sound or based on investor psychology. That's why I focus on the tried-and-true chart patterns to give you the critical ones to look for.
- **Fundamentals:** All too often, swing traders pay attention only to the chart and disregard the company behind the chart. You don't need to spend 20 hours a day analyzing a company's financial statements — swing traders don't have that kind of time on their hands. But it's essential to find out the basics and apply the most important measures in your trading.
- **Investment returns:** This is one of those unglamorous topics, but if you don't properly calculate your returns, you'll never know whether you're doing any better than the overall market.
- **The importance of a journal:** A journal is like a trading coach, telling you what you did wrong or right in past trades and helping you to avoid repeating mistakes you made previously. This book shows you the key features of a valuable trading journal.
- **Risk:** The most important chapter in this new edition is Chapter 10, where I explain how to manage your portfolio's risk. As remarkable as this may sound, even if you get everything wrong except your risk management, you can still make a profit.

» **Important updates:** There have been important changes in the investing environment since the first edition of this book was published in 2008. For example, tax laws have changed, new companies have emerged, old ones have died away, new order types are now available (for example, algorithmic trading), and social media has emerged as a potent force in moving financial markets.

Charts and figures used in this book have text next to them explaining the essential point the figure conveys. These captions make it easy to skip to different charts and take away the critical point made in each one.

Foolish Assumptions

I made several assumptions about you when I was writing this book. I'm assuming that you

» Know how to trade securities online

» Plan on trading stocks or exchange traded funds

» Have little or no experience swing trading but are well versed in the basics of trading in general

» Are able to access and use websites that cover research, charting, news, and your portfolio account

» Have the will to change your current trading approach

» Don't have an MBA, CFA charter, or CMT designation and need some terms and techniques explained clearly

Icons Used in This Book

I use icons throughout the book to highlight certain points. Here's what each one means:

REMEMBER

Often, the Remember icon highlights a nuance that may not be apparent at first glance.

WARNING

I don't use the Warning icon often, but when you see it, take heed. I use this icon to point out subject matter that, if ignored, can be hazardous to your financial health.

TIP

A Tip icon marks advice on making your life easier as a swing trader. The Tip icon cuts through the fluff and tells you exactly what you need to know. It also may signal some tidbits that are my own personal insights based on experience.

Where to Go from Here

Like all *For Dummies* books, this book is modular in format. That means you can skip around to different chapters and focus on what's most relevant to you. Here's my recommendation on how best to use this book depending on your skill level:

- **For a newcomer to swing trading:** I strongly encourage you to begin with Part 1 and proceed to Parts 2 and 4. You can skip Part 3 if you plan on exclusively using technical analysis in your swing trading.
- **For the swing trader looking to refine his or her skills:** Parts 3 and 4 will likely be of most value to you because you probably already have a good bit of technical analysis under your belt. Help in designing your trading plan, which I cover in Part 4, may be the best way to improve your results. Remember, Chapter 10 is the most important chapter in this book.
- **For the swing trading expert:** You may benefit most by using this book to target specific areas for improvement. The index or table of contents can help you identify which parts of the book to target.

If you're not sure where to start, flip through the Table of Contents or Index for a topic that piques your interest. For additional information you can access on a regular basis, check out the Cheat Sheet at `www.dummies.com`.

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Getting into the Swing of Things

IN THIS PART . . .

Figure out how best you can use swing trading — depending on your goals and time commitment.

Determine the what you'll swing trade (probably equities), where you'll swing trade (domestically or internationally), when you'll swing trade (during the market or using end of day data), and how you'll swing trade (will you strictly use charts, base your decisions on fundamentals or a combination of the two?)

Find out about the rules of the swing trading game so you can produce consistent returns and avoid a loss that wipes out your portfolio.

Understand the steps you need to take to set up your trading account, subscribe to the reputable service providers, and keep a trading journal.

Discover some recommended strategies for growing your portfolio into a swing trading success story.

IN THIS CHAPTER

- » Contrasting swing trading with other types of trading
- » Deciding how much time you want to devote to swing trading
- » Getting strategic by preparing your trading plan
- » Avoiding the mistakes that many swing traders make

Chapter 1

Swing Trading from A to Z

You can earn a living in this world in many different ways. The most common way is by mastering some skill — such as drugs in the case of pharmacists or coding for web developers — and exchanging your time for money. The more skilled you are, the higher your compensation. The upside of mastering a skill is clear: You're relatively safe with regard to income. Of course, there are no guarantees. Your skill may become outdated (there aren't many horse carriage manufacturers operating today), or your job may be shipped overseas. You also have a maximum earning potential given the maximum hours you can work without exhausting yourself.

But there's another way to make a living. Swing trading offers you the prospect of earning income based not on the hours you put in but on the quality of your trades. The better you are at trading, the higher your potential profits. Swing trading takes advantage of short-term price movements and seeks to earn a healthy return on money over a short time period.

REMEMBER

Swing trading is a good fit for a minority of the population. It involves tremendous amounts of responsibility. You must rely on yourself and can't be reckless or prone to gambling. If you're not disciplined, you may end up with no income (or worse).

This chapter is an overview to this book and your guide if you're interested in swing trading.

Understanding What Swing Trading Is (and Isn't)

Swing trading is the art and science of profiting from securities' short-term price movements spanning a few days to a few weeks. Swing traders can be individuals or institutions. They're rarely 100 percent invested in the market at any time. Rather, they wait for low-risk opportunities and attempt to take the lion's share of a significant move. Generally, large institutional investors (think of a pension plan or a sovereign wealth fund) can't swing trade because their size prohibits them from easily moving into and out of a position. Smaller traders, however, can profit from these short-term movements because their size allows them easier entry and exit from liquid positions.

Swing trading is different from day trading or buy-and-hold investing. Those types of investors approach the markets differently, trade at different frequencies, and pay attention to different data sources. You must understand these differences so you don't focus on aspects that are only relevant to long-term investors.

The differences between swing trading and buy-and-hold investing

If you're a buy-and-hold investor in the mold of Warren Buffett, you care little for price swings. Over the long term, equity indexes have tended to rise across countries. Therefore, you prefer to buy quality businesses at discounts to their intrinsic value (also known as their true worth). You pore over financial statements and read the notes to the financial statements. You read through earnings call transcripts (the management presentations given after quarterly earnings results). Short-term price movements are merely opportunities to pick up securities (or exit them) at prices not reflective of their true value. In fact, buy-and-hold investors tend to have a portfolio *turnover rate* (the rate at which their entire portfolio is bought and sold in a year) below 25 percent — meaning they turn over their portfolio once very four years.

UNCLE SAM DIFFERENTIATES BETWEEN TRADING TIME FRAMES

What would a discussion of swing trading be without mentioning our good old friend Uncle Sam? He has a say in your profits and losses because you presumably pay taxes. And he treats profits and losses differently depending on whether you're a day/swing trader or the buy-and-hold variety.

The factor that determines how you're taxed is based on your holding period. If you hold a position for 366 days (one year and one day) and then sell it, any profits from that position are taxed at a lower rate — called the *long-term capital gains tax rate* — than your ordinary income tax rate (which can be as high as 37 percent in 2019). In 2019, the long-term capital gains tax rate ranged between 0 percent and 20 percent (depending on the size of the capital gains). However, this rate can change due to tax law changes.

Swing traders, of course, are unlikely to qualify for this lower tax rate on positions. Holding periods for swing traders are measured in days, not years. Short-term profits are likely to be taxed at an individual's ordinary income tax rate — called the *short-term capital gains tax rate.*

But there's an exception. The government provides special tax treatment to people it considers pattern day traders. *Pattern day traders* must trade four or more round-trip day trades in five consecutive business days, and those trades must be more than 6 percent of your total trading activity during that same five-day period (in other words, those four or more round-trip trades can't be for small values just to qualify for the special tax treatment). Pattern day traders must also maintain a brokerage account with at least $25,000 worth of equity (cash and stock). You can read more about the requirements of pattern day traders from the Financial Industry Regulatory Authority's website at `www.finra.org/investors/day-trading-margin-requirements-know-rules`.

So why is qualifying as a pattern day trader so special? The major benefits are as follows:

- You can deduct your trading expenses, such as research subscriptions, home office expenses, start-up expenses, trading books expenses (ahem), on Schedule C of your tax return, which reduces your adjusted gross income. Normally, you would report these expenses on Schedule A where you can only write off expenses that exceed 2 percent of your adjusted gross income.
- You'll be exempt from the *wash sale rule.* No, this isn't a rule on how you do your laundry. Instead, the IRS doesn't allow most taxpayers to write off a loss on a

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security if that taxpayer buys back the same security sold for a loss within 30 days. But pattern day traders are exempt from the wash sale rule. Therefore, they can still write off any losses on securities regardless if they buy the same security back within 30 days.

- You can deduct an unlimited amount of losses from your income. Most taxpayers would treat gains or losses from trading in securities as capital gains and losses; there are limits to how much taxpayers can reduce their taxable income from such losses (if they exceed the capital gains). The pattern day trader, however, can treat all gains and losses from security trading as ordinary income and losses. This means if you're having a tough year with significant trading losses and you qualify as a pattern day trader, you can deduct these losses from your income and significantly reduce or eliminate your taxes for that year.

A swing trader who trades part time may have difficulty convincing the IRS that she is a pattern day trader. But if you're a full-time swing trader, you should be able to take advantage of the special treatment of pattern day traders. Otherwise, expect to pay taxes on profits at your ordinary income tax rate (unless you sell securities after holding them for 366 days or longer, which isn't a typical swing trader).

However, swing trading in tax-deferred accounts — like in an Individual Retirement Account (IRA) or a 401(k) Plan — takes care of the tax issue. Taxes on gains and profits in such accounts aren't paid until the account holder withdraws the assets (usually at retirement). Because taxes change often and depend on an individual's situation, I strongly recommend consulting an accountant or tax professional to understand how swing trading will affect your taxes.

Buy-and-hold investing is an admirable practice, and many investors should follow this approach, because it's not as time-intensive as swing trading and not as difficult (in my opinion). But if you have the work ethic, discipline, and interest in swing trading, you can take advantage of its opportunities to achieve the following:

- **Generate an income stream:** Buy-and-hold investors are generally concerned with wealth preservation and growth. They don't invest for current income because they sometimes have to wait a long time for an idea to prove correct. Swing trading, on the other hand, can lead to current income.
- **Time your buys and sells and hold a basket of positions to diversify your risk:** The majority of people aren't interested in closely following their finances and are best served by investing in a basket of domestic and international mutual funds covering stocks, commodities, and other asset classes. Swing traders can hold a few securities across asset classes or sectors and generate higher profits than those who invest passively.

- **Achieve lower drawdowns than buy-and-hold investing:** Sometimes markets become overvalued. Just because a market is expensive doesn't mean it will tank. Markets often go from being overvalued to even more overvalued. This inevitably sets the stage for a major market crash (think 2000 or 2008). During market crashes, buy-and-hold investors can experience drawdowns of 50 percent or more, meaning a decline in portfolio value from peak to trough. Swing traders, on the other hand, are only in the market when there is opportunity. If the trend is down, swing traders can sit on the sidelines with their cash in tact until sunny days return.

The differences between swing trading and day trading

Opposite the buy-and-hold investor on the trading continuum is the day trader. Day traders rarely hold positions overnight. Doing so exposes them to the risk of a gap up or down in a security's price the following day that could wipe out a large part of their account. Instead, they monitor price movements on a minute-by-minute basis and time entries and exits that span hours.

Day traders have the advantage of riding security price movements that can be quite volatile. This requires time-intensive devotion on their part. Near-term price movements can be driven by a major seller or buyer in the market and not by a company's fundamentals. Hence, day traders concern themselves with investor psychology and news flow more than they do with fundamental data. They're tracking the noise of the market — they want to know whether the noise is getting louder or quieter.

But it's not all cake and tea for day traders. They trade so often they rack up major commission charges, which makes it that much more difficult to beat the overall market. A $5,000 profit generated from hundreds of trades may net a day trader a significantly reduced amount after commissions and taxes are taken out. This doesn't include additional costs the day trader must sustain to support his or her activities.

Swing traders also face stiff commissions (versus the buy-and-hold investor), but nothing as severe as the day trader. Because price movements span several days to several weeks, a company's fundamentals can come into play to a larger degree than they do for the day trader (day-to-day movements are due less to fundamentals and more to short-term supply and demand of shares). Also, the swing trader can generate higher potential profits on single trades because the holding period is longer than the day trader's holding period.

What Swing Trading Is to You: Determining Your Time Commitment

Getting started in swing trading requires some reflection. Before you rush out to buy that top-of-the-line laptop or set up that brokerage account, you need to think about what kind of swing trader you want to be. (Yes, swing traders come in different shapes and sizes.)

Your first step is to determine just how much time you can commit to swing trading. You may be a full-time swing trader from your home, in which case you should consider yourself as trading for a living. Or you may be doing this part time for income with the intention (and hope) of becoming a full-time trader.

Many swing traders have full-time jobs and have little time to devote to trading, so they trade primarily to improve the returns of their investment accounts. Or perhaps they're already in retirement and swing trade to grow their assets over time. These swing traders watch the market during the day but rely on orders placed outside market hours to enter or exit their positions. And if they trade in tax-deferred accounts, like an IRA, they can ignore the tax issue (until they begin to withdraw money from their tax-deferred account).

REMEMBER

The point is, you can swing trade whether you have a full-time job or not, but you need to make adjustments depending on whether you're able to watch the market all day. And by the way, watching the market all day long doesn't necessarily improve your returns. In fact, doing so can lower them if it causes you to overtrade or react to market gyrations.

Swing trading as your primary source of income

If you intend to swing trade as your primary means of generating income, be prepared to spend several months — if not years — gaining experience before you're able to give up your job and trade from home full time. Swing traders who trade full time devote several hours a day to trading. They research possible trades before, during, and after market hours. And they handle pressure well.

Many traders find that they can't handle the stress of trading full time. After all, if swing trading is your main source of income, you face a lot of pressure to generate consistent profits. And you may be more tempted to gamble if you encounter a string of losses. What many traders fail to realize is that the correct response to a series of losses isn't *more* trading but *less* trading. Take a step back and evaluate the situation.

REMEMBER

Swing trading for a living isn't difficult in the sense that to excel at it requires some kind of amazing IQ level or insane work ethic. Rather, it requires an incredible amount of self-restraint, discipline, and calm. A swing trader who trades for income must always be unemotional. When things don't work out, he or she doesn't try to get even but moves on to another opportunity.

So don't quit your day job just because you generate impressive profits for a few months. The name of this game is to always have enough capital to come back and trade again. If you plan on living off of $5,000 per month, for example, you can't expect to generate that kind of profit on $30,000 of capital. That would require a monthly gain of 16.67 percent! Some of the best all-time traders in the world topped out at returns of 20 to 25 percent *annually* over 20 or 30 years.

Swing trading to supplement income or improve investment returns

This category likely applies to the lion's share of swing traders. Swing trading with an eye on earning additional income or improving the returns on your portfolio is less stressful than swing trading for a living. You still have something to fall back on if you make a mistake, and you can swing trade while holding down a full-time job.

Part-time swing traders often do their analysis when they get home from work and then implement trades the following day. Even though they may not be able to watch the market all the time, they can enter stop-loss orders to protect their capital. (They really *must* enter stop-loss orders to avoid the risk of a major decline wiping out a large portion of their capital.)

If you want to eventually swing trade full time, you should go through this phase first. Over time, you'll be able to determine how well you've done. And if you follow the other recommendations in this book (like keeping a trading journal, which I cover in Chapter 3), you'll learn from your mistakes and improve your techniques.

Swing trading part time is suitable for those individuals who meet the following criteria:

- Have a full-time job
- Can devote a few hours a week to analyzing markets and securities
- Have a passion for financial markets and short-term trading
- Have the discipline to consistently place stop-loss orders

- Are achieving subpar returns in their current investment portfolios from a financial advisor or third party
- Don't gamble with their own money and are unlikely to fall prey to doubling down or taking major risks

If you fit these criteria, then part-time swing trading may be for you. When you first start out, I recommend swing trading with just a small portion of your portfolio so any early mistakes don't prove too costly. Although paper trading can be beneficial, it can't compare to the emotions you'll be battling as a swing trader when you put your own money on the line.

Swing trading just for fun

Some swing traders get a rush from buying and selling securities, sometimes profiting and sometimes losing. Their motivation isn't to provide or supplement current income. Rather, these swing traders do it for the excitement that comes from watching positions they buy and sell move up and down. Of course, this can lead to significant losses if they abandon the rules designed to protect their capital — rules that I outline throughout this book (specifically in Chapter 10).

WARNING

If you want to swing trade solely for fun, my advice is: don't. I recommend that you get your kicks at a bowling alley or basketball court. The danger of trading for fun is that you're using real money with real consequences. You may begin to risk more of your capital to satisfy your need for excitement. If you lose, you may take extreme action to prove yourself right in the end, like putting all your money into one or two securities. By then you're really in the realm of gambling.

If you insist on trading for fun, at least restrict yourself to a small amount of your assets and never touch your retirement nest egg. Remember that you're competing with traders who are motivated by profit, not just excitement. That gives them an advantage over someone who just enjoys the game.

Sneaking a Peek at the Swing Trader's Strategic Plan

Plan your trade and trade your plan.

Fail to plan and you plan to fail.