



Wiley Trading

TRADE

Like an

O'Neil Disciple

*How We Made 18,000%
in the Stock Market*

GIL MORALES & Dr. CHRIS KACHER

Trade Like an O'Neil Disciple

Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

The Wiley Trading series features books by traders who have survived the market's ever changing temperament and have prospered—some by reinventing systems, others by getting back to basics. Whether a novice trader, professional or somewhere in-between, these books will provide the advice and strategies needed to prosper today and well into the future.

For a list of available titles, visit our Web site at www.WileyFinance.com.

Trade Like an O'Neil Disciple

*How We Made Over 18,000% in
the Stock Market*

**GIL MORALES
AND DR. CHRIS KACHER**



WILEY

John Wiley & Sons, Inc.

Copyright © 2010 by Gil Morales and Chris Kacher. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <http://www.wiley.com/go/permissions>.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

Charts provided courtesy of eSignal. Copyright 2010 by eSignal.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Morales, Gil, 1959–

Trade like an O'Neil disciple : how we made over 18,000% in the stock market /
Gil Morales, Chris Kacher.

p. cm. – (Wiley trading series)

Includes index.

ISBN 978-0-470-61653-6

1. Stocks. 2. Speculation. 3. Portfolio management. I. Kacher, Chris. II. Title.

HG4661.M597 2010

332.63'22–dc22

2010013522

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

It is said that dedicating a book is one of the most exquisite acts of love one can perform. I love all who seek out and find their passion in life and in spirit, which include those closest to me, you know who you are.

—Chris Kacher

*For the other riders in my bumper car of life: Linda, Claire, and Alex, and for the two people who are responsible for setting me off on this bumper car ride:
my parents, Bob and Irene.*

—Gil Morales

Contents

Foreword	xi
Preface	xiii
Acknowledgments	xvii
CHAPTER 1 The Evolution of Excellence: The O'Neil Trading Method	1
<hr/>	
Preparation, Study, and Practice	2
Buy Expensive—Not Cheap—Stocks	4
Averaging Down	5
Cutting Losses Quickly	5
Taking Profits Too Soon—Letting Your Winners Run	6
Position Concentration	7
Dealing in Big Stocks and Institutional Sponsorship	8
Chart Patterns	9
Pivotal Points versus Pivot Points	12
Timing the Market: When to Be In, When to Be Out	13
Emotions and Predictions	14
Listening to Opinions, News, and Tips	15
Overtrading	16
The O'Neil Approach: Techno-Fundamentalism	17
Conclusion	17

CHAPTER 2 How Chris Kacher Made Over 18,000 Percent in the Stock Market Over Seven Years	19
<hr/>	
Gaining a Foothold in the Business	20
1996—"Y2K" Stocks Put Me Over the Top	22
1997—Keeping Profits during the Asian Contagion	27
1998—Demoralization Sets In Just Before the Market Takes Off	29
1999—The Bubble Expands	31
2000—The Bubble Bursts	35
2001—A Lesson in Shorting	37
2002 to Present—Choppy, Sideways Markets and the Birth of the Pocket Pivot	39
CHAPTER 3 How Gil Morales Made Over 11,000 Percent in the Stock Market	43
<hr/>	
A Rocky Start Turns Golden	44
Climbing on Board the Rocket Ride	46
Joining the 1,000 Percent Club	49
Oracle Bubbles Up	50
Patience and a Watchful Eye	53
Cleared for Take-Off	54
Verisign: The "Spice in the Soup"	56
Sitting Not Thinking	60
Closing In on the Top	62
The Theme of Success	64
The Secret Ingredients	65
CHAPTER 4 Failing Forward	67
<hr/>	
The Psychology of Success Lies in Taming the Ego	68
Learning from Our Mistakes	72
Problems, Situations, and Solutions	107
Conclusion	125

CHAPTER 5 Tricks of the Trade	127
<hr/>	
Dr. K's Laboratory: The Pocket Pivot Advantage	128
Characteristics of Pocket Pivots	131
Definition of a Pocket Pivot Buy Point	132
Pocket Pivots and Standard Breakout Buy Points	133
Buying "in the Pocket"	136
Bottom-Fishing with Pocket Pivots	149
Continuation Pocket Pivots: Using the 10-Day Moving Average	153
Improper or "Do Not Buy" Pocket Pivot Points	157
Using Moving Averages as Sell Guides	163
Dr. K's Laboratory: Buying Gap-Ups in Leading Stocks	165
Selling Techniques Using the 10-Day and 50-Day Moving Averages	173
Putting It All Together	177
Conclusion	185
CHAPTER 6 Riding the Bear Wave: Timely Tools for Selling Stocks Short	186
<hr/>	
The Golden Rules of Short-Selling	187
Short-Sale Set-Ups	192
Shorting Rocket Stocks	221
Conclusion	224
CHAPTER 7 Dr. K's Market Direction Model	226
<hr/>	
Timing the Market	226
Chart Examples	234
Stealing the Model's Secrets	243
Timing Model FAQ	244
Conclusion	259
CHAPTER 8 Our Bill of Commandments	260
<hr/>	
Misconceptions	260
Surviving by Keeping Ego in Check	263

The First Commandment	265
The Second Commandment	265
The Third Commandment	267
The Fourth Commandment	267
The Fifth Commandment	267
The Sixth Commandment	268
The Seventh Commandment	268
The Eighth Commandment	268
The Ninth Commandment	269
The Tenth Commandment	269
Conclusion	270
CHAPTER 9 In the Trenches with Bill O'Neil	272
<hr/>	
1997-1998	272
1999-2000	286
The Great Bear of 2001-2002	307
2003-2005 Bull Market	318
Conclusion	329
CHAPTER 10 Trading Is Life; Life Is Trading	331
<hr/>	
Ed Seykota: Teaching a Technique That Has Helped Traders around the World	332
Eckhart Tolle: Helping People Achieve Inner Peace and Greater Fulfillment, a Prerequisite to Optimized Trading and Living	334
Esther Hicks: Teacher of the Law of Attraction	340
Jack Canfield: Seminal Works on Personal Optimization	341
Psychological Checklist: Questions to Ask Yourself	343
Parallels between Teachings	345
In Conclusion	346
APPENDIX Dr. K's Top 50 Wall Street Books	347
About the Authors	351
Index	353

Foreword

Bill O'Neil is a passionate student of the markets and one of the most successful traders of the modern era. From our days at SMU and later during his time in Alaska, Bill was studying charts and developing his vast understanding of the markets. Based upon his historical studies back into the nineteenth century, Bill has always tried to help the investor improve their success ratios.

His commitment to bringing that knowledge to the average and/or professional investment community has cost him millions of dollars through the subsidization of *Investor's Business Daily*[®] and other O'Neil projects.

It has been my privilege to have known Bill for almost sixty years and while my own investment style is not exactly O'Neil's, it is built upon the same building blocks. When I first went to Wall Street in June 1962 (ten years after meeting WON almost to the day), William T. Golden, the New York partner in Cornell, Linder & Co., a member of the NYSE, told me: "We mostly invest in stocks and convertibles with increasing sales and increasing earnings. Go find them, keep your losses under control and everything will work out."

Luckily for me, those few words of wisdom have been the basis of my investment style during the past fifty years.

Stripped to its core values that is also basically O'Neil's CAN SLIM[®].

O'Neil is often accused of being only a technician, but that is not true. His investment style builds heavily upon fundamentals, chart patterns, market trends, sector rotation, and economic strength. O'Neil is also not a fan of modern portfolio theory and often concentrates his portfolio in only a few stocks. Performance, not diversity, is the key to O'Neil's long-term success. There have been times when O'Neil's investment portfolio could be 100 percent in cash or concentrated in just one or two positions.

Gil Morales and Chris Kacher learned from O'Neil while working as successful portfolio managers at William J. O'Neil + Co., Inc. In this book, they help the investor understand how the CAN SLIM investment system works and have added a few tweaks to the O'Neil strategies that they have developed.

It is evident that they are highly indebted to O'Neil's philosophy and trading principles. However, like all traders that are constantly seeking an edge, they have also developed some of their own unique indicators and rules that they disclose in the book.

It is all here, the gains, the losses, both at the O'Neil firm and later on their own, the changes in the O'Neil system as market conditions dictate. Wall Street is a big casino and black swans do occur to upset the best laid plans.

Dr. K and Gil make it quite evident that there is a lot to learn from O'Neil and the CAN SLIM investment system and they are deeply indebted to WON as are his many legions of admirers for providing the tools to improve investment success ratios.

But most important, they also demonstrate that it is impossible to trade like Bill O'Neil because it is simply impossible to have his unique feel for the markets. But by understanding O'Neil's principles, investors can improve their success ratios.

Trade Like an O'Neil Disciple fascinated me and I will read it time and time again to improve my results!

Fred Richards
www.adrich.com
www.stratinv.net

Preface

As a successful investor, William J. O’Neil has touched the lives of individual and institutional investors around the globe whom he has taught to make money in stocks. How many we cannot know for sure, but rest assured that it is likely in the hundreds of thousands, if not far more. His methods and the investment tools he and his firm have developed for individual and institutional investors alike have empowered many to find financial freedom in their lives. We are two of those investors, and we can vouch for the fact that Bill O’Neil is responsible for helping to create many new millionaires in this world. As former internal portfolio managers at William O’Neil + Company, Inc. we met many individual and institutional investors who benefitted from O’Neil’s strategies and expertise, so we know this from first-hand experience. We’ve also made lots of money in the markets, thanks to learning and executing O’Neil’s methodologies.

This book is our attempt to articulate what we learned from Bill O’Neil, working directly with him under fire in real-time while trading the markets. But first a disclaimer: this book is not sanctioned by or approved by Bill O’Neil or William O’Neil + Co., Inc. Our interpretation and views may not be those of Bill or the company. This book explains how we trade based on our learning experience as proprietary traders at William O’Neil + Co., Inc. This book is also not about the CAN SLIM® methodology. Readers are encouraged to read Bill’s seminal work (and all his other books), *How to Make Money in Stocks*, and to refer to *Investor’s Business Daily* and investors.com. Between Bill’s excellent books, the reporting in the paper, and the web site, there is a plethora of tutorials and educational materials that detail O’Neil’s methods. We encourage you to make good use of these books and tools.

Trade Like an O’Neil Disciple is our unique experience with this man who we feel is likely the world’s greatest investor. In this book we provide insights into O’Neil’s genius as we saw it. We track the markets of the late 1990s and early 2000s with real-time excerpts from our trading diaries that bear witness to O’Neil’s incredible investment genius. In real-time, O’Neil embodies the Latin term *speculari*, which means “to spy out or

examine” as he perceives subtle shifts in the market, almost by osmosis. In this book we hope to provide insight into some of his thought processes, as we saw them unfold, using real-time market examples. The O’Neil methodologies primarily represent a dynamic approach to the stock market, and this dynamism is entirely correct and appropriate since the stock market is itself a dynamic beast. The brutal bear markets of 2000–2002, and 2008 have proven that “static” buy-and-hold strategies are a fantastic way to lose a lot of money. The markets are dynamic and O’Neil’s methods are likewise dynamic, yet we are still human beings with our foibles and quirks. O’Neil advises making up “little rules” along the way as you observe your own trading and recognize these little “quirks” in yourself. These little rules may be sub-systems or rules that establish boundaries for containing weaknesses or are put in place to capitalize on strengths. We ourselves, as long-term, experienced practitioners of O’Neil methodologies, have come up with many over the years. It’s not as if we are turning the system upside down, or using it in piecemeal fashion as we pick and choose what rules we choose to use. Instead, what we have done over time is to use the market as an effective feedback system with respect to our own trading to come up with small rules and sub-systems that enhance our own approach to O’Neil’s methods. One of our “quirks” is that we like to buy stocks earlier in bases, and not just when they stage an obvious new-high base-breakout. Another “quirk” of ours is that we like to buy gap-ups, particularly in a strong leader as it is breaking the “line of least resistance” to the upside and potentially embarking on a sharp price run. In this book we share with you trading rules that have worked well for us, and how we buy stocks and short stocks using refined “sub-methods” that we have tested both statistically and in practice, and have found to be effective enhancements to our investing.

We’ve also made a lot of mistakes, and in this book we discuss those mistakes in order to help prevent you from making the same mistakes, hopefully saving you time, money, and misery in the process.

Trading for us has been as much a spiritual journey as it has been an investing journey, and in the process has provided each of us with a microcosm of life itself. The return of +18,241.2 percent works out to +110.5 percent on an annualized basis over the seven-year period from January 1996 to December 2002. But to achieve such a result, a couple of sizeable drawdowns did occur including one that was nearly –50% during the second and third quarter of 1999. As well, we would point out that the returns we discuss in Chapters 2 and 3 were achieved in our personal accounts, and not in the accounts we managed for William O’Neil + Company, Inc.

While the dollars in our trading accounts and the returns are the way we track our success and performance, trading is ultimately not so much about making money as it is about understanding what Eckhard Tolle

referred to as “The Power of Now.” Like athletes and thrill-seekers who engage in activities that seem extremely dangerous, almost to the point of the unthinkable to those who live more normal lives, we as traders seek the “rush” that comes not from a successful trade, but from the experience of being entirely in the present as we operate “in the zone” and a certain fluidity and calmness pervades our actions as we engage the markets in real-time. Ocean wave surfers experience this as the intensity of riding a powerful wave-form that forces them to focus on the matter at hand as a matter of sheer survival. Focusing on the matter at hand forces one to operate entirely in the present—there is no worrying about yesterday’s problems, or tomorrow’s challenges, there is only the “now.” If you cannot understand why someone would seek to ride a 50-foot-high “death wall” of ocean water then you likely have never ridden one. Riding such a wave is the rush—what we call being “in the zone”—and it applies to trading as much as it applies to surfing, hang-gliding, rock-climbing or any other dangerous yet exhilarating endeavor that humans are drawn to like moths to a porch light. As traders we both share an appreciation for the spiritual aspects of this phenomenon, which is really nothing more than the simple, spiritual act of “becoming one” with the present moment; nothing more, nothing less. This is the essence of successful trading.

Gil Morales
Dr. Chris Kacher
June 2, 2010

Acknowledgments

While it is always important to acknowledge those who assisted in the production of a book such as this, we feel it is just as important to acknowledge that this book was written and produced with absolutely no assistance, endorsement, or cooperation from William J. O'Neil or any of the O'Neil organizations. This is an independent work. However, there were many people who are responsible in some way, large or small, for this book that you now hold in your hands. Among these, we would like to thank Mike Scott, who provided invaluable technical assistance in creating the charts for this book, the folks at eSignal, who let us use their excellent charts and data, Rachel Hain, who helped on several fronts during the writing of the book, and Kevin Marder.

CHAPTER 1

The Evolution of Excellence

The O'Neil Trading Method

As portfolio managers who once ran money for William J. O'Neil, we have observed that a meaningful portion of the O'Neil "body of thought" is derived from the philosophies of those who preceded him, particularly the works of Richard Wyckoff and Jesse Livermore. When it comes to market thought, you can never entirely understand Bill O'Neil until you have read and understood these two gentlemen. Obviously, the techniques and philosophies of the famous trader Jesse Livermore, as presented in the classic *Reminiscences of a Stock Operator*, by Edwin Lefèvre and Livermore's own *How to Trade in Stocks*, figure heavily in the underlying pulse that governs the way Bill O'Neil and his stable of portfolio managers trade. Richard Wyckoff, as one of the first to write about Jesse Livermore in his original work, *Jesse Livermore's Methods of Trading Stocks*, espoused much of the common sense investment philosophies and maxims that have found their way into the writings and investment thought of William J. O'Neil. Even Nicolas Darvas, in his famous book, *How I Made \$2 Million in the Stock Market* (Carol Publishing Group, 1998), laid the foundation for O'Neil's "chart bases" with his own "boxes," which he described as simply normal consolidation channels within which a stock's action was judged to be normal or abnormal.

The themes that echo from Wyckoff, Livermore, Darvas, and others weave the essential fabric from which "O'Neil-style" investment methodologies are cut. These methodologies utilized the work of O'Neil's predecessors by bringing into play the time-tested characteristics of winning stocks that O'Neil painstakingly identified, analyzed, catalogued, and verified in his numerous Model Book Studies, some of which your

authors had the privilege of producing and contributing to. By sifting through the best-performing, institutional-quality leading stocks in each and every type of market cycle, O'Neil identified their key common characteristics, the most basic of which provided the genesis for O'Neil's unique stock-selection template, commonly known to the investing public as CAN SLIM. Certainly, O'Neil owes a debt to the thinking of Livermore, Wyckoff, and others, and the roots of the O'Neil investment methodologies run deep in this regard. However, as former portfolio managers for William O'Neil + Company, Inc., we can vouch for the fact that such roots do not imply that O'Neil simply copied his predecessors. That would be a gross oversimplification, since the truth is that the O'Neil methodologies took the thinking of these outstanding stock market investors from the past to a much higher level by bringing greater clarity to the process as he formulated a concrete, concise, and practical approach to making money in the stock market.

The parallels between O'Neil and his predecessors provide an overarching backdrop to a general philosophy, a certain ethos, if you will, toward the market that is more than just Livermore's, or Wyckoff's, or even O'Neil's. As O'Neil himself used to tell us, "It's not MY system. It's the market's, because it is based on how the market actually works." In this manner, O'Neil simply sees his own work as furthering the basic process of understanding the market through observation and the application of common sense rules gained thereby. It is nothing more or less than understanding all the small realities that make up the stock market. Reviewing how O'Neil has taken and expanded upon the works of his predecessors is a useful exercise, and sets the backdrop for much of the research we have done to further our approach to the O'Neil/Livermore/Wyckoff approach to the market, and which is one of the main topics of this book.

PREPARATION, STUDY, AND PRACTICE

Don't dabble in stocks. Dig in and do some detective work.

—William O'Neil, *How to Make Money in Stocks*,
2nd ed. (New York: McGraw-Hill, 1995), 34

This the essential premise of O'Neil methodologies: They are in no way, shape, or form intended as a panacea for making money in the market. Human beings are complex organisms, and so represent the greatest variable in the implementation of any investment methodology, whether of "O'Neilian" origin or otherwise. This is why O'Neil insists that one must put in the time, effort, and work required if one intends to become a

successful stock market investor: “Human nature being what it is, 90 percent of the people in the stock market, professionals and amateurs alike, simply haven’t done enough homework.”

O’Neil laments the fact that so many investors are looking for some magic formula that enables them to produce an optimal result in the stock market with little or no effort. In *The Successful Investor*, he laments the “rise of the individual investor” during the dot-com bubble market of 1999. “Most people, both investors and advisors, got hurt in the 2000 to 2002 downturn because they never took the time to learn sound investment rules and principles. In the 90s they thought they’d found a way to make money without doing much homework. They just bought tips, touts, and stories” (William J. O’Neil, *The Successful Investor* [New York: McGraw-Hill, 2004], xii).

While most investors do not hesitate to dabble in the markets, they would rarely dabble in medical or legal practice, or even in playing professional baseball. O’Neil reminds us, however, “Outstanding stockbrokers or advisory services are no more frequent than are outstanding doctors, lawyers, or baseball players” (William O’Neil, *How to Make Money in Stocks*, 2nd ed. [New York: McGraw-Hill, 1995], 256). This is not too far off from Richard Wyckoff’s astute observation that “A person becomes competent in other fields because he has generally gone through a long period of practice and preparation. A physician, for example, goes to college, attends medical clinics, rides in an ambulance, serves in hospitals, and after some years of preparatory work, hangs out a sign. In Wall Street, the same M.D. would hang his sign first; then proceed to practice” (Richard Wyckoff, *How I Trade and Invest in Stocks & Bonds* [New York: The Magazine of Wall Street, 1924], 159–160).

Investing is hard work, and an investor requires no less preparation and expertise than any other white shoe professionals practicing their craft, whether it be law, medicine, software design, moviemaking, or otherwise. Jesse Livermore became annoyed when he was approached by friends or acquaintances who would ask him how they, too, could make money in the market. Biting his tongue, Livermore’s answer eventually evolved into a curt, “I don’t know,” as he found it difficult “to exercise patience with such people. In the first place, the inquiry is not a compliment to a man who has made a scientific study of investment and speculation. It would be as fair for the layman to ask an attorney or a surgeon: ‘How can I make some quick money in law or surgery?’” (Jesse Livermore, *How to Trade in Stocks* [Greenville: Traders Press, 1991], 15).

While reminding investors that success can only be achieved by hard work and persistence, O’Neil, always the optimist, makes it plain that success is within the reach of anyone willing to make the effort, and in his book, *How to Make Money in Stocks* (2009, 9), he urges us all on with a

touch of self-sufficient idealism, “The American dream can be yours if you have the drive and desire and make up your mind to never give up on yourself.” But O’Neil insists from the start that, as Wyckoff wrote, “. . . anybody who thinks he knows of a short-cut that will not involve ‘sweat of the brow’ is sadly mistaken” (*How I Trade and Invest in Stocks & Bonds* [New York: The Magazine of Wall Street, 1924], 93).

BUY EXPENSIVE—NOT CHEAP—STOCKS

Like Livermore, O’Neil despises a lazy approach to the market because it results in one trying to take what is perceived as the easy route to stock market riches. Nowhere else is this more embodied than in the idea of buying stocks that are “cheap.” This age-old trap is easy to fall into, since most novice investors approach the market with an incorrigibly ingrained consumer mentality that views anything selling today at a lower price than it was yesterday as a “bargain.” This is perhaps because the individual investor views herself as a consumer endpoint, when in fact the investor should act like a business that purchases raw or finished goods and intends to turn around and sell them at a higher price. Hence, O’Neil’s story about red dresses and yellow dresses, where the slower-selling yellow dresses are marked down by the store owner to get them out of the “portfolio,” otherwise known as the store inventory, so that more of the hotter-selling red dresses can be purchased and resold at higher prices.

O’Neil advocates buying stocks that are “red dresses” selling “like hot-cakes” at all-time high prices. The reason for this is simple: “. . . real leaders start their big moves by selling at new price highs, not near new lows or off a good amount from their highs” (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 426). In a contrarian sense, this is what makes the concept of buying stocks at new highs so effective. It is simply not obvious to the crowd, who fear buying a stock that looks to be selling at such a high price, because, as O’Neil points out, “What seems too high in price and risky to the majority usually goes higher eventually, and what seems low and cheap usually goes lower” (2009, 174). The market tries to fool the majority of investors the majority of the time, so if new high prices in a particular stock make the crowd timid about buying it, then that is likely the precise time to be buying the stock.

Like O’Neil, Jesse Livermore appreciated higher-priced stocks far more than “cheap” stocks, advising, “One should never sell a stock, because it seems high-priced. . . . Conversely, never buy a stock because it has had a big decline from its previous high. The likelihood is that the decline is based on a very good reason. That stock may still be selling at an extremely high price relative to its value—even if the current level seems

low” (Jesse Livermore, *How to Trade in Stocks* [Greenville: Traders Press, 1991], 25).

AVERAGING DOWN

Trying to buy cheap stocks is but one frequent sin committed by novice or lazy investors. Another lazy man’s sin eschewed by O’Neil and his predecessors is the concept of “averaging down.” Richard Wyckoff observed, “A great deal of money is lost or tied up by people who make a practice of averaging. Their theory is that if they buy a security at 100 and it goes to 90, it is that much cheaper, and the lower it goes the cheaper it grows.”

Retail stock brokers, when in need of a way to avoid taking responsibility for a bad recommendation, often try to use “averaging down” as a way to justify the initial decision to purchase a stock at higher prices. To some extent, this evolved as a convenient corollary to the retail investment concept of “dollar-cost averaging” when purchasing mutual funds, about which we’re sure many readers are only too familiar. To O’Neil, this is shameful: “About the only thing that’s worse is for brokers to take themselves off the hook by advising customers to ‘average down.’ If I were advised to do this, I’d close my account and look for a smarter broker” (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 247).

Jesse Livermore was no less harsh in his assessment of the averaging-down technique when he said, “It is foolhardy to make a second trade, if your first trade shows you a loss. Never average losses. Let that thought be written indelibly upon your mind” (*How to Trade in Stocks* [Greenville: Traders Press, 1991], 26). Richard Wyckoff took the concept just a little bit further by adding, “It is better to ‘average up’ than to ‘average down’” (*Stock Market Technique Number 1* [New York: Richard D. Wyckoff, 1933], 50). And as we know, O’Neil contrasts his sermons against averaging down by strongly advocating “averaging up” on one’s winning stocks.

CUTTING LOSSES QUICKLY

Jesse Livermore wrote in *How to Trade in Stocks*, “You should have a clear target where to sell if the market moves against you. And you must obey your rules! Never sustain a loss of more than 10 percent of your capital. Losses are twice as expensive to make up. I always established a stop before making a trade” (*How to Trade in Stocks* [Greenville: Traders Press, 1991], 171). O’Neil advises a 7 to 8 percent automatic stop-loss policy on all stock purchases, and the main reason for this is to keep oneself out of

danger. Huge losses in the market can be debilitating, and O'Neil views a strict stop-loss policy, whether at his threshold of 6 to 7 percent or Livermore's 10 percent, as absolutely necessary for survival in the stock market. Livermore observed, "Taking the first small loss is wise . . . profits take care of themselves but losses never do" (1991, 7).

Richard Wyckoff in *Stock Market Technique Number 1* advised: "Your first line of defense is a stop order—placed when you make the trade, or immediately thereafter. If you fail to limit your risk at inception, make a practice of looking over your commitments every day, or twice every week and selling out, at the market, all showing a loss. That will keep your sheet clean and allow your profitable trades to run until the time comes to close them out" (1933, 96). This concept of using a stop-loss as a "line of defense" runs parallel to O'Neil's thinking that "letting your losses run is the most serious mistake made by almost all investors" (*How to Make Money in Stocks*, 2nd ed. [New York: McGraw-Hill, 1995], 93) simply because "[i]f you don't sell to cut your losses when you get into trouble, you can easily lose the confidence you'll need to make buy and sell decisions in the future" (1995, 252). Not only do losses cut into the capital an investor has available to capitalize on potential opportunities in the stock market, they also take their toll on an investor's psychological capital, their all-important self-confidence.

To O'Neil, Livermore, and Wyckoff, losses are just part of the process, and it is always better to take a little pain now rather than a lot of pain later, because, as O'Neil reveals, "The whole secret to winning big in the stock market is not to be right all the time, but to lose the least amount possible when you're wrong" (1995, 240).

TAKING PROFITS TOO SOON—LETTING YOUR WINNERS RUN

The O'Neil methodology is essentially a trend-following system—you want to be in the market when the trend is in your favor, and you want to capture a large portion of any trend by riding with it for as long as possible. To O'Neil, buying a winning stock is only half the problem, because the key to capitalizing on a big price move in any potential, big, winning stock is in how you handle the stock once you have bought it. As Livermore said, it is the uncommon man who can "sit tight and be right," so sitting with and properly handling a meaningful position in a big, winning stock through the bulk of its upside price move is a big part of how O'Neil makes big money in the stock market. This necessitates adhering to a basic principle that Livermore stipulated when he said, "As long as a stock is acting right, and

the market is right, do not be in a hurry to take a profit” (*How to Trade in Stocks* [Greenville: Traders Press, 1991], 21). You can’t make big money in stocks if you don’t give them a chance to make big money for you.

O’Neil recommends “take your losses quickly and your profits slowly,” because “your objective is not just to be right but to make big money when you are right” (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 247–272). Trading for quick profits requires that one be constantly active and thinking about the next trade. It is a notoriously busy way to approach the market, and is entirely out of sync with the ideal that O’Neil-style investing tends toward. In our experience, there is nothing easier than making big money in the market once you have latched onto a big winner, because at that point all you are doing is sitting more and thinking less. When your stocks are trending nicely to the upside and you are fully invested, there is, from a practical standpoint, very little to do. You are simply letting your winners run. This is what we like to call “being in the zone,” a mental space that derives from Livermore’s principle: “It never is your thinking that makes big money. It’s the sitting” (Edwin Lefèvre, *Reminiscences of a Stock Operator* [New York: John Wiley & Sons, 1994], 68).

Richard Wyckoff had his own unique perspective on the idea of cutting losses quickly and letting winners run when he wrote in *Stock Market Technique Number 1*, “Are you getting rich backwards? Then you are taking two points profit on your speculative trades and letting your losses run. Why not reverse this rule? Limit your risk to one, two or three points and let your profits run” (1933, 52).

POSITION CONCENTRATION

A big part of handling a winning stock correctly is properly scaling one’s position size. If you only want to make average market returns, then scale your positions to a very small size, and your portfolio will act very much like a market index. Having scores of positions is nothing more than “closet indexing.” Most mutual fund managers take positions that make up 1 to 2 percent of their portfolio equity or less, and they may have 100 to 200 positions or more. To O’Neil, this is anathema. If you want to make big returns, then you absolutely must concentrate your capital in a strongly-trending stock, and position sizes of 1 to 2 percent of one’s total portfolio equity are, to put it bluntly, quite wimpy from an O’Neil perspective. The O’Neil method of pyramiding into strongly acting positions while weeding out weaker ones generally gets an investor concentrated in the right stocks during a bull market cycle. At times, your authors have been fully invested

in as few as two stocks, using full, 200 percent margin, so that each position represents 100 percent of the account's gross equity. This is how you make big money in the market, and it is the essence of handling one's stocks properly to achieve maximum effect.

For this reason, O'Neil eschews "diversification" and cites the wisdom of Gerald Loeb, who declared that diversification was a "hedge for ignorance." O'Neil's solution was to be very specific about what stocks one owned in any bull market cycle, suggesting, "The more you diversify, the less you know about any one area. Many investors overdiversify. The best results are achieved through concentration: putting all your eggs in just a few baskets that you know a great deal about and continuing to watch those baskets very carefully" (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 274).

The purpose of position concentration from an O'Neil perspective is two-fold. On the one hand it allows an investor to fully capitalize on a big price move in a winning stock, while on the other it allows the investor to focus his or her attention on "fewer eggs," which O'Neil views as a safer mental approach than trying to keep track of too many positions at once. Even Livermore himself thought "... that it is dangerous to start spreading out all over the market. By this I mean, do not have an interest in too many stocks at one time. It is much easier to watch a few than many" (*How to Trade in Stocks* [Greenville: Traders Press, 1991], 33).

To O'Neil, it is not necessary to own every stock in the market; to have a need to "kiss all the babies," as he is fond of saying. He whittles it all down to one basic concept: "The winning investor's objective should be to have one or two big winners rather than dozens of very small profits" (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 274).

DEALING IN BIG STOCKS AND INSTITUTIONAL SPONSORSHIP

Owning the biggest winners in the market means owning the stocks that institutions are piling into, and O'Neil sees modern-day mutual funds, hedge funds, and pension funds, and other members of the "institutional investor zoo," as akin to the "pools" and "trusts" of Jesse Livermore's and Richard Wyckoff's era. It is the accumulation of stock by large institutions that produces the huge price moves upon which O'Neil methodologies seek to capitalize. And the smart institutions, such as those with the better research and stock selection skills, are the ones in whose footsteps you want to follow. O'Neil asserts, "It takes big demand to push up prices, and by far the biggest source of demand for stocks is institutional investors, such as

mutual funds, pension funds, hedge funds, insurance companies, [etc]. A winning stock doesn't need a huge number of institutional owners, but it should have several at a minimum." O'Neil continues, "[Diligent investors] look for stocks that are held by at least one or two of the more savvy portfolio managers who have the best performance records" (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 193–194).

Knowing where the smart money is moving is central to O'Neil's methodology, and understanding the quality of institutional sponsorship coming into a stock is no different from what Richard Wyckoff advised when he wrote, "It is important to know whether large operators, inside interests, pools, or the public dominate the market for a certain security or group." Wyckoff went on to explain, "The reason this is so important is as follows: A combination of bankers will seldom be found on the long side of the market unless they expect a pronounced change in security market conditions in the near future. Their own purchases, therefore, are an indication of probable betterment. When a pool takes hold, it is usually in a certain one or a few issues which are likely to be favorably affected by developments known to a few but not generally known" (*How I Trade and Invest in Stocks & Bonds* [New York: The Magazine of Wall Street, 1924], 183).

O'Neil's unique and deep understanding of the institutional investor and the implications of institutional sponsorship is founded in the experience he has had advising some of the largest and most successful institutional investors on the planet. It is this understanding that generates what we have dubbed The Big Stock Principle that drove O'Neil's thinking in any market cycle. Knowing which stocks represented the cutting edge of developments driving any particular economic, and hence market, cycle means knowing where institutional investors "have to be" with respect to positioning their portfolios. When institutional investors start shoveling money into stocks that they "have to be" invested in, this fuels tremendous upside price moves in those stocks, and it is what makes them "Big Stocks." It is a central tenet of O'Neil-style investing.

CHART PATTERNS

Books like *How I Made \$2 Million in the Stock Market*, by the famous ballroom dancer Nicolas Darvas, figure into O'Neil's concepts of "bases," which Darvas termed "boxes." O'Neil, however, took it quite a bit further with his colorful, descriptive cataloguing of consolidation patterns or bases that he termed "ascending," "cup-with-handle," "double-bottom," "square box," "flat base," and "high, tight flag," among others—the chart

patterns from which, as O'Neil observed, big, winning stocks emerged as they started their huge upside price romps. As well, these patterns represented the "continuation" that patterns hugely performing stocks form on the way up as they naturally and normally pause and digest their gains during an overall intermediate to longer-term price run before proceeding higher.

Like O'Neil and his bases, Darvas's "box theory" emerged from his own direct observation and study of stock charts and tables: "I started to realize that stock movements were not completely haphazard. Stocks did not fly like balloons in any direction. As if attracted by a magnet, they had a defined upward or downward trend which, once established, tended to continue. Within this trend stocks moved in a series of frames, or what I began to call boxes. They would oscillate fairly consistently between a low and a high point. The area which enclosed this up-and-down movement represented the box or frame. These boxes began to exist very clearly for me" (Nicolas Darvas, *How I Made \$2 Million in the Stock Market* [New York: Carol Publishing Group, 1998], 51).

O'Neil is far more specific, however, about the precise structure of these "boxes" or "bases," and his work goes into much detail about the exact shapes, durations, and magnitudes of these various price consolidation structures. But, like Darvas, O'Neil recognizes: "Chart patterns are simply areas of price correction and consolidation, usually after an earlier price advance. The primary challenge in analyzing price consolidation structures is to diagnose if the price and volume movements are normal or, instead, signal significant weakness or distribution" (*How to Make Money in Stocks*, 2nd ed. [New York: McGraw-Hill, 1995], 161).

It is, however, important to understand that Darvas's "box theory" is nothing more than a very rudimentary, initial version of O'Neil's chart pattern zoo. Darvas never bothered to measure the minimum durations for his boxes to determine whether a longer duration was preferable to a shorter one, nor did he measure the magnitude, or range, of these boxes to determine any meaningful characteristics thereby. As he puts it, "I found that a stock sometimes stayed for weeks in one box. I did not care how long it stayed in its box as long as it did—and did not fall below the lower frame figure" (*How I Made \$2 Million in the Stock Market* [New York: Carol Publishing Group, 1998], 52).

O'Neil also went way beyond the simplistic "box theory" by recognizing the importance of applying historical precedent in his work. O'Neil observed that the chart patterns formed by market-leading stocks in one market cycle often repeated themselves in the market leaders of a later cycle. As an example, O'Neil has discussed in public forums how a big pull-back by America Online (AOL) to its 50-day moving average back in 1998