

 WILEY Trading

MASTERING THE STOCK MARKET

**HIGH PROBABILITY
MARKET TIMING AND
STOCK SELECTION TOOLS**

JOHN L. PERSON

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Mastering the Stock Market

*High Probability Market
Timing & Stock
Selection Tools*

JOHN L. PERSON



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Library of Congress Cataloging-in-Publication Data:

Person, John L.

The master stock trader : timing techniques to profit from seasonal & sector analysis / John L. Person.

p. cm.

Includes index.

ISBN 978-1-118-34348-7 (cloth); ISBN 978-1-118-41659-4 (ebk);

ISBN 978-1-118-43417-8 (ebk); ISBN 978-1-118-42054-6 (ebk)

1. Stocks—Charts, diagrams, etc. 2. Investment analysis. I. Title.

HG4638.P474 2013

332.63'2042—dc23

2012026739

To my loving wife Mary, my best friend and supporter.

Foreword

John Person has probably forgotten more about trading than most traders will ever learn. He has done it all in the industry—floor trader, broker, analyst, book author, and educator. Along the way, he has tested virtually every trading approach known to man. He knows what works, what doesn't, and what it takes to succeed as a trader.

I've known John for over 20 years. I've seen him after a good run in the market and seen him after he took a big hit. What I admire is his resiliency, tenacity, and his commitment to continuous learning. He is always increasing his knowledge and seeking to improve as a trader.

I think *Mastering the Stock Market* is John's best book yet. It brings together his extensive knowledge of sectors and seasonals with his deep understanding of technical analysis. It is the work of a market veteran who understands that your best bet to make money in the market is to have both technicals and fundamentals on your side.

Like John, I am optimistic that the financial and commodity markets will provide tremendous opportunities for investors in the years ahead. Technology, globalization, and entrepreneurship will drive economic growth and propel the U.S. stock market to new heights.

Many investors were chastened by the big stock market drop in 2008–2009. Four years later, a lot of these investors are still not back in the market. Instead, they may be earning just a few percentage points in bonds or CDs. That's not a recipe for growing a nest egg that will provide for a comfortable retirement or fund your children's education.

By studying the methods in *Mastering the Stock Market*, you will gain the knowledge to approach the markets with a high degree of confidence. You'll be able to identify

opportunities and fine tune your entries and exits using technical analysis. You'll gain the discipline to cut your losses when a trade doesn't work and to maximize profits when everything works as planned. In short, *Mastering the Stock Market* will help you to make sound trades and build your wealth.

Jake Bernstein
Santa Cruz, California
October 2012

P.S.—I must also add that in my more than 44 years as a trader, investor, and market analyst, I have met and known many of the top people in the business. John is a “Person” who ranks at the top, top of my list in credibility, commitment, and a deep love for his work. When John talks, I LISTEN!

Introduction

I firmly believe the second decade of the new millennium will bring another wave of prosperity and a new level of educated traders and investors. I am longer-term bullish on stocks and have had that bullish outlook since the market bottomed in March of 2009.

The divergence between technology indexes such as the QQQ or the Nasdaq 100's posting a double bottom in March 2009 versus the prior low from November 2008 was one clue, and sentiment indicators such as the CFTC COT reports, volume studies, and the longer-term Person's Pivot support levels all helped me form that conclusion. Even into 2011, at PA Stock Alerts, we held steadfast to our bullish bias, and as we enter the 2012 presidential elections, I continue to remain on the longer-term buy side of the market. I will continue to do so, of course, expecting the normal corrections, or shakeouts or fadeouts, but I am more optimistic on investing in the stock market now than ever. That opinion could change if the conditions and indicators I use change as well. But let me add that the reasons why I am bullish is the advancement of technology, the globalization of markets, and, of course, the need for prosperity still thrives. With those factors in play, I am not betting against the obvious that almost every generation has seen an increase in the wealth effect.

The one concern I have is that when we start to see market performance improve, the vast majority of investors will either not participate in the market because they are disbelievers, or because they don't trust the markets due to past experience, such as the tech wreck from 2000 or the flash crash in 2010.

I also have a concern that many investors have become more short term in nature, since the extreme level of volatility that existed in our marketplace from 2005 throughout late 2011 has nurtured day and swing trading from buy-and-hold investment strategies.

I am sure you can relate to the fact that time is passing—every year seems to pass more quickly than the one before. You know the saying “time flies when you are having fun.” There have been times in this life that it is not so much fun, but time still flies. Imagine buying a stock for 8.68 on the first week of March 2009, and after applying a buy-and-hold mentality, just 25 months later that stock was trading at 53.2. Not to brag, but this was a company I had shouted to everyone to get in on. I had traveled to Europe to speak at a conference in London and at the Technical Analysis Conference in Paris. I saw this company and the sales they were generating and said there is no way these guys are going to make a killing. The name of the company: Starbucks Coffee. Well, I know there are lots of success stories, such as Google, Wynn Hotels and Casinos, Apple, and the like. But here was a company whose product I actually used on a constant basis.

I believe buy-and-hold mentality for a period of time will pan out to be a stock picker's best friend in the next few years as this business cycle develops. An area of longer-term growth and opportunities will exist in the financial arena. Wealth management, real estate, energy, communication, technology, food, health care—these are all areas that will be in constant demand and as the global population grows and becomes more educated, I stand firm on the fact that there should be a place for investment dollars in these areas.

The key is choosing the right stocks, the right sectors, and the right time. I believe the chapters that follow will

enlighten you to a logical approach for you to make better investment decisions.

CHAPTER 1

Stock Indexes and Sectors

For those picking up this book who have little to no experience in the markets, I'll start off by welcoming you to the world of trading and investing. One of the greatest achievements for the human mind and psyche is to identify a business opportunity and then profit by taking decisive action.

Let me start off by addressing the newcomer or novice investor. I am not going to scare you away with heavy technical stuff, at least not now because that will come later. For the advanced trader, there are quite a few golden nuggets of trading concepts packed in these pages.

I want to share with you a story about my next-door neighbors' experience. These are awesome people. The husband is retired; the wife works as a travel agent in a North Shore suburb of Chicago. As the world was facing the financial crisis back in early 2009, the wife came over to our yard while I was surveying the garden. She knew that I worked in the financial markets, but had no idea exactly what I did. In the past, she had seen me on CNBC commenting on gold or crude oil and wanted my opinion on what to do. She had a feeling that stocks were too cheap and that there might be something she should get in on. She was right; stocks were cheap in March and April 2009.

She explained that they hadn't invested in stocks since the tech wreck of 2000, but they had some money and wanted some advice. I had her come over the next week for a lesson. All we did was go over some companies and get her

online to open a self-directed trading account. The online trading company at the time was Thinkorswim. Some of the stocks we started her off with were General Electric (GE), Starbucks (SBUX), and Bank of America (BAC), and then later she asked me about other names like McDonald's (MCD). I talked and she listened, and more importantly, took decisive action. I found it amusing when making comments like "here is where your stop should go." It was like I had just said something in a foreign language. But she learned. I am not saying she experienced enough success to start her own hedge fund, but she did experience success.

I wanted to start the book off with this story to show the beginner that good things can and do happen, but it takes the human mind and psyche's ability to identify an opportunity and then take decisive action.

Technology in the new millennium has given all of us a more equal playing field as far as pricing in regards to the cost of doing business, direct access to the markets by means of the Internet, and transparency by means of order execution platforms.

Many individuals exclude themselves from the markets for one reason or another. As it has been said, I believe more people plan for a family holiday than they do for their investments or financial futures. Perhaps others have a profound fear of loss and shy from making effective reasoning rationale.

Yet this is a business where it takes money to make money. There is no question about that. One has to be able to afford to lose once in a while and not let that hinder one's ability to make better educated and therefore more reasonable actions in the markets. My goal in this book is to help you to learn how to structure a formulated perspective in order to overcome all disputes that often lead to poor judgments or inaction.

Remember, the reason you are looking to trade is simple: to make money. Never forget this. Friedrich Nietzsche, the German philosopher, stated long ago, "The most fundamental form of human stupidity is forgetting what we were trying to do in the first place." Never forget that this is the bottom line, to make money. Yet many do, mostly as fear, doubt, and greed interfere with rational thinking.

In order to give you the edge, I want to take a comprehensive look at how we can use the information in this book and apply it to real-time trading. There are obviously volumes of different material we can look at, like macroeconomic effects and the business cycle. Or microeconomic events like earnings and other situations that will impact a stock or a sector and the overall market's performance. Quite frankly, we will most likely cover many of those subjects in this book.

My goal was to put together a sophisticated yet simplistic book in such an organized manner that any trader would be able to walk through the steps contained in these pages, which combine the most relevant tools we have at our disposal, to make better, lower-risk, and more profitable trades as a direct result of better educated investment decisions. I have what I consider some simple tools in a technically oriented and complex time.

In order of importance, here is my ideal checklist of noncorrelated, yet corroborating tools to use:

- Sector analysis
- Seasonal trend analysis
- Contrarian indicators
- Price patterns
- Momentum indicators
- Volume studies
- Breadth indicators
- Moving average tools
- Support and resistance

You can use fundamental analysis (study of current events), or you can take a pure technician's approach to studying the markets. I believe a trader needs to do both. The issue with fundamental analysis is that you need to receive information from the media and third parties, which can be unreliable. You can also look at the company's balance sheet, like the price-to-earnings growth rate (PEG) and the earnings per share (EPS) over multiple quarters. Most of this information is listed on your brokerage firm's trading platforms; if not, Yahoo! Finance works wonders.

The really fundamental question for traders and investors is not to seek answers to the questions of fact or finance, but rather the really deep question to seek an answer to is: What is value? What gives a stock value? When Netflix was at 304.79 back on July 13, 2011, many perceived this stock to be a good value, especially if one was long from a lower level. Fundamental news was released that they were going to charge more for their services, and that is what created a higher opening. We called it a "gap" higher open. The fundamental facts were released, and investors measured the mathematics of future earnings, but the real question that begged to be answered was: Is this stock at this point in time a good value or overvalued? As it turns out, the stock was more than overvalued, as it cratered to a low of 62.37 by November 30, just shy of four and a half months.

Were there ways to uncover the truth of whether this market was at a good or overvalued price over 300 per share? And, if so, were there avenues one could employ to take advantage of it? To be certain, there is a reasonable approach to investing that is unbiased, factual, and incorporates mathematic formulas, but best of all, uses what we all have at our disposal. It is the information provided to us in the form of prices such as the market's or stock's high, low, close, and opening levels, as well as the amount of volume traded and the volume detected in both

the up and down directions. The information is what we can find in what is called technical analysis.

Technical analysis shows us what the market is or has done. Certain tools, based on past performance, give us a clue what might happen but not what will absolutely happen.

However, there are several indicators and methods we can use to effectively help us in formulating a market opinion that can improve our chances for success. There are hundreds of methods for picking stocks to buy. The key is to know when to fold. I am talking about an exit strategy. Most individual traders have a hard time taking a loss, mainly because they believe the company's stock price will turn back in their favor. More importantly, most traders don't know when to take a profit either. Thus, the phrase “cut your losses and let your winners ride” might not be a complete truth. While it is important to cut losers, it is also just as important to establish profitable exit levels. This concept of setting an exit plan is imperative for overall success in trading. A pretty good analogy on this point can be summed up by a friend of mine, who once asked, “When flying a plane, what's more important—take-off or landing?” That's a profound question, as they are both important, but once you are in the air—just like once you are in a trade—landing is like your exit strategy. You need to have a profit objective in order to land the investment plane safely. That is why the subject on profit objectives will be covered in this book.

STOCK-PICKING QUANDARY

Picking stocks from a large universe can be overwhelming. So let's look at what I consider a systematic approach for picking stocks to trade. Rarely does one look at one method in what I call the top-down approach. Let's look at the

Standard & Poor's (S&P) 500. It is compiled of 10 sectors. Jeffrey Hirsch, my co-editor in the *Commodity Trader's Almanac*, along with his father Yale, put together a seasonal guide from a study done long ago by Merrill Lynch. Yet I believe most traders are not aware of this, or at the least, it is most often ignored.

Many of the reasons we see seasonal strength or weakness in markets are very logical. We will cover many of these reasons when we delve into seasonal analysis in the next chapter.

Many individual retail investors and traders start off their careers by looking at stocks that are brought to their attention by either the company they work for or by some means of communication, either in an e-mail or the news media—print, online, cable TV, and so on—or, the best way of all, a hot tip from a family member or friend.

Others who are invested in the stock market indirectly, either in a 401(k) or through mutual funds, rely on the professionals who run those funds. The fund manager's sole responsibility is to beat the benchmark, what is considered the S&P 500 Index. Here is the listing of these sectors:

- 1. Consumer Discretionary**
- 2. Consumer Staples**
- 3. Energy**
- 4. Financials**
- 5. Health Care**
- 6. Industrials**
- 7. Materials**
- 8. Technology**
- 9. Telecom Services**
- 10. Utilities**

The iShares U.S. sector and exchange-traded fund symbols are:

- 1. Technology (IYW)**

- 2. Consumer Goods (IYK)**
- 3. Consumer Services (IYC)**
- 4. Energy (IYE)**
- 5. Health Care (IYH)**
- 6. Financial (IYF)**
- 7. Industrial (IYJ)**
- 8. Basic Materials (IYM)**
- 9. Utilities (IDU)**
- 10. Telecommunications (IYZ)**

Next, there are the subsectors and then the stocks listed in those subsectors we can look at for investing and trading opportunities.

First, let's examine the Energy sector as a whole, not the actual commodities like Brent Crude Oil or West Texas Intermediate. I will cover these, including natural gas, in the next chapter.

We can break down this space into:

- a. Oil & Gas Exploration & Production**
- b. Oil & Gas Storage & Transportation**
- c. Oil & Gas Equipment & Services**
- d. Oil & Gas Refining & Marketing**
- e. Oil & Gas Drilling**

EXCHANGE-TRADED FUNDS

In this section, we will cover the exchange-traded fund (ETF), including inverse ETFs, leveraged ETFs, and inverse leveraged ETFs. We will also cover the features, benefits, and risks of trading leveraged ETFs, good risk-to-reward opportunities, and a comparative market analysis that dissects a leveraged ETF and a sector ETF strategy.

ETFs are investment instruments that have their own symbol and are traded on stock exchanges. An ETF includes

assets such as stocks, commodities, and futures. The easiest way to understand an ETF is to think of it as a mix between a mutual fund and a group of stocks in the same industry sector or futures contract . ETFs trade on an exchange just like an equity or futures contract, but contain bundles of the underlying asset like a mutual fund. Investors and traders are attracted to ETFs primarily because they have the ability to diversify risk like a mutual fund but have the flexibility of equities and contracts, which can be traded throughout the day and can be sold short. Since ETFs trade like stocks, a commission rate will apply just like a stock trade. Prices on an ETF change throughout the day as they are bought and sold, just like a stock. ETFs typically have lower marketing, distribution, and accounting expenses, and most ETFs do not have 12b-1 fees.

Investors look to ETFs to provide easy diversification, low expense ratios, and tax efficiency, while still maintaining all the features of ordinary stock, such as limit orders, short-selling, and options. ETFs are very versatile and can be included in an investment portfolio or trading plan as a long-term investment for asset allocation purposes, or to trade frequently to implement market timing investment strategies. The advantages of investing or trading in ETFs are:

- *Lower costs.* ETFs generally have lower costs than other investment products because most ETFs have lower management fees due to the fact that they are passively managed versus an index mutual fund or an active mutual fund that incurs higher fees due to increased trading and research expenses.
- *Buying and selling flexibility.* ETFs can be bought and sold at current market prices at any time during the trading day, unlike mutual funds and unit investment trusts, which can only be traded at the end of the trading day. As publicly traded securities, their shares

can be purchased on margin and sold short (enabling the use of hedging strategies) and traded using stop orders and limit orders, which allow investors to specify the price points at which they are willing to trade.

- *Tax efficiency.* In most cases, ETFs generate relatively low capital gains because they typically have low turnover of portfolio securities. While this is an advantage they share with other index funds, their tax efficiency is further enhanced because they do not have to sell securities to meet investor redemptions.
- *Market exposure and diversification.* ETFs provide an economical way to rebalance portfolio allocations. ETFs are designed to track the underlying assets, which may contain hundreds or even thousands of securities. This offers the trader or investor the diversification of an index mutual fund with the trading flexibility of a stock. ETFs offer exposure to a diverse variety of markets, including broad-based indices, international and country-specific indices, industry sector-specific indices, bond indices, and commodities.
- *Transparency.* Most investment vehicles provide quarterly disclosure of their holdings. ETFs, whether index funds or actively managed, publish their exact holdings on a daily basis (transparent portfolios) and are priced at frequent intervals throughout the trading day. Investors are able to see exactly what is included in the ETF, from fees to the basket of assets.

There are many types of ETFs, ranging from stock indices like the S&P 500 (SPY) to commodities that relate to precious metals like gold (GLD), energies such as crude oil (USO), and agricultural markets like grains (DBA) and livestock (COW). In addition, there are ETFs that correlate to the financial markets such as bonds (TLT), and those that reflect changes in the yield (TBT). In December 2005, Rydex

launched currency ETFs, with the first being FXE, which tracks the euro currency.

Inverse ETFs

Inverse ETFs are structured to perform in the opposite direction of the underlying or benchmark asset. These funds short-sell derivatives and other leveraged investments as the basis for the inverse relationship. Over a short time frame, the inverse ETF should provide performance, which is opposite the benchmark vehicle. For example, if the established benchmark is the S&P 500, the inverse ETF should move in the opposite direction by a similar amount. If the S&P 500 declines by 1 percent, the inverse ETF should rise by 1 percent (not including fees and costs). Because short-selling stocks is extremely risky, inverse ETFs can provide trade opportunities for stock traders in bearish market conditions, since bear ETFs should rise during a declining market.

Leveraged ETFs

Leveraged ETFs are designed to take advantage of short-term market swings by using debt to amplify the returns of the underlying asset. The goal of the ETF fund manager is to maintain the debt ratio at 2:1 or 3:1 depending on the fund. In the case of a 2:1 debt ratio, the ETF is matched with twice the amount of debt to investor capital, while a 3:1 debt ratio is matched with three times the amount of debt to investor capital. With this leverage, the ETF is expected to gain a return of 200 percent or two times (2×), or 300 percent or three times (3×) the average return of an underlying index or other benchmark over a specific period of time. For example, if the S&P 500 goes up 2 percent, a 2× S&P 500 ETF is expected to return 4 percent.

Leverage is two-sided. While leverage applied to a winning trade compounds the size of the return, leverage applied to a losing trade compounds the size of the loss. If a trader wishes to profit from uptrends in an index, sector, commodity, or currency move with less cash outlay than traditional ETFs, they will take advantage of the increased compounding effect that is found with leveraged ETFs. The opposite is also true. If the market moves against the direction of the fund, the losses will be compounded as well.

Another important consideration in trading leveraged ETFs is to understand that fund managers work to maintain the leverage balance and produce returns over one trading day. If the fund is out of balance, the manager will incur trading losses because they need to keep the debt ratio intact. This means that in a bear fund, they must buy when the index goes up and sell when the index goes down in order to maintain a fixed leverage ratio. For example, if an ETF is a -2x bear fund, a 2.5 percent daily change in the index will reduce the value by about 0.18 percent per day, which means that about a third of the fund may be wasted in trading losses within a year ($0.9982^{252} = 0.63$).

Inverse Leveraged ETFs

When a trader wishes to trade the inverse, or opposite, of the daily performance of the benchmark asset in a single day and wishes to use leverage, he or she would look to trade an inverse leveraged ETF. Using a combination of leverage and the inverse relationship to the benchmark, the inverse leveraged ETF will seek a return of -2x (-200 percent), positioning itself in the opposite direction of the benchmark.

Detailed information regarding leveraged ETFs can be found at the following web sites:

ProShares: www.ProShares.com

Direxion Funds: www.direxionfunds.com

Rydex-SGI: www.rydex-sgi.com

Deutsche Bank: www.dbfunds.db.com

Following are some of the most well-known ETFs, as well as specific examples of several ETFs and their application:

- *SPY ETF*. One of the first ETFs developed was SPY. Known as the SPDR, the benchmark is the S&P 500.
- *QQQ ETF*. Known as the “Q’s,” this ETF uses the Nasdaq 100 as the benchmark. In 2011, the name was changed from QQQQ.
- *DIA*. Dow “Diamonds” uses the Dow Jones Industrial Index as the benchmark.
- *XLF*. The financial select sector SPDR is produced to match the returns of the financial select sector.
- *SSO*. The SSO is a leveraged ETF that uses the S&P 500 as the benchmark and seeks investment results of 200 percent utilizing leverage of 2:1.

The SPY ETF is a product that could provide a good trading vehicle for a trader that is looking at an investment option that provides good liquidity and volume and does not wish to utilize more leveraged products such as futures.

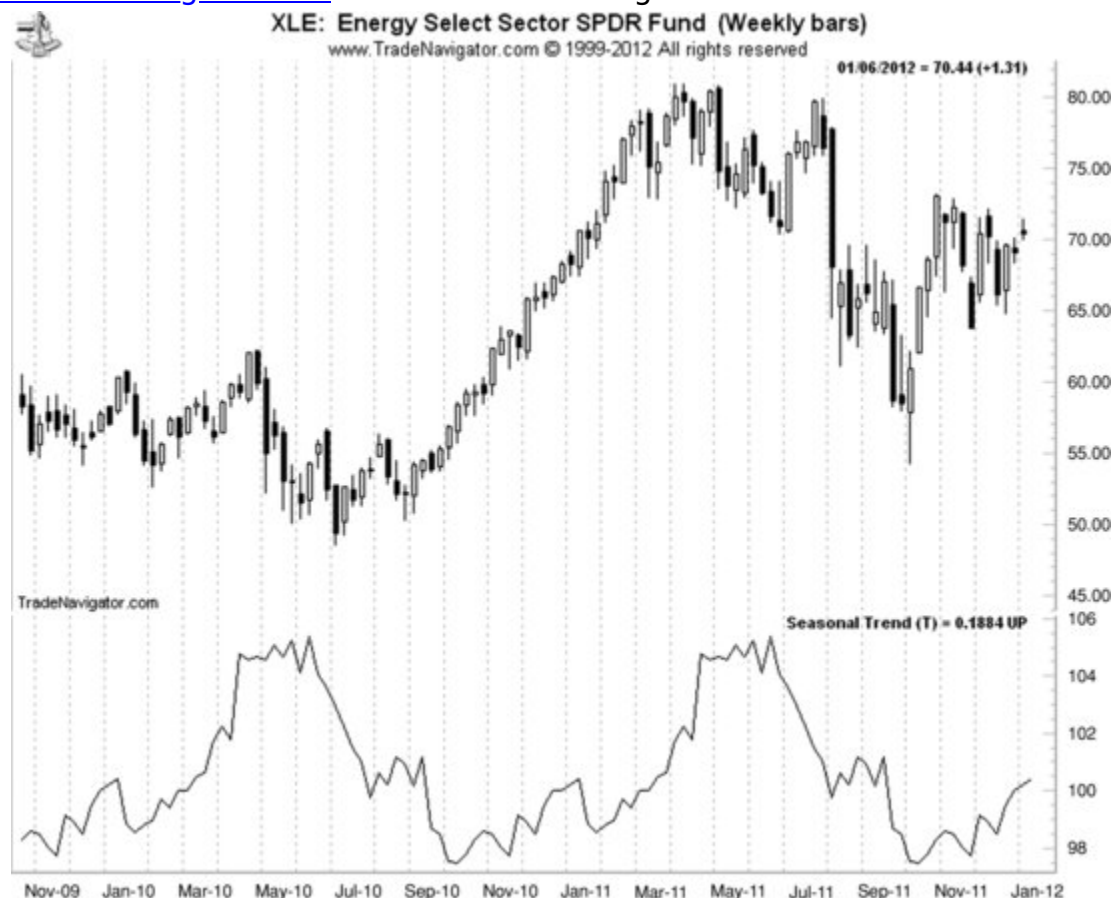
One of the most important disclaimers or warnings on a leveraged ETF is to advise you to do your due diligence, as these instruments employ constant leveraging and compounding, which can skew the average returns. Make certain you clearly understand how this investment vehicle works before entering a trade.

If we use a chart on the ETF index XLE that represents the energy complex, based on past historic price data we can draw a seasonal chart, which I have included in the lower quadrant of the graph as shown in [Figure 1.1](#). You will see that the seasonal trend history shows the typical annual high is established in the May through June time frame. The market then typically bottoms in October, with a strong move upward starting in early February. With this chart one can conclude that by buying in late October and holding

through late May, one may capture the best upside trend of the year for this sector.

FIGURE 1.1 XLE: Energy Select Sector SPDR Fund (Weekly Bars)

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Now let's look at the subsector Refining & Marketing as shown in [Figure 1.2](#) from 2011. Notice that the seasonal peak was around late April and bottomed in early October. This is a very similar pattern to the overall sector as shown in [Figure 1.1](#) with the XLE.

FIGURE 1.2 \$-OLG3: Oil & Gas Refining & Marketing (Weekly Bars)

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Now let's look a bit further and dissect this energy sector to examine one of the companies listed under that subsector. I started with Sunoco (SUN), as shown in [Figure 1.3](#). The seasonal chart on this stock itself resembles the seasonal chart on the subsector it is listed under and as was just explained the seasonal price movement of that sector formed a peak in May and bottomed in October. Now we can conclude not only is it highly correlated to the subsector and the subsector, but Sunoco is highly correlated to the Energy complex itself as represented by the XLE. Armed with that information, one can now start looking for buying opportunities in October and start looking for a profit target by the late April through early May time frame.

FIGURE 1.3 SUN: Sunoco, Inc. (Weekly Bars)

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Let's examine another sector, Telecommunication or Telecoms. In the chart in [Figure 1.4](#), the seasonal study shows where we typically have a strong buying opportunity from late August through early October that can last into the first part of January. Once we scan and look for the top stocks in that space, we can then apply a seasonal study to if the individual stock has a similar seasonal price pattern compared to the sector itself.

FIGURE 1.4 \$XTC North American Telecoms Index (Weekly bars)

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