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In the TRADING COCKPIT with the O'Neil Disciples

Stragtegies That Made Us 18,000% in the Stock Market

Gil Morales | Dr. Chris Kacher

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In the Trading Cockpit with the O'Neil Disciples

Strategies that Made Us 18,000% in the Stock Market

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This book is dedicated to the members of VirtueofSelfishInvesting.com, who have helped us understand what can be misunderstood better than we could have on our own.

To dare is to lose one's footing momentarily. To not dare is to lose oneself.

—Soren Kierkegaard

Acknowledgments

This book is filled with charts, and it is the charts that complete the material such that in many ways they are firmly entwined with its essence. We would like to thank Ron Brown, George Roberts, and Ian Woodward of HGS Investor software (highgrowthstock.com) for the use of their wonderful charts throughout the book, as well as the generous folks at eSignal, Inc. (www.esignal.com) for the use of their charts and monitor graphics.

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Finally, as is the case with our unique situation, it is 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.

Introduction

Those who have been trading for at least the past several years have likely experienced the frustration of trying to invest in the mostly sideways, trendless markets of the mid-2000s. Base breakouts were not in abundance as they had been in the 1990s, and most breakouts failed during these trendless years. But one must always take the attitude that what does not kill you only makes you stronger. So it was in mid-2005 that we began seeking answers to the basic conundrum dictated by the fact that we were no longer in the smooth, parabolic-trending market environments of the 1990s—the environment that we “grew up” in after we began our investment careers in the early 1990s.

Thus began the process of seeking a solution to this conundrum by looking for alternative methods to buying base breakouts in stocks that were becoming obvious to the crowd. Despite the sideways, choppy markets of 2004–2005, what does not kill you can make you stronger, and the pocket pivot and buyable gap-up concepts were born, concepts created by Chris Kacher (a.k.a Dr K) in 2005 as a result of these challenging markets that were rarely seen in the 1990s. While the pocket pivot and various other permutations of early and alternative buy point techniques were concepts that had been swirling around in the minds of both of us in the mid-2000s, it was Chris Kacher who, through painstaking statistical analysis and the study of thousands of chart examples, finally formalized a set of rules and characteristics that defined these concepts—thus the pocket pivot and buyable gap-up buy points were born, as well as selling strategies embodied by The Seven Week Rule that are designed to keep one in a stock through the fat part of the stock's price move.

One major advantage of using pocket pivots is that it affords one an early entry point within the base of a potential leading stock *before* it breaks out and hence helps to lower the average cost as you first begin buying and building an initial position in the stock. The lower cost basis gained as a result of getting an early start in buying the stock also translates into a smaller percentage loss if the stock ends up failing on the actual base breakout. The extra cushion gained as a result of initiating a position in a leading stock within the base first and then pyramiding on the actual breakout, as opposed to first entering the stock on the breakout, translates into an additional risk-management edge. Thus if one is stopped out on a breakout failure, the loss is reduced by virtue of having a lower average cost, thanks to starting the position out at an early entry point provided by a pocket pivot buy point occurring at a lower price within the base. In practice, the pocket pivot buy point has proven to be a formidable tool.

The formalization of the characteristics of and rules in applying pocket pivot buy points within a base also spawned the identification of the *continuation* pocket pivot buy point, a buy point that provides a coherent and easily definable framework for effectively pyramiding positions in a leading stock as the stock climbs higher. This provides a very concrete and elegant solution to pyramiding a winning position as it moves higher in price that is, in our view, more effective than simply adding as a stock goes higher a certain percentage, say 2 percent, from your initial buy point as is advocated by O'Neil. Also the continuation buy point expands upon the number of buy points at which to add to a winning position than would otherwise be available to an investor who is relying solely on waiting for a stock to stage its first pullback to the 50-day or 10-week moving averages.

With pocket pivots and continuation pocket pivots providing two potent trading arrows to add to our quiver of techniques, the third leg came in the form of the buyable gap-up. During the mid-2000s we also noticed that stocks that have powerful upside price gaps often move higher from that point despite the fact that, to the crowd, they often seem too high to buy. We observed that we had been effectively making use of buyable gap-ups in our own trading simply on the basis of Jesse Livermore's concept of breaking through the “line of least resistance,” but had not created any fact-based set of rules to identify and handle such buyable gap-ups. Examples of such trades where we exploited the concept of a buyable gap-up before we even really understood the phenomenon are found in the purchase of Apple (AAPL) in October 2004 as it gapped-up on earnings and began a sharp upside move (see Figure I.5).

All three of these buying techniques and concepts, combined with the Seven-Week Rule, were first revealed in our book, *Trade Like an O'Neil Disciple: How We Made 18,000% in the Stock Market,* and were enthusiastically received by readers of the book as well as members of our investment advisory website, www.VirtueofSelfishInvesting.com. In this book, our intention is to bring the reader down to the level of where the rubber meets the road, so to speak, utilizing detailed exercises and associated discussions to build upon and expand the reader's understanding of these new ideas in the trading methodology and ethos espoused by William J. O'Neil, Richard D. Wyckoff, and Jesse Livermore. This is what we refer to as the O'Neil-Wyckoff-Livermore methodology, or the OWL for short.

Learning how to trade is about getting your hands dirty—it is best achieved by doing, and this is the primary limitation of any book. It can tell you all you want to know in so many words, but your brain does not really start imprinting anything until it starts engaging in the process in real time using real money. Thus the nagging question for any author is the problem of how to bring everything to a level where the reader has the opportunity to get down and get dirty in order to establish a more visceral connection to the concepts being discussed. Thanks to the thousands of questions we have received from our followers, we have started to gain an understanding of the practical problems that investors encounter when trying to implement our methods. In this book we take that initial understanding and attempt to address that point at which the rubber meets the road. Our understanding of where readers need further clarification and explanation is also evolving, and so we are convinced that this remains a work in progress. Future editions of this book or similar works that we will produce in the future and which seek to bring the reader into our "trading cockpit" will evolve from what we continue to learn based on the feedback from readers of our books, members of our website, www.VirtueofSelfishInvesting.com, and our general following, which now numbers somewhere north of 80,000. Thus we encourage your feedback, whether good, bad, or ugly, and suggest that you email us with any and all feedback at info@virtueofselfishinvesting.com.

The first order of business is a quick update and review of the meat of this book: pocket pivot buy points, buyable gap-ups, and the Seven-Week Rule. The true introduction to this book is our prior book, but a quick trip to "Disciple Boot Camp" will make the rest of the book more meaningful and useful.

DISCIPLE BOOT CAMP

What is unique about our work as it relates to O'Neil-style methodologies is that we identify and utilize expanded techniques with respect to how we buy stocks while at the same time employing a far more definitive and manageable system of risk management. To this end we have identified and catalogued the characteristics of what we call *pocket pivot* buy points and buyable gap-up buy points to initiate and add to positions in leading stocks. These are early or relatively nonobvious buy points where the crowd does not tend to act like one. Like all O'Neil-style traders and investors, we also buy on the basis of standard new-high base breakouts, but we consider pocket pivots and buyable gap-ups to be far more potent tools when it comes to buying leading stocks. Pocket pivots and buyable gap-ups enable us to gain an edge in a world where all traders and investors have ready access to charts and every technical breakout is seen by everyone at the same time. As we know, what is obvious to the crowd in the stock market is often too obvious.

Our buying methods are also based on the fact that we find the method of buying a leading stock on a new-high base breakout and then adding to the position as it moves up 2 percent from our initial buy point to be deficient. At best it is inexact and impractical, since a stock that breaks out and begins to act strongly will draw you into adding to your position for no other reason than the fact that it goes up a little more from where you first bought it. In many cases, this only results in jumping into a significant initial position as it runs up a few more percentage points after breaking out, only to see the stock drop back toward the breakout point, at which point you are suddenly underwater on your position.

Solving the problems of (1) how to find early or nonobvious buy points in a potential leading stock and (2) how to add to and pyramid a position in a leading stock at highly defined low-risk points is precisely what our system does. Through the use of pocket pivots, buyable gap-ups, and what we refer to as the Seven-Week Rule in determining which moving averages to use as reliable selling guides, we have demonstrated that O'Neil-style traders and investors, if not traders and investors of all stripes, can gain an edge using these innovative technical tools. In the following sections we will review these essential tools, which we first discussed in detail in our book, *Trade Like an O'Neil Disciple: How We Made 18,000% in the Stock Market.*

Pocket Pivot Buy Points

One of the primary weapons that we employ to gain an advantage when initially building and then pyramiding a position in a leading stock during a bull market phase is the pocket pivot buy point. The pocket pivot is a unique price/volume signature that occurs either as an early buy point within a stock's base or consolidation, or as a continuation pocket pivot buy point that occurs as the stock is trending higher and is well extended from its previous base or consolidation.

In Figure I.1, we outline the basic anatomy of a pocket pivot in terms of its contextual factors. Generally, a pocket pivot within a base is desirable to see when the stock is quieting down to some extent as it begins to move relatively tightly sideways as volume begins to dry up. Pocket pivots that occur within noisy, choppy, and volatile chart formations are prone to failure, so we look for pocket pivots to occur within technically constructive areas of a stock's chart pattern. Generally this will be on the right side of a consolidation, as we see in Figure I.1, where the stock begins to act tightly and coherently around a moving average such as the 10-day or 50-day simple moving averages. The pocket pivot buy point then occurs as the stock is coming up and off or up and through the 10-day or 50-day moving average, or both in some cases, and it must occur with a particular volume signature.

Figure I.1 Anatomy of a pocket pivot. The essential contextual factors that comprise a valid pocket pivot buy point. Constructive, sideways price action with volume settling down provides fertile ground from which the pocket pivot can spring.

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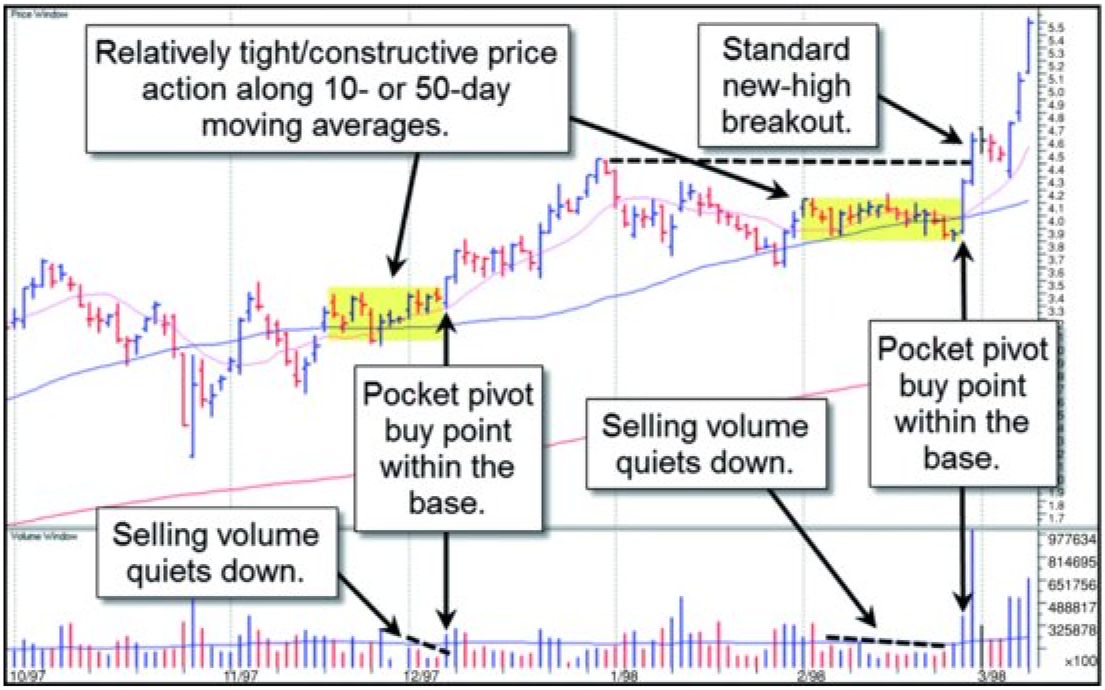

The essential characteristic of any pocket pivot buy point is its volume signature, which must be present for the pocket pivot to be valid as a legitimate buy point. This volume signature rule dictates that volume on the day of the pocket pivot must be higher than any down-volume day in the pattern over the prior 10 trading days, as Figure I.2 illustrates. It is possible to have a higher up-volume day in the pattern over the prior 10 trading days, since this is positive action, but in order to determine a pocket pivot buy point the volume must first and foremost be higher than any down-volume day over the prior 10 trading days.

Figure I.2 The anatomy of a pocket pivot. The defining and most essential characteristic of a pocket pivot buy point is its particular volume signature, which indicates that volume on the day of the pocket pivot price move must be greater than any down-volume day that has occurred over the prior 10 trading days.

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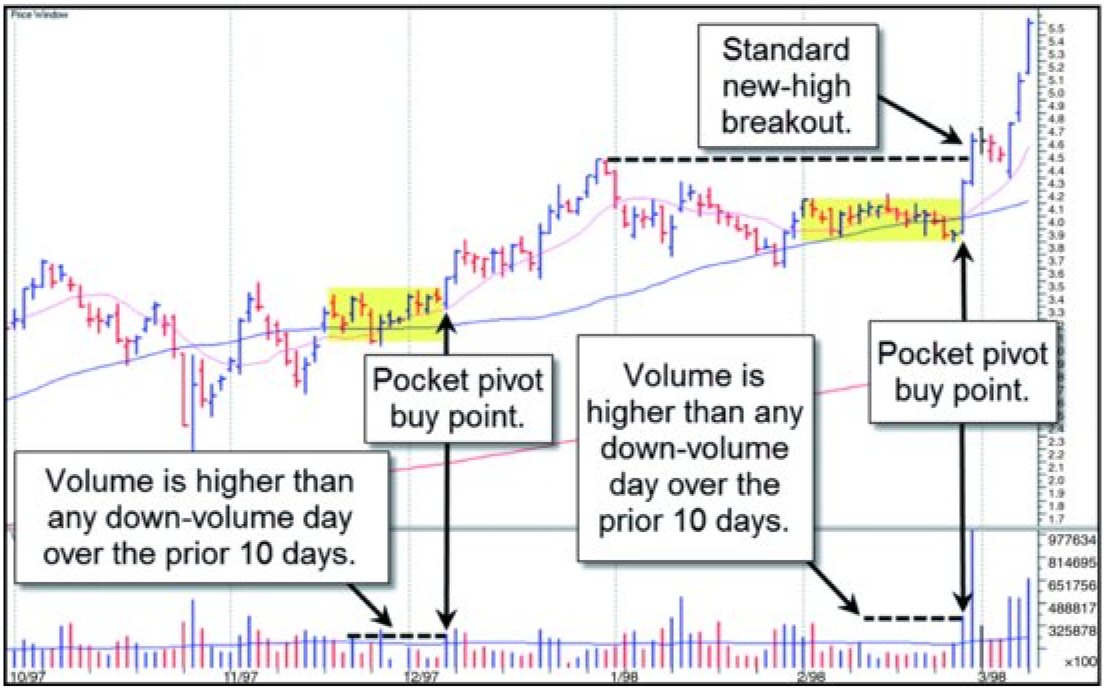

Figures I.1 and I.2 illustrate pocket pivots that occur within a stock's base or consolidation, and they also demonstrate how the pocket pivot provides an early buy point that occurs before the stock stages a standard O'Neil-style new-high breakout from the base. This gives the trader or investor a head start before the crowd sees the obvious new-high breakout. Note that on the far right of Figure I.2 we can see how the new-high breakout leads to a pullback that could potentially scare out anyone who bought at the peak of the breakout day's trading range. Meanwhile, entering on the pocket pivot that occurred the day before the new-high breakout in Figure I.2 would keep one above water on the ensuing pullback.

Figure I.3 illustrates how the continuation pocket pivot buy point provides a highly definable, low-risk method of adding to and pyramiding one's initial position in a potential leading stock. A continuation pocket pivot occurs as a movement up and off or up and through the 10-day or 50-day simple moving average after the stock has already broken out and has run up a bit in price, becoming extended from the initial base-breakout buy point. In this example we see that the stock, in this case Google (GOOG) right after it became public in July 2004, breaks out from a short “IPO flag” formation and begins moving higher in earnest. As the stock moves up in price it tracks along the 10-day moving average, and several pocket pivot volume signatures occur within the uptrend along the 10-day line that coincide with the stock moving up and off the moving average. There is nowhere in the O'Neil literature that considers these critical continuation buy points as actionable, but we find them to be one of the most potent tools when it comes to adding to an initial winning position without resorting to simplistic methods of adding as the stock moves up an additional 2 percent. This sort of method strikes us as quite arbitrary and imprecise, at least from our own practical experience, since some stocks are more volatile than others, so that a 2 percent move in one stock is just a “volatility wiggle” in another.

Figure I.3 The anatomy of a pocket pivot. Pocket pivot buy points also serve an important second purpose as continuation pocket pivots, which provide lower-risk points at which to add to a position taken on an earlier technical buy signal, such as a base-breakout. In this case, the base-breakout came from a short “IPO flag” formation in Google (GOOG) right after it became public in July 2004.

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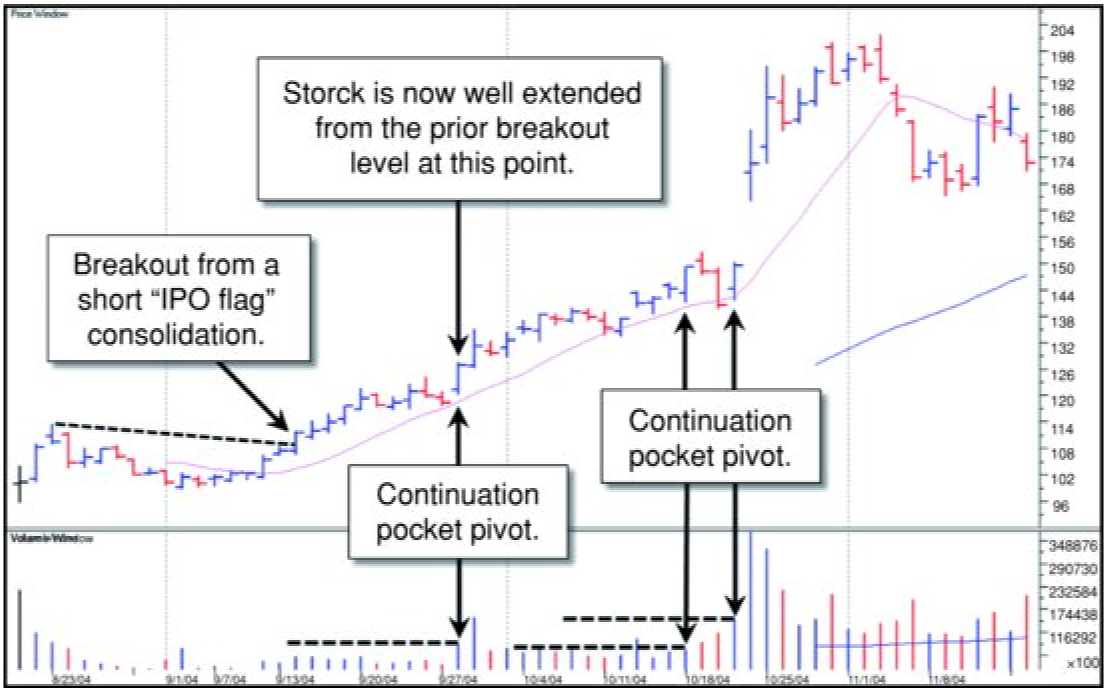

Buyable Gap-Ups

Massive gap-up moves in leading stocks present a trader with some of the most promising and profitable opportunities. Despite the fact that a huge upside gap can often appear to be too high, the hard trading reality may be that the move is very buyable; hence when it occurs under the proper conditions, we call it a buyable gap-up. A buyable gap-up is the point at which the bulls have decisively won the argument over the bears, and this is manifested by the tremendous upside volume displayed by such a move. Take the example of Apple, Inc. (AAPL) in Figure I.4 as it began a sharp upside move in early 2012. The accelerated move occurred right after a buyable gap-up that represented a breakout from a cup-with-handle type of base formation where the handle was on the short side, but still viable. Viewed in terms of standard new-high breakout buy points, the stock might be viewed as borderline extended. However, using the principles of buyable gap-ups one is able to easily buy into this move right at the outset.

Figure I.4 The anatomy of a buyable gap-up. A massive gap-up from a base formation that occurs on massive buying volume looks “too high” but is in fact very buyable.

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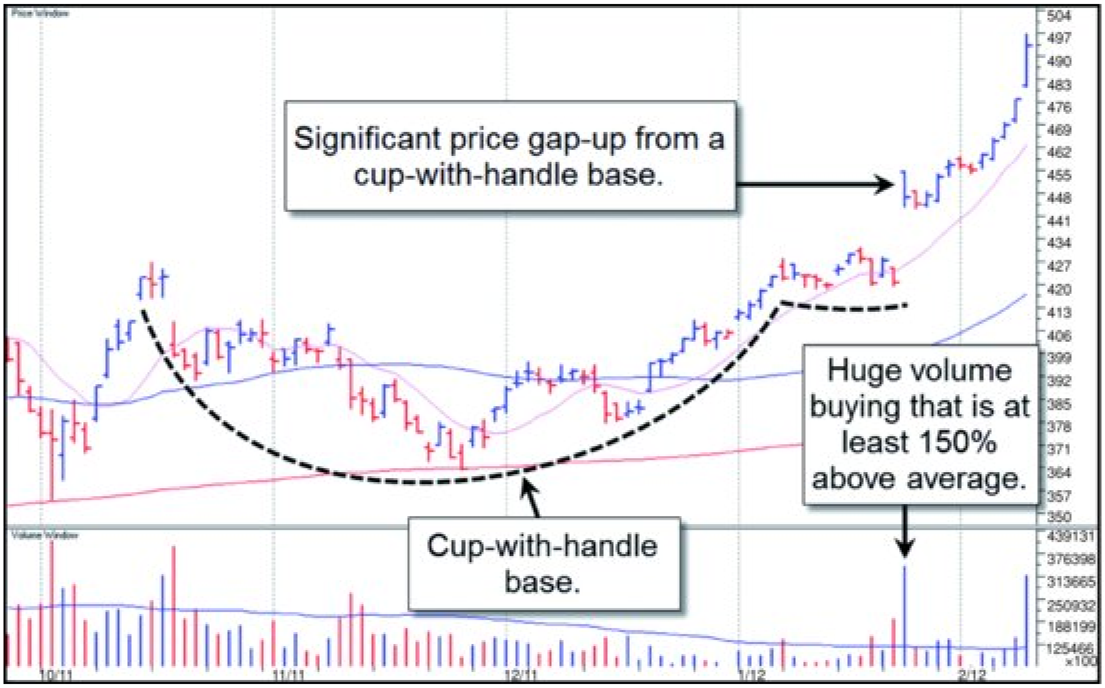

The criteria for buyable gap-ups are relatively simple. The move itself should be significant, and while we have previously used a calculation that required the gap-up to be at least 0.75 times the 40-day average true range of the stock in question, in practice it is enough to be able to “eyeball” a gap-up move that appears to be of sufficient magnitude on a standard arithmetic daily chart. Of more importance is the magnitude of volume present, which should be at least 1.5 times, or 150 percent of the 50-day moving average of daily trading volume. Thus if a stock's 50-day moving average of volume is equal to one million shares a day, you would want to see it trade at least 1.5 million shares on the day of the gap-up, but the higher the volume, the more powerful the gap-up is. In a powerful gap-up move, one can intuitively grasp the power of the move in both the magnitude of the price move and buying volume, particularly if one has studied many examples of buyable gap-ups that have worked in the past. We think it is a simple matter to discern AAPL's big gap-up move in January 2012 as a significant and material "jump to light-speed" type of move by the stock, both on the basis of the size of the gap relative to its overall pattern and the massive upside volume spike evident on the chart.

Buyable gap-ups do not always have to emerge from constructive base patterns. While many leading stocks will start a major price advance with a buyable gap-up that emerges from a well-formed base formation, buyable gap-ups can also occur within uptrends that are well formed and coherent. In Figure I.5 this concept is illustrated by the example of Apple, Inc. (AAPL) in late 2004 after it had been slowly and ploddingly trending higher in a shallow up-trending channel. The stock tested the lows of the trend channel before launching higher on a massive-volume gap-up move from which the stock never looked back.

Figure I.5 Anatomy of a buyable gap-up. Buyable gap-ups can occur at any point within a stock's price chart provided that they do so within a constructive context, such as a coherent uptrend. In this case a gap-up from an uptrend channel sets the stock off on an accelerated upside move.

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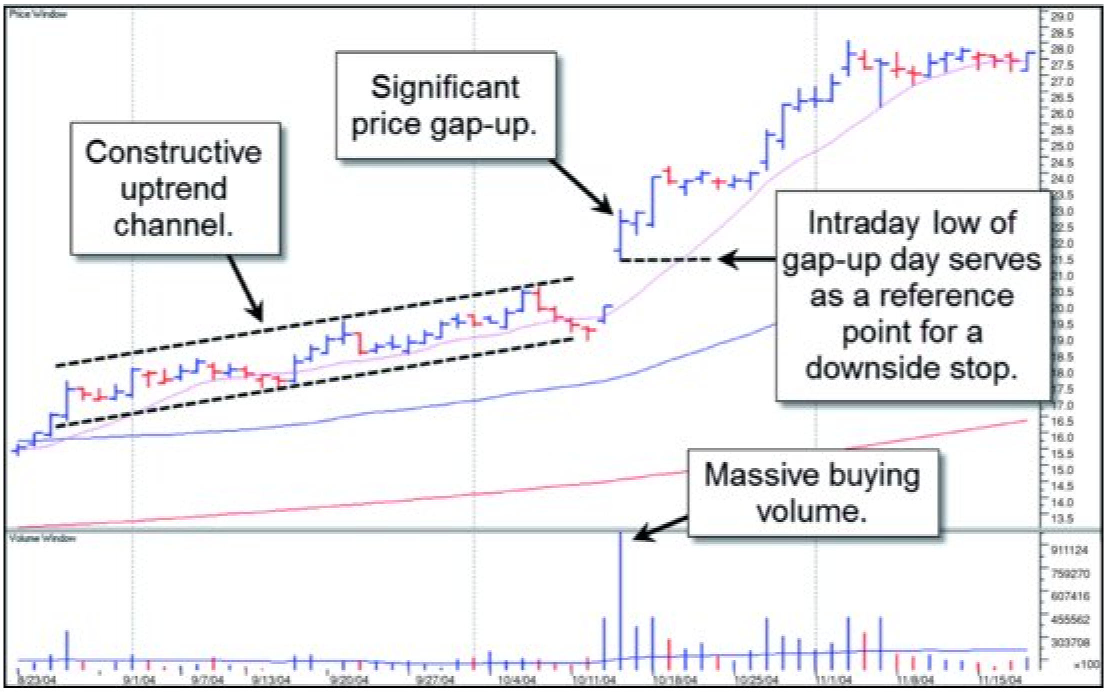

What makes a buyable gap-up such a simple trade to execute is that it comes with a built-in selling guide, which is the intraday low of the gap-up day, as we see in Figure I.5. Once AAPL gapped up it never moved below that intraday low, and so one could buy the stock on the gap-up day or the day after since the stock was still in range. In Figure I.4, which shows AAPL's gap-up in January 2012, note that the stock dipped just a hair below the intraday low of the gap-up day, and this helps to make the point that the intraday low is used as a selling guide, allowing for some porosity to occur around the intraday low. In other words, it can be prudent to use the intraday low plus 2–3 percent more on the downside to allow for a little bit of a fudge factor that can be present in some stocks. While in Figure I.5 AAPL never even got close to that intraday low of the gap-up day, in Figure I.4 AAPL did in fact slide just a tiny bit below the gap-up day's intraday low. Accounting for the possibility illustrated by Figure I.4 by adding 2–3 percent to the intraday low on the downside as a sell-stop level would have kept one in the stock, and this example demonstrates the utility of allowing for some porosity around the intraday low of the gap-up day.

Buyable gap-ups thus become easy trades to execute because they are quite obvious when they occur, but they tend to work most likely because the crowd sees such moves as too high and thus is too timid to buy into them. Since the market likes to fool the most number of investors most of the time, this sets up a key contrarian rationale for why buyable gap-ups work—they fool the crowd!

Moving Average Violations

Moving averages are commonly used by many traders and investors. Thus they have a tendency to be something that the crowd is following, and from a contrarian basis one might assume that the crowd is susceptible to being fooled or faked out. Because so many expect that a particular moving average will provide precise support for a stock, there is perhaps a contrarian rationale for the fact that price movements in stocks can often be observed to slide past a moving average. This tendency to briefly move beyond a moving average before returning back above it is what we refer to as porosity. If it occurs around the 10-day moving average, then it is porosity around the 10-day moving average. To account for this, we do not consider the first time a stock closes below a moving average as a violation of that moving average. Figure I.6 shows a stock that has a tendency to follow the 10-day moving average. It does, however, close once below the 10-day line, but this is not a 10-day moving average violation. In order for it to violate the moving average, it must now move below the intraday low of the first day it closed beneath the 10-day moving average. That may be a mouthful, but in Figure I.6 we can see that the stock quickly moved back above the 10-day line over the next two days. And it did so without ever moving below the intraday low of the first day it closed below the 10-day moving average, as the dotted-line shows.

Figure I.6 Anatomy of a Moving Average Violation. The initial day on which the stock closes below a moving average does not in and of itself indicate a moving average violation.

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Based on the necessary criteria for a moving average violation as described above, Figure I.7 illustrates what a true moving average violation looks like with two examples on a single chart. On the left side of the chart we see an example of a 10-day moving average violation, while on the right side we see an example of a 50-day moving average violation. The astute reader may notice that the moving average violation on the right is not only a 50-day moving average violation, but a 10-day moving average violation as well.

Figure I.7 Anatomy a moving average violation. This stock first violates its 10-day moving average, then violates its 50-day moving average.

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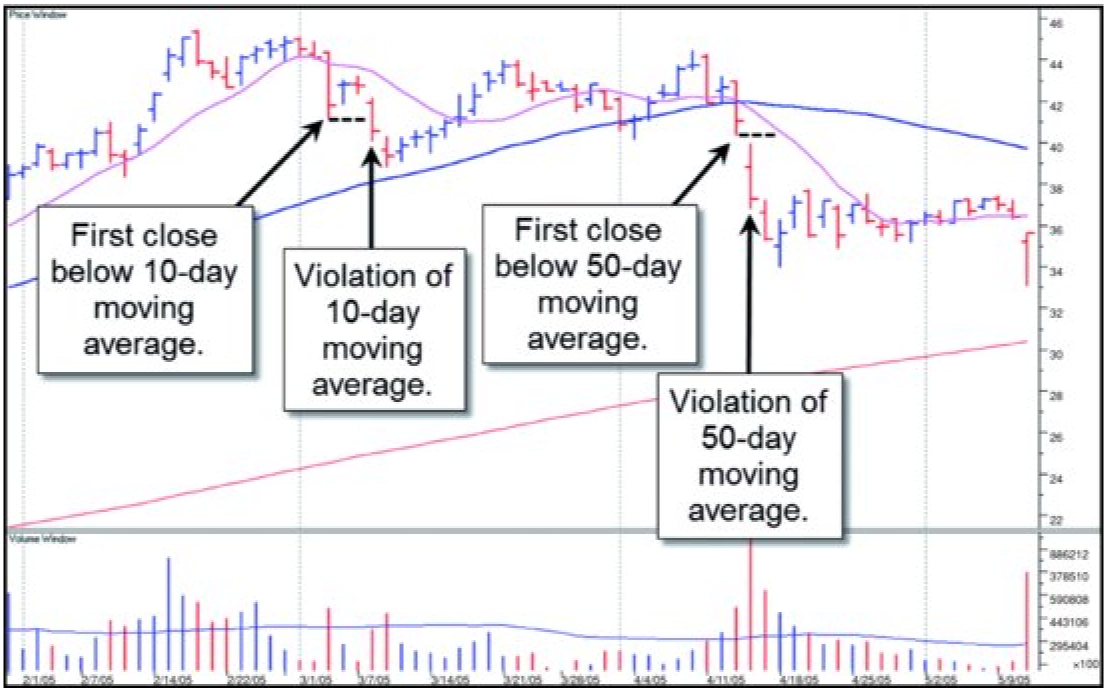

Moving average violations are a critical component in our risk-management strategies, and integrating these with buyable gap-ups, pocket pivots, and other buy points in leading stocks provides us with the building blocks of a simple position-management algorithm that we refer to as the Seven-Week Rule.

The Seven-Week Rule

It is often a simple matter of determining when to buy stocks, but where most investors run into difficulties is in determining when to sell them. One can build and pyramid a significant position in a leading stock, but it can all be for naught if one does not have a system for selling and cashing in paper profits. The Seven-Week Rule is based on the idea that stocks will show a tendency or characteristic to “obey” either their 10-day or 50-day moving average. This is determined by observing whether the stock is able to hold above its 10-day moving average for at least seven weeks following a buy point without ever violating the moving average. In Figure I.8 we can see that Apple, Inc. (AAPL) by April 2012 had never violated its 10-day moving average from the time of its January buy point, and by early March had done so for at least seven weeks. Thus because AAPL showed that its tendency or characteristic was to follow the 10-day moving average for at least seven weeks from the buy point, the 10-day moving average is used as the selling guide, such that a violation of the moving average would cause you to sell your position, or at least some portion of it.

Figure I.8 Apple, Inc. (AAPL) daily chart, 2012. AAPL follows and obeys the 10-day moving average for at least seven weeks from the buy point, hence the 10-day moving average is used as a selling guide for the stock.

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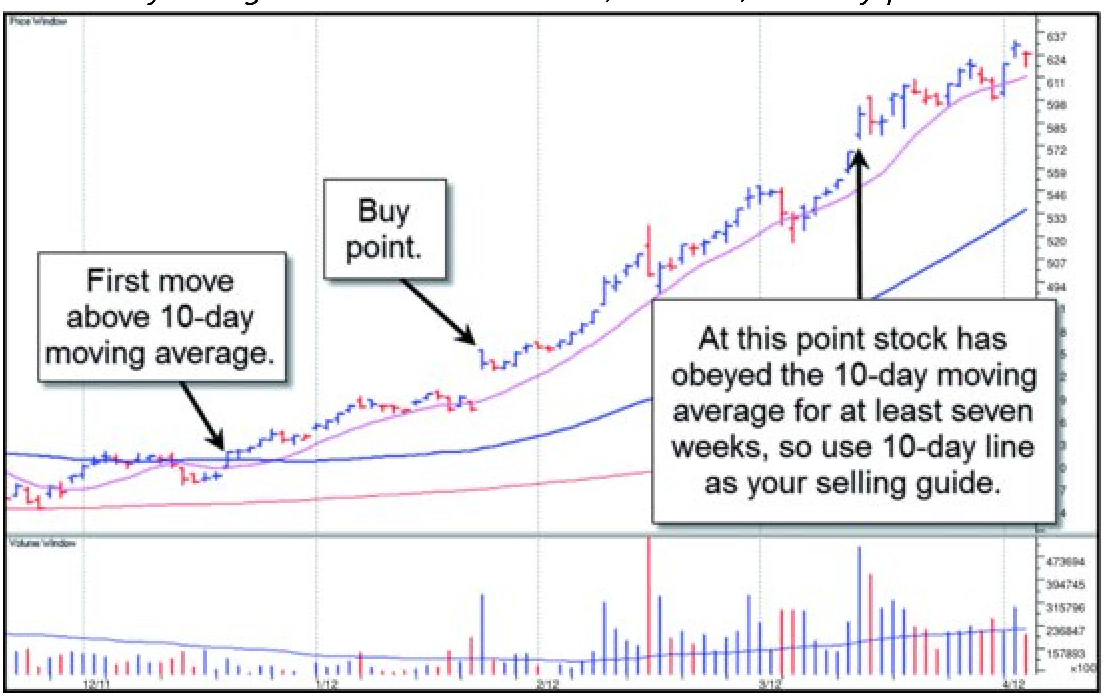

In Figure I.9 we see another example of AAPL, this time from 2010, where it breaks out of a base formation to new highs and then within the time span of about two weeks violates its 10-day moving average. In this case, because the stock violated the 10-day moving average within seven weeks of the buy point, which occurred at the base breakout, we would then revert to using the 50-day moving average as our selling guide for the stock.

Figure I.9 Apple, Inc. (AAPL) daily chart, 2010. AAPL breaks out of a base but immediately violates its 10-day moving average before going higher. Since it does not show a tendency to obey the 10-day moving average, we revert to using the 50-day moving average as our selling guide.

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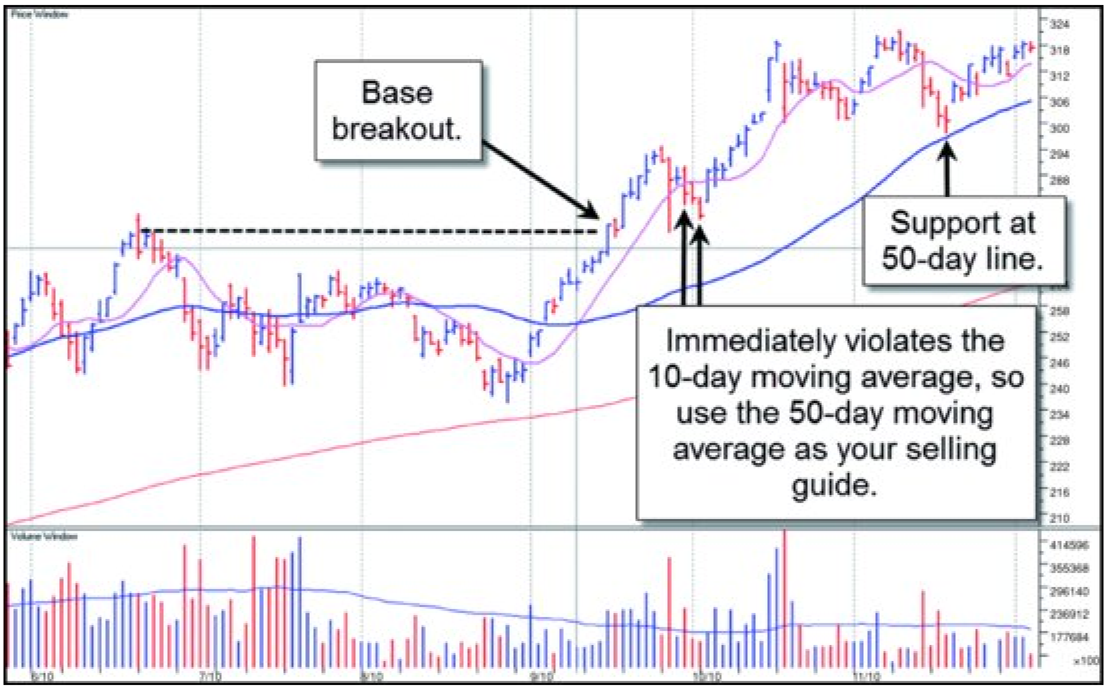

AS YOU BEGIN

You can improve your stock selection and performance by using all these tools together in one seamless system to enable you to buy the next big leaders early or when they undergo constructive buyable gap-ups. They also provide a sound solution to the problem of pyramiding effectively and confidently into the winning names as they move higher. Strategic use of the 10-day and 50-day moving averages will enable you to stay in the position for weeks if not months so as to capture the intermediate-term trend in the stock. Then, when the stock goes through a trendless period