

Little Primer

By J. Peter Steidlmayer and Ted Hearne

Outlook and attitude are critical factors in one's trading success. In everyday life, our outlook and attitude might be stable for prolonged periods of time, but experience shows that in trading they can be quite fragile.

Why do our outlook and attitude become so fragile when we confront trading decisions?

There is a great gulf between our near-term experience and our expectations; taken by itself, each successive trade has the potential to undermine our confidence and cause wild swings in outlook. There is also the element of money -- financial goals and other issues related to money are a major reason that our stability runs off the tracks. So for whatever reason, we get down on ourselves, and this causes only more trouble for the trader. Second-guessing ourselves is probably the most self-destructive weapon we have in our arsenal. As soon as we hear ourselves say things like 'if only I had entered there, or reversed here,' we know we are on a bad track.

These difficulties arise when we operate without an overall program or game plan. Without a plan, we jump around emotionally in a herky-jerky fashion, first here, then there, stabbing at the market and reacting in an uncontrolled manner. This inevitably leads to an unstable attitude and vastly heightens the chance of financial loss.

As traders, one of our most fundamental needs is to develop a game-plan that will allow us to operate within reasonable limits,

where success is clearly defined as following a set of guidelines as efficiently and effectively as possible. The game-plan is not a goal but a strategy, and moreover, a strategy that is well-thought-out and studied. If we execute the plan correctly, then we will experience success, no matter what level of skill we bring to the trading arena.

The failure to follow a successful game-plan can be attributed to many reasons. One of the most common is when there is no plan; the trader just reacts and then second-guesses himself retrospectively, following an imaginary, non-existent plan that would, if it were put into play, require him to function near perfection, at 90 or 95 percent efficiency. This is of course impossible, and so frequent failure is experienced with all of the consequent destabilizing and disheartening results. It is better to develop a plan that permits success when applied at a 10 to 15 percent rate of effectiveness. If we can experience success when operating at this low level, then we have a reasonable base for growth. As we develop through small, incremental improvements, we build consistent confidence and a positive attitude towards our work and our prospects. Instead of holding out a goal of winning instant wealth, our goal is to stick to the plan. We avoid second-guessing ourselves. In a sense, we let the game-plan 'take the heat' for all the negative bounces that previously would have destabilized us. Relying on the big play, focusing on the great trades that got away, or feeling the need to enter exactly at the precise point when the market is starting a

really big move -- these are random approaches, and not the basis for a solid trading plan that will sustain most of us in the long run.

What is the most destabilizing thing that happens to traders in general? What is the most destabilizing thing for you? What gets you (and what gets most traders) back into a smooth, easy, clear-headed and rational state of mind? If you can answer these questions then you are on the way towards building a successful game plan. The best program is to play offense most of the time, not defense.

What constitutes a good offense in the market? What is a defensive stance?

Let's talk about the latter first. For a trader, defense means trying not to lose; it means usually taking the second or third opportunity, not the first. It means trying to hold your own, always waiting for the perfect opportunity. In general, it means not being in control. An offensive posture, on the other hand, starts with being in control, making trades when first offered, clearly seeing the potential, taking advantage of opposite moves, not dwelling on negative outcomes, bouncing back after a personal mistake, accepting results and moving on, forcing the activity, constantly attacking the market in a consistent way, and making trades where and when the opportunity exists. Traders can learn much from this comparison to sports. In trading as in sport, the offense offers more: on the ball field a strong offensive team will control the ball longer, just as in trading you can hold your position longer, and thus have more time for

decisions -- and for lucky breaks. An offensive trader is more likely to be in tune with the market and aboard for major trends.

Defense is basically trying to stop the market. It is characterized by a quick entry-exit, and generally calls for more perfection in order for something good to come out of it. Going with the market is really being on the offense, as opposed to a go-against trade, which can work but calls for a lot of effort in order to make a little.

Concept Control

The ability to understand the market's normal output is the single most important weapon in the trader's arsenal. (The market's output is the way it expresses itself naturally.) Developing a clear concept of market output is like developing a smooth-working athletic team, where all of the players' talents are placed in proper perspective and subjected to the goals of the whole. It is the best way to engage opportunity.

With concept control, traders do not just count on pricing the right spots but have a program that will carry them forward in time.

What is concept control? Essentially it is the over-riding game plan you have for trading. A game-plan forces you to be prepared, and you'll know it by the benefits it confers upon you:

- You can see things early.
- You experience great fluidity and ease with the functional or executional aspects of trading.
- You have positive results in the long

term. (You are "winning on the grind").

- You do less and experience better results.
- You rarely experience "forced reactions" when you are compelled to take rapid action against your trade idea.
- You experience peace of mind.
- You don't have to have perfect execution in order to succeed.
- Your expectations are positive, yet realistic.
- You allow each trade to develop to its fullest potential before bringing it to conclusion.
- Your efforts are focused and disciplined.

Many traders are dependent on a fast-moving, hot market to make money -- in other words, dependent on a market that will make money. If beans are limit up four days in a row, then anyone who owns beans is making money. But if you look at the at the more common trading situation, we need to place a lot more emphasis on the individual and how he or she accommodates each trading situation. Concept control means that we are giving ourselves a discipline from which we can begin to operate, and from which we can really engage opportunity in the market.

In our experience, most traders have become quite sophisticated in the manipulation of data and in the use of common analytical studies. State-of-the-art computing equipment can be found on every desktop. There is no shortage of indicators that will identify plausible entry points, exit points, stop placement, and so forth. What is

lacking is a consistent methodology which lets a trader sort through all of this multidimensional information and reduce it to the one-dimensional, yes-or-no decision that trading ultimately demands. When a trader is confronted with too much information (all of it valid, some of which is always going to be contradictory), decisions become subjective, and he or she will then always bring in outside influences and personal experiences. The outcome is that the trader's results run hot and cold without an undercurrent of stability.

The question to be answered is "Can we take this to another level entirely?" Can we get above this conventional level of trading, to a point where we can stabilize and better focus our trading efforts? Can we eliminate exposure without market opportunity, streakiness related to outcomes, and spot starting and stopping? Clearly, all of these trading characteristics are not a program of steadiness. One needs to have a program to trade through the vagaries of market conditions.

With a clear sense of concept control, the trader has patience. He is able to start trading, stop trading, and to restart the process in a fluid and easy manner, always in the game, always playing. This constant engagement represents the greatest overall opportunity. If we can achieve the discipline of concept control, then we will be able to take command of our uncontrolled talents in a productive and organized way.

Concept Control in Action

Of what does concept control consist?

It starts with how we approach opportunity in the market; first by defining it, second, by recognizing it, third, by taking it, and fourth, by managing it as the opportunity moves towards trade maturity. These four steps must come from the output of our data. And so to help organize our thoughts, we can use our understanding of the world at large. For instance, good traders have always had the ability to sort through noise and come to a buy/sell decision ... they also tend to get on a trade early they also typically have extreme thoughts concerning market direction new traders, without a lot of experience, can do exceedingly well . . . venture capitalists seek out new and developing companies growth stocks are a vital part of any investment program . . . new issues are good to get . . . major houses are now featuring 'emerging' markets from less developed countries and we could go on with more examples like this. All of these are relevant and are going to help us define opportunity in the market. What is the common denominator in all these situations? They are all looking at one dimension. They are getting it all to one side -- not in the middle -- just one side. For these companies or these traders, it is easy to determine right or wrong. They are on the extreme and what is right soon proves itself-, what is wrong quickly becomes apparent. One is not fighting the constant up-and-down, tug-of-war between two ideas; the market or the company is clearly moving in one direction or the other.

So we see that an opportunity in the market, like good opportunities elsewhere in life, should be lopsided. A great opportunity should show just one side, or to put it more formally, show just one dimension.

What do we mean by dimension? A dimension is a measurement, and further, it is an objective measurement. One dimension is a single measurement, then, not one that has multiple sides or characteristics.

Our database is limited to two dimensions, one vertical, the other horizontal. What is the opportunity that we look for? We seek out those situations where we can see a one-sided vertical dimension. It is not difficult to get the market into this type of position, as it naturally develops that way. The market's two dimensions move separately, and do not move in relation to each other. Each dimension will attempt to dominate, shutting out the other dimension. The vertical dimension wants to be purely vertical, the horizontal wants to be purely horizontal. Each wants to "overdo" itself. This does not hurt the trader, for only when one dimension gets cut short does the trader need to be alert, due to the fact that curtailment means minus development. When we see that either the vertical or the horizontal is in dominance, we can say that one dimension is isolated; such isolations allow us to identify that one dimension, and also provide a needed contrast. In an objective format, it is important to have relativity, and not to rely on static concepts. When we can see and assess the relative

importance or dominance of the two dimensions as they interact with each other, we have a much more precise method of analyzing the market's output.

We might also mention couple of other characteristics of our two-dimensional database. First, the smaller the sample at the beginning of a move, the more it tends to be one-dimensional and to manifest directional integrity. Second, larger sample sizes of data are always more two-dimensional; the trader needs to work with them to bring out the underlying one-dimensionality. This activity generally occurs in mid-zone. 'Forwards the mature completion of a market move, one dimension is going to be more visible and will stand out and dominate (but take heed: very late in a move, directional integrity can seem strong but actually be fragile and easily overcome by the opposite direction.)

The software permits us to apply any scale or filter to the data that we wish, so that we can identify and isolate those situations when the vertical is in dominance, or when the horizontal is in dominance, according to the specifications we apply. This ability to manipulate the database to meet our specifications and thus to objectively measure the relative importance of both dimensions at any given time is extremely important, and the key to successful trading under our program.

By contrast, a conventional market database only has a single dimension against which to measure itself. Time is a constant, not a variable, and thus the trader has to measure

all movement against the vertical alone. By definition, all trading opportunities using a conventional database are going to be subjective because there is no natural or dimensional contrast against which to measure an opportunity.

PROGRAMS

For this primer, we have developed four programs, using only a small number of the studies and tools available in Capital Flow Software. The goal is to produce a skeletal blueprint of trading programs that illustrate clear concepts. Of course these can be enhanced and further developed, but for now, we want to outline the process completely before we (or others) begin to add complications and refinements to it.

Program I: Market Matrix

The market matrix is a measure of the maturity of a market opportunity. It is-a framework or scale against which we can put the largest directional, one-dimensional opportunity. In doing this, we are trying to establish the outside parameter for a single dimension. Thereby encompassing the normal area where this base unit begins, ends, and starts again. This maturity is measured on a horizontal scale of 0 to about 50, with the numbers on the scale corresponding to the number of horizontal slots used. (Traders are referred to the Capital Flow Software manual Fundamentals of Q=Operation: Phase III for a fuller discussion of 'slots used" and market maturity. See especially pp 27-28).

Basically this study can help the trader anticipate the timing of the market's move out of a development area.

Looking at this scale of slots used, we see that somewhere around ± 50 on our horizontal development scale the market will complete its development. It generally will peak vertically at ± 40 on the same scale.

We can view this measurement of 0 to ± 50 in a way that can make the one-dimensional element of the market stand out. The market matrix is the base. It shows one-dimensional developmental activity, in spite of all of the vagaries of the market that can take place within this zone. The market matrix contains all market activity.

The market matrix of 0 to 50 horizontal slots used measures the largest directional activity that we have found in the market. It is comprised of vertical activity, and we have found from our experience that it is a 3-2-1 structure. It is a horizontal control parameter which begins with zero and matures with plus or minus 50. It can be greater, without really affecting the trader, also it can be shorter; when shorter it can have a bigger impact on the trader, because that can signify the presence of minus development. It does this by affecting our sense of the "normal" market maturity, as opposed to what is actually happening, as measured by the number of horizontal slots used. A trader who misses this cue will tend to overstay or will find himself trading where there is no opportunity.

A casual, ballpark understanding of the 3-2-1 development as it relates to the horizontal development at each stage would be to generally say that the third standard deviation would be generally between 0 and 15; the 2nd would occur between 18 and 28; and the first standard deviation would occur between 30 and 50. Try to learn to pick these out visually on the screen, and use the horizontal numbers scale as a loose approximation of trade types.

It is important to ream that, given an up direction, the vertical base of the first needs to come on a break. If the market doesn't break, then the market is still on a second standard deviation. Also note that an early development of the first (which is going to be a 3-1-3), the market's vertical changes will take place in very early spectrums. The first standard deviation of a 3-2-1 is in itself always a 3-1-3. It develops by working against a base of the vertical range of the 1st and proceeds to move towards less instability and larger spectrums as it develops horizontally. These characteristics can be used in setting up your control for these occasions. Market matrix provides a tool for understanding, measuring, and developing a "working prediction" of the maturity of a market move.

We follow this closely because this continuous market movement is a fundamental base that helps us to understand and control the market. Traders who are unsure about the degree of opportunity present can mandate out after x number of horizontal slots used. Beginning traders can

confine their activities to 0 to 6 on the matrix scale, for example, while a more experienced trader might be comfortable in trading out to 0 to 20, or 0 to 40 on the scale, or when the opportunity comes as the market reaches 50+ on the horizontal scale, etc.

To restate: our goal was to identify situations when the market is controlled by one dimension. With the market matrix we can measure the maturity of an opportunity inside all the eight spectrums. (See Fundamentals of Q=Operation: Phase H pp. 12-13 for more on the eight trade spectrums). If we see an opportunity early in the scale, then we can play the move one way; when we see a move later in the scale, we can treat it entirely differently. We have created for ourselves a consistent basis for control.

Probably one of the most destabilizing things a trader can deal with is the maturity of an opportunity. It can really ruin the effort of finding and getting a good trade on to find that a new position is, after all, near the very end of an overall market cycle, or that one has exited far too early in a major move.

The point is that the matrix gives us a norm against which to measure current decisions. Anytime we over-ride what would be typical market action for that point in the market matrix scale, we are applying subjective judgement. This may not necessarily be a bad thing to do, but we are on the alert as we do it. If we have no particular opinion or if we don't know why we are doing what we are doing, and we are tempted to go against

the background of the market matrix, then we have an objective study to lean on that gives us a standard to evaluate. Or if our style is to operate in a more organic manner, we can put the trade on and then use the market matrix to assess the potential of the position we have taken. Can you see how the market matrix would help you gain control over the market and over yourself? Can you see how you would gain patience, the ability to start, to stop, and to restart your engagement with the market?

Program U: Base Market Movement

Base market movement is a technique that lets you measure and monitor each new beginning in the market, no matter how small or how tentative. We do this by establishing 'D-Sets' on successive data unit segments. ("D-Set' is our lingo for "design management ratio set-ups.")

Anytime a trader sees two units next to each other with one measurably higher or lower than the first, we have an opportunity to start a D-Set. This is a starting zone in which the market has just one dimension as it moves either up or down. In the context of our current thesis, we are identifying and isolating the dominance of one dimension (the vertical) over the other dimension (the horizontal). Once we have isolated this dimension, we have identified a tradeable phenomena.

The D-Set flags a situation where the two dimensions have become de-coupled and the vertical movement is the primary focus. Once we flag a D-Set, the question then

becomes: how much more horizontal development will take place within the existing vertical structure before fatigue causes a breakdown of the vertical control? Experience has shown that this generally occurs at or around six on the horizontal scale. So when trading a D-Set, you are trading out to the "fatigue point" of six slots used. Of course we are hoping for a continuation or an acceleration of the vertical move to take place before six slots used is reached, but we can usually rely on the safety of the position until six has been accomplished. The move tends not to break down before six time slots used, giving one ample time to exit at this level, because the market is then moving sideways. Beyond six slots, the market can become two-dimensional, given our strict definition of a D-Set. The D-Set is important because it permits you to play as if the market were beginning anywhere along the matrix of market maturity, not just at the beginning. D-Sets are micro situations that occur throughout the entire range of the market matrix and they are most helpful in identifying and trading one-dimensional moves in the midst of what seems like a lot of two-dimensional activity. If we constantly monitor D-Sets we will find plentiful opportunities for entering, exiting, and reentering the market in a productive manner, no matter where on the horizontal scale of 0 to 50 the market is at the moment. Generally there will be few D-Sets against the trend in a developing market matrix; those that do occur will quickly play themselves out. This further illustrates and is a good clue of the one-dimensional nature of

a vertical 3-2-1.

Program HI: Natural Vertical Movement

We trade for vertical movement, and we know that the market typically moves through a four-step program consisting of a relatively fast vertical movement followed by a mostly horizontal development. We could also call these areas of horizontal development 'areas of fair trade;' between these fair trade areas we find vertical movement that we term the market's "natural opportunity."

We have devised a program to identify the areas of fair trade that the market will move from as it starts a vertical move towards another area of fair trade at a different vertical level. Here again, we focus upon the separateness of the vertical and horizontal. Our program finds and flags those horizontal areas where the horizontal dimension is dominant, according to the parameters we set in the scanner. We know that following this horizontal area of fair trade, there will be some degree of vertical movement. In a way, the scans 'force our attention' onto a specific area of the market out of which we expect some type of one-dimensional vertical move (either up or down); for that reason we call these "forcing scans." We can illustrate this by setting up a "forcing" scan with parameters of 12-4-15. When the scan hits we force our attention toward this impending one-dimensional move. Note that there is not necessarily a trade there but it is a place which warrants our attention. This one-dimensional move will 'fit' a portion of the market matrix (also, there may be a D-Set

there.) When the next 12-4-15 scan appears, then the job the market had set out to do is completed (according to the specifications we set), and we can expect a pause in the current market's vertical action, and we go on the alert, expecting a new one in the near-term.

Program IV: Visual Data Program

The eye is one of our natural senses and as such it gives us the means for a basic form of control. Over longer periods of market time, we commonly see a lot of two-dimensional data ... with a lot of vertical and a lot of horizontal on the screen. When there is a lot of chop it can be hard to pick out the important underlying movement.

If we could eliminate from the screen everything that is non-essential, and leave visible only that part of the data that revealed the underlying direction, then the resulting picture would vastly enhance a trader's power and control. That part of the data that we do not need to see can be referred to as noise, which is the more tempestuous or destabilizing part of data.

Our software gives us the possibility of displaying such a filtered visual. We can in fact eliminate or greatly reduce the noise on our screen. This leaves for our inspection a picture with greatly enhanced one-dimensionality, thereby also greatly enhancing our ability to see continued opportunity.

There are several keys to accomplishing this

successfully. The first is to freely eliminate just noise; the second is to have a manageable change parameter that remains sensitive to all input yet filters out the unneeded data. Both these need to meet the practical timing needs of the trader.

We can accomplish both goals by using our automatic splitter, instructing the computer to process the data for a given contract using larger data parameters. In order to maintain the integrity of our main data arrangement, we apply this new data setup to Page Two only; to do this, copy data to Page Two and organize the data for the entire segment using new parameters for the automatic splitter. For this program, set the parameters at either 98-50 (for financials), or at 60-30 (for currencies and grains). When we view this new Page Two as a Capital Flow Bar Chart (F2), we will see an entirely different visual data arrangement, one that can be extremely useful in helping the trader identify and stay with the longer-term trade --or to stay out of trades that go against the major trend.

The result is that if we have applied a noise-reduction filter to the market. By changing the parameters for the number of TPO's that, the computer counts before splitting and the number of TPO's to compare before starting a new distribution, we are establishing a new natural confinement against which the market has to prove itself. We can see long-term moves clearly; our vision is unimpeded by random "noise" or short-term chop. When the market moves out of this larger set of confinement

parameters, we can say with some confidence that a significant change has occurred, and needs to be put into your trading perspective.

By this unique data arrangement, we have taken our one-dimensional concept towards the outer reaches of directional integrity. We can see the smallest unit of directional integrity in the D-Set. We can portray mid-range moves through rearranged data units, and the linking of these into a series. And we can see the largest possible directional moves through the application of these "noise reduction filters" which reveal the underlying directional move over huge time spans. In short, we can take this concept as far as you need to go.

This new technique of adjusting the "noise" level of the visual display, by adjusting the automatic splitter parameters, is a major breakthrough, in our ability to recognize and manage trades. As we learn more about the capabilities of this powerful tool, we can expect correspondingly powerful improvements in trading returns as well. We customize the set-up to our favorite style and time-frame.

What does the future hold?

Putting all these pieces together in a coherent plan will take some work initially. Obviously all the parts of this plan do not have to be there equally; some of them do not have to be there at all. But through study your preparedness will be high, and improvements will come just from that.

Remember that the human part of the equation will always be a major part of success. At times things will be going good, and at other times they will go poorly, but with a well-developed program built on a solid market concept we hope to enhance the former and limit the effects of the latter.

As you gain more and more control over the market, it is important to continue to expand your capability. However, humans can't handle multiple programs with multiple parameters in real time all at once; the computer is essential to manage this process.

In the future, we expect to further enhance our software capabilities beyond the current studies to allow you more flexibility. Traders using our software now can follow the natural movement of the market develop independent insights, and will be able to create default set-ups and transfer them to a disk which can easily and effectively be implemented by less experienced traders.