

Wiser Trader Advisory Services

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Trading Approach

Primarily I use a trend following trading system taught by Dr. Stephen Cooper. Adjustments were made to fit my trading personality. The system has several parts, watch lists, option selection, money management, a trade entry sequence and a trade exit sequence. Integral to all of these is chart analysis. Dr. Cooper teaches classes and describes his system in several books and CD's available at OnlineOption.com. Here I will just try to give you a brief overview.

Selecting Stock Candidates for the Watchlist

Watch lists are created by several filters. Two stock candidate filters identify trending stocks for taking long positions based on both fundamental and technical characteristics. In order to pass this screen the stock must belong to a leading industry. It must have outperformed 90% of all other stocks over the past 6 months and be within a few percent of its 52 week high. The stock must also have increased its EPS by at least 80% over the past year. For the call option filter, listed as (1) in Table 1, the stock's price should be at least \$50. For the covered call writing filter, listed as (3) in Table 1, the stock's price should be under \$20. The chart for such a stock needs to show a definite up trend. Yes, these are growth stocks.

Table 1
Stock Filters Used to Create Watch Lists

Description	(1) Stock Candidate	(2) Down-market	(3) Stock Candidate
Options	Buy Calls	Buy Puts	Write Covered Calls
Stocks	Long Positions	Short Positions	Long Positions
Market direction	Up, Sideways	Down, Sideways	Up, Sideways
Price	> \$50	> \$30	< \$20
12 month EPS growth	> 80%	< 20%	> 80%
Relative Strength	26 wk > 90%	26 wk < 20%	26 wk >90%
Price within	5% of 52wk high	5% of 52 wk low	5% of 52wk high
Exchanges	NASDAQ, NYSE	NASDAQ, NYSE	NASDAQ, NYSE

In a down or sideways market, a different filter is needed to identify candidates for put options and taking short positions. A down market filter, listed as (2) in Table 1, was created to mirror the above filters as closely as possible. Stocks passing this screen must have a price greater than \$30, an EPS growth of less than 20%, a 26 week percent rank relative strength less than 20% and a price within 5% of their 52 week low. Shorting stocks is more difficult than

going long because of their historical upward bias. Usually some kind of persistent chronic problem with the company needs to be identified, in addition to technical chart features.

It is very difficult for the three filters just described to pick up new trending stocks in a choppy, sideways market because they rely on detecting 26 week relative strength and 52 week price behavior. Two additional filters are used for a sideways market. I call these near term filters because they only look at prices (highs, lows and relative strength) over the most recent 4 week period. All other features remain the same. These near term filters address the indecisive nature of a sideways market and are best used for quick in and out trades.

Option Selection

Based on candidate stock charts, one needs to estimate how long a trade needs to remain open in order to make a profit. Option expiration dates are chosen based on this time estimate while adding another full month. We want to be out of the trade before the final 30 days prior to expiration because the time value decays exponentially in the final 30 days.

The strike price is chosen to be at the money in an orderly trending market so that the option premium increases immediately when the underlying stock begins to move in the intended direction of trade. In a disorderly market that takes unexpectedly wide swings in opposite directions on alternate days, expiration dates are chosen to be slightly in the money in order for the option premium to maintain its value on days the market moves against the trade. The more in the money an option is, the better it retains its value when the market goes against the trade.

Money Management

There are at least two levels of approach to money management. In the first, trailing stops are used with a maximum percentage of capital per trade to limit draw-downs to less than 1 or 2% of investment capital. This method of money management is needed when a trader does not have access to a well characterized trading system. There has been little published theory to explain how position size and trailing stop losses should be arrived at, leaving the impression that they should always be arbitrarily chosen based on one's risk tolerance. Fortunately, when one uses a consistent trading system, a more precise relationship exists for choosing the correct stop loss setting F_L based on the average profit per trade F_P , the percentage of correct choices in the direction of a trade F_C and the average fractional gain per winning trade F_G . The correct stop loss setting is given by $F_L = (F_P - F_C F_G) / (1 - F_C)$. All quantities are decimal fractions. This is a more refined approach to money management.

When equal sized trades are made, the number of trades needed to earn an amount equal to the average trade size is $1/F_P$. When F_P decreases below about 0.1, the number of trades required to earn the average traded amount grows exponentially. When a trading system's performance is improved by increasing F_P from 0.1 to say 0.2, the number of trades required to earn the average traded amount is cut in half from 10 to 5. Although the average size of your trades is selected independently of the trailing stop percentage, it is a good idea to play it safe and limit your maximum trade size to 10 or 20% of your risk capital. This assumes that your risk capital is no more than 10% of your total investment capital.

F_P is the easiest trading system parameter to obtain. Variables for the rest of the model are based on average values of historical trading system performance. The model is only applicable when a trading system is consistently followed. It should not be applied to unstructured trading across a variety of instruments requiring varying trading techniques. Each trading system or technique generates a unique set of statistics to which this reasoning is applied on an individual basis. When a trading system is used consistently, this model enables precise money management. A full derivation of the model can be found at <http://www.wisertrader.com>.

Trading Templates

The trade entry sequence for call positions begins with a stock that has a well defined upward trending 30 day simple moving average (SMA). Next, we look for the Williams %R to become over sold at -80 or less. This is a trigger to consider the stock for a long trade. If this has not occurred, we move on to the next stock in the list. After we get a trigger, we look for a confirmation in the form of the stock price moving above its 7 day SMA. When a confirmation is received, the stock price is moving upward and the major averages are moving upward, we enter the trade. This trading template consisting of the 30 day SMA, the Williams %R and the 7 day SMA is called a TTC-A trading template. The same template is used in a reverse fashion for taking short positions.

The trade exit sequence is a bit more involved. It begins immediately after a stock is purchased and is designed to give winning stocks room to run in order to retain profits and minimize losses. This involves the use of chart analysis, a very broad subject. Basically, we look at how prices respond to support and resistance in conjunction with volume. When price falls below support on higher than average volume, a short term position would most likely be exited. In this context, short term refers to option trades measured on daily charts.

Trade Conditions and Timing

One of the more important features of this service is the "suggested conditions for trade". I will send an email to confirm when conditions are met for each trade.

Trading conditions consists of four parts:

- Direction of the major averages at the time of trade,
- Direction of the underlying stock price at the time of trade,
- Time of day the trade is made, typically after the first hour of trading.
- Technical confirmation - either MACD crossing or stock price crossing its 7 day SMA

The intent is to trade in the direction of maximum momentum, to avoid the first hour of trading during which the market has yet to establish a direction and to stay within the ideal parameters of Dr. Cooper's trading system. Before buying options I like to send subscribers a watchlist of candidates for the week, at least the night before the market opens, and make trades based on what is on the list. This list gives everyone a chance to perform due diligence and become familiar with each candidate.