

Chapter #9

Trading Options

"Just because a market maker has to sell you an option, doesn't mean he has to sell it to you at a price so that you will make money."

Trading Options is a little bit different than trading stocks. Stocks are longer term investments where we can use trend stop losses. An average stock may fluctuate only \$.25 to \$.50 a day and we take a position and hold it maybe 3 to 6 weeks at a time and try and make 10% or more on our money during that 3 to 6 weeks. We may even hold it for months and months as long as the trend continues up week after week. When we are trading options, it is a different environment in that we are buying options from the market maker, an option specialist, so to speak, on the floor of the Exchange.

This man is selling directly to and in competition with us. For when you go down to the option floor to buy an option, you are usually buying it from a professional who is shorting it to you (or a group of professionals as at the CBOE). They can read the tape every bit as well as you can and probably better, for they have been on the floor of the Exchange for years and make their living selling options everyday. Therefore, they have priced the option accordingly so you will lose money and they won't.

If the market is up 20 points and booming and you want to buy a call option, be aware that the call option you are buying assumes that trend will persist and the market will probably travel another 20 points tomorrow, because that is the normal expectation.

So if you expect to buy a breakout you had better have in your calculations a movement of the market that goes 3 or 4 days or 100 Dow points in a certain direction. For when that market maker shorts that option to you, the very next day if we go up 20 points or only 5 or 6 more and pulls back, the option will drop immediately, and perhaps get cut in half because the premium of that amount was already factored in the price. I can't tell you how many times I could predict exactly the next day's movement but still had no investment vehicle to trade because the expectations were already built in. Professionals learn to skip those overpriced option situations. The public has to buy them and is always shocked to be right and still lose money. Just because a market maker has to sell you an option, doesn't mean he has to sell it to you at a price so that you will make money!

This is why it is imperative to know the main trend when investing in options. For you see, if the main trend is up you can afford to buy **down** days, when other people are afraid the downtrend is going to continue and they are selling out their call options and the market makers themselves are uncertain of the trend.

So if you buy with the full realization that the main trend is up and that it is a temporary dip, that will stop at a higher level than the previous dip, and you have entered the market at a point slightly higher than the previous dip, aware that the market will probably stop dead in its tracks, you will have a tremendous advantage over the market maker and you will buy cheap calls.

When the market does indeed stop and reverse, and the next day it goes up 20 points and everybody else rushes in to buy the calls, you have the flexibility at that point to sell the calls back at a huge profit. Often times the option itself will have doubled by that point. The significance of trading with the main trend is that you will get cheap premium. You will be able to take advantage of the specialist and if you are investing with the main trend you will trade out of your position within a few hours to a day or two, and you will have a reasonable stop loss exit point.

I might add another unique trading tip about options that I have found. It has been well stated that a professional trader is not afraid to take a huge unlimited profit. Meaning, that if a Bull Market starts and goes up and up, you just do not arbitrarily sell your stocks because you have a \$1 gain, when if you just sit on them, they will go higher and higher every day. However, in many cases **taking small gains is a superior strategy.**

Sometimes in the option market, with these speculative instruments that are fluctuating 30%, 40% or more per day, you do not want to become the long ball hitter, looking for home runs in options, where you buy an option for \$1 and expect to get \$6, \$8, \$10 for it. That is for the public who do not know what they are doing, who are just gambling. Remember, 70% of all options expire worthless.

Many people have the attitude that this is a high risk venture. They will take their \$1 premium and either get a huge score or be completely wiped out. Since 7 out of 10 get wiped out the other 3 might break even or the other 3 might make 6 times their money and still might come out ahead. There is no need for this kind of investing when you can use "scientific" technical analysis.

In **scientific technical analysis**, as I have been describing, we can easily define our risk, the probable direction of the market, the number of hours of persistence of that trend, whether they be Fibonacci 8, 13, 21, 34 number counts or natural squares, and support and resistance calculations. If we use this, we can frequently buy options at \$1 and sell them \$.50 higher for a 50% return on our money and do that almost every single day rather than waiting for one option to go to 6 or 10 times our money over an entire month.

The professional trader wants to make money all the time, small, steady amounts of money. In trading options, I have usually found it better not to go for the big unlimited reward that sometimes is technically available and is a better strategy for investing in stocks, where we would just buy a stock and

use a trailing stop loss, that as long as the stock went higher and higher and higher we would just raise our stop and carry the stock for years. With options the better strategy is to bank the gains quickly and frequently.

Options actually expire, they have a set time period and they have premium. The market makers are setting the premium levels to expectations. Every time there is a little dip in the market, the premium expectations will expand and contract as the market makers adjust prices according to expectations. Therefore, it is usually best to trade options. As soon as we have our entry, this is where we have our biggest risk, the 1 or 2 hours when we make our trade, the approximately 10 point trading range within the "stair steps" on the Dow Jones hourly chart.

Let us say we make our trade and bought our option at \$1. It is usually wise to immediately offer it back and put it on the books at 1 5/8 or 1 3/4 or even maybe \$2, if we are looking for a big explosive move, and often we will find that in the very next hour or two, a sudden reversal occurs and the market is up as we expected. The calls easily double as the market makers adjust the premium. They sling shot through our price level and we are sold out immediately for a wonderful profit in a very short period of time. Within a couple of hours, when we have a normal little counter move, the options come plunging right back to what we paid for them, only a little bit more.

Perhaps we can buy the same option back at 1 1/4 this time and since we are still bullish on the long term trend, we offer our option, let us say at 1 3/4 and are sold out. We turn right around and bid for them back at 1 1/4, 1 3/8. A few hours later, if there is a dip, there is a very good chance that our order will be filled at 1 3/8. Then we can turn around and offer them this time at 2 1/4. This way we can get several good, consecutive trades of 30%, 50% or 100% on our money.

Believe me, several trades at 50% or 100% on your money will always be more superior than one trade at 6 to 10 times your money, that only comes once a month and has a probability of being totally wiped-out once a month. Remember the beauty of compound interest, especially with options. Options fluctuate at least 20% to 30% a day and often times double or triple in a day.

The world's greatest *investors* frequently have long term track records in stocks of making 25% per year. Very good stock *traders* make 70% per year or more and very good commodity traders might make 300% per year. However, with options that fluctuate by 30%, 50% or double everyday, why are these people not all infinitely wealthy?

The truth is, trading opportunities for big gains with limited risk is not the same everyday. We have seen from counting our numbers of hours from a high or low and counting our impulse waves and counting our main trend that there are patterns within the market. If we are only trading options, we want to be in a pattern that not only is 80% probable of being right in terms of the direction we are going, but also a pattern that gives us the biggest reward over the shortest time period.

This is a very important theoretical point for many people make the mistake of buying puts and calls in a basing pattern. After a long term decline the market is quite scary, especially when it is making a bottom. The market will go up and down, and up and down, often over a week or two weeks at the lows.

Now, from our time cycle analysis or some other technique, we know the market has stopped going down, but **just because it has stopped going down does not mean it is time to buy** call options expecting it to go up. The market will usually decline, base, oscillate back and forth in a trading range, and then break out to the upside and have an extended move of 1, 2, 3, 4, days in a row up. It is during that 3 or 4 days in a row, when it is going up, that we are going to have our biggest winnings in the option market.

Historically, these moves come maybe once every two weeks. However, maybe once a week there is a trade where you can easily double your money in options, but it does not come every day. If you are going to trade options every single day, your probability of success is going to be more like 50/50 rather than 80%. You will be subject to the daily fluctuations of plus or minus 20%, 30% in the option's price, rather than probabilities where your option will double and triple and quadruple because the market is going up 50 points.

This is universally what separates the professional trader from the public. The public does not realize that **each day's trading has different probabilities of success**. There are many days during the week when the market is caught in a consolidation band of plus or minus 10 on the Dow Jones Averages, maybe because there is news that people are apprehensive about, or some unexpected event that just happened, or maybe the market is getting ready to reverse.

The professional trader sees and realizes that we are in a consolidation band of plus or minus 10 points and that it is not worth trading options. He therefore, does nothing but watch the ticker tape and be prepared for evidence of when there is a breakout of that trading band.

Practicing with an hourly chart and observing these patterns gives one confidence from observation of past historical breakout points. When the market breaks out after a basing period it usually advances 3 or 4 days in a row and extends upwards, maybe 100 Dow points in a straight line. Once you start to oscillate from the top, you have entered a topping pattern and it is inappropriate to own calls at that point.

The first time the market goes down you can buy a dip if the market has advanced 100 points, but if it suddenly pulls back 20 or more it is likely that that is the final top and calls would be inappropriate. Now you would wait for a topping action over several days before it would be appropriate to think about puts for the breakdown. Catching the final high or low is a sign of trading inexperience. Although, the final high or low can often be forecast right down to the hour, the public and the vast majority of investors, will never see it. As a result, the options at the final reversal point are always too expensive. It is only after the first minor correction that the premiums collapse, making them a bargain, because it is then that most people think the main movement is resuming and throw their options out the window.

Options - What They Mean

Professionals use options not in the normal sense that public speculators do. Professional trading is often a game of strategy and thinking and the use of options is not simply to gain leverage.

Options are a very important tool in today's market in judging what the market will do. Although we have great legislative bodies, such as the SEC and the various stock exchange organizations policing what is going on, in reality it has always been the case that there is tremendous inside information on Wall Street.

To the poor and the man on the street, acquiring information about a merger or a takeover is a rare event. If he has a friend, who is an attorney, who happens to be writing a proposal for a takeover, it is a rare opportunity. However, to the rich, the super-rich, the knowledgeable people, the heads of Wall Street brokerage firms, accounting firms, and law firms, it is a way of life. It is not inside information at all to go to cocktail parties and discuss nothing but inside information.

In theory this is illegal. In reality, it is a way of life if all your friends are on the board of directors of various companies or are high ranking attorneys at major, exclusive, law firms. Of course on Wall Street, when you have a wired hand or a guaranteed knowledge of an event, such as a takeover of a stock going to be shortly announced, the natural greed being what it is, forces the individuals involved to put as much money on that speculation as they can. If they know a stock is going to be bought out at \$50 and is currently selling at \$30, not only will they try to beg, borrow or steal all the money they can to invest in it, they will almost always use as much leverage as they can because there is no risk to the insider who has secret information.

This is what options trading is really all about. **Option premiums will always reflect inside information that is not available to the general public.** This is a very important point to be considered not only in terms of illegal information, but in terms of legal information that is of a very grey area, such as major basket programs, or major pension fund liquidations or buy programs that are operating in the market. At the major firms of Wall Street, where they have sizable, multimillion dollar buy and sell programs, they will not only race the tape to protect themselves and buy lots of call or put options before that program hits, but also as part of that program, they will buy thousands of puts and calls to hedge themselves and to protect their customer from unusual market fluctuations until that program is completed.

These movements of tremendous amounts of money into options are instantly reflected in the option premiums. The average retail investor who has learned to use a "Black-Scholes" options model or some kind of theoretical options premium model, that says what the fair value of options are, entirely misses the point. He will end up looking for **cheap options** that the theoretical model says are cheap, that will go to their natural price.

What he should be looking for are options that **are ridiculously expensive**. Premiums that are outrageous, premiums that are selling for prices far more than the theoretical models say they should be selling for. This is always a tip off to a major trading opportunity.

For instance, on individual stocks that are takeover candidates, if, on a stock selling for \$40, one were to look at the out of the money 45 call options whose normal theoretical value might be \$.50 and suddenly find that 1,000 options have traded at \$1.50 and yet the stock is lifeless on the tape, with

low volume and small range, this would give you an immediate tipoff. The tape is being raced for a certain transaction that will transpire sometime in the future and the insiders know about it.

Whether it is illegal because of a takeover, or legal as part of a basket program, or a forthcoming recommendation by a famous analyst, we will never know until after the fact. However, the fact remains, when big money has a sure thing they use lots of leverage and they use options.

In today's markets that are so influenced with basket programs, buy-write programs and pension fund investing, the OEX, and XMI puts and call options are dead giveaways as to what the major players are doing.

I cannot tell you how many times I have seen at 11:00 AM or 12:00 PM a major transaction of 2000, 5000, or 10,000 puts or calls cross up \$.50 from the last trade. Inquiries result only with names of the brokers who traded them and no indication on the tape of any kind of unusual activity in the market whatsoever. Seemingly a random transaction and yet three hours later out of the blue, massive buy or sell programs hit the tape going in the direction of those puts or calls that were bought or sold by the major brokerage house. Further inquiries indicate, the same broker did the program who did the options earlier that day.

The professional is keenly aware to watch for not only the premium levels themselves for the tip off, but more important, the time and the price level the trade went on. Major arbitrage activity may last in the market for several hours to several days. If one notes the time and price the options were traded and notes that they do not trade under that price again, it is very likely the conditions in the market will last until the options move back under the price level where the original trade was made. Sometimes that can be three days later and 60 points on the market averages.

Another thing to know about option premium levels in gauging the strength of the market and its direction, is relative strength. No matter what you think about the tape, remember there are insiders at major brokerage firms who have guaranteed information. If a multimillion dollar sell program is around, no matter how bullish the tape looks, it will not be able to go up because they will be feeding out stock every twenty or thirty minutes to check the rise of the market.

The telltale sign of this, is when the out of the money call options in a bullish rising market are flat or down on the day. Typical, would be a market that may be 12 or 15 dollars up on the day, looking quite bullish and yet the \$5 above strike options just above the market are down 3/8 to 1/2 on the day from the previous night's close.

Out of the money puts and calls, tell you a great deal about what the leverage players are doing. People who have absolutely guaranteed information do not pay large premiums and get near money strikes and pay \$6, \$8, \$10 premiums. They will get fairly out of the money premiums because they know exactly what is going to happen within fair tolerances. Likewise, in a Bull Market this is not just illegal inside information, but the overall total amount of investing by the public. When a large cycle is present in a Bull Market for instance, a sudden plunge of \$15 or \$20 in the market is often accompanied by out of the money puts being completely unchanged to down on the day with the market down

\$20. When you see something that looks like the market is breaking down, and is down, and yet no one who owned puts overnight, who should have taken advantage of that, has made any money, it virtually tells you that the tape action is an illusion, that it is a temporary blowoff and the market makers know it. They are flooding the market with put options that they are selling naked because there is no way the market can go down.

Even more guaranteed is the situation where the market is down, the puts are down and the call options are being bid up. When you see that, it does not pay to fight that kind of information, even though the trend is down and the stocks are down on the day. As a professional, you cannot trade against the premiums.

Also be aware that options themselves influence the market tremendously. Large insurance companies have multibillion dollar positions in the stock market. Most of these companies are long term passive investors who collect dividends and do what is known as buy-writes.

They will buy hundreds of thousands of shares of stock because they think the trend is up and will catch the dividends and sell call options to collect premiums. This gives them attractive annual rates of return of 15 to 20 to per year with little risk. This being the case, they will always commit their money to stocks that have seemingly unusually large option premiums.

In the last several years we have seen potential takeover stocks literally become self-fulfilling rumor stocks that go higher and higher and higher with little substance to the rumor. This is the effect of the tail wagging the dog. The more the rumors spread the more the speculators bid up the call premiums. The theoretical value of the premium based on the stock's history might be small, but the prospect of the stock suddenly being bought up \$30, \$40, \$50 higher makes the premium level 3 or 4 times what it should normally be.

Insurance companies see that premium and are forced to do buy writes. They come into the market and buy 100 to 500 thousand shares of stock to sell those premiums and get that juicy annualized return. They do not care if it is a true rumor and if it is bought out or not. If it is bought out they will still be exercised at the higher strike price, thus getting a capital gain and the premium, so they will be happy.

What happens in the short run, is that it is almost guaranteed that a large option premium will attract buyers. The buyers will push the stock up. The stock going up will expand the option premium and the process will feed on itself until all players who do buy-writes have exhausted their pool of money and have their positions. At which point, after 3, 4, 5 days to sometimes several weeks, the stocks go right back where they came from, the premiums collapse and the insurance companies close out their positions by buying back the options that they wrote at \$3, \$4, \$5. They buy them back at 1/8 or 1/4 and they sell out the underlining stock...and we are back to where we started.

To the professional, those heavy premiums with little activity in the underlying stock is a dead *give-away* as to what to do. The professional will always buy those stocks, knowing they will be attracted to the higher strike price, because of the premium. He may also set up a spread where he may buy the

way out of the money calls for a fraction and buy the stock. As the stock starts to go up, sell it out and sell the deep in the money calls against his out of the money hedge position.

With the advent of computers in the home, there are tens of thousands of investors who now have the ability to scan option activity every day. **Be aware that these large premiums on individual stocks have important information as to the direction of individual stocks and the market averages.** This is a very important professional point which needs much consideration.

While discussing options, I might reflect back on some basic misconceptions the public has concerning options. That is the basic creation of options. There are hundreds of books written about the risks of options, or how one purchases and sells them. I assume you know that much. However, what a lot of people do not understand is that when you buy a call option on a stock, somebody actually sold that call option to you.

Even though there are market makers quite willing to sell these call options naked, without the underlining stock behind it, most transactions are covered transactions. That is, if you buy a call option, on the other side of the equation somebody bought stock and sold the call to you. That is why if you ever decide to exercise your call, they will have the stock and they will be exercised out and the stock will go to you. That would be a covered write.

Now, on the put side of the equation, if the speculator wishes to buy a put, although a market maker may sell a put naked to him, he often likes to be covered on a position. A covered writer of puts is a person who sells short the underlining stock and then sells the put. That way, if the person who buys the put ever exercised it (and you buy it because you think the stock is going down) he probably already owns the stock. If you buy a put to protect yourself and the stock should collapse, you would exercise the put, forcing the person who sold you the put to buy your stock.

That is why a covered writer of puts, is a person who shorts the stock ahead of time, with the expectation of being exercised at a later date, and forced to buy the stock to cover his short. Naturally, he would not be forced to buy the stock unless the stock went down, so his only consideration is being short the stock if it goes up. As long as the stock goes up and he sold the put, the put is worthless. He has no risk and he can cover his short. However, as long as the stock is below the strike price he will usually be hedged against the put by being short.

What I am explaining is what causes the major movements around the options expiration dates. Over a three or four week period the public as a whole is Bullish or Bearish. They accumulate, let us say a large put position, because they are Bearish on the market. What they do not realize, is that over the course of time, as they are buying puts on their favorite stocks, market makers are selling short these stocks to accommodate them and write the puts.

The public has no intention of exercising the puts because they do not usually own the stock, they are just speculators. Their intention, as we get closer to option expiration, is to sell the put at a profit. The natural effect of this, as they go to sell the put, is that the market maker on the floor buys the put

back. He has not extinguished his liability from when he initially wrote the put, days, weeks, months ago and since he was short stock when he wrote it, he now has no need to be short stock and he buys back the stock.

The net effect is that the speculator who sells out a put position, forces someone to buy stock. Groups of people who, very quickly on news items, or trendline breakouts, or for any other reasons, are forced into simultaneously selling large amounts of puts, create massive buying in the stock market. The more the massive buying hits the stock market and stocks go up, the more the people who own other puts, see their profits evaporate and are forced to sell. The more they sell, the more the buying ensues.

This is a double-edged sword, in that the more the buying ensues the more other speculators want to buy calls. As those speculators come in and buy calls it forces market makers to also buy stocks and sell the calls. So you have a double effect, people selling puts which causes buying of stocks, and people buying calls which forces buying of stocks. This happens until the market gets saturated and stops going up. At which point people take their profits.

Now the people who have call options start to sell. As they sell out, the person who originally wrote the call and had bought stock, buys back their call options and no longer needs the stock and sells out the stock. The selling of the stock forces the market down. The forcing of the market down, forces more people who have calls and see their money evaporating to sell the calls even faster. The more they sell the calls faster, the more the stocks go down.

Now as the stocks go down, speculators want to profit and they buy puts on the market. As they buy puts on the market, the market maker shorts stocks, forcing them to go even lower...and we have a vicious cycle that oscillates back and forth. This is why on the option expiration days, we see the market gyrate up 10 points, down 10, up 20 or 30, seemingly random, but what you are seeing is massive buying and selling that reaches saturation due entirely to put and call transactions.

In analyzing the stock market, one must be cognizant of these types of fluctuations as you get closer and closer to option expiration, because there you have the combined buying and selling of the last several days, several weeks, maybe months, coming to an end where there is a legal deadline in a matter of days or hours, and thousands of people have to make up their minds simultaneously to do something about their positions.

It is during these times that it is very important to watch outstanding interests in the puts and calls listed in the newspaper. If there is a huge position in outstanding puts, there is a maximum floor under the market, which no matter what kind of selling pressure it has, will not go through. If those puts are stampeded, if they are in the money puts of any value, it will force the stock market higher as those speculators sell the puts.

In recent years when the market had a bearish bias from '89 through '90 and beyond, we frequently saw a phenomenon where most people had puts. Going into option expiration, the market always rallied up forcing them out of their puts, leaving them high and dry at a loss on option expiration date,

not wanting to pay the very large premiums for a whole new month of trading activity.

Consequently, no one had any puts on the close of business on options expiration and the following Monday the market opened down 50 to 70 points. This gets the juices flowing on the Bears. They rush to buy their puts anyway and by Tuesday morning or Wednesday morning the stock market stops going down from the short selling, as everybody has bought puts and then it starts to creep back up again. The puts start to lose their value, people start to sell their puts and it creates buying, and the market comes right back to where it was.

These are natural cycles. If you look at every single option expiration, you can see where the masses, as a whole, had either a net bullish or bearish bias. This can be a good sentiment indicator. It is no accident that almost all of the big "crashes" in recent years occurred during option expiration.

Another thing to keep in mind, is that although there is a legal deadline for option expiration of the third Friday of every month, during the last several years, the legal, practical deadline has slipped into Monday, not Friday. This has come about because in many firms trades in margin accounts are considered day trades without money having to be put up to pay for them on exercises of options.

Therefore, if a speculator owns options and they are going out worthless Friday afternoon by selling for 1/16th and he has strong conviction that the trend will reverse on the following Monday, and he will actually make money, he will frequently exercise the call into a stock position. Since the exercise notice is not received until Monday morning, as long as he sells the stock out by Monday's close, he does not get a margin call for that transaction. So many investors have taken advantage of this to get a free ride over the weekend on lots of stocks.

Market makers in particular, who used to arbitrage by selling naked puts and calls at the strike price, straddling both the calls and puts right down to the index strike price, used to cover themselves by buying baskets of stocks. Now they do not bother until the Monday afterwards. They prefer to capture all the premium, close the OEX and XMI on the exact strike levels and if it requires them buying odd amounts of stock on Monday, they will do that rather than destroy the chance of getting all the premium on each side of the strike price. It is not an accident or a coincidence that every option expiration the OEX and the XMI's close exactly at the strike levels.

Several years ago, it also was no coincidence either, that all the underlining component stocks also closed exactly at the strike levels. However, in today's market, apparently greed has gotten to such an extreme that the market makers no longer buy the individual stocks and many individual stocks that weigh heavily in the indexes no longer close at their strike price until the following Monday. They want the indexes to be exactly at the strike so they get all the premium and after the indexes expire worthless Friday, they will buy the one or two individual stocks they need in that basket on Monday to force it to the index strike.

The net result of all this, especially because of the speculators who get a free ride on Monday, is that after the option expiration the stocks have a tendency to have severe gyrations from 2 PM to 4 PM on Monday afternoon, very often in a completely opposite direction to which the day had been going.

What happens, is that somebody who exercises a call on IBM, because he thinks it will go up on Monday, is exercised into the stock at the same strike price it was Friday afternoon. He hangs on all Monday afternoon hoping the stock will go up and sell at a profit, but the market makers know he does not have the capital to pay for the stock and must sell it by the close. So they will start a drive in the market to lower the bids and in the afternoon, sure enough, IBM will start to sink.

Alluding to the poor, undercapitalized speculator, who knows he has to sell it by the close anyway, he will be forced out on the very first dip, usually at 2:00 PM to 3:00 PM and be certainly out of the position by the close. The net result is that the market makers scoop up cheap stocks at 4:00 PM and the **Tuesday** following the option expiration, we are off to the races.

All the big, big winners in the last five years have usually exploded on Tuesday, following the Monday after option expiration. It does not pay as a professional trader to gamble on that Friday or Monday unless you are a short term scalper and you have very strong convictions. Watching the market trend emerge on Tuesday or Wednesday, following option expiration, is often a very profitable endeavor.

The public should also be aware, especially during the weeks surrounding option expiration, against trying to read the tape. In my opinion during everyday of the week, at least 30% if not 60% of all transactions on the floor of the New York Stock Exchange are now option related.

To most people this sounds ridiculous and is very hard to prove, but many people who are buying, for example, IBM, are buying it under some type of option strategy. If not individual options on IBM, they would be buying IBM or selling it, because it is part of the Dow Jones Averages, the OEX, the S&P 100 largest big cap stocks or the XMI, the twenty big cap stocks. People buying puts or calls on the XMI, on the OEX, the S&P futures will be affecting the price of IBM. Someone recently mentioned to me that for every listed stock, there were now up to seven individual derivative option listings on each.

It is almost impossible to differentiate all the different players in the market, all their reasons, the amount of money each has and the influence that a few small highly leveraged players have to more than compensate for large legitimate fully paid for stock buyers. This is why the influence of stock option activity is so high.

The problem with reading the ticker tape around the option expiration is this influence. I have often seen brokers say, "There is a big buyer of such and such a stock" and I say, "It is probably option related," and the broker says "No! I have the account right here, they are just buying stock." What that broker does not realize is that big institutions have a dozen accounts all over the street and they keep all of the accounts guessing, because they do their options at one place and their stocks at the other and do not tell either side that they are the same guy down on the floor.

Often times, after completion of buying 100,000 shares of stock on the NYSE, you will see in Chicago 1,000 calls trade and the 1,000 calls that represent 100,000 shares are probably connected and being crossed in some kind of an option related transaction.

Around option expiration, when people have puts or calls and have made large amounts of money, let us say, they bought a put at \$2 and the market broke, the stock went down and the put is now selling for \$16, the public loves to call up the broker and tell him to sell their \$16 puts. In reality, on the last day of trading and the day before, no market maker wants to invest all his capital in expensive \$16 puts. The only way you will ever find a willing buyer of those puts is through an arbitrage transaction. Remember, the person who originally wrote a put is short stock.

The transaction that takes place in order to extinguish a liability is that a market maker will first buy stock. He will buy the puts, exercise the puts and through the exercise of the puts will sell his stock to the person who originally wrote the puts. For instance, if the put strike price was \$100 for IBM and IBM is now selling at \$90, the put is worth \$10. For that market maker to pay \$10 for the put, he would buy stock at parity with the put. In other words, buy stock at \$90, no less, no more, then buy the put at \$10, exercise the put which forces whoever originally issued the put, to buy stock at \$100 from him at the strike price.

The specialist owns the stock at \$90, (he just bought it) and sells it to the original buyer at \$100 making a \$10 gain, but the specialist bought the puts for \$10 and that offsets the gain on the stock. The net effect to the specialist is zero, no gain or loss but he will make a commission on the trade and the speculator will sell his puts.

What this is all about, is that when you look at the tape on option expiration, you will see unusual orders of 20,000, 50,000 shares of stock being bid for or being offered. This does not mean that there are actual sellers or buyers for your stock and that it is going up or down. These are arbitrage orders and are limited to a price. The reason they are limited is that on the other side of the equation there is somebody trying to sell a put or a call. So he is patiently hoping that the market maker can either short that many number of shares or buy that many number of shares at that exact price so his in the money puts or calls can be traded.

Often you get a sense of this by watching the option activity throughout the day, especially deep in the money puts and calls. Every twenty or thirty minutes you will see some trade and then you will know what is going on, on the floor. I have seen many naive investors see a 100,000 share bid for stock on the floor and think that it would force the stock up.

In reality that 100,000 bid does not even exist, except only at that price, because somebody is trying to get out of a deep in the money option transaction. So there is no need for the bid to leap frog and force the stock higher and higher as normally would be the competitive position if there was a 100,000 share buyer of stock around. In this case the 100,000 share buyer of stock is a neutral trade, is exercising put options at the same price he is buying the stock and the net effect is usually no effect on the stock.

Similar to this, is the public's misconception of the market on close orders. Market makers and arbitragers who have bought and sold for weeks at a time, going into option expiration, try to extinguish their positions. However, as you get down to the last day they frequently do not trade every

minute each day, for they are totally hedged. The only time they are unhedged is when the options expire at 4:00 PM on the close of business on option expiration and at that point they are either long or short stock and no longer have an adequate hedge in puts or calls.

This is why they close out their positions when the market closes, on the last trade of the day. At that point, it does not matter if they pay up for the stock or down because the offsetting put or call market index goes exactly with the stock and their offsetting transaction will settle in cash with the cash index. They do not care that on the last transaction of the day IBM may go up \$3 from 4:00 PM to 3 minutes after 4:00 PM. They do not care because they may have OEX or XMI puts or calls and they may have to pay more for IBM increasing their cost. However, if they have the puts or calls on the index, it will go up that exact same amount because IBM is in the index and by definition, as IBM goes up, the index goes up. It is completely offset.

The public assumes when they get information about option expiration that the market makers have stock to buy, that the market makers are just going to walk into the market all day long and buy IBM right up to the buzzer. So the public rushes in during the morning and they buy IBM all day and nothing happens. As the day goes on, one by one they get frustrated. As IBM starts to go down and down and down and they start to lose their money and they sell their IBM at a loss and they all wonder, "I thought the market makers were going to buy the stocks!"

In reality, the market makers do have stock to buy. They may have 1,000,000 shares of IBM to buy, but they do not have to buy it until 4:01 PM. when the market is closed on the last transaction of the day. So, for professional option traders, the best trade on option expiration is to go counter to the trend in existence at 11:00 AM in the morning because it is always going to be the public invested in the wrong direction. Then make your maximum bet at 5 minutes of 4:00 PM in the afternoon. At that point all of the premium in the puts and calls has been rung out of the market and you are truly paying for the speculative possibility of the market going up or down in the last few minutes of trading. **Those are by far the most profitable trades if you are unwise enough to trade at all in the gambling casino of option expiration.**

One other professional observation I might make about options for the professional trader, is that these days there are so many highbred types of arbitrage transactions, that one must be particularly careful not to go by just one indicator, such as premium level on options related to the market. Over an average period of time for instance, expansion of call option premium usually means the stock market is going up.

It is usually true, that either there are inside information buyers around or just pressure on the call options to go up which attracts buyers. However, there are unusual times when the premiums go just the opposite to what you would expect. When the market is plunging, the call option premiums go up.

This type of market always fools the trader into thinking that there is a short term low in the market and that something has happened to end the sell program and the option premium expanding means that the market is about to reverse.

Many times this is true, but I have also seen a number of arbitrage situations recently where the professionals are shorting S&P's and buy OEX call options. They are completely hedged. If the market goes down they make money on the S&P future shorts, if it goes up they make money on the call options. Depending on the degree of leverage and the degree of bullish or bearishness they want, they will either buy calls and sell S&P's or they will buy puts and go long S&P's. This usually happens when major moves are under way and people are using maximum amounts of leverage.

During these times the premium levels will give you almost backwards readings from what is normally expected. It is important during these times to use some common sense and see what the direction of the overall tape action is. If the market is very strong down on heavy volume, big leadership on the downside, I would not expect premium level expansion in call options to be a good indicator. But in dull, quiet, everyday type of trading activity, with the market in a normal trading range, call option premiums are quite valid as to what they actually mean.

I might mention one other phenomenon that has occurred quite frequently in the last several years. Professional traders and professional hedge fund managers usually do not buy put options when they think the market is going down as you are paying too big a price. Puts and calls have always had premium levels worth about 12 to 20 points on the Dow Jones in the direction they anticipate. If you think the market is going down and you buy an out of the money put for a couple of dollars, unless the market goes down more than let's say, 20 or 25 points, in theory you are not going to make any money anyway.

So what the professional does when he expects the market to go down 20 or 30 points is to sell calls naked, rather than buy puts. As the market goes down the call premiums collapse point for point with the market, especially if they are deep in the money calls and the professional merely covers his short, buys back his call option and collects the full amount of the premium. Whereas if he had bought a put for \$2 and the market went down 25 points his \$2 put may only go to 2 5/8 or \$3. If he sells a \$10 OEX call naked it would go from \$10, maybe down to \$6 or \$7, he would get the full effect of the drop in the indexes.

What this does, and the reason they do it, is that a professional can usually tell by reading the tape if the market is going up. If he is short calls it is rare that the market ever explodes in such a rapid fashion that he cannot buy his calls back at parity with the market averages. If the market averages open up one day and surprise him they usually only open up 8 to 12 points. It is rare that the market opens up 20 points. However, there are times when there are unusual news items where the market literally gaps open from 18 to 20 points and suddenly call premiums explode. When you see this activity you know that the short call players are trapped.

What we have seen in recent years when this occurs, and it only occurs when the market gaps up through a strike price, because it is the near money strike price where these people are short, is that people start to lose money. Rather than be in a desperate bind to buy the calls back they will merely sell more naked calls of the higher strike, assuming that the market will fail when it gaps open points.

As the day goes on the market does not come down at all. Later in the afternoon it goes from plus 20 to plus 35 points. At this time they must buy back the calls they sold the day before, and they have compounded things by selling new calls at the higher strike, but they are still essentially even. What they have lost on the calls they were naked the night before, they now figure they will make on the next dip having sold calls at a higher price.

What usually happens is that this trend feeds on itself, the market never does dip at 3:00 PM and at 3:15 PM it is up 40 points and by 4:00 PM it is up 45 or 50 points. This forces the market makers again to roll up to the next higher strike, buy back the calls they sold naked at the lower strike and roll up to a higher strike and sell the calls naked.

Statistically, this has given us many three day moves of 30 or more points each day with a Dow Jones movement of about 100 points before all these players are exhausted and they stop selling the naked calls. If you see this pattern on the tape, you usually know it does not last just one day. It will usually last a good three days and a good 100 points or more.

The same thing happens on the down side when the puts get out of control and a few big players, especially in the Bull Market, who instead of buying call options on the way up, sell the deep in the money naked put options. As the market starts to rally they sell naked puts, collapsing the premium, hoping to buy them back at the end of the day. Sometimes they get caught when the market gaps down on them and they have to buy back their deep in the money puts they sold naked and so they sell the next strike down naked. They keep doing this until the market stops going down.

The 1987 crash proved to many people that it was very unwise, indeed, to sell naked puts because of the severity of the declines and the unlimited liability. Now, the only time most market makers will sell naked puts is when there is a very strong trending market that is up on the day, and as long as it is getting stronger and stronger they will continually sell the puts naked right up to 4:00 PM when they usually buy them back as a day trade.

Chapter #10

Cycles

"I cannot emphasize enough how very valuable such knowledge is of the long term trend and how profitable it can be to you to trade with that certain knowledge."

The major cycles consist of the 100 year cycle, the 90 year, the 60 year, the 50 year, the 30 year cycle, the 20 year cycle, the 10 year cycle, the 7 year cycle, the 5 year cycle, the 3 year cycle and the cycle of 1 year.

Most of these cycles as you see are in harmonic relationships to each other. For instance, the 20 year cycle and the 40 year cycle are probably related and the 10 year cycle and the 20 and 30 year cycles may be related. We also know that these are complete cycles in that highs to highs and lows to lows come out on these dates, very similar to prior highs and lows.

There are complete cycles of these lengths. We also know that there are harmonic sub-cycles of shorter divisions. For instance, a cycle of 20 years might give us 1/4 turn movements of 5 years or 1/2 movements of ten years, 3/4 of the cycle every 15 years, and 20 years for the full cycle. It has often been supposed that the 20 year and the 10 year cycles are the ones that give rise to the famous decennial pattern, or the 10 year cycle in that the starting point would be at year 1 up to the opposition point at year 10 and then back down to your 20th year for the next low. This is why we see a 10 and 20 year pattern that seems to repeat over and over again in the stock market.

Basic analysis must start with the historical record of the individual stock, commodity or market average. Because of the lengths of these cycles the more data we have for analysis, the better. Obviously everybody cannot get 100 year old data but there are some charts around if you search that will show graphic representations of the market averages for more than 100 years.

There are also chart books such as the SRC's (Security Research Corporation in Boston) on individual stocks covering 35 years. The Horsey Chart Book Service in Salisbury, Maryland, also covers 5, 10, 20, to even 30 years of activity on selected issues.

In public libraries you will often find the New York Stock Exchange record service, which has a day to day record of each stock listed on the New York Stock Exchange. Depending on the library you might have volumes of these going back 20 or 30 years.

Once we have the data, we can then make a cursory examination of the highest highs and lowest lows to find out if any cycles are obviously present. We should, for instance, see highs to highs every 10 years or every 5 years if those cycles are present in the data. Keeping in mind the theoretical basis of cycles is that time is of a cyclical nature and prices on stocks respond to cycles. Therefore, when a cycle returns to the same place it was, the price levels of individual stocks should likewise return to their exact same trading levels unless there has been a change in the outlook of the company or growth. Under these circumstances, which is the usual, we find that as a cycle returns to its same time period location, it also returns at an exact proportional multiple of that prior price level.

For instance, in 1966 when the Dow hit 1,000 for the first time, we would expect if there was a cycle of 10 years, that 10 years later the Dow might hit 1,000 again or be at a multiple of that price. We clearly see this from 1976 when the Dow hit 1,000 some 34 different times over the course of the year (10 years from the first 1000 in 1966). When we compare this with a cycle of 15 years length, hitting in 1991, we see that the Dow got seesawed above 3,000 (3×1000) for most of the year. We can also see a comparison with 1986 and 1991, the five year cycle, only this time at a Fibonacci ratio of 1.618 times the 1986 price. This is the effect of numbers tying in with cycles.

What our analysis hopes to find, is the beginning and ending points of the cycle and the number and the proportions of these numbers that tie in with those beginning and ending points. Once we have this we can make some good assumptions about how long the current trend in effect will last and what price multiple it will expand or contract to based on the prior cycle. It is truly amazing to see long term cycles repeat almost in an exact fashion.

For example, as I write this book in 1991, one of the dominant cycles is the 90 year cycle from 1901. One of the interesting things I noted this year was that the company U.S. Steel, letter X on the New York Stock Exchange, was listed for the very first time in history on the Exchange in the spring of 1901. In the past several years U.S. Steel changed its name to USX Corp, but in the spring of this year, within a few weeks of its first day of listing, 90 years later, it changed its name back to U.S. Steel again and was relisted under the letter X under the name U.S. Steel, just like it was 90 years ago.

Another obvious example was the recent tearing down of the Berlin Wall, almost exactly 45 years from its erection ($1/2$ of 90 years). This type of information, though rather subjective, gives us a good idea as to identifying which cycles are operative. As we look through our historical record and see price patterns that may appear to the eye to be similar to what is currently happening, we can look at some of the individual sociological events of the day from newspaper clippings and find out if those events are repeating in similar fashion. For instance, there may be a problem with the president's health, there may be a sociological clash with women or with groups of minorities in society, there may be cultural changes. Whatever we notice helps our analysis to determine which is the exact cycle we are dealing with.

If cycles were of fixed lengths, that is, if a 10 year cycle ran exactly 10 years to the day, it would be easy. However, cycles expand and they contract, they breathe out, they breathe in, so we have at best a subjective analysis of the cycle. To keep track of the overall period of time, let us say a 10 year

cycle, our turning points may be off by 1 to 3 months compared with what happened 10 years ago. We must be prepared for some flexibility in our analysis.

The first way to start is to pinpoint the low day 10 years ago, if we are using a 10 year cycle. Knowing that natural minor cycles exist in the stock market of 3 to 4 weeks and 6 1/2 weeks duration, we will often find that these small cycles give us the break points in the larger cycles. So if there was a major low on March 1st, 10 years ago and we expected a minimum 3 1/4 week cycle, (that is what happened 10 years ago) we would look to see if there was a top around March 22nd, 23rd, ten years ago. What we want to do this year, 10 years later, is look anywhere from the middle of February through the middle of March to find an identifiable low point that could have been our low point on March 1st 10 years ago followed by a top 3 1/4 weeks later.

Once we have that identifiable low point on our chart, we can then count our number of days up to our high. It does not have to be the natural cycles of 3 1/4, 6 1/2 weeks, but they work most of the time. What we would actually want to do is count the exact number of days the market advanced 10 years ago from our low.

Most people in starting the analysis make the mistake of going 10 years to 10 years on anniversary dates. They will pick the low on March 1st, assume there is a low this year on March 1st, and if the market back then did not top out until the middle of April, they will forecast that the market will not top out this year until the middle of April.

The problem here, is that if our cycle does not bottom exactly on March 1st this year, but let's say it bottomed the last week in February, the cycle of the same number of days from 10 years ago would no longer top out at the middle of April, but would be short of that by a week or two. So we want to keep track of the number of days up or the number of days down from our identifiable high or low point on our cycle 10 years back.

Having the harmonics of these cycles with the fractional components to break them down is a function of our Gann Square Analysis. Starting with a high, let's say we are dealing with a 10 year cycle, we draw our angles down from the high price at 1 point per day, or a larger square of 1 point per week, or 1 point per month. When these angles go down at those rates they will eventually get down to the zero point based on how many days, weeks or months they are from the all time high. If the price of a stock was \$50, 50 days later, 50 weeks later or 50 months later, our first Gann square of 50 time units would come out.

It is nice to try and find a square that ties in with the overall natural time cycle. For instance a 10 year time cycle might require a 120 month Gann square because this is the normal, natural number of months in the time cycle. So if the market averages were 800, 900, 1000, or 2000 ten years ago it does not matter. We may want try a cycle of 120 or its multiples until we find one very similar to the price level.

Any experimentation with drawing a few squares and subdividing them, and subdividing them, and subdividing them, will show us very quickly if this type of analysis applies to our particular cycle. If

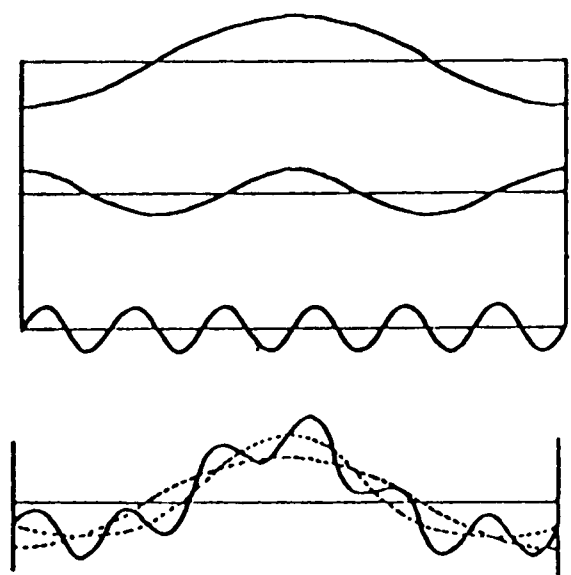
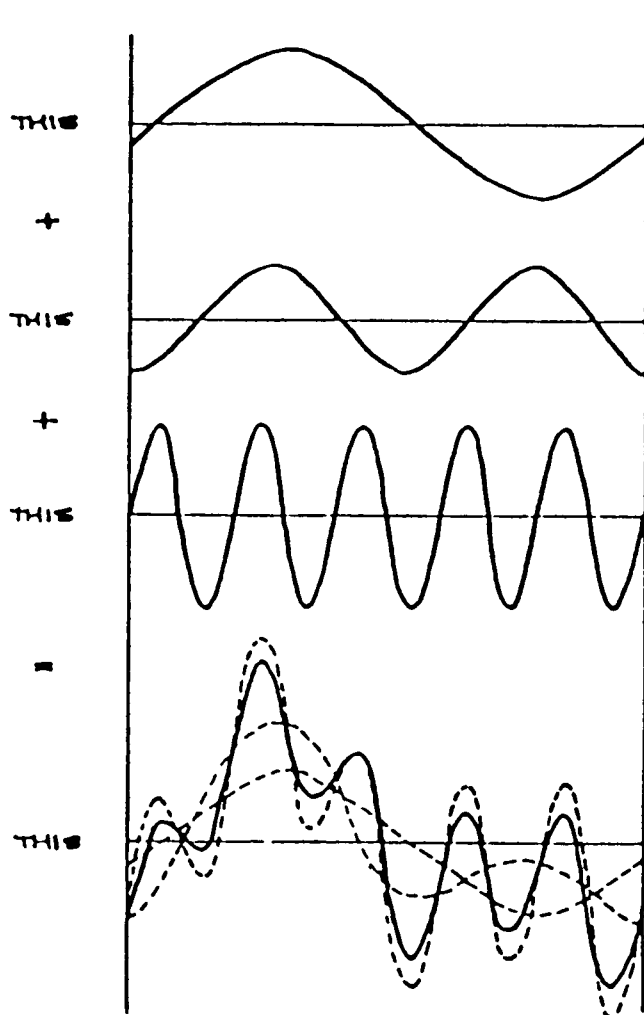
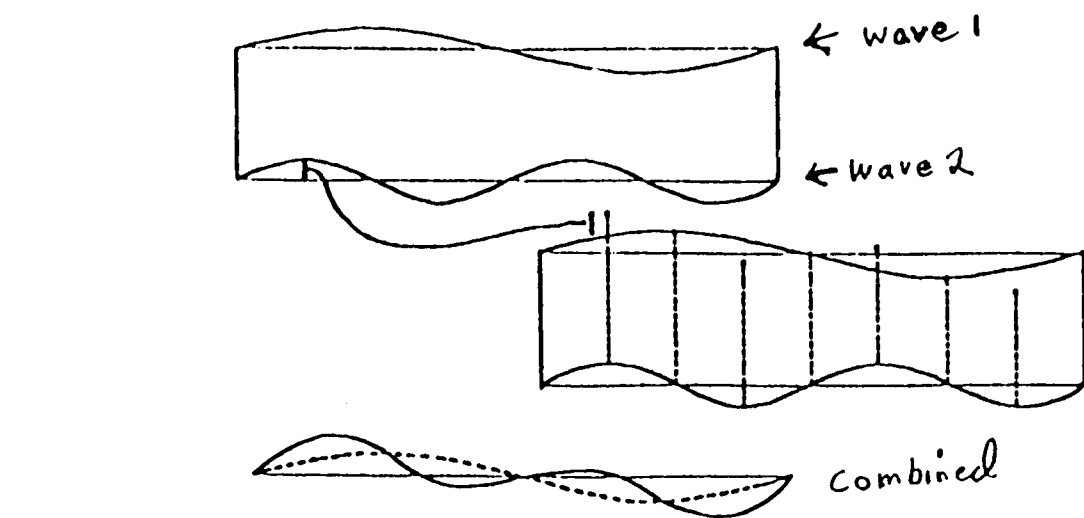
the midpoint of our square seems to hit a major inflection point on the market averages it is reliable. If the 3/4 point hits it again it is even more reliable. If we divide it into 1/8's and we find that all the 1/8's point turns hit, then we know we have a grid that fits the cycle very closely.

At this point we at least have a rough time table based on the subdivisions of our square, as to give us a point when to expect major harmonic turns in our cycle. Remember that these break points will not exactly repeat from the past, but will correspond to highs and lows of the past somewhere near the turning point we have predicted in this time frame.

We now want to go back and check the exact number of days again, keeping track also of the total number of days from the extreme high or low. Even if we are looking for a little rally from a short term low, that might have run 30 days, we will also want to know where that short term low started from in terms of where the final high or low was, which could have been 200 days earlier. In a 10 year cycle, do not forget we are dealing with 1 to 10 years of data. So from each high and low we want to keep track of such counts as how many days they were from the original high or low. This seems like a lot of work, but actually it is quite simple to do and of course with today's personal computers it is no work at all.

Added confirmation of our cyclical turns on the 10 year cycle is given by looking at the price levels at each important high or low. As I mentioned, when the cycle comes back to its origination point each time, the price levels will be mathematical proportionate parts of the prior price level. So if we are dealing with a cycle, let's say 100 years ago, when the Dow Jones sold at 80 or 90, we might very well find a multiple of 10 times that with the Dow Jones Average selling at 800 or 900.

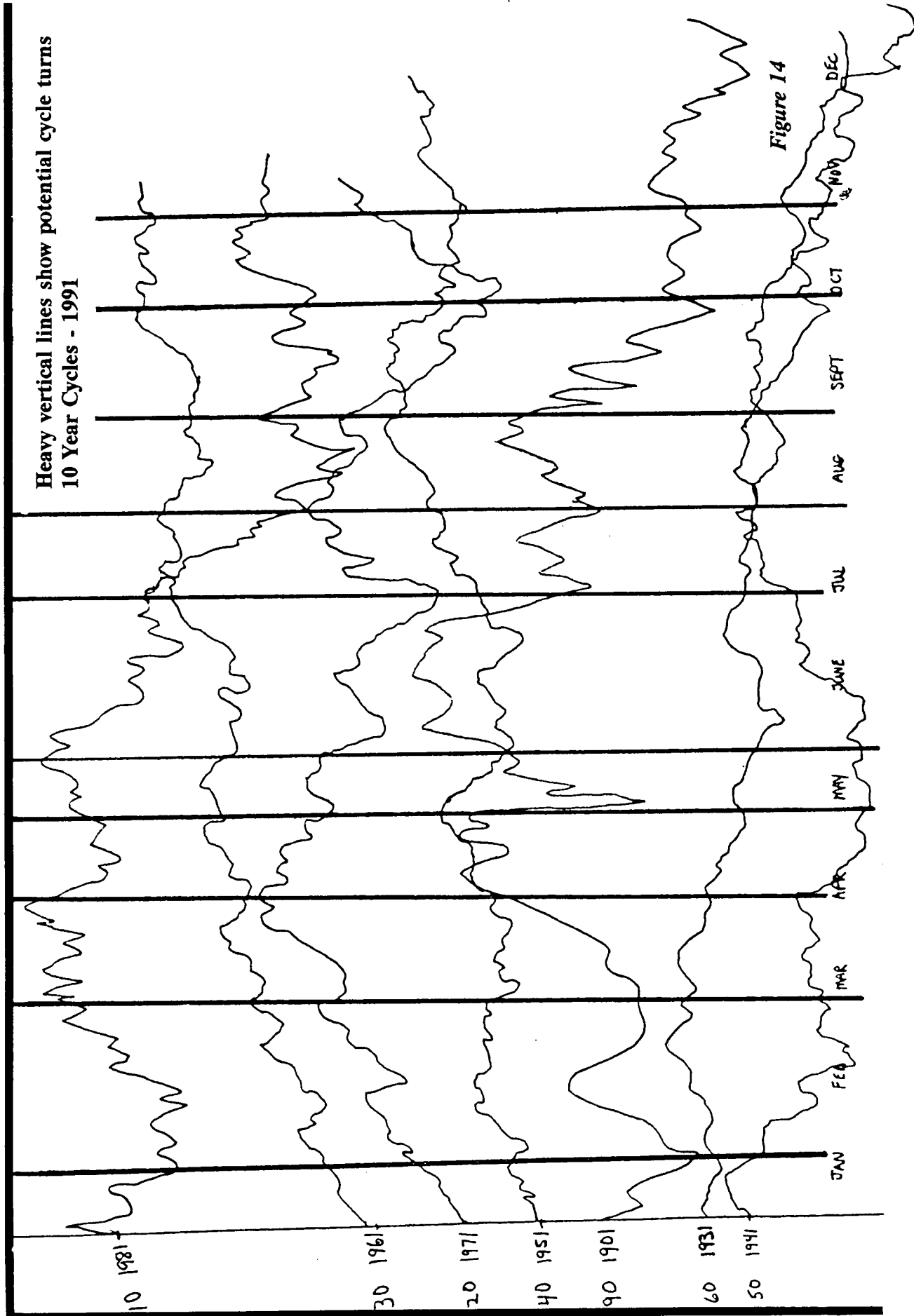
Throughout the 1960's and 1970's the Dow Jones sold at an even multiple of 10 times the prior sixty year cycle price. In 1966 the market hit 1000 and in 1906, 60 years earlier, the market hit 100. That master cycle of 60 years basically followed, true to form, from 1966 all the way into the late 1980's at a 10 multiple of what the price level was. If we find a visible high or low in our cycle, to identify where we are in the cycle, and find that the price level at that time is an exact, proportionate multiple of the high or low in the prior time cycle, then we can make a good forecast as to how long the trend will last and on the expected turning point date what the price level will actually be.



CYCLES ARE ADDICTIVE

Figure 13

STICK FIGURE CYCLE FORECAST



When we combine this type of analysis with our trendlines, our Gann analysis, our Fibonacci numbers, and our hourly chart wave patterns, we find that we can get some very, very accurate projections. When we do our cycle analysis, the first thing we must remember is that cycles are additive. That is, if we have a 10 year cycle that is going up for 3 months, but we have a 50 year cycle that is going down for 3 months, it is very likely our expected outcome will be a flat, sideways movement for 3 months. (See Figure 13)

Whereas, if we had three well known cycles, a 10 year, 20 year and a 50 year, all going down at the same time for three months, not only would our forecast be that the cycle was down for three months but it might be a tremendous down, as all three of the downward cycles add to give their impetus to the movement.

This is indeed what happened in October of 1987. In early October of 1987 I had 12 different cycles going in different directions. As we got into the middle of the month all 12 of them simultaneously went down for periods of 1 week, 2 weeks, 3 weeks and after that short 3 week period, when all of my cycles had been turning down, many of them started turning back up, some continued to go down, some went sideways. What we saw was that the combined influence of all of these cycles going down for a short period of 1 or 2 weeks combined to bring about a devastating waterfall liquidation.

Obviously, those of you who are mathematicians and scientists will want to track and computerize all these cycles and add them up on the computer and get composite cycles. This is very good and will give you a very good composite drawing of what to expect if the cycles you are dealing with are the right cycles for that time period. However, for the average person this is not even necessary. We are just doing a cursory exam of cycles to get a rough idea of how to forecast the coming year. This can easily be done in a matter of minutes on a simple piece of graph paper by just merely going from point to point and marking the visible highs and lows on each of our cycles.

For instance, on a vertical column on your graph paper list your cycles, 5 years, 7 years, 10 years, 20 years, 30 years, 40 years, 50 years, 60 years, 90 years, 100 years and whatever other cycles you think are significant. Then go to your 10 year cycle, say you look at the month of January, if it basically goes down all month draw a general down trending line for the month of January. If it stops at the middle of the month and turns up, make a little "V" pattern.

Then trace out the 10 year pattern in kind of a "*stickfigure*" on your graph paper month by month. There are usually not more than one or two inflection points a month at most, so it might only take us 30 seconds to a minute to quickly draw out the general direction of stock prices on the 10 year chart. (See Figure 14)

We do this for each of our cycles in turn. When we are done with this analysis we can easily see the time periods that have simultaneous turns in the market. We may find for instance, that in the month of February all major cycles make a turn. Let's say, we are dealing with ten cycles, 8 of them have major lows and then go up the next three months. What I often do is draw a red vertical line down through the whole series, the 10, 20, 30, 40, 50, right down through that inflection point to let me know that coming up in the middle or end of a certain month there is a high probability that there will be a major change in direction.

This is also the point in time each year when we want to revise our forecast. If our 10 year cycle has been tracking very closely, if there is going to be an aberration and the cycle is going to jump from a ten year, being the dominant cycle, to the 60 year, it is at these inflection points where the cycles jump.

This is another basic fact that is often overlooked by people when they first learn about cycles. When you are forecasting a major turn in the market, based on a cycle from the past, two things could happen. Either the current cycle will change from the existing cycle ten years ago or the turn ten years ago was an aberration of the true ten year cycle. If we went back ten years prior to that, we would not find the turn on that date going in the same direction. It may have been what we call a cycle inversion. That is, a turn in the cycle in the opposite direction of what is predicted or the opposite direction of what it did in the past cycle.

These happen frequently and play havoc with our long term forecast. However, when we get to that pivot point since we know it is a pivot point, there is no need to make a mistake as to which way it is going. If we find that we get to our turning point date and the market starts going in the opposite direction, we have to assume that from that pivot point, until the next forecasted pivot on our model, the trend in effect will be in the same direction. Even though it might be exactly backwards from the direction that occurred on the prior, let us say ten year pattern. If we have a cycle inversion, we must be aware that there will probably be another inversion in the not too distant future, that will flip the pattern back for the major cycle.

Cycle inversions only occur in short periods of time, 3 to 6 weeks in short cycles and maybe 3 or 4 months in a long cycle. Since long term patterns, like 10 year, 20 year and 60 year patterns work over and over and the highs and lows in the stock market follow these long term patterns, you cannot have one of these cycles invert forever. The inversion is some minor cycle that will drop out, and it will be over and done usually within a 3 to 6 week natural cycle. Then we will find ourselves getting back on track, getting caught up with the original projection.

Keep in mind when using our graph paper technique, of adding up the sums of the directions of the various market cycles, that we are not doing this mathematically precise, we are just visually looking at all the cycles and summing them up in our head. This is all that is really necessary because when we trade, we do not trade off of a specific forecast, we use the forecast to plot our trading strategy, not to trade. If the forecast says that the market is going up the next three months, we do not blindly just buy and go away for three months and assume we have made money.

What we do, when we forecast the market will go up for three months, is to look at the ticker tape, using our technical analysis tools, such as trendlines, overbought, oversold oscillators, and whatever tools we are using, to give a valid technical buy or sell signal. If we get our technical buy signal and it goes with the forecast, we develop our strategy to buy all the dips and assume the forecast will work, ever keeping in mind a stop loss discipline if the trend actually starts to deviate from the forecast. Because of this, it is not that necessary to have a detailed, minute to minute forecast of our cycles. These are just stop signs along the road of our game plan to investing.

For many years, a famous technician, George Lindsey, whom I had the privilege of knowing until his death in 1987, developed a technique called Mirror Image Forecasting. Although, he is widely cred-

ited for developing this and practicing it to a high art for over a 30 year period, and writing a newsletter and making incredible predictions, there were many others who used this technique all the way back into the 1800's. What this technique involves is very similar to what we have talked about in our cursory graph presentation of cycle analysis.

From every major high and low in market history, we record on a piece of graph paper the direction the market went from each of these highs and lows. What the mirror image fold back pattern tells us is that time goes both forward and backward. So for example, if the bull market in 1980 went from the low in March up until year end, and then went down again, at some point in the future this cycle of going up that many months would fold back and go down the same number of months.

What the actual analysis consists of, is that on January 1st of this year we are "X" number of days from the all time market low of December 1974. We would calculate the exact number of calendar days we are from the low in 1974, and that would equate to January 1st of this year. We now want to graph a visible pattern that occurred prior to the low in 1974, the **same exact number of days** that we are today (January 1st), but going **backwards in time** from that point on a day to day fashion. Whatever the market did in a backwards graphic fashion we would expect to happen from January 1st of this year on.

We do this for several historical observations. Taking all the major Bull and Bear Market highs and lows, we keep track up to January 1st of every year, the exact number of days we are from each of these highs or lows. The initial graph paper might require a lot of work but maintaining it year to year is quite simple. Even if we have 20 or 30 different observations of major all time highs or lows, we know as of January 1st of each year, the exact number of days we are from each of those highs and lows and the next year when we do our projection we need only add 365 days. (See Figures 20, 20A)

The essence of the analysis is that we will end up with 15 or 20 observations. We will draw on our graph paper from January through December of this year, a little stick figure representation of what the market averages did backwards from these points so many years ago. We then visibly look up and down, in a vertical fashion, the month of January, February, March, April on our comprehensive graph sheet to see if we can find common inflection points.

This technique actually works very, very accurately. George Lindsey was able, years ahead of time, to forecast the market averages within a day or two of major turns and predict which direction the turns would go and exactly how many days it would last. This was possible because of cycles.

Now in the actual mirror image fold back technique we don't have to address cycles *per se*. We are just using the numbers of the days of the week and the patterns themselves. Remember that these patterns are a form of cycle.

Today, an easy way of doing this is to use Xerox transparencies. If you have a Xerox machine that takes plastic transparencies, you can simply photograph backwards your chart pattern. Xerox the Dow Jones averages over the last five or ten years and then turn your transparency backwards. You will have a beautiful graphic representation of a mirror image fold back.

If you take this transparency approach with ten different market years, and line them all up vertically, you will see at a glance 4 or 5 major pivot points over the course of the year. We can then look at our normal forward moving cycles, like the 10 year, the 20 year, the 30 year and see which of those patterns give us a pivot point at approximately the same date, and will help us on the direction of the move coming out of that pivot point.

For years I was able to make accurate, long term predictions on the stock market based on these rough graphic sketches, whether they be 10 year, 20 year, 30 year composite pictures, or the mirror image fold backs. One thing which is very good about this analysis is that once you have one of these cycles that is working, they have a tendency to persist for long periods of time before you have to make an adjustment to the forecast.

On long term cycles of 10 or 20 years, it is often the case that a trend in effect will last for at least three to six months, sometimes nine months. So during that time period you will have a very accurate forecast and be right on the market with all of your trading, whether you buy every single dip or short every single rally.

I cannot emphasize enough to you how very, very valuable such knowledge is of the long term trend and how profitable it can be to you to trade with that certain knowledge.

I might allude to one important cyclic point at this time to motivate you into further research. Although many people believe the BIBLE is a document of many things, I can assure you that you will find the keys to all major cyclic themes in life hidden in this work. One example is sufficient. The key prophetic cycle is 360 days, and 360 years equal to the 360 degrees of the circle. Although we use 365.2422 days to the astronomic year, this is not so in prophecy, which is 360 days to the year. For example, Abraham Lincoln was assassinated on April 14, 1865. John Kennedy was assassinated on November 22, 1963. The time period between these dates is 98.608 years by our counting, but the actual days are $365.2422 \times 98.608 = 36016$, or if we divide by the prophetic year of 360 days we get 100.04, only two weeks off from a perfect 100 year cycle! You might want to check some stock market cycles for this adjustment factor. It might also not be a bad idea to read the Bible!

THE TEN YEAR DECENIAL PATTERN

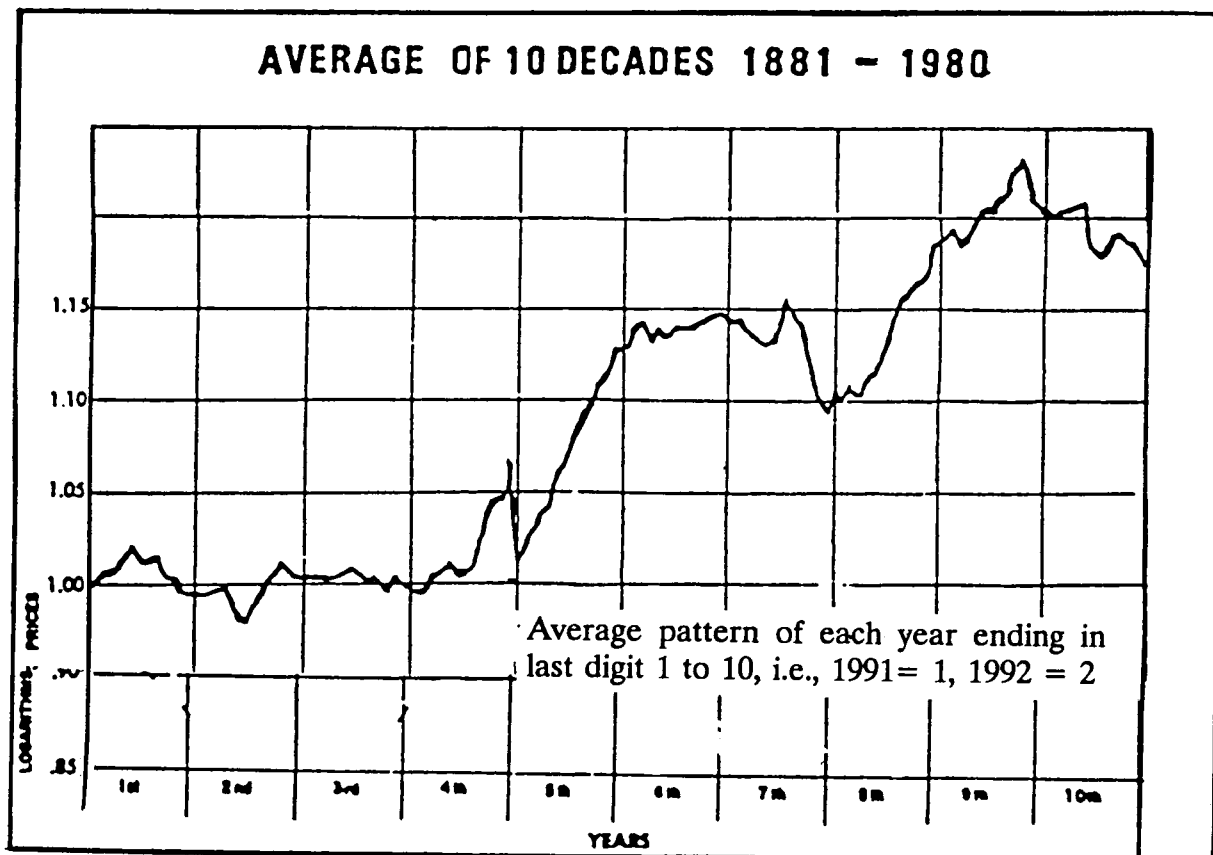


Chart courtesy of
Arthur Merrill, Technical Trends
P.O. Box 792, Wilton, CT

Chapter #11

What is a Professional?

"Professional traders are merely odds makers who speculate when the odds are all in their favor."

You will find that professional trading encompasses more than just business organization. First, there is an attitude towards speculation that it is a business, not a gamble, not a crap shoot. More important, it is a belief that it is a legitimate business, a profitable business, where money can be made month after month, year after year consistently, in good times and bad. Much of this has to do with what I call a professional attitude toward investing.

This attitude is exclusively risk oriented. The professional trader has to make money. He cannot be subjectively biased by his belief, by his value system, newspaper articles or peer pressure. He must have an overriding concern for losses and being wrong on the direction of the market movements. Making money is never a problem, taking profits is not a problem, but a true professional especially knows how and when to take losses.

A professional also trades slightly different than the average retail brokerage firm customer. Often the word "professional trader," designates people who either own seats on the various stock exchanges, or have agreements with business partners who own such seats. The advantage, of course, of owning a seat on the stock exchange is that you do not have to pay commissions. However, there are usually minor service charges, called clearing charges that must be paid for clerks to process the order, write up the tickets, and submit them to the computerized clearing firms, but these are token charges.

For instance, if you buy 1000 shares of IBM, you may have a ticket charge of between \$2 to \$3, to maybe as high as \$15 in total. This would be the same charge, whether you bought 1000 shares or 10,000 shares. Because of this low overhead, without commissions, professionals, who have a business do have an advantage over the public. Buying 1000 shares of IBM and seeing it go up 1/8 of a dollar, which is a \$125 profit, a professional is free to sell the stock, and with very small ticket charges realize almost the entire gain. The average person who uses a broker, might have to pay 10, 15, maybe 20 cents a share, each side of the buy and sell in commissions. He is literally incapable of making a profit on only a 1/8 fluctuation.

Nowadays, with the advent of discount brokers and deep discount brokers, much of this has been eliminated. There are many brokers, who advertise in newspapers on a nationwide basis stock com-

missions as low as 1 or 2 pennies per share, and most will certainly do business at 7 to 10 cents per share. So the professional trading advantage that insiders and members of the stock exchange used to possess, has largely been eliminated, as a barrier to professional trading for a living.

There are other advantages professionals have, such as capital requirements. In many cases, owning a seat on the stock exchange floor allows you different margin requirements than the average public. Sometimes becoming registered as a market maker allows you even more privileges.

By and large, what this book is about **is professional trading techniques and secrets as to entry and exit points into profitable trades.** For most purposes, commissions are no longer a consideration, nor is leverage. The public can often times use options or financial futures and acquire leveraged positions for as little as 10 percent down or less.

In professional trading, time horizons are much shorter. To a professional, every month is like a year, every week is like a quarter, every day is like a week. A professional will almost always make money every month. He will have an occasional losing week and he could have several losing days, but by and large if a professional starts to lose money he will stop trading. He will cut down on his trading size until he becomes profitable.

I have often seen professionals who trade 1000 to 5000 shares of stock a day, who, if they start to lose money, will cut their trading in half. One professional I know, who trades often up to 5000 shares a day, if after 2 or 3 days of losing money, will cut down his positions to as small as 100 to 500 shares until he consistently starts to make money again.

This is a good principle to follow, as often our own internal cycles are detrimental to our own profitability. It is then that our rigid discipline, our technical tools and our professional attitude towards losses, saves us.

Professional traders are merely odds makers. You can never be absolutely certain, but you can speculate when the odds are all in your favor. This is the big difference between gambling at Atlantic City Casinos, and trading in the speculative markets. In gambling, you are taking a risk, in the stock market you are also taking a risk, but you are taking a risk when all the odds are in your favor. You are free to pick and choose what the trades will be, and how you want to stack the odds.

Do you want to wait for a near certain trade, a 90% probability, or are you willing to take a small probability of only being right 60%? The best trades have the probability as high as 90% of being right on the main trend, and also have a high probability that the direction and momentum of the movement will be so extreme that the profits will be large. It is one thing to be 80% right on a trade, and only having the prospect of making \$1 on an individual stock, and another being 80% right on the direction of the trade and having an 80% probability that the stock will go \$10 to \$30 in that direction.

The professional spends most of his time setting the odds on how he will play. He does not allow

news events or peer pressure or other items to set the odds or the rules of the game for him.

When you are consistently around Wall Street, employed as a professional, day in and day out, there are many fringe benefits. The most obvious, and the one overlooked by the public is the opportunity benefit. There are times over the course of the year by just having the right of being at the Stock Exchange when an explosive move in the market gets under way, that people connected with the market will make unlimited amounts of money in a short period of time. Those people who happen to be school teachers or construction workers or in other areas of life, do not have that opportunity. They can only read in the papers several days later that the market was active.

A professional trader learns to recognize opportunity. When opportunity presents itself a professional will act. It is a crime to be a professional trader and see a major move underway and not do anything about it because of fear of taking a loss. A professional, usually follows the trend quite quickly and is quite happy to be stopped out of the trade at a small loss, if he is wrong.

Another characteristic of professionals is that they employ strategy. Most of the public being fundamentalists, have no strategy at all. They merely think something is going to go up over time because of some fundamental development, and everything is thrown into the pot known as long term investing. The professional trades all the time and only short term. He never trades for long term capital gains, and he is never concerned about tax consequences. Money is money, profits are profits, and whether you pay 10% tax or 90% tax, if you have a profit, you have more than you had the day before.

Therefore, the consideration that the professional has is how best to exploit the opportunities that present themselves. Does he want to be a Bull or a Bear? Does he want to buy the dips or sell the rallies? What is the best way and the best vehicle to employ such a strategy? Does he want to use leverage, options, futures? Does he want to pyramid? What are the active markets, stocks or commodities? A professional cannot afford to tie up his money in idle stocks or commodities that are not moving. His cash flow must pay his bills. He cannot buy a great quality stock that is just lying dormant. He must restrict his investment activities to big movers.

Because of this, the professional has no need to catch the high or low "tick". He is merely interested in making a consistent profit in the middle. Although the techniques in this book teach you how to find the high day and the low day and to predict the cyclical changes in the market, these forecasting tools are of use only for setting your trading strategy. Professional trading itself is a highly specialized, disciplined activity and forecasting has nothing to do with it.

Once you make a trade, and you are in it, profit and loss is the only consideration, not the forecast. The forecast is used to set your strategy, of being a Bull or a Bear; setting the odds as to the probabilities of success, the magnitude of the success, and watching the tape activity based on that forecast, to see if the technical conditions and the tape validate the strategy.

Professional trading strategy is a lot like poker playing. Professionals are constantly watching the other players in the market, be it mutual funds, the public, well known television commentators, or

any other force that has an influence on the market. Themes and group cyclical activity must be considered. If one group is showing weak earnings reports, professionals will develop a strategy to short the stocks prior to earnings announcements. If the market is mesmerized by economic statistics being released at recurring intervals, professionals will not trade around those intervals where there is little likelihood of major movement, until the figures are released.

A professional will usually let the market tell him when it is time to change. He will exploit a specific strategy until he loses money. That is, he will buy a dip, day after day, after day, as long as it is profitable, and the first time he starts to lose money he will change his strategy. On the Bear side, he will short a rally. The public on the other hand will often buy a dip once, take a quick profit, and immediately start shorting rallies. They will get confused as to the long term trend direction.

A professional trader knows that making a living in the stock market is hard work. That in reality, it is like a game, and that you must know the rules of the game. The rules are not variables. The rules say, buy or sell, you win or you lose. The idea of the game is to lose as little as possible, not to make as much as you can. If you try and make as much as you can, you are going to have large wins and large losses. The rules say, lose as little as possible and you will win consistently.

The public does not know such rules exist. The public invests for long periods of time under the accepted notion, that it is okay to lose money. It is okay to lose 20%, 30%, 40% over six months, because in the long run, the market always comes back. This is absolutely ridiculous. There is no such thing as investing over the long term unless it is profitable positions day after day, week after week, that are making money. Simply investing and holding stocks in a losing position, is just plain stupid.

I learned a great lesson starting off in bank trust departments. I had first hand experience in looking at very wealthy people's accounts over 20, 30, 40 year periods and seeing that often, people owned a stock that went from \$10 to \$200, \$300 to \$400 dollars, and split many times, and made them infinitely wealthy. However, as time went on they could do nothing about their holdings, but watch them go up and down 20%, 30%, 40% every couple of years, because of the huge and steep, onerous tax burdens. Many people had an adjusted tax basis of a fraction of a dollar.

In the final analysis, it was always that they could not sell because they would have to pay 20 or 30% of the stock's value in taxes, and unless the market was going down 20 or 30% it made no sense to sell. The lesson from this is, pay your taxes currently. If you want to keep a position over 20, 30, 40 years, buy every dip every time it breaks out, make certain you buy your position back but do not blindly buy and hold and be afraid to sell because of the tax consequences. People can get guaranteed income of 7 to 9 percent on a long bond. What is wrong with short term trading profits of 40%, 80%, 100% per year and paying taxes on them?

Professional trading is a humbling experience. You must be capable of trading without personal pride, dignity, inability to admit defeat. Being wrong is part of the game and being wrong many, times is expected. No one can be a successful trader unless they have taken many, many losses. It is the magnitude of the losses and how quickly they are taken, which is important.

The professional trader, more than anyone else, learns from his losses, his mistakes, not his winning trades. The public only looks at their winning trades, and how successful they were, and ignore their losses out of shame. The professional studies his losses and vows never to have them repeated.

Chapter #12

Professional Trading

"You must be 80-90% right on the primary direction but also 80-90% right that your sale at a specific profit goes off."

Professional trading differs from investing in many regards. To the professional trader the most important consideration is not profit or how to make money, but losses and how to avoid losing money. As I have said before, the only thing easier than making money in the stock market is losing it.

From the professional standpoint, the trader does not care how big his gain will be, or how long it takes to get it, or if he is right or wrong. His only consideration is not losing money. To the professional trader opportunities come every day of the week. The professional is a technical trader. He knows how to read the tape, he knows how to pick stocks and there are thousands of opportunities to choose from. He is somewhat similar to a professional odds-maker in gambling. It has often been said, that the difference between gambling and speculation is that in the case of speculation, you are taking a **risk** when the **odds are entirely in your favor**.

Being a professional odds-maker, a professional trader only takes those trades when, in his judgment and assessment, the market conditions, fundamental, technical and all the tools of his trade, show the odds are probably 80% to 90% he is right in the direction of the market and the trade. However, more important, if he makes the trade, what kind of risk is involved and when he can get out of it if he is wrong, and how much money will he lose if he is wrong.

There are many times when the professional trader knows exactly what the market is going to do and will refuse to make a trade. He may know the market is going up another twenty points to an all time high. However, if the assessment is such that in that final twenty points something could go wrong, and the market could suddenly reverse on him, the risk factor involved in being wrong or having an accident happen is far too great to make a trade, so he will let the trade go by and not trade at all. This is a consideration that entirely escapes the average person who is not used to making money on a professional basis. The average person has been duped by the large brokerage firms into **accepting losses**, in the belief in some distant, "**long term**", investing horizon, where all investments eventually workout fine.

Remember, the professional trader makes a living exclusively from capital gains month in, month out. He must make money every single month that he trades. He may occasionally lose money on a day to

day basis, a few times a year lose money on a weekly basis, but he will rarely lose money on a monthly basis. This is due to his ability to weed out the bad trades and only trade with all the factors in his favor. More importantly, he has an exit point that is clearly defined as to degree of risk, amount of money, and amount of time it takes him **to find out if he is wrong**. This is **all done before he makes the trade**. Many good professional traders I know will often watch the ticker tape all day long, for days on end and never make a single trade. **Learning how to do nothing is a very important trait. Knowing when not to trade is often much more important than knowing when to trade.**

For instance, when the market is in a trading zone bound by heavy resistance just above, and major support just below, and is neither going to break out to the upside nor break down dramatically to the down side, and there is significant economic news that is being released within a day or so, such as a GNP report, trade balances, options expiration, or Presidential speeches or trips, trading would be curtailed significantly rather than gamble.

During these times the professional trader knows that the opportunities for a major move in the stock market are quite limited. Therefore, trades made during this time period are subject to frequent whipsaws, small gains and lots of random noise. If one decides to trade in such an environment he must adapt his strategy to very short term scalping. Buying on the bid side, immediately offering it for sale 1/4 point higher, not expecting \$2, \$3, \$4, on some big move.

Often times the technical analysis will tell us what these opportunities are. If we are near a major trendline we know that we are probably not going to go through that trendline, and if the market is just too overbought or oversold to penetrate that trendline in the other direction, or bounce off it, then the probabilities are not good in making the trade.

Another factor in assessing risk versus reward is that a professional understands the amount of leverage to take on any one trade. When there is significant potential in the stock market, such as a major basing period over weeks and months, or economic conditions have suddenly changed unexpectedly to the better and the stock market breaks out of a trading range, then more leverage would be considered. This type of opportunity is immediately seized by the professional, where not only are the probabilities good for trading with the primary trend but one may use leverage, such as options and financial futures to double and triple one's normal position and get a very large profit with a reasonable amount of risk.

Most other times when trading probabilities do not exist, leverage may be totally inappropriate to the professional trader who must be 80% right on the trades he picks. Being right 80% of the time, as to the direction of the market, is not an advantage if you use leverage inappropriately. A highly leveraged position that goes against you 20% of the time when you are wrong on the direction, can still destroy your overall performance over the course of a year.

To a real professional trader it is usually discovered that his true rate of return is made in three or four spectacular trades during the year, when the stock market spends six weeks going in one direction, i.e. 200 points. The rest of the year is spent entirely keeping out of trouble, breaking even, and a lot of small scalping trades.

The opportunities for large money rewards and the use of leverage do not exist everyday. This too is a distinguishing characteristic that the professional knows how to assess but which the average public investor has no conception of. To them, the equal probability of the market going up or down any one day is the same. **They do not know that major moves only happen 2, 3, 4 times a year at most, and they do not know how to recognize major moves.**

The professional knows that when a major move exists, and he recognizes it, he must do something about it. For that is what being professional is all about...**seizing the opportunity when it happens.** This is where our knowledge of historical measured moves comes in and **what is normal market action and what constitutes abnormal moves.**

Since there are so many opportunities in the stock market to make money, the professional trader is never emotionally attached to any one trading vehicle or stock. He learns to risk his capital in the most attractive markets. When stocks are dull and there is no hope for a major turnaround, his attention might be focused on soybeans, gold, foreign currencies or bonds, but he will always try and keep his capital employed in the most active tradeable markets and avoid the quiet ones.

He tries not to have a personal, subjective bias to any one particular trading vehicle, such as gold. Even though he may think the long term outlook is very clear, if there is no volatility on the tape, he learns not to waste his time and his capital trading it now. The big money is made investing with the main trend, well off the lows and well before the highs. That is where most of the easy money is made by the professional.

Professionals treat stocks, commodities, options like a grocer would heads of lettuce. The produce truck comes almost every day and dumps off a major shipment. If you buy a head of lettuce, let us say for \$1, you are not looking to sell it for \$1.30 or \$1.50, you are looking to sell it for \$1.10 or \$1.15 and to sell quite a few. The professional trader treats stocks this way. 1000 shares of IBM bought in the morning up 3/8 is \$375. A professional might make that single trade 3, 4, 5 times in a single day, trying to scalp out 1/4, 3/8, 1/2 and maybe net out \$500 to \$1000 every day on a 1000 share position.

I have known many option players, who only trade 20 or 30 options, which is the equivalent of 2000 or 3000 shares. They buy the options at \$1 and no matter what they think about the prospects for doubling, tripling, quadrupling their money, they offer it for sale at 1 3/8 of a dollar. The **probability of being successful** in that trade is very great.

Professionals can usually tell the direction of the market and if the stock will go up \$1 or \$2. If they don't try and get the maximum out, they will probably be 95% right and they can get a minimum fluctuation of a 1/4 or 3/8. If you buy 30 calls, (3000 shares) and make 3/8 on it, you are making \$1000 a pop. If you can further be 90% to 95% right when you do that...it does not take a rocket scientist to figure out that your money adds up very quickly!

That is not to say that the professional will deliberately turn down a much larger profit if trading conditions warrant. In a major blast off of a new Bull Market, where the breadth is spectacular and the

market is going up 50, 60 points per day, and the average glamour stock is going to be up \$2 or \$3 at the end of the day, it is not reasonable for a professional to look for 1/4 or 3/8. A professional at that point would buy 100 call options (10,000 shares) and sit on them for up to three days and get \$2, \$3, \$5. However, those opportunities do not come everyday.

For the day to day opportunities, it is always a function of the highest percentage batting average, trying to get wins of 90%, 95%. Even though they are small wins, small percentages add up tremendously when you have many, many trades. Just like the grocer who sells truckloads of lettuce, marked up at only pennies, it adds up to big money when done in volume. In the final analysis, the professional trader/odds maker has two probabilities to calculate:

- 1 - The probability of direction.
- 2 - The probability of making x amount on the vehicle he has chosen to trade the trend with.

In other words, you must be 80-90% right on the primary direction but also 80-90% right that your sale at a specific profit goes off. Being right on the move but never realizing the profit because the move wasn't big enough can be a real disaster. This is another very important distinguishing characteristic that separates the professional from the public...**knowing that banking a successful trade is more important than being right!** Strategy is used to fix the odds that put the most winning trades in the bank.

Remember, once you are in a winning trade with a profit, your odds automatically start to decline from 90% to only 50-50% after the run. You must have a strategy to bank the profit before that 90% trade becomes a badly executed nightmare. Because of this, almost all traders have a rule, to use a stop loss but never a stop loss that results in a loss after a profit has already been achieved. If you lose on a trade, it should only be because it went against you from inception and you were stopped out at your predetermined risk level, not at a loss after a good profit run that was not taken!