If you can download your data at the end of each day, do your homework, write down your orders for the day ahead, watch the opening and record your entries, and then track your market each day, adjusting your profit targets and stops—if you can do all of this for several months in a row, recording your actions, without skipping a day—then you probably have the discipline to trade that market. Someone who is in it for entertainment will not be able to paper trade this way because it requires work.

To paper trade your system, download your data at the end of each day. Apply your tools and techniques, reach trading decisions, calculate stops and profit targets, and write them down for tomorrow. Do not place your orders with a broker, but check whether they would have been triggered and write down those fills. Enter paper trades in your spreadsheet and your trading diary (see Chapter 8, "The Organized Trader"). If you have the willpower to repeat this process daily for several months, then you have the discipline for successful trading with real money.

Still, there is no substitute for trading with real money, because it engages emotions more than any paper trade. It is better to learn by putting on very small real trades than paper trades.

Triple Screen Update

One of the most pleasant encounters that occur several times each year is when a trader comes up to me at some conference and tells me how he started trading for a living after studying my book or participating in a Camp. At that point, he may be living and trading on a mountaintop, and as often as not he owns the mountaintop. I noticed long ago that half-way through our conversation these people become slightly apologetic. They tell me they use Triple Screen, but not exactly the way I taught it. They may have modified an indicator, added another screen, substituted a tool, and so forth. Whenever I hear that, I know I am talking to a winner.

First of all, I tell them they owe their success primarily to themselves. I did not teach them any differently than the dozens of others in the same class. Winners have the discipline to take what is offered and use it to succeed. Second, I see their apology for having changed some aspects of my system as an indication of their winning attitude. To benefit from a system, you must test its parameters and fine-tune them until that system becomes your own, even though originally it was developed by someone else. Winning takes discipline, discipline comes from confidence, and the only system in which you can have confidence is the one you have tested on your own data and adapted to your own style.

I developed the Triple Screen trading system in the mid-1980s and first presented it to the public in 1986 in an article in *Futures* magazine. I updated it in *Trading for a Living* and several videos. Here I will review it, focusing on recent enhancements.

What is a trading system? What's the difference between a method, a system, and a technique?

A method is a general philosophy of trading. For example; trade with the trend, buy when the trend is up, and sell after it tops out. Or—buy undervalued markets, go long near historical support levels, and sell after resistance zones have been reached.

A system is a set of rules for implementing a method. For example, if our method is to follow trends, then the system may buy when a multi-week moving average turns up and sell when a daily moving average turns down (get in slow, get out fast). Or—buy when the weekly MACD-Histogram ticks up and sell after it ticks down.

A technique is a specific rule for entering or exiting trades. For example, when a system gives a buy signal, the technique could be to buy when prices exceed the high of the previous day or if prices make a new low during the day but close near the high.

The method of Triple Screen is to analyze markets in several timeframes and use both the trend-following indicators and oscillators. We make a strategic decision to trade long or short using trend-following indicators on long-term charts. We make tactical decisions to enter or exit using oscillators on shorter-term charts. The original method has not changed, but the system—the exact choice of indicators—has evolved over the years, as have the techniques.

Triple Screen examines each potential trade using three screens or tests. Each screen uses a different timeframe and indicators. These screens filter out many trades that seem attractive at first. Triple Screen promotes a careful and cautious approach to trading.

Conflicting Indicators

Technical indicators help identify trends or turns more objectively than chart patterns. Just keep in mind that when you change indicator parameters, you influence their signals. Be careful not to fiddle with indicators until they tell you what you want to hear.

We can divide all indicators into three major groups:

Trend-following indicators help identify trends. Moving averages, MACD lines, Directional system, and others rise when the markets are rising, decline when markets fall, and go flat when markets enter trading ranges.

Oscillators help catch turning points by identifying overbought and oversold conditions. Envelopes or channels, Force Index, Stochastic, Elder-ray, and others show when rallies or declines outrun themselves and are ready to reverse.

Miscellaneous indicators help gauge the mood of the market crowd. Bullish Consensus, Commitments of Traders, New High–New Low Index, and others reflect the general levels of bullishness or bearishness in the market.

Different groups of indicators often give conflicting signals. Trend-following indicators may turn up, telling us to buy, while oscillators become overbought, telling us to sell. Trend-following indicators may turn down, giving sell signals, while oscillators become oversold, giving buy signals. It is easy to fall into the trap of wishful thinking and start following those indicators whose message you like. A trader must set up a system that takes all groups of indicators into account and handles their contradictions.

Conflicting Timeframes

An indicator can call an uptrend and a downtrend in the same stock on the same day. How can this be? A moving average may rise on a weekly chart, giving a buy signal, but fall on a daily chart, giving a sell signal. It may rally on an hourly chart, telling us to go long, but sink on a 10-minute chart, telling us to short. Which of those signals should we take?

Amateurs reach for the obvious. They grab a single timeframe, most often daily, apply their indicators and ignore other timeframes. This works only until a major move swells up from the weeklies or a sharp spike erupts from the hourly charts and flips their trade upside down. Whoever said that ignorance was bliss was not a trader.

People who have lost money with daily charts often imagine they could do better by speeding things up and using live data. If you cannot make money with dailies, a live screen will only help you lose faster. Screens hypnotize losers, but a determined one can get even closer to the market by renting a seat and going to trade on the floor. Pretty soon a margin clerk for the clearing house notices that the new trader's equity has dropped below limit. He sends a runner into the pit who taps that person on the shoulder. The loser steps out and is never seen again—he has "tapped out."

The problem with losers is not that their data is too slow, but their decision-making process is a mess. To resolve the problem of conflicting timeframes, you should not get your face closer to the market, but push yourself further away, take a broad look at what's happening, make a strategic decision to be a bull or a bear, and only then return closer to the market and look for entry and exit points. That's what Triple Screen is all about.

What is long term and what is short term? Triple Screen avoids rigid definitions by focusing instead on the relationships between timeframes. It requires you to begin by choosing your favorite timeframe, which it calls intermediate. If you like to work with daily charts, your intermediate timeframe is daily. If you are a day-trader and like five-minute charts, then your intermediate timeframe is the five-minute chart, and so on.

Triple Screen defines the long term by multiplying the intermediate timeframe by five (see "Time—The Factor of Five," page 87). If your intermediate timeframe is daily, then your long-term timeframe is weekly. If your intermediate timeframe is five minutes, then your long-term is half-hourly, and so forth. Choose your favorite timeframe, call it intermediate, and immediately move up one order of magnitude to a long-term chart. Make your strategic decision there, and return to the intermediate chart to look for entries and exits.

The key principle of Triple Screen is to begin your analysis by stepping back from the markets and looking at the big picture for strategic decisions. Use a long-term chart to decide whether you are bullish or bearish, and then return closer to the market to make tactical choices about entries and exits.

The Principles of Triple Screen

Triple Screen resolves contradictions between indicators and timeframes. It reaches strategic decisions on long-term charts, using trend-following indicators—this is the first screen. It proceeds to make tactical decisions about entries and exits on the intermediate charts, using oscillators—this is the second screen. It offers several methods for placing buy and sell orders—this is the third screen, which we may implement using either intermediate- or short-term charts.

Begin by choosing your favorite timeframe, the one with whose charts you like to work, and call it intermediate. Multiply its length by five to find your long-term timeframe. Apply trend-following indicators to long-term charts to reach a strategic decision to go long, short, or stand aside. Standing aside is a legitimate position. If the long-term chart is bullish or bearish, return to the intermediate charts and use oscillators to look for entry and exit points in the direction of the long-term trend. Set stops and profit targets before switching to short-term charts, if available, to fine-tune entries and exits.

Screen One

Choose your favorite timeframe and call it intermediate. Multiply it by five to find the long-term timeframe. Let's say you prefer to work with daily charts. In that case, move immediately one level higher, to the weekly chart. Do not permit yourself to peek at the dailies because this may color your analysis of weekly charts. If you are a day-trader, you might choose a 10-minute chart as your favorite, call it intermediate, and then immediately move up to the hourly chart, approximately five times longer. Rounding off is not a problem; technical analysis is a craft, not an exact science. If you are a long-term investor, you might choose a weekly chart as your favorite and then go up to the monthly.

Apply trend-following indicators to the long-term chart and make a strategic decision to trade long, short, or stand aside. The original version of Triple Screen used the slope of weekly MACD-Histogram as its weekly trend-following indicator. It was very sensitive and gave many buy and sell signals. I now prefer to use the slope of a weekly exponential moving average as my main trend-following indicator on long-term charts. When the weekly EMA rises, it confirms a bull move and tells us to go long or stand aside. When it falls, it identifies a bear move and tells us to go short or stand aside. I use a 26-week EMA, which represents half a year of trading. You can test several different lengths to see which tracks your market best, as you would with any indicator.

I continue to plot weekly MACD-Histogram. When both EMA and MACD-Histogram are in gear, they confirm a dynamic trend and encourage you to trade larger positions. Divergences between weekly MACD-Histogram and prices are the strongest signals in technical analysis, which override the message of the EMA.

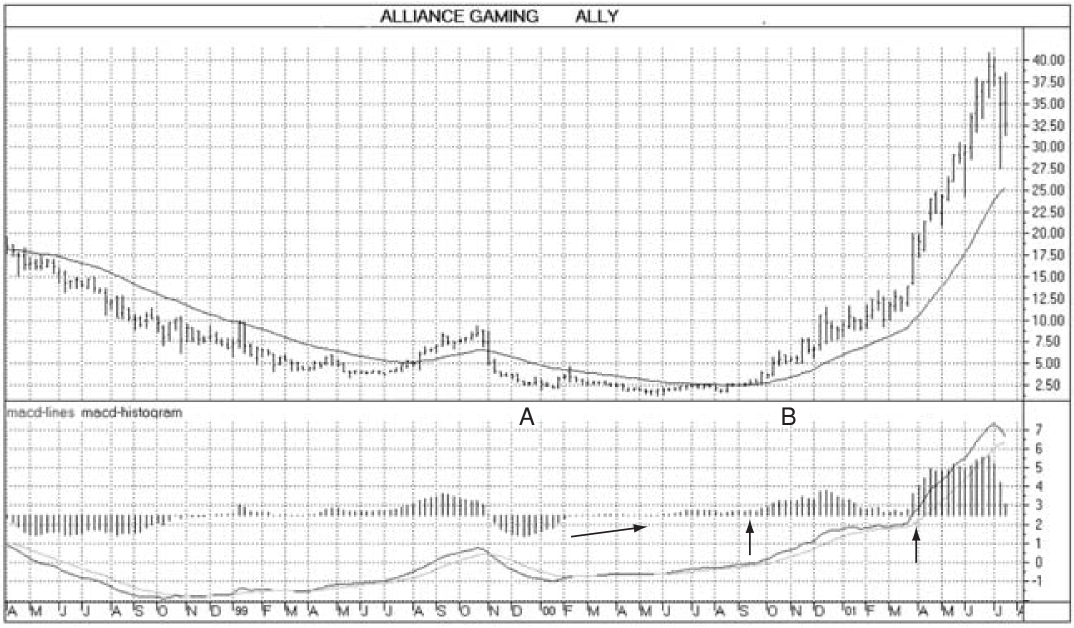

Figure 6.1 Triple Screen—Weekly Chart

Gaming stocks tend to do well in a weak economy—gambling appeals to people down on their luck. In 2000 and 2001, as the broad stock market was declining, gaming stocks put in a stellar performance. Alliance Gaming, for instance, rallied from below 2 to over 40, with very few pullbacks. How could Triple Screen help us benefit from this performance?

The pattern between points A and B is called a *saucer bottom,* a slow drawn-out minimal decline and just as minimal a rise on hardly any volume. Still, during that time ALLY had managed to put in a bullish divergence of MACD-Histogram, a hugely powerful signal that is rarely seen on weekly charts. It traced a low in area A, but could not even push below zero at the bottom of the saucer. The first vertical arrow marks the point where MACD-Histogram starts trending higher. A few weeks later the weekly EMA also turns up, and at that point, with both weekly indicators trending up, ALLY becomes a screaming buy. It is time to switch to the daily charts and look for buying opportunities. The second vertical arrow marks another period when both the EMA and MACD-Histogram are in gear to the upside, and then the stock doubles in a few weeks. The clean, steady uptrend of the weekly EMA keeps telling us to trade ALLY only from the long side.

At the right edge of the chart, the weekly EMA keeps trending higher, but wildly volatile price action shows that the easy portion of the uptrend is over. MACD-Histogram is moving opposite the EMA, warning of high volatility ahead. The relatively easy money is off the table.

Screen Two

Return to the intermediate chart and use oscillators to look for trading opportunities in the direction of the long-term trend. When the weekly trend is up, wait for daily oscillators to fall, giving buy signals. Buying dips is safer than buying the crests of waves. If an oscillator gives a sell signal while the weekly trend is up, you may use it to take profits on long positions but not to sell short.

Figure 6.2 Triple Screen—Daily Chart

The uptrend on the weekly chart keeps telling us to trade ALLY from the long side or stand aside. With the daily EMA also rising, we have several options. We may buy when prices pull back to their rising daily EMA, or when short-term Force Index dips below zero. The upper channel line provides a logical profit-taking target. An experienced trader can pyramid his position, adding to it whenever a new buy signal appears and only tightening stops instead of exiting at the upper channel. That channel keeps getting wider as prices rise—from 10 points wide in April to 16 in July.

At the right edge of the chart, the alternating spikes of Force Index warn traders that the days of relatively easy money are over. The market has become hysterical, and the likelihood of trend continuation is low. Better bank your winnings and go look for another stock in another group that is rising or falling quietly, not yet discovered by the market crowd.

When the weekly trend is down, look for daily oscillators to rise, giving sell signals. Shorting during upwaves is safer than selling new lows. When daily oscillators give buy signals, you may use them to take profits on shorts but not to buy. The choice of oscillators depends on your trading style.

For conservative traders, choose a relatively slow oscillator, such as daily MACD-Histogram or Stochastic, for the second screen. When the weekly trend is up, look for daily MACD-Histogram to fall below zero and tick up, or for Stochastic to fall to its lower reference line, giving a buy signal.

Reverse these rules for shorting in bear markets. When trend-following indicators point down on the weekly charts, but daily MACD-Histogram ticks down from above its zero line, or Stochastic rallies to its upper reference line, they give sell signals.

A conservative approach works best during early stages of major moves, when markets gather speed slowly. As the trend accelerates, pullbacks become more shallow. To hop aboard a fast-running trend, you need faster oscillators.

For active traders, use the two-day EMA of Force Index (or longer, if that's what your research suggests for your market). When the weekly trend is up and daily Force Index falls below zero, it flags a buying opportunity.

Reverse these rules for shorting in bear markets. When the weekly trend is down and the two-day EMA of Force Index rallies above zero, it points to shorting opportunities.

Many other indicators can work with Triple Screen. The first screen can also use Directional System or trendlines. The second screen can use Momentum, Relative Strength Index, Elder-ray, and others.

The second screen is where we set profit targets and stops and make a go–no go decision about every trade after weighing the level of risk against the potential gain.

Set the stops. A stop is a safety net, which limits the damage from any bad trade. You have to structure your trading in such a way that no single bad loss, or a nasty series of losses, can damage your account. Stops are essential for success, but many traders shun them. Beginners complain about getting whipsawed, stopped out of trades that eventually would have made them money. Some say that putting in a stop means asking for trouble because no matter where you put it, it will be hit.

First of all, you need to place stops where they are not likely to be hit, outside of the range of market noise (see SafeZone on page 173). Second, an occasional whipsaw is the price of long-term safety. No matter how great your analytic skills, stops are always necessary.

You should move stops only one way—in the direction of the trade. When a trade starts moving in your favor, move your stop to a break-even level. As the move persists, continue to move your stop, protecting some of your paper profit. A professional trader never lets a profit turn into a loss.

A stop may never expose more than 2% of your equity to the risk of loss (see Chapter 7, "Money Management Formulas"). If Triple Screen flags a trade but you realize that a logical stop would risk more than 2% of your equity, skip that trade.

Set profit targets. Profit targets are flexible and depend on your goals and capital. If you are a well-capitalized, long-term-oriented trader, you may build up a large position at an early stage of a bull market, repeatedly taking buy signals from the daily charts, as long as the weekly trend is up. Take your profits after the weekly EMA turns flat. The reverse applies to downtrends.

Another option is to take profits whenever prices on the daily charts hit their channel line. If you go long, sell when prices hit the upper channel line and look to reposition on the next pullback to the daily moving average. If you go short, cover when prices fall to their lower channel line and look to reposition short on the next rally to the EMA.

A short-term-oriented trader can use the signals of a two-day EMA of Force Index to exit trades. If you buy in an uptrend when the two-day EMA of Force Index turns negative, sell when it turns positive. If you go short in a downtrend after the two-day EMA of Force Index turns positive, cover when it turns negative.

Beginners often approach markets like a lottery—buy a ticket and sit in front of the TV to find out whether you have won. You will know that you are becoming a professional when you start spending almost as much time thinking about exits as looking for entries.

Screen Three

The third screen helps us pinpoint entry points. Live data can help savvy traders but hurt beginners who may slip into day-trading.

Use an intraday breakout or pullback to enter trades without real-time data. When the first two screens give you a buy signal (the weekly is up, but the daily is down), place a buy order at the high of the previous day or a tick higher. A tick is the smallest price fluctuation permitted in any market. We expect the major uptrend to reassert itself and catch a breakout in its direction. Place a buy order, good for one day only. If prices break out above the previous day's high, you will be stopped in automatically. You do not have to watch prices intraday, just give your order to a broker.

When the first two screens tell you to sell short (the weekly is down, but the daily is up), place a sell order at the previous day's low or a tick lower. We expect the downtrend to reassert itself, and try to catch the downside breakout. If prices break below the previous day's low, they will trigger your entry.

Daily ranges can be very wide, and placing an order to buy at the top can be expensive. Another option is to buy below the market. If you are trying to buy a pullback to the EMA, calculate where that EMA is likely to be tomorrow and place your order at that level. Alternatively, use the SafeZone indicator (see page 173) to find how far the market is likely to dip below its previous day's low and place your order at that level. Reverse these approaches for shorting in downtrends.

The advantage of buying upside breakouts is that you follow an impulse move. The disadvantage is that you buy high and your stop is far away. The advantage of bottom fishing is that you get your goods on sale and your stop is closer. The disadvantage is the risk of getting caught in a downside reversal. A "breakout entry" is more reliable, but profits are smaller; a "bottom-fishing entry" is riskier, but the profits are greater. Make sure to test both methods in your markets.

Use real-time data, if available, for entering trades. When the first two screens give you a buy signal (the weekly is up, but the daily is down), use live data to get long. You could follow a breakout from the opening range, when prices rally above the high of the first 15 to 30 minutes of trading, or apply technical analysis to intraday charts and finesse your entry. When trying to short, you may enter on a downside breakout from the opening range. You could also monitor the market intraday and use technical analysis to enter into a short trade, using live charts.

The techniques for finding buy and sell signals on real-time charts are the same as on daily charts, only their speed is much higher. If you use weeklies and dailies to get in, use them also to get out. Once a live chart gives an entry signal, avoid the temptation to exit using intraday data. Do not forget that you entered that trade on the basis of weekly and daily charts, expecting to hold for several days. Do not be distracted by the intraday chop if you are trading swings that last several days.

DAY-TRADING

Day-trading means entering and exiting trades on the same day. Watching money flow from the screen into your account is extremely appealing. Surely we are smart enough to use modern technology to outrun slow-moving folks who follow their stocks through the newspapers.

Every partial truth contains a dangerous lie. Day-trading can bring profits to professionals, but it is also a common last stop for losers who blow what little is left of their accounts. Day-trading offers advantages and disadvantages, while placing extreme demands on its practitioners.

Day-trading offers one of the markets' greatest challenges, but it is amazing how little literature on it exists. There are several "day-trading for dummies" types of books, a few get-rich-quick jobs, but not a single definitive volume on day-trading. Bad day-traders write bad books and good day-traders are too action-oriented to sit down to write.

A good day-trader is a street-smart person with fast reflexes. He is quick, confident, and flexible. Successful day-traders are so focused on the immediate results that they do not make good writers. I hope one of them will rise to the challenge of writing a book, but in the meantime, here are a few notes, even though each of them deserves its own chapter in a thick book on day-trading.

The late 1990s saw an explosion of interest in day-trading. Even housewives and students were pulled in by the bull market and the easy reach of the Internet. Brokers advertise for more people to come in to day-trade, knowing full well most will bust out.

The advantages of day-trading include:

Trading opportunities are more frequent. If you can trade with daily charts, you'll see similar trades more often on intraday charts.

You can cut losses very quickly.

There is no overnight risk if a major piece of news hits your market after the close.