

CHAPTER 1

The Evolution of Excellence

The O'Neil Trading Method

As portfolio managers who once ran money for William J. O'Neil, we have observed that a meaningful portion of the O'Neil "body of thought" is derived from the philosophies of those who preceded him, particularly the works of Richard Wyckoff and Jesse Livermore. When it comes to market thought, you can never entirely understand Bill O'Neil until you have read and understood these two gentlemen. Obviously, the techniques and philosophies of the famous trader Jesse Livermore, as presented in the classic *Reminiscences of a Stock Operator*, by Edwin Lefèvre and Livermore's own *How to Trade in Stocks*, figure heavily in the underlying pulse that governs the way Bill O'Neil and his stable of portfolio managers trade. Richard Wyckoff, as one of the first to write about Jesse Livermore in his original work, *Jesse Livermore's Methods of Trading Stocks*, espoused much of the common sense investment philosophies and maxims that have found their way into the writings and investment thought of William J. O'Neil. Even Nicolas Darvas, in his famous book, *How I Made \$2 Million in the Stock Market* (Carol Publishing Group, 1998), laid the foundation for O'Neil's "chart bases" with his own "boxes," which he described as simply normal consolidation channels within which a stock's action was judged to be normal or abnormal.

The themes that echo from Wyckoff, Livermore, Darvas, and others weave the essential fabric from which "O'Neil-style" investment methodologies are cut. These methodologies utilized the work of O'Neil's predecessors by bringing into play the time-tested characteristics of winning stocks that O'Neil painstakingly identified, analyzed, catalogued, and verified in his numerous Model Book Studies, some of which your

authors had the privilege of producing and contributing to. By sifting through the best-performing, institutional-quality leading stocks in each and every type of market cycle, O'Neil identified their key common characteristics, the most basic of which provided the genesis for O'Neil's unique stock-selection template, commonly known to the investing public as CAN SLIM. Certainly, O'Neil owes a debt to the thinking of Livermore, Wyckoff, and others, and the roots of the O'Neil investment methodologies run deep in this regard. However, as former portfolio managers for William O'Neil + Company, Inc., we can vouch for the fact that such roots do not imply that O'Neil simply copied his predecessors. That would be a gross oversimplification, since the truth is that the O'Neil methodologies took the thinking of these outstanding stock market investors from the past to a much higher level by bringing greater clarity to the process as he formulated a concrete, concise, and practical approach to making money in the stock market.

The parallels between O'Neil and his predecessors provide an overarching backdrop to a general philosophy, a certain ethos, if you will, toward the market that is more than just Livermore's, or Wyckoff's, or even O'Neil's. As O'Neil himself used to tell us, "It's not MY system. It's the market's, because it is based on how the market actually works." In this manner, O'Neil simply sees his own work as furthering the basic process of understanding the market through observation and the application of common sense rules gained thereby. It is nothing more or less than understanding all the small realities that make up the stock market. Reviewing how O'Neil has taken and expanded upon the works of his predecessors is a useful exercise, and sets the backdrop for much of the research we have done to further our approach to the O'Neil/Livermore/Wyckoff approach to the market, and which is one of the main topics of this book.

PREPARATION, STUDY, AND PRACTICE

Don't dabble in stocks. Dig in and do some detective work.

—William O'Neil, *How to Make Money in Stocks*,
2nd ed. (New York: McGraw-Hill, 1995), 34

This the essential premise of O'Neil methodologies: They are in no way, shape, or form intended as a panacea for making money in the market. Human beings are complex organisms, and so represent the greatest variable in the implementation of any investment methodology, whether of "O'Neilian" origin or otherwise. This is why O'Neil insists that one must put in the time, effort, and work required if one intends to become a

successful stock market investor: “Human nature being what it is, 90 percent of the people in the stock market, professionals and amateurs alike, simply haven’t done enough homework.”

O’Neil laments the fact that so many investors are looking for some magic formula that enables them to produce an optimal result in the stock market with little or no effort. In *The Successful Investor*, he laments the “rise of the individual investor” during the dot-com bubble market of 1999. “Most people, both investors and advisors, got hurt in the 2000 to 2002 downturn because they never took the time to learn sound investment rules and principles. In the 90s they thought they’d found a way to make money without doing much homework. They just bought tips, touts, and stories” (William J. O’Neil, *The Successful Investor* [New York: McGraw-Hill, 2004], xii).

While most investors do not hesitate to dabble in the markets, they would rarely dabble in medical or legal practice, or even in playing professional baseball. O’Neil reminds us, however, “Outstanding stockbrokers or advisory services are no more frequent than are outstanding doctors, lawyers, or baseball players” (William O’Neil, *How to Make Money in Stocks*, 2nd ed. [New York: McGraw-Hill, 1995], 256). This is not too far off from Richard Wyckoff’s astute observation that “A person becomes competent in other fields because he has generally gone through a long period of practice and preparation. A physician, for example, goes to college, attends medical clinics, rides in an ambulance, serves in hospitals, and after some years of preparatory work, hangs out a sign. In Wall Street, the same M.D. would hang his sign first; then proceed to practice” (Richard Wyckoff, *How I Trade and Invest in Stocks & Bonds* [New York: The Magazine of Wall Street, 1924], 159–160).

Investing is hard work, and an investor requires no less preparation and expertise than any other white shoe professionals practicing their craft, whether it be law, medicine, software design, moviemaking, or otherwise. Jesse Livermore became annoyed when he was approached by friends or acquaintances who would ask him how they, too, could make money in the market. Biting his tongue, Livermore’s answer eventually evolved into a curt, “I don’t know,” as he found it difficult “to exercise patience with such people. In the first place, the inquiry is not a compliment to a man who has made a scientific study of investment and speculation. It would be as fair for the layman to ask an attorney or a surgeon: ‘How can I make some quick money in law or surgery?’” (Jesse Livermore, *How to Trade in Stocks* [Greenville: Traders Press, 1991], 15).

While reminding investors that success can only be achieved by hard work and persistence, O’Neil, always the optimist, makes it plain that success is within the reach of anyone willing to make the effort, and in his book, *How to Make Money in Stocks* (2009, 9), he urges us all on with a

touch of self-sufficient idealism, “The American dream can be yours if you have the drive and desire and make up your mind to never give up on yourself.” But O’Neil insists from the start that, as Wyckoff wrote, “. . . anybody who thinks he knows of a short-cut that will not involve ‘sweat of the brow’ is sadly mistaken” (*How I Trade and Invest in Stocks & Bonds* [New York: The Magazine of Wall Street, 1924], 93).

BUY EXPENSIVE—NOT CHEAP—STOCKS

Like Livermore, O’Neil despises a lazy approach to the market because it results in one trying to take what is perceived as the easy route to stock market riches. Nowhere else is this more embodied than in the idea of buying stocks that are “cheap.” This age-old trap is easy to fall into, since most novice investors approach the market with an incorrigibly ingrained consumer mentality that views anything selling today at a lower price than it was yesterday as a “bargain.” This is perhaps because the individual investor views herself as a consumer endpoint, when in fact the investor should act like a business that purchases raw or finished goods and intends to turn around and sell them at a higher price. Hence, O’Neil’s story about red dresses and yellow dresses, where the slower-selling yellow dresses are marked down by the store owner to get them out of the “portfolio,” otherwise known as the store inventory, so that more of the hotter-selling red dresses can be purchased and resold at higher prices.

O’Neil advocates buying stocks that are “red dresses” selling “like hot-cakes” at all-time high prices. The reason for this is simple: “. . . real leaders start their big moves by selling at new price highs, not near new lows or off a good amount from their highs” (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 426). In a contrarian sense, this is what makes the concept of buying stocks at new highs so effective. It is simply not obvious to the crowd, who fear buying a stock that looks to be selling at such a high price, because, as O’Neil points out, “What seems too high in price and risky to the majority usually goes higher eventually, and what seems low and cheap usually goes lower” (2009, 174). The market tries to fool the majority of investors the majority of the time, so if new high prices in a particular stock make the crowd timid about buying it, then that is likely the precise time to be buying the stock.

Like O’Neil, Jesse Livermore appreciated higher-priced stocks far more than “cheap” stocks, advising, “One should never sell a stock, because it seems high-priced. . . . Conversely, never buy a stock because it has had a big decline from its previous high. The likelihood is that the decline is based on a very good reason. That stock may still be selling at an extremely high price relative to its value—even if the current level seems

low” (Jesse Livermore, *How to Trade in Stocks* [Greenville: Traders Press, 1991], 25).

AVERAGING DOWN

Trying to buy cheap stocks is but one frequent sin committed by novice or lazy investors. Another lazy man’s sin eschewed by O’Neil and his predecessors is the concept of “averaging down.” Richard Wyckoff observed, “A great deal of money is lost or tied up by people who make a practice of averaging. Their theory is that if they buy a security at 100 and it goes to 90, it is that much cheaper, and the lower it goes the cheaper it grows.”

Retail stock brokers, when in need of a way to avoid taking responsibility for a bad recommendation, often try to use “averaging down” as a way to justify the initial decision to purchase a stock at higher prices. To some extent, this evolved as a convenient corollary to the retail investment concept of “dollar-cost averaging” when purchasing mutual funds, about which we’re sure many readers are only too familiar. To O’Neil, this is shameful: “About the only thing that’s worse is for brokers to take themselves off the hook by advising customers to ‘average down.’ If I were advised to do this, I’d close my account and look for a smarter broker” (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 247).

Jesse Livermore was no less harsh in his assessment of the averaging-down technique when he said, “It is foolhardy to make a second trade, if your first trade shows you a loss. Never average losses. Let that thought be written indelibly upon your mind” (*How to Trade in Stocks* [Greenville: Traders Press, 1991], 26). Richard Wyckoff took the concept just a little bit further by adding, “It is better to ‘average up’ than to ‘average down’” (*Stock Market Technique Number 1* [New York: Richard D. Wyckoff, 1933], 50). And as we know, O’Neil contrasts his sermons against averaging down by strongly advocating “averaging up” on one’s winning stocks.

CUTTING LOSSES QUICKLY

Jesse Livermore wrote in *How to Trade in Stocks*, “You should have a clear target where to sell if the market moves against you. And you must obey your rules! Never sustain a loss of more than 10 percent of your capital. Losses are twice as expensive to make up. I always established a stop before making a trade” (*How to Trade in Stocks* [Greenville: Traders Press, 1991], 171). O’Neil advises a 7 to 8 percent automatic stop-loss policy on all stock purchases, and the main reason for this is to keep oneself out of

danger. Huge losses in the market can be debilitating, and O'Neil views a strict stop-loss policy, whether at his threshold of 6 to 7 percent or Livermore's 10 percent, as absolutely necessary for survival in the stock market. Livermore observed, "Taking the first small loss is wise . . . profits take care of themselves but losses never do" (1991, 7).

Richard Wyckoff in *Stock Market Technique Number 1* advised: "Your first line of defense is a stop order—placed when you make the trade, or immediately thereafter. If you fail to limit your risk at inception, make a practice of looking over your commitments every day, or twice every week and selling out, at the market, all showing a loss. That will keep your sheet clean and allow your profitable trades to run until the time comes to close them out" (1933, 96). This concept of using a stop-loss as a "line of defense" runs parallel to O'Neil's thinking that "letting your losses run is the most serious mistake made by almost all investors" (*How to Make Money in Stocks*, 2nd ed. [New York: McGraw-Hill, 1995], 93) simply because "[i]f you don't sell to cut your losses when you get into trouble, you can easily lose the confidence you'll need to make buy and sell decisions in the future" (1995, 252). Not only do losses cut into the capital an investor has available to capitalize on potential opportunities in the stock market, they also take their toll on an investor's psychological capital, their all-important self-confidence.

To O'Neil, Livermore, and Wyckoff, losses are just part of the process, and it is always better to take a little pain now rather than a lot of pain later, because, as O'Neil reveals, "The whole secret to winning big in the stock market is not to be right all the time, but to lose the least amount possible when you're wrong" (1995, 240).

TAKING PROFITS TOO SOON—LETTING YOUR WINNERS RUN

The O'Neil methodology is essentially a trend-following system—you want to be in the market when the trend is in your favor, and you want to capture a large portion of any trend by riding with it for as long as possible. To O'Neil, buying a winning stock is only half the problem, because the key to capitalizing on a big price move in any potential, big, winning stock is in how you handle the stock once you have bought it. As Livermore said, it is the uncommon man who can "sit tight and be right," so sitting with and properly handling a meaningful position in a big, winning stock through the bulk of its upside price move is a big part of how O'Neil makes big money in the stock market. This necessitates adhering to a basic principle that Livermore stipulated when he said, "As long as a stock is acting right, and

the market is right, do not be in a hurry to take a profit” (*How to Trade in Stocks* [Greenville: Traders Press, 1991], 21). You can’t make big money in stocks if you don’t give them a chance to make big money for you.

O’Neil recommends “take your losses quickly and your profits slowly,” because “your objective is not just to be right but to make big money when you are right” (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 247–272). Trading for quick profits requires that one be constantly active and thinking about the next trade. It is a notoriously busy way to approach the market, and is entirely out of sync with the ideal that O’Neil-style investing tends toward. In our experience, there is nothing easier than making big money in the market once you have latched onto a big winner, because at that point all you are doing is sitting more and thinking less. When your stocks are trending nicely to the upside and you are fully invested, there is, from a practical standpoint, very little to do. You are simply letting your winners run. This is what we like to call “being in the zone,” a mental space that derives from Livermore’s principle: “It never is your thinking that makes big money. It’s the sitting” (Edwin Lefèvre, *Reminiscences of a Stock Operator* [New York: John Wiley & Sons, 1994], 68).

Richard Wyckoff had his own unique perspective on the idea of cutting losses quickly and letting winners run when he wrote in *Stock Market Technique Number 1*, “Are you getting rich backwards? Then you are taking two points profit on your speculative trades and letting your losses run. Why not reverse this rule? Limit your risk to one, two or three points and let your profits run” (1933, 52).

POSITION CONCENTRATION

A big part of handling a winning stock correctly is properly scaling one’s position size. If you only want to make average market returns, then scale your positions to a very small size, and your portfolio will act very much like a market index. Having scores of positions is nothing more than “closet indexing.” Most mutual fund managers take positions that make up 1 to 2 percent of their portfolio equity or less, and they may have 100 to 200 positions or more. To O’Neil, this is anathema. If you want to make big returns, then you absolutely must concentrate your capital in a strongly-trending stock, and position sizes of 1 to 2 percent of one’s total portfolio equity are, to put it bluntly, quite wimpy from an O’Neil perspective. The O’Neil method of pyramiding into strongly acting positions while weeding out weaker ones generally gets an investor concentrated in the right stocks during a bull market cycle. At times, your authors have been fully invested

in as few as two stocks, using full, 200 percent margin, so that each position represents 100 percent of the account's gross equity. This is how you make big money in the market, and it is the essence of handling one's stocks properly to achieve maximum effect.

For this reason, O'Neil eschews "diversification" and cites the wisdom of Gerald Loeb, who declared that diversification was a "hedge for ignorance." O'Neil's solution was to be very specific about what stocks one owned in any bull market cycle, suggesting, "The more you diversify, the less you know about any one area. Many investors overdiversify. The best results are achieved through concentration: putting all your eggs in just a few baskets that you know a great deal about and continuing to watch those baskets very carefully" (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 274).

The purpose of position concentration from an O'Neil perspective is two-fold. On the one hand it allows an investor to fully capitalize on a big price move in a winning stock, while on the other it allows the investor to focus his or her attention on "fewer eggs," which O'Neil views as a safer mental approach than trying to keep track of too many positions at once. Even Livermore himself thought "... that it is dangerous to start spreading out all over the market. By this I mean, do not have an interest in too many stocks at one time. It is much easier to watch a few than many" (*How to Trade in Stocks* [Greenville: Traders Press, 1991], 33).

To O'Neil, it is not necessary to own every stock in the market; to have a need to "kiss all the babies," as he is fond of saying. He whittles it all down to one basic concept: "The winning investor's objective should be to have one or two big winners rather than dozens of very small profits" (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 274).

DEALING IN BIG STOCKS AND INSTITUTIONAL SPONSORSHIP

Owning the biggest winners in the market means owning the stocks that institutions are piling into, and O'Neil sees modern-day mutual funds, hedge funds, and pension funds, and other members of the "institutional investor zoo," as akin to the "pools" and "trusts" of Jesse Livermore's and Richard Wyckoff's era. It is the accumulation of stock by large institutions that produces the huge price moves upon which O'Neil methodologies seek to capitalize. And the smart institutions, such as those with the better research and stock selection skills, are the ones in whose footsteps you want to follow. O'Neil asserts, "It takes big demand to push up prices, and by far the biggest source of demand for stocks is institutional investors, such as

mutual funds, pension funds, hedge funds, insurance companies, [etc]. A winning stock doesn't need a huge number of institutional owners, but it should have several at a minimum." O'Neil continues, "[Diligent investors] look for stocks that are held by at least one or two of the more savvy portfolio managers who have the best performance records" (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 193–194).

Knowing where the smart money is moving is central to O'Neil's methodology, and understanding the quality of institutional sponsorship coming into a stock is no different from what Richard Wyckoff advised when he wrote, "It is important to know whether large operators, inside interests, pools, or the public dominate the market for a certain security or group." Wyckoff went on to explain, "The reason this is so important is as follows: A combination of bankers will seldom be found on the long side of the market unless they expect a pronounced change in security market conditions in the near future. Their own purchases, therefore, are an indication of probable betterment. When a pool takes hold, it is usually in a certain one or a few issues which are likely to be favorably affected by developments known to a few but not generally known" (*How I Trade and Invest in Stocks & Bonds* [New York: The Magazine of Wall Street, 1924], 183).

O'Neil's unique and deep understanding of the institutional investor and the implications of institutional sponsorship is founded in the experience he has had advising some of the largest and most successful institutional investors on the planet. It is this understanding that generates what we have dubbed The Big Stock Principle that drove O'Neil's thinking in any market cycle. Knowing which stocks represented the cutting edge of developments driving any particular economic, and hence market, cycle means knowing where institutional investors "have to be" with respect to positioning their portfolios. When institutional investors start shoveling money into stocks that they "have to be" invested in, this fuels tremendous upside price moves in those stocks, and it is what makes them "Big Stocks." It is a central tenet of O'Neil-style investing.

CHART PATTERNS

Books like *How I Made \$2 Million in the Stock Market*, by the famous ballroom dancer Nicolas Darvas, figure into O'Neil's concepts of "bases," which Darvas termed "boxes." O'Neil, however, took it quite a bit further with his colorful, descriptive cataloguing of consolidation patterns or bases that he termed "ascending," "cup-with-handle," "double-bottom," "square box," "flat base," and "high, tight flag," among others—the chart

patterns from which, as O'Neil observed, big, winning stocks emerged as they started their huge upside price romps. As well, these patterns represented the "continuation" that patterns hugely performing stocks form on the way up as they naturally and normally pause and digest their gains during an overall intermediate to longer-term price run before proceeding higher.

Like O'Neil and his bases, Darvas's "box theory" emerged from his own direct observation and study of stock charts and tables: "I started to realize that stock movements were not completely haphazard. Stocks did not fly like balloons in any direction. As if attracted by a magnet, they had a defined upward or downward trend which, once established, tended to continue. Within this trend stocks moved in a series of frames, or what I began to call boxes. They would oscillate fairly consistently between a low and a high point. The area which enclosed this up-and-down movement represented the box or frame. These boxes began to exist very clearly for me" (Nicolas Darvas, *How I Made \$2 Million in the Stock Market* [New York: Carol Publishing Group, 1998], 51).

O'Neil is far more specific, however, about the precise structure of these "boxes" or "bases," and his work goes into much detail about the exact shapes, durations, and magnitudes of these various price consolidation structures. But, like Darvas, O'Neil recognizes: "Chart patterns are simply areas of price correction and consolidation, usually after an earlier price advance. The primary challenge in analyzing price consolidation structures is to diagnose if the price and volume movements are normal or, instead, signal significant weakness or distribution" (*How to Make Money in Stocks*, 2nd ed. [New York: McGraw-Hill, 1995], 161).

It is, however, important to understand that Darvas's "box theory" is nothing more than a very rudimentary, initial version of O'Neil's chart pattern zoo. Darvas never bothered to measure the minimum durations for his boxes to determine whether a longer duration was preferable to a shorter one, nor did he measure the magnitude, or range, of these boxes to determine any meaningful characteristics thereby. As he puts it, "I found that a stock sometimes stayed for weeks in one box. I did not care how long it stayed in its box as long as it did—and did not fall below the lower frame figure" (*How I Made \$2 Million in the Stock Market* [New York: Carol Publishing Group, 1998], 52).

O'Neil also went way beyond the simplistic "box theory" by recognizing the importance of applying historical precedent in his work. O'Neil observed that the chart patterns formed by market-leading stocks in one market cycle often repeated themselves in the market leaders of a later cycle. As an example, O'Neil has discussed in public forums how a big pull-back by America Online (AOL) to its 50-day moving average back in 1998

reminded him of another big winner he played, Syntex Corp., in 1965. In this manner, Syntex served as a “historical precedent” for AOL in 1998, and served as an invaluable guide in helping O’Neil handle the position for what turned out to be massive gains. We know—we were there when it happened.

The idea of historical precedence, of course, can be seen as derived from Jesse Livermore, who declared in *How to Trade in Stocks*, “I absolutely believe that price movement patterns are being repeated. They are recurring patterns that appear over and over, with slight variations. This is because markets are driven by humans—and human nature never changes” (Greenville: Traders Press, 1991, 96). And, as O’Neil says, “It’s just history repeating itself over and over again, human nature continually on parade” (*The Successful Investor*, 3rd ed. [New York: McGraw-Hill, 2004], 84). Wyckoff also observed that, “In a certain sense, reading charts is like reading music, in which both endeavor to interpret correctly the composer’s ideas and the expression of his art. Just so a chart of the averages, or of a single stock, reflects the ideas, hopes, ambitions, and purposes of the mass mind operating in the market, or of a manipulator handling a single stock” (*Stock Market Technique Number 2* [New York: Richard D. Wyckoff, 1933], 136).

O’Neil is often pejoratively dismissed as a “chartist,” as if this is proof that he should be written off as some sort of investment pariah. But we should not forget that while he was a pioneer in figuring out how to automate the production of printed stock charts, he was not the first to recognize the usefulness of charts in stock forecasting. In *Stock Market Technique 2*, Richard Wyckoff devoted a short chapter to answering Why You Should Choose Charts and summed up his assessment of the usefulness of consulting stock price charts by writing, “The ticker records stock market history on a long strip of tape. The charts record the same history transposed into another form, more convenient, more valuable for the purpose of studying past performance as an aid in forecasting—I should say *invaluable*” (1933, 66).

For O’Neil, technical analysis and the use of charts is all about determining the actions of institutional investors as they set about systematically accumulating stocks. In this way O’Neil does not approach the use of charts in a mechanical way, without incorporating any aspects of judgment, but rather as a tool to determine what the big players, the institutions, are doing. In this manner he is similar to Wyckoff, who advised that investors study charts in order to uncover the “motives behind the market action to interpret the behavior of stocks” (*Charting the Stock Market, The Wyckoff Method*, ed. Jack K. Huston [Seattle: Technical Analysis, Inc., 1948], 13, 16).

PIVOTAL POINTS VERSUS PIVOT POINTS

Buying at the exact right point is a key mechanic in the O'Neil methodology, and O'Neil's concept of a "pivot point" is drawn from Livermore's "pivotal point," of which Livermore had a "reversal pivotal point" and a "continuation pivotal point." We might consider O'Neil's pivot point buy points in stocks, generally defined by breakouts to new price highs, as more in keeping with Livermore's concept of a "continuation pivot point," whereas O'Neil's concept of a "follow-through day" as confirming an upturn in the market after a prior correction or bear market to be similar to Livermore's "reversal pivotal point" since it indicates a reversal in the market's trend from bear to bull phase. In *How to Trade in Stocks* by Jesse Livermore and *How to Make Money in Stocks* by William O'Neil, both writers share a common regard for such a "pivot" or "pivotal" buy point as the exact point where the risk/reward equation is most in the investor's favor, where the ducks are lined up in a row, so to speak, and so the stock should be bought once the price reaches this key pivot/pivotal point.

Waiting for the pivotal point to present itself requires patience, and Livermore would do his best to avoid taking action until and unless the correct pivotal point signal was given, because this assured his success, as he puts it, "Whenever I had the patience to wait for the market to arrive at what I call a 'Pivotal Point' before I started to trade, I have always made money in my operations. Why? Because I then commenced my play just at the psychological time at the beginning of a move" (*How to Trade in Stocks* [Greenville: Traders Press, 1991], 43). O'Neil says, "The winning individual investor can afford to wait and begin buying at these precise pivot points. This is where the real move starts and all the exciting action originates" (*How to Make Money in Stocks*, 2nd ed. [New York: McGraw-Hill, 1995], 164). The correct buy point lies at what both O'Neil and Livermore saw as a "line of least resistance," where the stock was "in the clear" and able to launch higher with little to no impediment.

The point of buying right is to enter a stock right at the point where the real move begins, so that if a stock is trading at 50, but the correct pivotal point is at 55, one must still wait for the stock to trade at the higher price if it is determined that this is where the line of least resistance lies. In this way, neither O'Neil nor Livermore were interested in capturing the movement between 50 and 55 as the stock approached the 55 pivotal point, but rather the "big move" from 55 to 100. As O'Neil says in *How to Make Money in Stocks*, second edition, "Your object is never to buy at the cheapest price or near the low but to begin buying at exactly the right time. This means you have to learn to wait for a stock to move up and trade at your buy point

before making an initial commitment” (p. 165). In Chapter 6, we take the concept of pivot and pivotal points further.

TIMING THE MARKET: WHEN TO BE IN, WHEN TO BE OUT

From the O’Neil/Livermore perspective, waiting for the “pivotal point,” or the exact right time to enter the markets means only being in the market when it is ripe for making money. Wait for the trend to develop and then jump on. A line with which we are all familiar came from something Jesse Livermore wrote in *How to Trade in Stocks*, “Successful traders always follow the line of least resistance. Follow the trend. The trend is your friend” (Greenville: Traders Press, 1991, 69).

O’Neil and Livermore both maintain that there is a time to be in the market and a time to be out of the market, even though common investment wisdom dictates that one cannot time the market and therefore should always be fully invested in the market so as not to miss a bull phase and fail to keep up with the market indexes. O’Neil vigorously disagrees with such mindless orthodoxy when he writes, “Don’t ever let anyone tell you that you can’t time the market. This is a giant myth passed on mainly by Wall Street, the media, and those who have never been able to do it, so they think it’s impossible.” According to O’Neil, “The erroneous belief that you can’t time the market—that it’s simply impossible, that no one can do it—evolved more than 40 years ago after a few mutual fund managers tried it unsuccessfully. They relied on personal judgments and feelings to determine when the market finally hit bottom and turned up for real. At the bottom, the news is all negative. So these managers, being human, hesitated to act” (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 200).

Indeed, opinions have no place when it comes to stock selection or market timing, and we have sought to implement objectivity to our methods. The “Dr. K Market Direction Model,” which is discussed in detail in Chapter 7, is a statistical formalization of the price/volume action of the NASDAQ Composite and S&P 500 Indexes. The timing model, from its earlier forms to its most evolved form of today, has guided our trading with success since 1991. It was inspired by the “M” in O’Neil’s “CAN SLIM” investment system. More about Dr. K’s Market Direction Model and the current market timing signal can be found at the following web site: www.virtueofselfishinvesting.com, and Gil Morales’s work with respect to market trend timing can be found at www.gilmoreport.com.

EMOTIONS AND PREDICTIONS

Trading the market is a very “Zen” activity, where you stay in the now, not worrying about what the market will do in the future, and not getting upset about a bad trade you may have made in the past. Instead one should stay focused in the present, reacting in real time to the evidence that the market is constantly presenting. No one has ever been able to predict market direction with any consistent reliability, but that is wholly unnecessary to being a successful investor. Successful investing is about watching the market day-to-day and acting accordingly. In fact, attempting to predict the market often leads to over-intellectualization, which is usually a recipe for losing money in the market. When the market goes against your own intellectualized “conclusions,” you may be less likely to reverse your position, even in the face of factual price/volume action that is telling you that you are wrong. Pay less attention to what you think the market should be doing, and more to what the market is actually doing. As Livermore wrote, “Don’t try and anticipate what the market will do next—simply go with the evidence of what the market is telling you—presenting you.” (Richard Smitten, *Trade Like Jesse Livermore* [Hoboken, NJ: John Wiley & Sons, 2005], 13).

In the same vein as Livermore, O’Neil preaches that an investor does not need to know what the market is **going to do**, but only what it is **doing right now**. O’Neil wrote in *How to Make Money in Stocks*, third edition, “The key to staying on top of the stock market is not predicting or knowing what the market is going to do. It’s knowing and understanding what the market has actually done in the past several weeks and what it is currently doing now” (2002, 75). Even Wyckoff adhered to this concept of remaining in the present at all times as he evaluated fresh evidence from the market in real time. He declared, “I am not one of the many who form opinions as to the future course of the stock market and then insist that the market justify their predictions. . . . It is enough to know that the market tells me what it is probably going to do today and in the near future. I do not expect to be informed very far in advance, because the market often changes its course. I must change my position accordingly” (*Stock Market Technique Number 1* [New York: Richard D. Wyckoff, 1933], 53).

This entire line of thought speaks to the concept of keeping one’s emotions out of the equation. To Livermore, the twin evils of fear and hope were the undoing of most investors who operated heavily in the realm of emotion. Perhaps it is not so much that investors fear and then hope, but that they rarely fear or hope at the right time, as Livermore observed, “. . . when you inject hope and fear into the business of speculation . . . you are apt to get the two confused and in reverse positions” (*How to Trade*

in *Stocks* [Greenville: Traders Press, 1991], 20). On the other hand, when it comes to operating without fear, and keeping one's emotions in check when taking losses in the market, O'Neil borrows a bit of advice that comes from Richard Wyckoff suggesting one "sell down to the sleeping point."

LISTENING TO OPINIONS, NEWS, AND TIPS

When someone asks for a tip, it is best to tell them this: "Take no tips." Much money is lost by those who listen to tips. The person giving the tip may have an underlying motive. Or he just may not have all the facts even though he thinks he does. As Jesse Livermore wrote in *How to Trade in Stocks*, "Markets are never wrong—opinions often are" (1991, 18).

Markets are the final arbiter of all news known up to that point in time. At least that is what the big auction known as the stock market does. It prices the stock relative to its peers, so it is best to believe the market's assessment.

O'Neil wrote in *How to Make Money in Stocks*, fourth edition, "Many people are too willing to risk their hard-earned money on the basis of what someone else says, rather than taking the time to study, learn, and know for sure what they're doing. As a result, they risk losing a lot of money. Most rumors and tips you hear simply aren't true" (2009, 305). The same could be said of opinions by experts. O'Neil continued, "Maybe this explains why virtually every analyst appearing on CNBC after September 2000 continually recommended buying high-tech stocks as they were on their way to 80–90 percent declines." To paraphrase Livermore, opinions are often wrong, but markets never are.

Yet much of the investing public prefers the lazy way out. Wyckoff wrote, "Depending on the advice of others is a widespread public weakness" (quoted in William O'Neil *How to Make Money in Stocks*, 3rd ed. [New York: McGraw-Hill, 2002], 253). Many prefer to be handed the answers. Over the years, the question we have heard most frequently is "What are you buying?" The person asking the question usually has little understanding of the market and even less confidence in her own judgment, since she has not done the necessary preparation. Diligent study is the antidote. Wyckoff wrote, "When you understand stock market science you have no concern about important developments in your morning newspaper, because the news is not a factor in your operations. An experienced judge of the market regards the whole story that appears on the tape as though it were the expression of a single mind; that is, the composite mind of all traders, investors, bankers, pools, institutions, and others who are

participating in the transactions” (*Stock Market Technique Number 2* [New York: Richard D. Wyckoff], 139).

OVERTRADING

Once an investor becomes seasoned and has developed a winning strategy that he has executed successfully for a number of years, he is still not immune to overtrading. Overtrading seems to plague both novice and expert alike, both in terms of trading when one should just be sitting in cash, and in terms of selling a position too soon, only to buy it back a few days later, then repeating this pattern of buying and selling.

Jesse Livermore wrote of an investor who lived in the mountains and received quotes that were three days old. Only a few times a year would this investor call his broker to place trades. This man was quite detached from the markets, so it came as a total surprise when people learned of his remarkable long-term success in the markets. When asked about his success, the man replied, “Well, I make speculation a business. I would be a failure if I were in the confusion of things and let myself be distracted by minor changes. I like to be away where I can think. Real movements do not end the day they start. It takes time to complete the end of a genuine movement. By being up in the mountains I am in a position to give these movements all the time they need” (*How to Trade in Stocks* [Greenville: Traders Press, 1991], 32).

Wyckoff echoed this sentiment when he wrote, “When in doubt do nothing. Don’t enter the market on half convictions; wait till the convictions are fully matured.” Wyckoff continued, “And so, whenever we feel these elements of uncertainty, either in our conclusions or in the positions we hold, let us clean house and become observers until, as that eminent trader Dickson G. Watts wrote, “The mind is clear; the judgment trustworthy” (*Stock Market Technique Number 1* [New York: Richard D. Wyckoff, 1933], 51, 108).

O’Neil acknowledges that there is a time when doing nothing is the best thing to do, and he is more specific about the symptoms: “It isn’t that bases, breakouts, or the method isn’t working anymore; it’s that the timing and the stocks are simply all wrong. The price and volume patterns are phony, faulty, and unsound. The general market is turning negative . . . Be patient, keep studying, and be 100 percent prepared” (*How to Make Money in Stocks*, 4th ed. [New York: McGraw-Hill, 2009], 151). Indeed, patience exercised wisely by staying out of the market when conditions are not right can save an investor a huge sum of money.

THE O'NEIL APPROACH: TECHNO-FUNDAMENTALISM

O'Neil is often chided for being a “technician,” but anyone who truly understands the O'Neil methodology understands that it is in reality a “techno-fundamental” approach that combines the use of technical analysis to determine when a stock is under accumulation within a chart pattern and where the proper pivot buy point is on the one hand with essential fundamental characteristics of historically big, winning stocks on the other hand. Nicholas Darvas coined the term “techno-fundamental” to describe his system for investing in stocks, which combined monitoring the price action of a stock to determine that it was acting correctly within its “boxes” as well as to define buy points as a stock emerged from the top of a “box” with earnings growth as Darvas describes, “I saw that it is true that stocks are the slaves of earning power. Consequently I decided that while there may be many reasons behind any stock movement, I would look only for one: improving earnings power or anticipation of it. To do that, I would marry my technical approach to the fundamental one. I would select stocks on their technical action in the market, but I would only buy them when I could give improving earnings power as my fundamental reason for doing so” (*How I Made \$2 Million in the Stock Market* [New York: Carol Publishing Group, 1998], 79).

O'Neil doesn't just buy a stock just because it has a pretty chart—it must also exhibit the proper fundamental characteristics typical of winning stocks throughout history, according to O'Neil's own studies of historical precedent.

CONCLUSION

After intensive study of multitudes of market cycles spanning over one hundred years, it is clear that O'Neil carries on and refines the conversation that Jesse Livermore, Richard Wyckoff, and Nicholas Darvas started. Human nature does not change, so we carry on the conversation, voicing our successes, failures, and findings—all of which carry deep learning both on analytical and psychological levels. This is not rocket science, and almost anyone can apply these methodologies to become successful in their own right, but the technique does require long-term focus and dedication. While we do not pretend to be equal to the stature of any of these gentlemen, we do believe that as former O'Neil portfolio managers and

as successful investors in our own right, using the O'Neil methodologies, we have something of value to add to the conversation. Certainly, as the markets continue to evolve, certain mechanics and applications of O'Neil methodologies will evolve as well, and it will be left up to traders like us to continue to evolve and improve our methods, but the basic philosophical foundation, the "ethos," of the O'Neil methodologies will remain the same.

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