

PART I

**The New Trading
Paradigm**

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CHAPTER 1

The Great Stock Market Meltdown

The turbulent U.S. economy and stock market have recently encountered a chaotic and challenging chain of events. The year 2008 may be recorded as the worst year ever for the phenomenon of wealth destruction for investors and traders. Despite the massive \$820 billion U.S. government bailout, the stock market has continued its spiral sell-off and meltdown. For early March 2009, the Standard & Poor's (S&P) 500 index, since peaking at an all-time closing high of 1,565.15 on October 9, 2007, had lost 57 percent. The Dow had lost nearly 54 percent since closing at an all-time high of 14,164.53 on the same day in 2007. Since hitting a bull-market high of 2,859.12 on October 31, 2007, the NASDAQ had lost 56 percent.

Investors suffered a great blow when the S&P 500 plunged to a 13-year low as fears of a prolonged recession sparked a massive selloff, closing at its lowest point since April 1, 1996. However, as investors experience their biggest-ever losses in pension funds and investment portfolios, some financial gurus and advisors continued to spew out "stay the course" advice. They dispense this so-called wisdom as though we hadn't learned the hard lesson of listening to their irresponsible and downright fraudulent advice just months before on some of Wall Street's long-term holdings, such as Lucent, WorldCom, Enron, Merrill Lynch, and Bear Stearns.

Wall Street today is encountering its most disastrous crisis in decades. The demise of Lehman Brothers and Bear Stearns, the federal bailout of mortgage giants Fannie Mae and Freddie Mac, and the forced sale of Merrill Lynch to Bank of America are on the growing list of casualties in this ongoing financial crisis. As of July 10, 2009, the Federal Deposit Insurance Corp. (FDIC) announced that 79 banks failed in 2008 and 2009.

According to an FDIC press release dated August 26, 2008, “rising levels of troubled loans, particularly in real estate portfolios, led many institutions to increase their provisions for loan losses in the quarter. Loss provisions totaled \$50.2 billion, more than four times the \$11.4 billion the industry set aside in the second quarter of 2007. Almost a third of the industry’s net operating revenue (net interest income plus total noninterest income) went to building up loan-loss reserves.”

A great deal of consumer wealth has dissipated as a result of recent stock market losses; consumers now have far less money to spend. Unemployment has been rising as well, so overall there is less money in the economy. Without this money circulating in the economy and with nothing to replace it, it is hard to see where the resources will come from to generate an economic recovery.

According to the *Washington Post* of October 8, 2008, a top Congressional budget analyst said, “The stock market’s prolonged tumble has wiped out about \$2 trillion in retirement savings over 15 months, a blow that could force workers to stay on the job longer than planned, tighten their wallets and possibly further stall an economy reliant on consumer spending.”¹

Many investors have been shocked to open their 401K, individual retirement account (IRA), and pension funds statements to see a tremendous loss in their nest-egg savings. What happened? they ask, dumbfounded.

A quick glance at the prices for stocks held by the majority of the investing-class population amply illustrates the ugly side of the “investing for the long term” theory. Table 1.1 depicts 15 of the most widely held stocks in pension funds, mutual funds, and institutional and investor portfolios. As an investor you might have experienced the agony of opening your monthly statement, only to see the latest loss in your investment and pension fund portfolio. You have no doubt noticed how drastically your equity account has depreciated if you were holding any of the well-publicized “sound” investment stocks, including National City Corporation (NCC), Morgan Stanley (MS), Fannie Mae (FNM), Freddie Mac (FRM), Wachovia Corp. (WB), General Electric Co. (GE), Apple Inc. (AAPL), Washington Mutual (WM), American International Group (AIG), MBIA (MBI), Ambac Financial Group (ABK), Citigroup (C), Lehman Brothers Holdings (LEHMQ), Merrill Lynch (MER), UBS (UBS), Bank of America Corp. (BAC), General Motors Corp. (GM), or Ford Motor Company (F).

According to Bloomberg News, about 56 percent of hedge funds posted losses in October 2008. They lost 18.3 percent in 2008, their worst year on record.² Their total loss amounted to \$350 billion globally in 2008, the highest on record.³ Hedge fund assets fell \$100 billion in the month as investors withdrew their money and funds were forced to sell stock, exacerbating the severe volatility that pounded global markets during the month. Hedge

TABLE 1.1 Price Changes for Some of the Most Widely Held Stocks, 2007–2008

No.	Stocks (Ticker Symbol)	52-Week High	52-Week Low	52-Week Change
1	National City Corp. (NCC)	\$20.49 (11/30/07)	\$1.25 (9/29/08)	−91.82%
2	Morgan Stanley (MS)	\$55.39 (12/24/07)	\$6.71 (10/10/08)	−79.86%
3	Fannie Mae (FNM)	\$40.45 (12/31/07)	\$0.30 (11/21/08)	−99.07%
4	Freddie Mac (FRE)	\$37.18 (12/7/07)	\$0.25 (9/17/08)	−98.45%
5	Wachovia Corp. (WB)	\$45.43 (12/7/07)	\$0.75 (9/29/08)	−89.94%
6	General Electric Co. (GE)	\$38.67 (11/30/07)	\$12.58 (11/20/08)	−62.76%
7	Apple Inc. (AAPL)	\$202.96 (12/27/07)	\$79.14 (11/21/08)	−51.86%
8	Ambac Financial Group (ABK)	\$32.28 (12/10/07)	\$0.76 (11/19/08)	−95.19%
9	Citigroup (C)	\$35.29 (12/11/07)	\$3.05 (11/21/08)	−88.11%
10	Lehman Brothers Holdings (LEHMQ)	\$66.58 (2/01/07)	\$0.02 (9/30/08)	−99.95%
11	Merrill Lynch (MER)	\$63.11 (12/10/07)	\$7.08 (11/21/08)	−84.42%
12	UBS (UBS)	\$51.89 (12/10/07)	\$8.33 (11/20/08)	−79.11%
13	Bank of America Corp. (BAC)	\$47.00 (12/11/07)	\$10.01 (11/21/08)	−73.42%
14	General Motors Corp. (GM)	\$29.95 (11/30/07)	\$1.70 (11/20/08)	−88.73%
15	Ford Motor Co. (F)	\$8.79 (4/24/08)	\$1.01 (11/20/08)	−80.11%

Data source: Yahoo! Finance.

fund assets totaled \$2.497 trillion at the end of the third quarter, according to HedgeFund.net, a hedge fund data provider.⁴

The demise of Bear Stearns and Lehman Brothers, for years seen by investors as reliable, represented two of the more prominent failures, reinforcing the fact that many institutional and professional traders were caught by surprise when the current financial crisis struck. Their trading systems and risk management strategies, which were based on some market model that had presumably worked well in the past, were unable to foresee the financial markets' meltdown.

The events of 2008 have led to seemingly peculiar and strange market behavior for many active investors and traders. Traders who lack an organic market timing method and a robust trading system have been unable to cope with the current market volatility. You could be like the many active investors and professional traders who have lost a great deal of

money by trying to apply an old system to new market behavior. Despite your disciplined methodology and your best efforts to follow a trading system, you might be finding that your trading losses are growing faster than your profit. Maybe it's becoming more challenging and difficult to trade your favorite security and market. Times have changed—but your way of thinking has not!

Needless to say, to be successful at trading you need a sound system that is resilient enough to adapt to different market conditions. All trading systems are rule based, and the simpler systems seem to be more successful and adaptable when there are major market shocks. However, to develop a system, you need to have a realistic view of market behavior. In other words, without a valid and sustainable market model, you can't develop a robust system. And without a robust system, you cannot become a successful trader. What you must always keep in mind is that a thriving and profitable trading system, which is a collection of rules and trading strategies, has to be based on some realistic market model that explains market behaviors in varying conditions.

In this book I present you with my Winning Edge market model, which is nonlinear and based on dynamic system behavior. Furthermore, I show how you can develop a winning system based on my model. Before we proceed any further, however, let's see what is so unique and different about recent market price actions. To do so, we first review the current market conditions to build a foundation for developing a robust system.

PRIMARY CAUSES OF THE CURRENT FINANCIAL CRISIS

The current financial crisis is attributed mainly to three factors: cheap money due to low interest rates; excessive borrowing by three economic sectors (consumers, corporations, and government); and lack of proper oversight and vigorous standards.

Low interest and cheap money were available for all, with less discretion. As a prolonged response to September 11, 2001, Federal Reserve Chairman Alan Greenspan cut the overnight Fed rate 13 times, to a mere 1 percent effective rate. After the stock market crash in 2000 and the bursting of the tech sector bubble, this action carried down all the major indices. It seemed that investors once more learned that "irrational exuberance" leads to a correction in market participants' mindsets and financial settings. The NASDAQ index fell 60 percent while the S&P index and Dow Jones, two other major equity market indices, fell 50 percent and 40 percent, respectively. However, the housing market was on a path to reach an "exuberant" growth.

The stage was set by Baby Boomers at their peak productivity, by low interest rates, and by Bush Administration policy that encouraged banks to lend to low-income sectors and poor neighborhoods under the Community Redevelopment Act. Finally, the relaxed lending models used by Freddie Mac and Fannie Mae contributed to the creation of one of the highest-ever price appreciations for the U.S. housing market. Hedge funds and financial managers kept pumping more cash and funds into ever-heating housing sectors. Quasi-government agencies such as Fannie Mae and Freddie Mac, which had the unofficial backing of the government, purchased all types of mortgages, called *papers*, either grade A, B, or C. The clever investment bankers seized the opportunity to make more profit by buying these papers in bulk and securitizing them in more values to sell them to money markets, pension funds, insurance agencies, and public investors. Wall Street and the financial markets were shifting into a new gear to create a highly artificial and shallow economic expansion.

However, homeowners used their houses like automatic teller machines to withdraw more funds under home-equity lines of credit (HELOCs) for all types of discretionary and unwarranted expenses and speculative investing in real estate and hedge funds. Corporations kept buying their own shares to boost up their stock prices by borrowing more money and issuing more debt. The U.S. government and the Bush Administration were on a shopping spree of their own kind and kept spending, to become the second largest spender and holder of deficits since the FDR Administration.

In the past few years, about 60 percent of our gross domestic product (GDP) growth was the result of big government spending. The other 40 percent was primarily from the housing bubble. However, as the saying goes, all good things must come to an end. Some of the subprime borrowers were not able to make their mortgage payments because the interest rate was going up. They rushed to sell their real estate. Consequently, as more supply came to the market and there was less demand, prices had to come down. As the housing market fell and real estate prices dropped, the vicious market meltdown cycle began. Consequently, more borrowers and homeowners had more difficulty making their monthly mortgage payments, resulting in an even greater price drop. However, some homeowners found that their houses were less valuable than the amount they owed to the bank. This led them to file for bankruptcy and leave the houses for the banks to foreclose on.

Securitization of mortgages created a huge supply of mortgage-backed securities (MBSs), which were sold to mutual funds, money market funds, pension funds, and insurance agencies. The Wall Street genius investment banks went even further. That is, if mortgage-backed securities were sold to investors, they created collateral mortgage obligations (CMOs), some of

them very high risk and below investment grade. To push these securities into financial distribution channels, our clever financial engineers created credit default swaps (CDSs) to insure the CMOs, MBSs, and other bonds and papers so that the sellers of debt instruments could convince buyers to buy their bonds. Now MBSs and CMOs were in big trouble. However, as the CMOs, MBSs, and other structured debt instruments got into trouble, the CDS market and the insurance market got into hot water, too. Giant international insurance agencies such as American International Group (AIG), which insured a large number of CDSs, were not able to keep up with payment defaults. As AIG went under, the foundation of the CDS market, which had grown to about \$6.5 to \$7 trillion, was shaken.

As the housing prices dropped and more homeowners were forced into foreclosure, the values of MBSs and CMOs dropped as well. Furthermore, since 2001 the financial institutions reporting rules had changed from cost-basis to mark-to-market value. (See Appendix A for more information on valuation methods.) During the housing market rise, financial institutions had been quite happy and felt rich because they could show very valuable assets on their financial balance sheets. Consequently, showing high-valued assets enabled them to borrow more and create stronger leverage.

However, as the housing prices fell, the same institutions did not have much to show for it. Moreover, since they had to report based on mark-to-market, either there was no market for their assets or it was very low, about 25 to 30 percent of original prices. This meant that each asset had to be devalued.

New Federal Reserve Chairman Ben S. Bernanke presented the situation at the National Association for Business Economics 50th Annual Meeting in Washington, D.C., on October 7, 2008:

... financial systems in the United States and in much of the rest of the world are under extraordinary stress, particularly the credit and money markets. The losses suffered by many banks and non-bank financial firms have both constrained their ability to lend and reduced the willingness of other market participants to deal with them. Great uncertainty about the values of financial assets, particularly more complex and opaque assets, has made investors extremely reluctant to bear credit risk, resulting in further declines in asset prices and a drying up of liquidity in a number of funding markets. Even secured funding has become expensive and difficult to obtain, as lenders worry about their ability to sell collateral in illiquid markets in the event of default. In addition, many securitization markets, such as the secondary market for private-label mortgage-backed securities, remain closed or impaired.⁵

The equity and stock market sold off to react to a financial crisis that seemingly began in the United States and soon spread across the globe. As the credit market dog was wagging its stock market tail, more financial problems came into play. The liquidity crisis changed to a confidence crisis. The central banks in the United States and across the world tried to calm the market anxiety by injecting more liquidity and reducing the overnight rates.

Fed Chairman Bernanke continued:

AIG's difficulties and Lehman's failure, along with growing concerns about the U.S. housing sector and economy, contributed to extraordinarily turbulent conditions in global financial markets in recent weeks. Equity prices have fallen sharply, the cost of short-term credit, where such credit has been available, has spiked, and liquidity has dried up in many markets. One money market fund's losses forced it to "break the buck"—that is, the value of its assets fell below par—an event that triggered extensive withdrawals from a number of money market funds. Those funds responded to the surge in redemptions by attempting to reduce their holdings of commercial paper and large certificates of deposit issued by banks. Some firms that could not roll over maturing commercial paper drew on back-up lines of credit with banks just as the banks were finding it even more difficult to raise cash in the money markets. At the same time, a marked increase in the demand for safe assets—a flight to quality and liquidity—resulted in a further drop in the value of mortgage-related assets and sent the yield on Treasury bills down to a few hundredths of a percent.⁶

In the following sections, we preview methods that you can use to deal with the current financial market meltdown.

DEALING WITH THE EMOTIONAL TOLL

Don't count on the market or on government to rescue you. You need to be proactive and take matters into your own hands. It's easy to blame the market and feel petty, falling into the victim mindset. If you are like many traders who experienced great losses in their investment and equity accounts, you might have gone through four distinct emotional stages: denial, anger, helplessness, and hopelessness.

First you went into denial due to total shock over the unexpected losses you experienced. It might have taken some time for you to realize what happened and what consequential changes you had to make to your

lifestyle and spending habits. However, as time passed and you watched more TV reports, read more articles, and heard more financial news, you gradually came to an emotional realization about what occurred. You understood that a financial crisis had swept the nation, wiping out the majority of your equity.

Then perhaps you grew angry as the second stage of dealing with this phenomenon. You felt upset and aggravated and couldn't take it anymore. You felt like screaming and expressing your anger. But then the anger passed and you moved on to feeling helpless. You felt you had lost control and there was nothing you could do to stop the massive loss and burden on your life. As the catastrophe spread to other financial institutions and companies, you recognized this is a massive market correction that was becoming a great market meltdown. You decided to follow the advice of the best financial advisors. You invested in the top-name hedge funds, which had enjoyed an impressive return in the past five years or so.

As you continued dealing with your losses, you reached the last stage: feeling hopeless. You started to experience emotional withdrawal. You didn't feel like socializing with your friends and kept quiet in family and social gatherings. Sometimes you felt like you wanted to sleep forever and shield yourself from the burden of your financial losses, which had created a glum outlook for your life. You could care less what came next.

This stage, if not dealt with quickly, could create a major psychological problem for you. This is the time when you need to take control of your financial destiny again, seeking solutions and, if necessary, professional advice.

If you are among those who have been holding the bluest of stock market blue chips, hoping that they go back up so you can at least break even, here's some sobering news for you. Your stocks and investments need to have moved up 1,000 percent in some cases, or even more, just to reach the price they were before this great stock market meltdown! If you think this is incredible, think about Freddie Mac's stock price, for example; it was \$37.18 on October 31, 2007, and dropped to \$0.25 on September 17, 2008. It would take *more than a 14,000 percent increase* just to reach the original price for breakeven!

It's time to look for a real plan and implement a real solution to get you out of such a financial mess.

RESCUING YOURSELF FROM FINANCIAL DISASTER

The past is past; there is no sense feeling bad about your past losses. Take your past as an expensive life learning lesson and move on. Remember,

there is no way you can control market behaviors. But you *can* control your own behavior. Here is a five-step process for rescuing yourself from this financial disaster:

1. Don't blame the market, or anyone else, for your investing losses.

Even people who've built careers studying economics were caught by surprise when the recent market turmoil struck. If professional investors were hard hit by the crisis, you obviously weren't going to emerge from it unscathed. And don't blame the market itself, either. It is simply a function of various factors and the dynamic ways in which they interact with one another. Accept what has happened—and the fact that the markets as well as your financial situation will not snap back to the way they were—and move forward. Life goes on, and the life of the market does, too.

2. Take personal responsibility for the things that you *can* control.

Whatever you do, never adopt the mentality of a victim. Whatever losses you have taken, you know that investing always comes with a certain amount of risk. You can never truly win at something if there is zero chance of losing. I urge you to use this sobering realization as a launching pad for greater success in the future. It is a sign of wisdom and maturity to know the difference between those things that are within your control and those that are not. You must learn to skillfully control and benefit from the former and bravely accept and endure the latter.

3. Become a trader.

As part of taking control of your own financial destiny, you should take a more active role in your investing. This means becoming a more active trader. The main difference between an investor and a trader is the frequency of their decision making. A trader makes more investing decisions with the help of a system. A trading system is a collection of trading rules that have been tested in various market conditions through a back-testing process (against historical data) and have proved to constitute a sound and robust system.

Never forget that you are captain of your own financial ship, so to speak. Steer her in the right direction and you are headed for a happy destination. But it is also your duty and obligation to yourself to be a vigilant watchman, on the lookout for any icebergs that may loom on the horizon.

4. Learn a winning investing plan and trading system.

To become a successful trader, first and foremost you need a proven and sound trading plan or system. In this book, I'll teach you about my Winning Edge System that can help you become a successful trader.

5. Trade your plan.

Having a winning system is an essential part of your trading success. However, you need to work your plan and implement it properly. To execute your plan flawlessly with no emotional burden, your trading system should be compatible with your personality and psychological makeup. In this book I provide you a test that can identify your important personality traits. By knowing your trading personality, you could achieve a much higher level of success and execute your trading plan under stressful market conditions.

The essence of this rescue plan is taking an active role in creating your own financial destiny. Devise a proper strategy to adapt to those events that are not under your control. However, be proactive and implement a sound plan to achieve your financial prosperity and success. This begins with transforming yourself from a passive investor to a proactive trader. Consequently, for maximum performance you must plan for the long term but monitor and execute your plan in the short term.

TRANSITIONING FROM INVESTOR TO TRADER

One of the most important steps to achieve your financial rescue is to transform yourself from a passive and long-term investor to a proactive trader. You could become a part-time or full-time trader, but if you invest actively and decide what to invest in and how to monitor your investment portfolio and positions, you're a trader.

Make sure you go into your trading endeavor with both eyes wide open, realizing how the investment world has changed. There's an important mental shift that you need to make to begin your journey toward financial independence and success. You need to fully comprehend the various drastic changes that have taken place in terms of the way investments work. To become a successful trader, you should have a better understanding of the new market conditions, which is the topic of Chapter 2.