

S E C T I O N
O N E

QUESTIONS

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HOW TO BUY, MANAGE RISK, & KEEP RECORDS

When I sat down to write a book about selling, it soon became clear that it had to begin with a section on buying and all that relates to it. Beginners buy when some vague tips float their way. Experienced traders know that serious buying requires serious research.

Scanning the stock market and researching individual stocks is very important, but analysis alone will not make you a successful trader. Serious buying requires good money management. There are simple mathematical rules that tell you how much risk you may accept on any individual trade as well as on all your open trades combined. Those who violate risk limits have a very short life expectancy in the markets.

There are certain psychological rules that can help you make your life in the markets less stressful and more satisfying and profitable. And there are certain highly desirable ways of record-keeping that will help you grow into a mature and successful trader.

You have to buy well in order to sell well.

That is why, before we discuss selling and shorting, you need to answer important questions about psychology and money management, buying decisions, and record-keeping.

Please do not rush as you work through this chapter. A house is only as strong as its foundation. Please answer these questions with a great deal of thought and record them on the Answer Sheet on pages 4 and 5. Re-read the appropriate sections in *Sell and Sell Short* if you miss any answers.

Answer Sheet

Questions	Max. Pts. Available	Trial 1	Trial 2	Trial 3	Trial 4	Trial 5	Trial 6
1	1						
2	1						
3	1						
4	1						
5	1						
6	1						
7	1						
8	1						
9	1						
10	1						
11	1						
12	1						
13	1						
14	1						
15	1						
16	1						
17	1						
18	1						
19	1						
20	1						
21	1						
22	1						
23	1						
24	1						
25	1						
26	1						

(continuing)

Answer Sheet, *continued*

Questions	Max. Pts. Available	Trial 1	Trial 2	Trial 3	Trial 4	Trial 5	Trial 6
27	1						
28	1						
29	1						
30	1						
31	1						
32	1						
33	1						
34	1						
35	1						
36	1						
Total points	36						

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Question 1—The Stress of Holding a Position

Having bought a stock, most people find themselves in the least stressful position if that stock:

1. Rises slightly
2. Skyrockets
3. Declines slightly
4. Collapses

Question 2—Your Trading Edge

Your trading edge can come from:

1. Fundamental analysis
2. Technical studies
3. Discipline
4. All of the above

Question 3—The Three Great Divides

The three great divides in trading include all of the following, except:

1. Technical vs. fundamental research
2. Trend vs. counter-trend trading
3. Relying on TV news vs. an advisory service
4. Discretionary vs. systematic trading

Question 4—Price and Value

Find the incorrect statement about the relationship between price and value:

1. Values change slowly, prices change fast.
2. Studying earnings reports and industry trends allows you to discover value.
3. Moving averages help define the value zone by tracking public consensus.
4. Price equals value at any given moment.

Question 5—Fundamental and Technical Analysis

Which of the following statements about fundamental and technical analysis is incorrect?

1. A fundamentalist calculates the value of the business that issued a stock.
2. Having precise information about the fundamentals tells you exactly which way a stock is going to go.
3. A technician looks for repetitive patterns in price data.
4. A pure technician does not care about earnings or corporate news; he only wants to know the stock ticker and price history.

Question 6—Trend vs. Counter-Trend Trading

All of the following are advantages of trend trading over counter-trend trading, except:

1. Greater profit potential per trade
2. Lower commission expense
3. More time to make decisions
4. Lower stress level

Question 7—System vs. Discretionary Trading

System trading has all of the following advantages over discretionary trading, except:

1. Knowing in advance what profits or losses to expect over a period of time
2. Less emotional involvement in every trade
3. A greater degree of freedom
4. A method for handling the uncertainty of the markets

Question 8—Technical Toolbox

A technical trader uses a toolbox of indicators in his or her decision-making. Find the correct statement among the following:

1. Selecting the tools that give the signals you want is a sound practice.
2. The more tools, the better the toolbox.
3. “Five bullets to a clip” allows you to use only five indicators.
4. The best indicators are well known, and a trader should use them.

Question 9—New High–New Low Index

Find the incorrect statement about the New High–New Low Index:

1. NH-NL confirms uptrends by reaching new highs; it confirms downtrends by falling to new lows.
2. The signals of NH-NL are symmetrical at tops and bottoms.
3. Bearish divergences of NH-NL warn of impending market tops.
4. Downspikes of NH-NL often identify important market bottoms.

Question 10—Trading Psychology

Find the incorrect statement about trading psychology:

1. If you set your technical system just right, you need not worry about psychology.
2. The mind of a trader continually filters the incoming information.
3. Wishful thinking causes traders to “see” non-existent technical signals.
4. A bullish trader is more likely to overlook sell signals.

Question 11—Trading Discipline

Traders need discipline because the markets present an endless parade of temptations. Please identify the incorrect statement among the following:

1. People with a history of poor impulse control are likely to fail in trading.
2. AA (Alcoholics Anonymous) provides a useful model for dealing with market temptations.
3. If you have a good trading system, discipline is not really an issue.
4. Some traders have personality flaws that make them destined to fail.

Question 12—Dealing with Losses

Many traders feel ashamed of their losses. Please review the following statements and find the correct one:

1. In training, punishments are more effective than rewards.
2. If you have taken several right steps and one wrong one in making a trade, you should punish yourself for it.
3. Successful traders love the game more than the profits.
4. It does not pay to keep records of losing trades.

Question 13—Overtrading

Trading a position that is too large for one's account will lead to all of the following, except:

1. Less spontaneity and greater stiffness
2. Less calm and adaptability
3. Fear of pulling the trigger
4. A greater focus on the market

Question 14—The 2% Rule

A beginning trader with a \$20,000 account decides to implement the 2% Rule of money management. He finds a stock quoted at \$12.50 and decides to buy it, with a price target of \$15 and a stop-loss order at \$11.50. The maximum number of shares this Rule allows him to buy is close to:

1. 900
2. 400
3. 350
4. 200

Question 15—Modifying the 2% Rule

An experienced trader with a \$2,000,000 account decides to modify the 2% Rule and cap his risk per trade at 0.25%. He finds a \$9 stock which he plans to ride to \$12, while putting his stop at \$8. The maximum number of shares his Rule allows him to buy is:

1. 2,000
2. 4,500
3. 5,000
4. 12,000

Question 16—The 6% Rule

Find the statement about the 6% Rule that is correct:

1. It will protect your account from a drawdown caused by a bad trade.
2. It will protect your account from a drawdown caused by a series of bad trades.
3. When losses begin to mount, the best response is to trade more actively, to trade your way out of a hole.
4. The 6% Rule needs to be applied after putting on a trade.

Question 17—The Top Two Goals for Every Trade

What are the top two goals for every trade?

1. Make money and test a new system.
2. Face the challenge and feel the joy of victory.
3. Make money and become a better trader.
4. Test your discipline and the ability to implement a plan.

Question 18—Learning from Experience

The best way to learn from experience is:

1. To make lots of trades
2. To keep good records
3. To discuss your trades with friends
4. To review your brokerage statements

Question 19—A Record-Keeping Spreadsheet

Which of the following must be included in a basic record-keeping spreadsheet?

- A. Gross and net P&L
 - B. The grade of each trade
 - C. Slippage on entry and exit
 - D. Source of every trade idea
1. A
 2. A and B
 3. A, B, and C
 4. All of the above

Question 20—Trading Mistakes

Which of the following statements about trading mistakes is incorrect?

1. Intelligent people do not make mistakes.
2. Making mistakes is inevitable when you learn and explore.
3. Repeating mistakes is a sign of impulsivity.
4. Keeping a diary helps you learn from your mistakes.

Question 21—Trader's Diary

Find the correct statement about the Trader's Diary:

1. There is no need to rush documenting your entry if you plan to fill in the diary after you exit.
2. The diaries of losing trades tend to be more valuable than those of winning ones.
3. It is essential to create diary entries only for your best trades.
4. An active trader who cannot document all trades can pick and choose what trades to document.

Question 22—Diary Entry

The diary of an entry into a trade must include all of the following, except:

1. The reason for making this trade
2. The buy grade for long or sell grade for short trades
3. Charts of your trading vehicle at the time of the entry
4. The trade grade

Question 23—Trading Plan vs. Diary

Which of the following describes the difference between a Trader's Diary and a Trading Plan?

1. Contains charts in two timeframes.
2. The charts are marked up to identify buy or sell signals.
3. The document is named after the stock ticker.
4. Buy or sell grades are recorded.

Question 24—The Monitoring Screen

The window for monitoring stocks in your trading software should include all of the following, except:

1. Key market indexes
2. Your open positions
3. The stocks you consider trading
4. The stocks you have exited

Question 25—Comments on the Screen

Keeping your comments about your open positions on the screen is useful for all of the following reasons, except:

1. It reminds you how long you have been in a trade.
2. It helps you see whether you are winning or losing in an open position.
3. It helps you keep track of your profit target and stop-loss order.
4. It helps you measure your performance.

Question 26—Pinning a Chart to a Wall

“Margret’s method”—pinning a chart to a wall and marking the trading signal for which you will be waiting—has all of the following advantages, except:

1. It forces you to clearly express what price or indicator action you expect.
2. It keeps you from forgetting a plan.
3. Removing the charts from the wall if your plans change helps keep your mind fresh.
4. Keeping charts on a wall ensures that you will act when the time is right.

Question 27—A Trial-Sized Order

Which of the following statements about a “Chihuahua trade”—a trial-sized order designed to draw your attention to a trading opportunity—is correct?

1. There is little difference between an electronic alert and an order for a handful of shares.
2. Chihuahua orders are good for placing stops.
3. Getting a fill on a Chihuahua order forces you to make a decision.
4. Once you have a fill on a trial-sized order, you must bring that trade up to full size.

Question 28—Grading Buys and Sells

Find the incorrect statement about grading buys or sells:

1. The closer you buy to the low of the bar, the better your grade.
2. The closer you sell to the low of the bar, the better your grade.
3. Selling above the midpoint of the bar earns a positive grade.
4. Buying in the lowest quarter of the bar earns an excellent grade.

Question 29—Grading Completed Trades

Find the correct statement about grading completed trades:

1. Money is a good measure of the quality of each trade.
2. A long-term trend trader can use channels to measure the quality of trades.
3. A trade capturing over 30% of a channel earns an “A.”
4. A trade capturing less than 20% of a channel earns a “D.”

Question 30—Buying

Find the incorrect statement about buying:

1. The principle of value buying is “buy low, sell high.”
2. The principle of momentum buying is “buy high, sell even higher.”
3. The upper channel line identifies the level of depression and the lower channel line the level of mania in the markets.
4. Momentum trading works well in runaway trends.

Question 31—Value

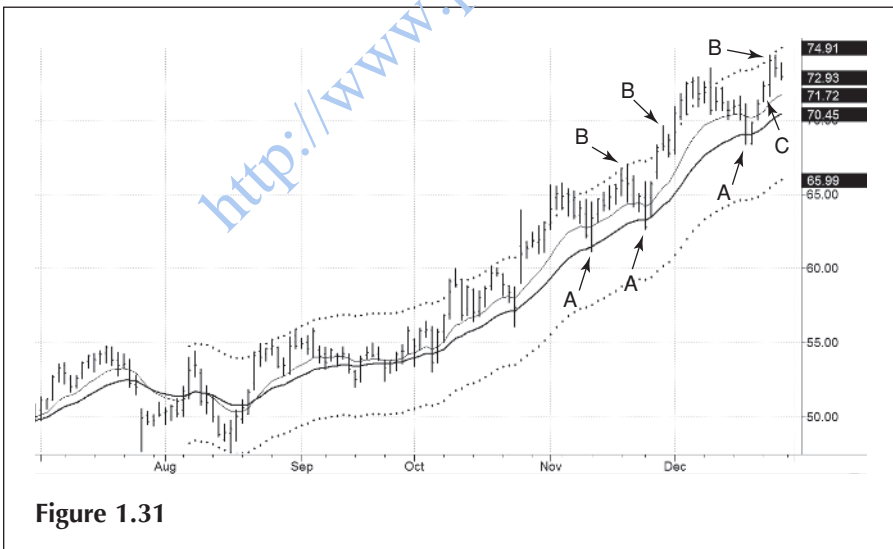


Figure 1.31

Please match the following descriptions with the letters on the chart:

1. Value zone
2. Below value—consider buying
3. Overvalued—consider selling

Question 32—The Impulse System



Figure 1.32

The Impulse system tracks both the inertia and the power of market moves. Some software packages allow traders to color price bars in accordance with the Impulse reading. Even on a black-and-white chart, a trader can tell what color any of the bars should be in accordance with the Impulse rules. Please match the following comments on the Impulse system with the letter bars on the chart:

1. Impulse Green—buy or stand aside; shorting not permitted
2. Impulse Red—sell short or stand aside; buying not permitted
3. Impulse Blue—no position is prohibited

Question 33—The Signals of NH-NL

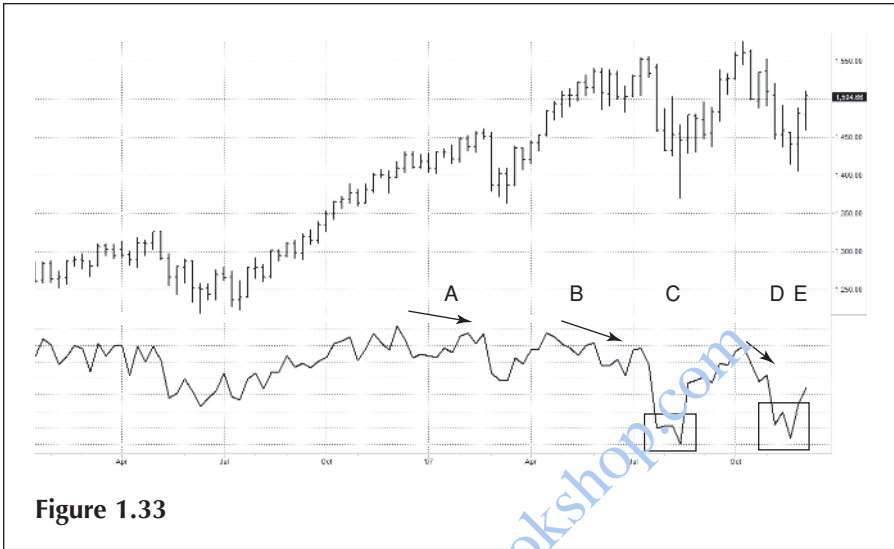


Figure 1.33

The weekly chart of New High–New Low Index (NH-NL) can help traders anticipate important turns in the stock market. Please match the following comments on NH-NL with the letters on the chart:

1. A spike identifies an unsustainable extreme and calls for a reversal.
2. A divergence identifies the weakness of the dominant crowd and calls for a reversal.

Question 34—A Trade Diary

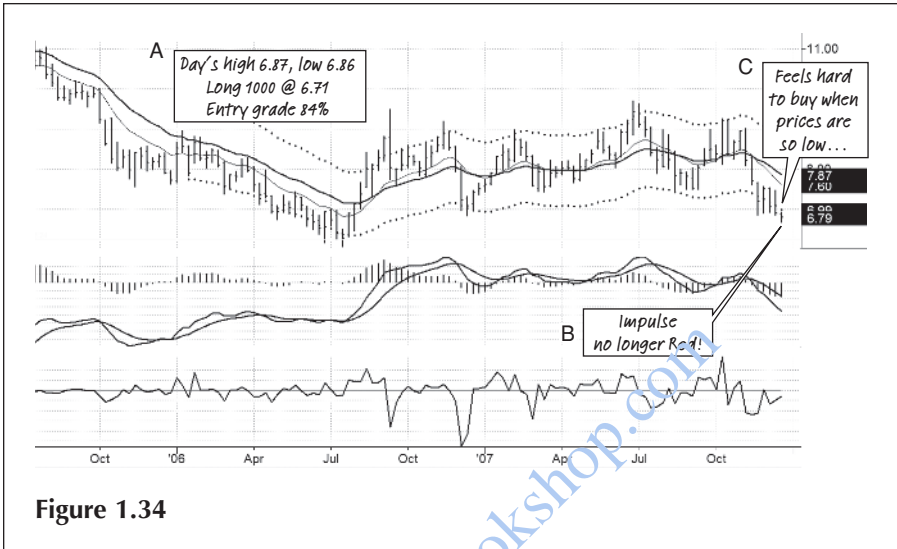
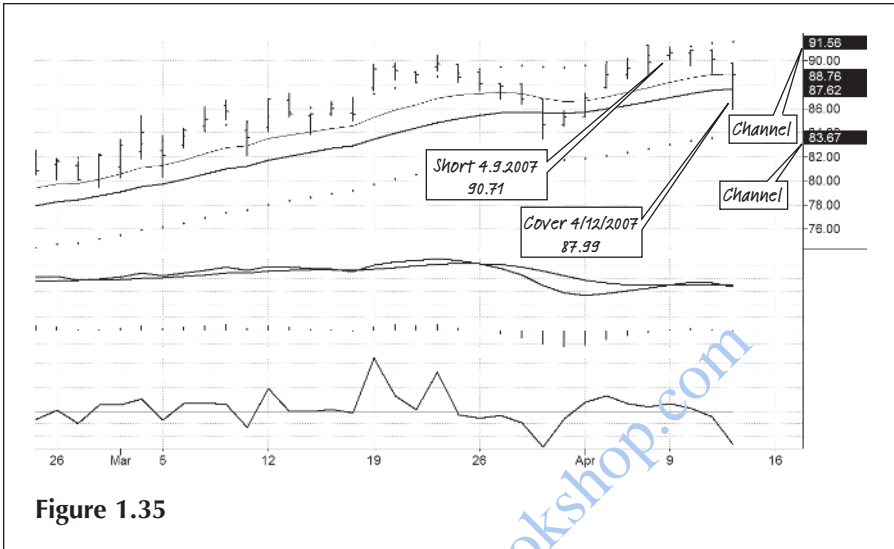


Figure 1.34

This chart comes from a Trader's Diary and illustrates an entry into a trade. Match the following with the letters on the chart:

1. A technical comment on a chart pattern that led to a trade
2. A performance rating
3. A psychological comment

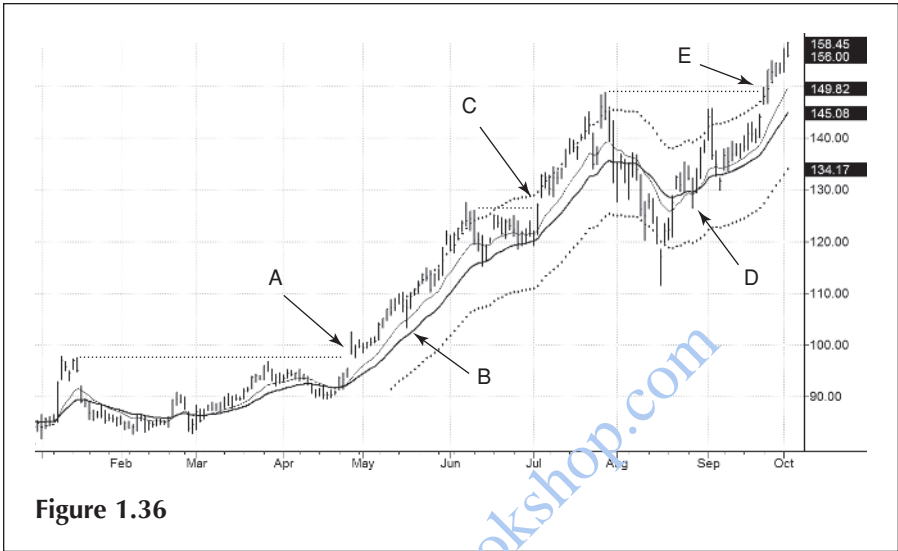
Question 35—Grading a Trade



This chart shows one of the trades in which I was piggybacking a Spike pick. The weekly chart is not shown here, but you can see bearish divergences of MACD Lines and Force Index on the dailies. The question, however, is about grading this trade: in at 90.71, cover at 87.99, upper channel line at 91.56, lower channel line at 83.67. What is the trade grade?

1. Trade Grade A: Over 30% of the channel
2. Trade Grade B: 20–30% of the channel
3. Trade Grade C: 10–20% of the channel
4. Trade Grade D: Below 10% of the channel

Question 36—Value Buying vs. Momentum Buying



Take a look at the letters on this chart and identify which represent value buying or momentum buying zones.

1. Value buying zones
2. Momentum buying zones

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