PART I

Introduction

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CHAPTER 1

Some Things Have Changed, but More Has Stayed the Same

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Since the publication of our last book in 2008 (*Trading ETFs: Gaining an Edge with Technical Analysis)*, many things have changed in the world of exchange-traded products. Not surprisingly, some of the less popular exchange-traded fund (ETF) families have ceased operations altogether, while a handful of fresh players have stepped in to take their place. In addition to traditional ETFs, investors now have the ability to buy and sell newer offerings known as exchange-traded notes (ETNs) and exchange-traded commodities (ETCs) as well.

Collectively, these three different types of fund offerings are generally referred to as "exchange-traded products (ETPs)," but for the sake of simplicity, we will continue to refer to the collective group of ETPs as ETFs throughout this book.

Despite the several hundred new ETFs that have been launched in recent years, bringing the total number of exchange-traded offerings to more than 1,000, approximately *half* of the total ETF asset base in the United States remains parked in *less than 30 different ETFs*. In this regard, there have been a significant number of changes in recent years, but not as much has changed as would initially appear on the surface.

More importantly, one other key element has not changed—the effectiveness of tried-and-true technical analysis strategies on ETFs. The same indicators and strategies we were using to trade ETFs back in 2008 are equally as effective today, just as they have been since beginning our trading careers. This is because technical analysis is nothing more than a graphical way to measure the levels of the various human emotions driving the markets at any given time. Although technology has evolved at breakneck speed in our current lifetimes, raw and basic human emotions have essentially remained the same since the dawn of humanity. That's why the same technical analysis strategies continue to work generation after generation, regardless of the instrument traded, and regardless of location in the world. We will dive more thoroughly into this in the chapters in Part IV, "Mastering the Psychology of Trading," later in the book.

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What Can I Expect in This Book?

In our first ETF book, *Trading ETFs: Gaining an Edge with Technical Analysis*, we focused on the use of very basic technical indicators including trend lines, moving averages, support and resistance levels, volume, and price action (swing highs and swing lows). Although it is not necessary, you may find it useful to read that book because it lays the groundwork for the advanced technical strategies covered in this book.

In this follow-up book, we will introduce several new technical indicators and strategies that enhance the effectiveness of our proven "top-down" trading strategy detailed in the last book. While the merits of our initial top-down strategy can certainly stand alone, applying additional technical indicators, strategies, and concepts only serves to improve the profitability of ETF traders.

Specifically, we will introduce and focus primarily on candlestick patterns, Fibonacci levels and Fibonacci time series, and accumulation-distribution combined with the Relative Strength Index (RSI). Although we believe in the simplicity of our core trading strategy, we have found these technical indicators to be quite useful without being cumbersome. There is a balance between simplicity and using additional technical tools to enhance your trading performance.

After detailing the new technical analysis strategies, we then walk you through the outcomes of 30 different actual ETF trades that were provided to subscribers of *The Wagner Daily* newsletter. Of these 30 trades, we have chosen 20 winning and 10 losing trades because obviously not every trade is a winner. Knowing how, when, and why to exit a losing trade is a critical skill for any serious trader of the markets. The analysis and explanation of these actual trades will follow the format of the actual trades detailed in our last book, which many readers have told us was their favorite part of the previous book.

Upon presenting the new technical analysis indicators and strategies and demonstrating their application with actual past trades, we then proceed to an entire chapter dedicated to mastering the psychology of trading. Hundreds of books have been written about trading strategies, but very few of them spend much time on the psychology of trading, which we strongly believe is one of the most important, yet often overlooked, elements of being a consistently profitable and successful trader of ETFs, stocks, commodities, futures, or any other instrument. Of the few books we have seen that actually are dedicated exclusively to trading psychology, the deep concepts may be overkill or the authors fail to draw the critical connections between the individual trader and interaction with the "group." These books are usually too esoteric and lack the explanation of what is really driving the markets. In Chapters 8 and 9 of Part IV, "Mastering the Psychology of Trading," we provide you with just the right amount of crucial details explained in a user-friendly and easy to comprehend manner.

Finally, we will conclude with an update on the latest developments in ETF trading. In addition to explaining the newer types of ETPs, such as ETNs, we will also address special account considerations for these instruments that investors and traders are typically not made aware of. Admittedly, understanding accounting

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and tax considerations may sound a bit boring, but understanding key financial implications of trading certain ETPs is another piece of the puzzle that impacts the overall profitability of your bottom line in ETF trading.

Let's Rewind

Before diving into the advanced technical analysis and strategies, we must first provide a brief recap of the top-down trading strategy taught in our first book, *Trading ETFs: Gaining an Edge with Technical Analysis*, because the framework of this entire book is predicated on our top-down methodology. However, before you can implement our strategy, you must first select a trading time frame that best suits your personal preference. Only then will you be able to implement the system.

Every trader is faced with decision of determining which trading strategy and time frame best fits his or her individual style. A preliminary requirement for using our top-down method is to first identify your preferred time interval for trading. The preferred trading time frame is important because it is used as a point of reference to determine the interval of the trend you should be following. For instance, if you are a day trader (opening and closing positions intraday), the five-year trend in an ETF plays no role in your intraday trade selection or decisions. Conversely, a traditional "buy and hold" investor who holds positions for multiple years should not care at all about intraday price movements on a 5-minute or 60-minute chart.

The beauty of our ETF trading strategy is that it works equally well for all time intervals. Examples throughout this book will focus on the "swing trading" time frame because that is what we personally utilize in investing client funds in our Managed Account program, and with the detailed ETF and stock trade picks we provide to subscribers of *The Wagner Daily* newsletter. However, there are four different time periods to choose from, and the pros and cons of each time frame are discussed below. Again, our preference is swing trading, but this methodology works equally well with any of the following time frames.

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Four Trading Time Frames (Intervals) for Investors

There are basically four trading strategies employed by the majority of investors. They include the traditional buy and hold strategy, position trading, swing trading, and day trading. Following is a basic review of each of these strategies.

1. Traditional "Buy and Hold"

The buy and hold strategy is probably the most common investment strategy. The characteristics of this strategy include the following:

- Holding period of several years to decades.
- Focuses on following trends on long-term weekly and monthly charts.

- Typically consists of a balanced portfolio of 20 or more stocks.
- Usually based primarily on fundamental analysis, rather than technical analysis.

Pros

- Very passive, minimal work required once investment selection is made.

Cons

- Limited flexibility. When positions are entered, they are held for years or even decades.
- Potentially large equity drawdowns and acceptance of long periods of time in which there may be little or no portfolio appreciation.
- Dependent on long-term market movements and the assumption that the market will always move higher over the long term.
- Little or no consideration of current trend when entering a position.

2. Position Trading

Position trading is not as well known as the buy and hold strategy. It is a trend-following strategy that seeks to derive profits over relatively long time periods, but while seeking to avoid the potential major drawdowns associated with long-term buy and hold investing. It is defined by the following characteristics:

- Holding period of several months to several years.
- Narrow portfolio selection with more heavily concentrated positions.

Pros

- Designed to achieve big gains from riding strong trends over intermediate time frames.
- Market exposure may be reduced when drawdowns result in long- and intermediate-trend reversals in the broad market.

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Cons

- Moderate flexibility in terms of entering and exiting positions.
- Larger drawdowns in choppy or range-bound markets.
- High volatility swings in profit and loss (P&L).

3. Swing Trading (Near and Intermediate Term)

Swing trading is the preferred methodology upon which our strategy is based. This strategy allows for potentially large gains with limited risk from overnight exposure, since holding periods are shorter. Here are the characteristics:

- Holding period:
  - Near-term trades are several days to weeks. Intermediate-term trades range from one to six months.
- Flexible, well-balanced strategy with solid reward-risk characteristics.

Pros

- Strong risk control due to market timing. Limited market exposure.
- Flexibility. Provides the ability to take advantage of shorter-term trends in both uptrending and downtrending environments.
- Offers trading opportunities in trendless (range-bound) environments.

Cons

- Requires active trade management. Positions must be monitored and adjusted every several days to several weeks. It is a more time-consuming, active strategy.
- Requires solid understanding and implementation of market-timing skills.

4. Day Trading

As the name implies, day trading is based on the intraday buying and selling of securities:

- Holding period ranges from several minutes to a full day. When "in the money," day trades are sometimes held overnight.
- Takes advantage of intraday price and volume momentum in the markets.

Pros

- Extremely risk-averse strategy due to no overnight exposure and risk of outside events.

Cons

- Requires very active management, sitting in front of a monitor all day.
- Physically and mentally demanding (requires solid reflexes).
- Quite time consuming; only suitable for full-time traders.

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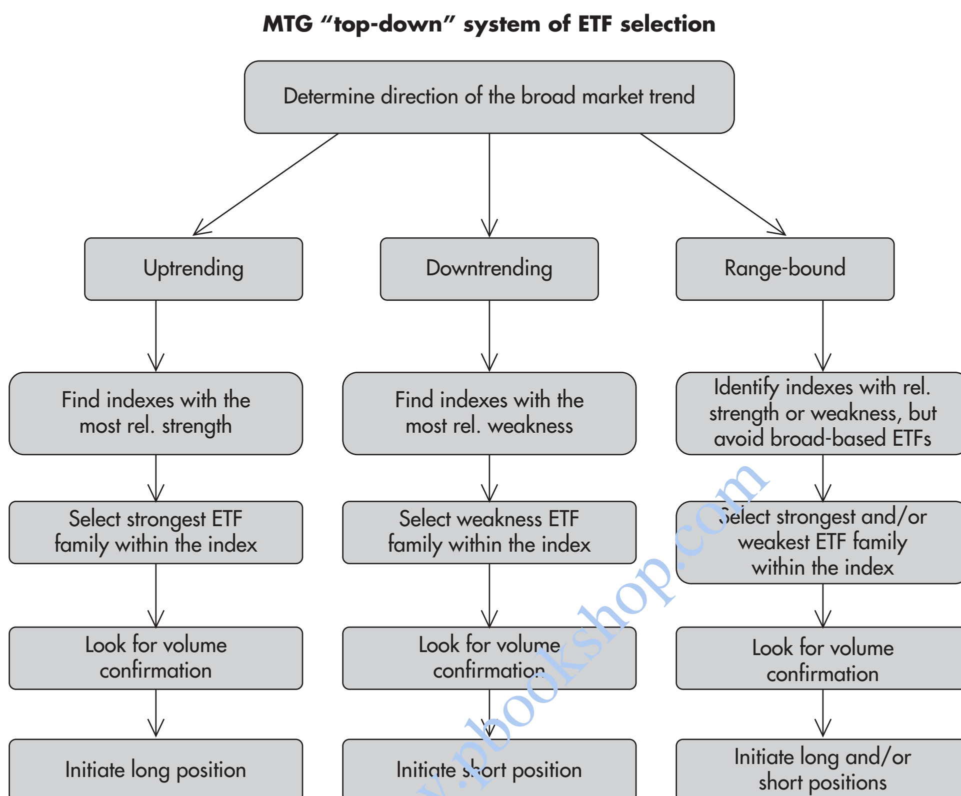
With the above information, we have provided you with an objective overview of each of the four main time frames for trading and investing. If you already have a preferred time frame for investing, there is no reason to change it. But if you're just getting started in the markets, it's important to make the personal decision as to which trading time frame best suits your needs.

Recap of Our Top-down Strategy

The following is a basic summary of our top-down strategy for selecting ETFs, which was detailed in the previously mentioned book. Our top-down trading approach is highly effective, yet rather simple. Many trading systems seek complexity, but we have found that the more complex trading systems become, the more difficult they are to monitor and manage. The relative simplicity of our logical strategy is illustrated in Figure 1.1.

FIGURE 1.1 Overview of top-down strategy



Source: Morpheus Trading Group

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Step 1: Determine the direction of the broad market trend.

- If the main stock market indexes (S&P 500, Nasdaq, and Dow Jones Industrial Average) are trending steadily higher, nearly any type of ETF with relative strength to the broad market can be traded.
- If the major indexes are in a steady downtrend, seek out any ETFs with relative weakness to the broad market.
- If the major indexes are range-bound, avoid trading in broad-based ETFs that track the major indexes.

Step 2: Determine which individual indexes are showing the most relative strength or weakness (divergence) to the main stock market indexes.

- Compare the charts of industry-sector indexes and specialty ETFs with the S&P 500 or Nasdaq Composite Index (the Dow is too narrow-based).
- Buy ETFs in the sectors or indexes with the most relative strength if the market is uptrending overall.
- Sell short ETFs in the sectors or indexes with the most relative weakness if the market is downtrending overall.

As an alternative to the graphical method of looking at charts, use numerical percentage-change market minders to identify relative strength or weakness.

Step 3: Compare all the ETF families within the specific index to find the individual ETF with the most strength (or weakness) relative to the corresponding index.

- Again, overlay charts of each ETF family with the corresponding sector index.
- Ensure that the ETF is also showing relative strength (or weakness) to itself, closing in the upper 30 percent (or bottom 30 percent) of its intraday range every day.
- Monitor changes in volume to confirm institutional buying interest.

Step 4: Select the resulting long or short ETF position now most likely to outperform the market.

Step 5: Find the proper timing for a new position entry in the ETF most likely to outperform the stock market.

- Use the strategies in this book to locate ideal technical entry and exit points for new ETF trades, then exit with maximum profitability or minimal loss.
- Know how to manage overnight gaps in your positions.
- Trail stops based on trend lines and other technical indicators for maximum profitability and conservation of profits.

In this book, we will build on the concepts taught in the five basic steps to our "top-down" strategy summarized above by introducing additional indicators to improve your overall market timing, new technical trade "setups," and key rules for successful understanding of the psychology of trading.

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