Market Line Update for Monday, May 17, 2004
FYI
When Things Don't Go As Planned

Anyone who has been a student of the Wyckoff approach for a while knows that some times things do not go as planned even when the greatest care and effort has been used in employing the concepts. How these situations are handled can make or break a market operation. The best plan for managing a bad situation is to avoid denial and panic and to actually have a plan that has been determined before the need to use it arises.

Denial and panic are both the result of uncontrolled fear. Most Wyckoff students are more vulnerable to one than the other. In an effort to better know yourself and where your personal vulnerabilities lie, consider making a study of trades that went badly to see whether there is a pattern of denial or panic in dealing with problem trades. This knowledge can be the first step in developing a solution.

Denial is probably more costly than panic. It can present itself in two ways. The first is the most deadly. It arises up front when a position is being established and the trader denies the possibility that he could be wrong and fails to use a stop order. The unprotected position actually has a stop order. In the case of a long position it is zero. For an unprotected short position the stop is infinity. No one ever rides a bad position to either of these extremes. However, most students who allow themselves to get into these situations are ultimately stunned by how much pain they are willing to endure when they are forces to realize the loss.

The other way in which denial presents itself is by ignoring a developing problem on a day to day basis. Each day, the combination of price spread, volume and the position of the close relative to the spread make a statement. Some are positive, some are negative and some are neutral. Wyckoff tells us to take positions at danger points. These are the primary trading opportunities such as springs and up thrusts. The character of the action around these points on a day to day basis is critically important. If the character of the action does not support the trading opportunity that was acted upon and that fact is denied or somehow ignored, the traded is vulnerable to seeing I=his position break decisively in the wrong direction and result in a loss that could have been avoided.

Panic is seldom as costly as denial over the short term. However, enough panic attacks over a prolonged period of time will get expensive and can result in a crisis of confidence. The individual who is already facing such a crisis may opt to place a stop a few pennies away from the low or high on the day on which a position is established. This requires perfect timing on the part of the trader and immediate performance by the position. It is unlikely that this combination will be realized on a consistent basis. The trader who falls into this trap is likely to spend a considerable amount of time looking back on profits that could have been.

Consider the student who buys a potential spring position on the day the support level is first penetrated based on the fact that the character of the action on that day indicates that a positive response may be anticipated. The stop is placed ten cents below the low on that day. If this is a spring with only a one day penetration, the result is an excellent trade. However, most springs penetrate the support level for several days and frequently the first penetration is not the deepest. The person who is so fearful of being wrong that he behaves in this manner is going to take many small losses and have to then watch many of those positions go on to perform as anticipated.

Panic is more frequently seen when a position is taken with a liberal 3 to 1 risk/reward ratio and then experiences one clearly bad day. The traded panics and gets out to protect his stop. Protecting a stop is a good idea. However, it is also a good idea to consider whether the one bad day can reasonably fit into a positive outcome. For example, if a long position is established on what is anticipated to be a shakeout and the position is taken one day before the bottom is reached, that one additional bad day may result in the position being closed out just as the turn is occurring. It should be noted there is a danger here of allowing the desire to avoid panic to develop into denial.

The best way to avoid both denial and panic is to have a general plan of operation predetermined before a position is taken and to follow that plan. A plan can have only a few broadly defined steps or many much more detailed steps. A detailed plan is usually better because it helps limit the effect of adverse emotions that lead to denial and panic.

A plan of action may include a list of what primary trading opportunities will serve as the basis for taking a position. A limited list is likely to work better than a more general list. A good basis for determining what is on the list is past performance. Most students do better with some trading opportunities than with others. It is best to do what you have proven that you can do and leave the rest for practice trading.

An absolutely essential part of any plan has to be protection. The most important part of protection is placing the initial stop. The days immediately after a position is established is the period when denial and panic can do the most damage. Failure to use a stop in combination with a position that quickly goes decisively bad almost always leads to denial that can be fatal. A good example of where this can happen is when a potential spring fails just after a long position has been established with the result being a fall through the ice. The individual who does not have a stop is vulnerable to labeling the fall through the ice a shakeout and stay with the position for the balance of the mark down.

The other extreme from the one just mentioned is the individual again trading foolishly without a stop who takes a position and is quickly in a panic because of a few days of nonperformance that are seen as an indication that the position was a mistake. A good example of where this can happen is when someone sells a potential up thrust and then has to watch the stock hang in that position for several days making slightly higher highs each day. Panic over the possibility that the position is going to turn into a jump frequently results in the position being closed out just before it begins to perform as anticipated. The student who is vulnerable to this type of behavior but who does use a stop can fall into the same trap by using an extremely close stop. In this case, the tendency to panic can be denied even though it was actually realized at the time the position was established. In this case, the responsibility for any loss that results can be transferred to the stop. Actually using a stop with a three to one reward/risk ratio prevents denial from being fatal and prevents panic from causing premature evacuation.

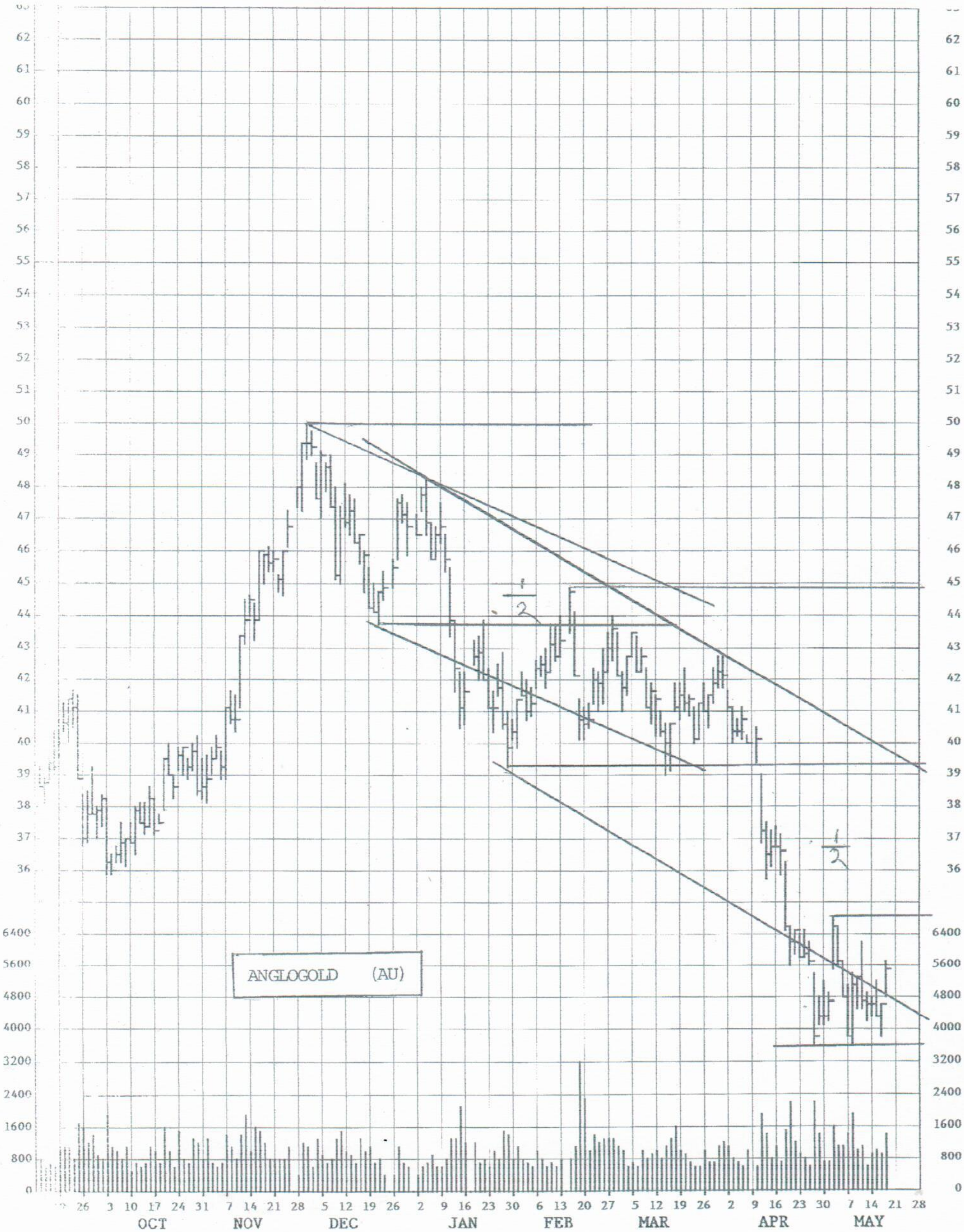
Another part of a potential plan is to consider buying insurance (options) in addition to using a stop when a position is established. This insurance can help reduce any loss from a stop that is caught or when the character of the action suggests that the stop will be caught. The potential down side of buying insurance is that it is not free. In situations where it turns out to not be needed, it will diminish positive results.

A recent example of how denial can be fatal can be seen in the case of AU, which was introduced based on the test of a spring. The response to the test took out the high of the response to the spring. The price then backed up for a more important test. We would prefer that these more important tests not happen. There is no reason that they should or need to happen unless the first test was of poor quality. However, they do happen frequently. Therefore, we have to live with them. In this case, however, there was a decisive failure on the test and the price fell through the ice so quickly that any stop had to be caught. Note that in this case having insurance would have helped limit the damage. Also note that where denial let the fall through the ice be viewed as a shakeout the traded is likely still long and hopelessly under water.

A recent example where panic could have resulted in missing a profit can be seen in AVY introduced on what appeared at the time to be a decisively successful test of an up thrust. However, the following day produced an intra-day failure to the down side and that was followed by a wider price spread to the up side. If a position was established on the wider spread to the up side before the day had a chance to develop that character, the position may have been stopped out in the days that followed. If the position was established after the day was known to be a wider spread to the up side, one has to wonder why it was established. The character of that action does not confirm the desirability of taking that position at that time.

The individual vulnerable to panic who sold on the wider spread to the up side before it was known to be that could easily have been feeling the panic after the day was over and might have gotten out on the open the next day. However, the character of the action on that day was not consistent with that of a potential jump. The same was true of the action on the next two days. The position then went on to become profitable.

No one likes when things don't go as planned. Having a plan to deal with these situations can help prevent a disaster of frustration. Having a plan may not prevent a loss, but it will help keep it under control. Remaining in control is essential to achieving consistent success. Denial and panic represent a lack of control. Anything and every thing that can be done to avoid them should become a regular part of any market operation.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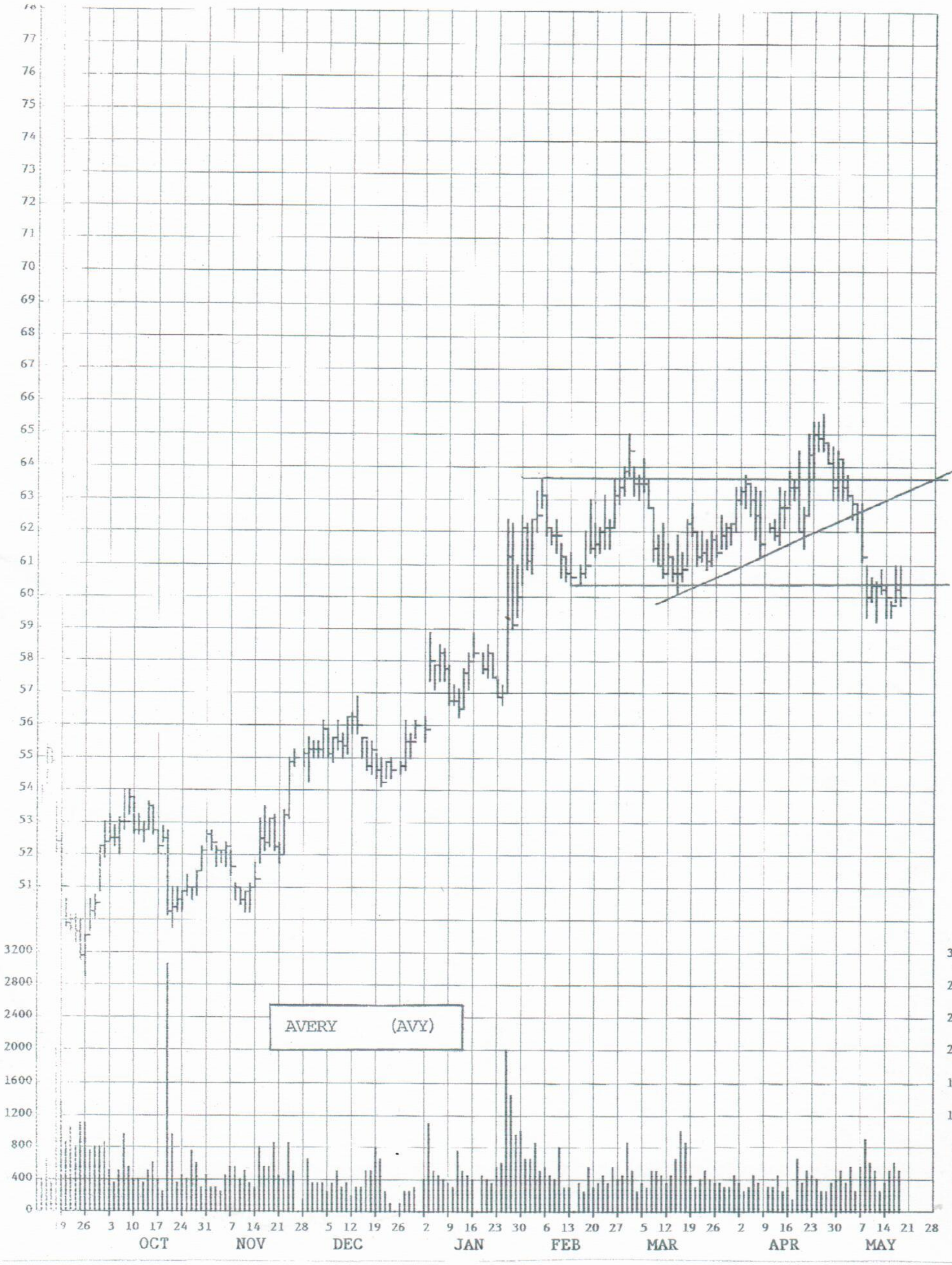
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