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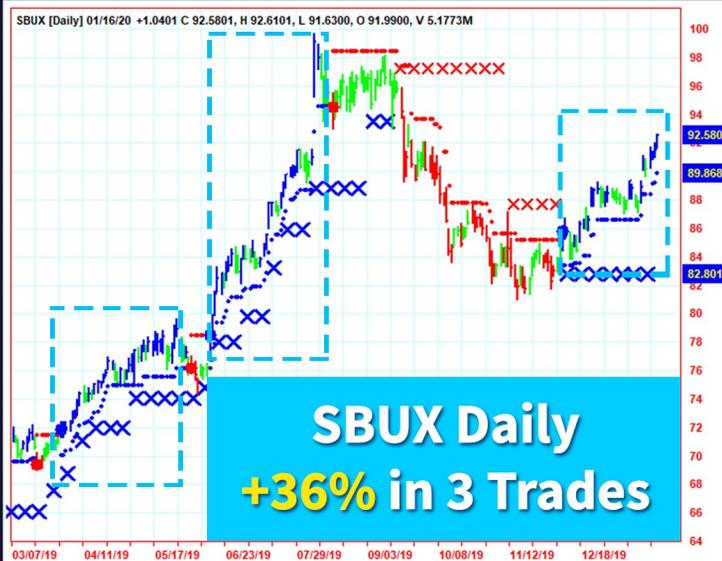
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*Follow The Yellow Dots*

# What Is Trading?

*The idea of making money from the stock market is what attracts us to the markets. But what does it really take? Here's a realistic look.*

by Sunny J. Harris



What is the difference between trading and investing? Why would someone want to trade instead of taking a position and holding it for a long time? What is buy & hold? These are questions we ask as we progress in life far enough to have funds to speculate with.

## INVESTING

Most of the speculative populace is interested in investing. It is generally believed that buy & hold makes the most sense, year after year, since the stock market supposedly returns about 9% per year over the long term, and that few traders ever do better than this. It is a rare breed that chooses to try trading.

The buy & hold method is simple. At some point, when you decide you have the funds to speculate with, you choose a stock (maybe one that is

currently at a low historical price, one that pays good dividends, or one that your coworker told you was a hot one to get) and you buy a certain number of shares.

Generally, you buy the number of shares that your funds divided by the current price allows. Say you have \$1,000 to invest and you want to buy shares in Google Inc. (GOOG). If GOOG is trading at \$540, then you can only buy one share, almost two. Maybe you stretch your funds and invest \$1,080 to purchase two shares. You hold onto these two shares for your retirement and only sell them when you need the money to fund your leisure years. Let's say you are 40 years old and have about 25 years until retirement. In 2005, GOOG was at about \$100 per share. Over the past nine years, the price of GOOG has gone from \$100 to \$540 a share; that's \$440 of profit per share.

Assuming the stock continues to accelerate at the same tempo, then theoretically, over the next 25 years (by 2039), the price should rise to \$1,222. That's about 682 points over 25 years that a buy & hold investor would potentially benefit from.

## TRADING

What if you didn't want to hold onto the stock during recessions or periods of downturns? What if you wanted to take profits at the top of market trends, and buy back when the price hits a new low and begins to turn around? That approach—buying low and selling at highs—is referred to as trading. If a stock trades linearly upward, no matter what the economy, no matter what the profitability of the company, then there are no trading opportunities. However, if the stock goes up and then down and then up again several times over the next 25 years, then there will be trading opportunities.

Trading doesn't necessarily mean making several trades during the trading day. You can analyze your stock using prices settled at the end of each trading day, that is, daily data. You could also choose to use weekly data, that is, prices settled at the end of each week (on Friday). In Figure 1 you see a weekly chart of Google Inc. (GOOG) over a nine-year period. You can clearly see that there are periods when price is high and periods when price is lower. The move from a local high to a local low is often called a *drawdown*.

## MARKING IDEAL ENTRIES

I have an indicator I call PHW, which stands for *potential hourly wage*. I created this indicator to show me how much money I could make trading any stock or commodity. (You can find out more about this indicator in my article "First,

You Design The System” that appeared in the June 2012 issue of *Technical Analysis of STOCKS & COMMODITIES*.) In creating this indicator, I wanted to be able to explore whether I could make more money trading or whether I should get realistic and realize that even an hourly job at a local fast-food joint would actually pay more. After all, if my trading results are negative, it doesn’t make sense to engage in trading, does it?

### BUYING & SELLING, BUYING & SELLING

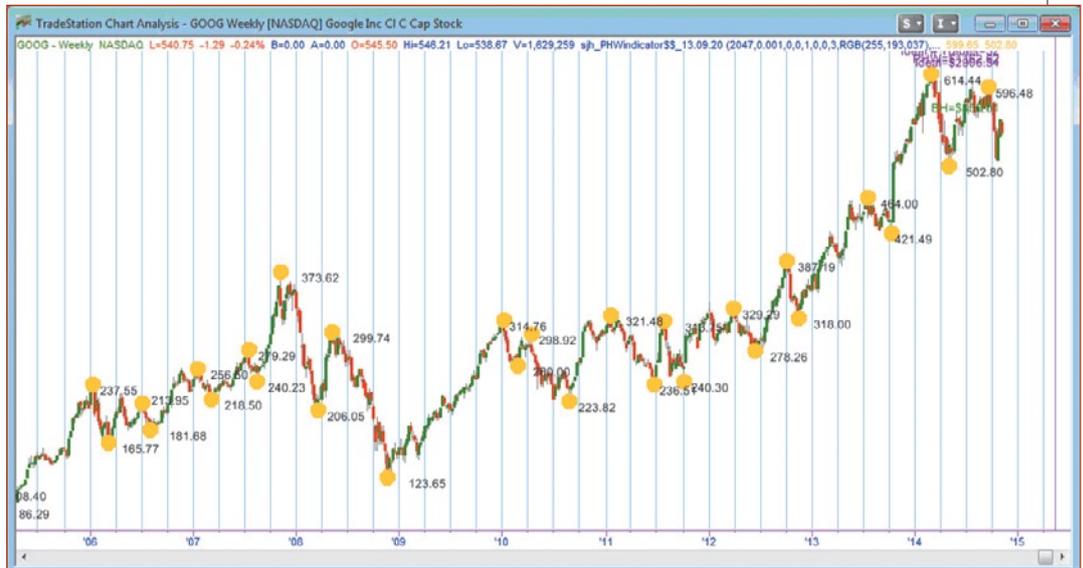
In the chart in Figure 2 I inserted my PHW indicator, which draws yellow dots at all the ideal highs and lows. You can’t trade with this indicator because highs & lows can only be calculated after the fact; the yellow dot is calculated after price has already moved on and created enough new information to tell where the dot goes.

Notice that each yellow dot is accompanied by numbers printed in black. These numbers show the price at the time of the dot. This makes it possible to figure out your profits or losses if you had hypothetically opened a long position at each low and sold it at each high, or taken a short position after liquidating your long position at a local high price.

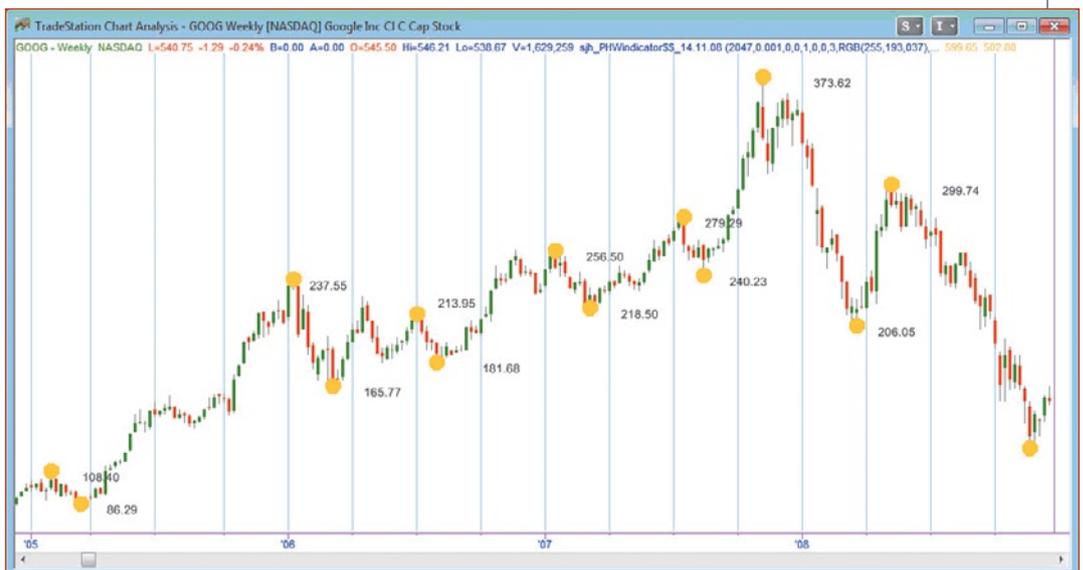
In Figure 3 I have enlarged the left-hand side of the chart in Figure 2. It makes it easier to see the prices associated with the



**FIGURE 1: NINE YEARS OF WEEKLY DATA.** It’s clear that there are periods when price is high and periods when price is lower.



**FIGURE 2: THE POTENTIAL HOURLY WAGE (PHW) AT WORK.** Here you see a weekly chart of Google Inc. (GOOG) with the PHW indicator inserted.



**FIGURE 3: ZOOMING IN.** Here are the prices at which the yellow dots occurred.

**TRADING SYSTEMS**

108.40
86.29
237.65
165.77
213.95
181.68
256.50
218.50
279.29
240.23

**FIGURE 4: BUYING & HOLDING.**

Over this period of time, a buy & hold investor would buy at \$108.40 and sell at \$240.23 for a gain. You would be a winner to the tune of \$131.89 per share.

dots. In the table in Figure 4, I have entered the prices of the first 10 dots from the left-hand side of the chart. The first dot shows a price of \$108.40. The last dot has a price of \$240.23. Over this period of time, a buy & hold investor would buy at \$108.40 and sell at \$240.23 for a gain. In other words, you would be a winner to the tune of \$131.89 per share. A trader, on the other hand, would have made nine trades, which would look similar to those listed in the table in Figure 5. If you could make all these ideal trades, you could have a profit of \$538.47 per share, whereas if you were a buy & hold investor you would have only made \$131.89 per share. Obviously, the difference is significant. Now imagine the profit difference if you performed this same exercise over the entire nine-year period.

Don't think that I want everyone to rush out and become traders. Far from it! It takes a special kind of person to be a trader. First, to be a trader, you need to have a high tolerance for risk. Second, you need an account that can withstand serious amounts of drawdown.

And third, you need to devote more time to study and the practice of trading than you do if you are an investor. Furthermore, you need to have the time during the day that you can devote to trading. You can't just do it at night after work.

**NOT PERFECT, BUT GOOD ENOUGH**

Although it may not be possible to catch all the trades highlighted by the PHW indicator, I have found over the past 33 years of my

**A stock that just ambles along from low to high is an opportunity for buy & hold, while a more volatile stock offers trading opportunities.**

Trade	Entry price	Exit price	Profit
Sell short	108.40	86.29	22.11
Buy	86.29	237.65	151.36
Sell short	237.65	165.77	71.88
Buy	165.77	213.95	48.18
Sell short	213.95	181.68	32.27
Buy	181.68	256.50	74.82
Sell short	256.50	218.50	38.00
Buy	218.50	279.29	60.79
Sell short	279.29	240.23	39.06
<b>TOTAL</b>			<b>538.47</b>

**FIGURE 5: FOR TRADERS ONLY.** Here you see the ideal trades that were marked by the yellow PHW dots. A trader could have potentially made nine trades with a profit of \$538.47 per share.

own trading that it's likely that you could have achieved approximately 60% of the ideal trades. You catch the low a little late and you get out a little past the high. So you miss about 20% on the entry and you miss about 20% on the exit. In Figure 6, which is an expanded view of the right-hand side of the chart in Figure 2, you can see the ideal profit, ideal number of trades, date span, and PHW profit written on the chart. The PHW value you see there is 60% of the ideal profit.

**CHOOSING WHAT TO TRADE**

I also have a RadarScreen version of my PHW indicator. Rather than drawing yellow dots, I can select stocks (or anything else) that have a high degree of tradability (versus buy & hold) by listing the PHW values in individual cells. I can sort the PHW column in ascending or descending order.

In Figure 7 you see a display of the stocks that make up the Dow Jones Industrial Average (DJIA) with the PHW indicator at the right. The columns are labeled *BH* for buy & hold; *ideal* for the ideal possible points; *PHW total* for the 60% value of the ideal; and *N#trades* for the ideal number of possible trades. A stock that just ambles along from low to high is an opportunity for buy & hold, while a more volatile stock offers trading



**FIGURE 6: ZOOMING IN.** Realistically, you get in a bit after the low and you get out a little past the high. At that rate, you would make approximately 60% of what would be an ideal trade.

opportunities. High PHW values indicate stocks that could present multiple trading opportunities.

Sorting the columns based on their PHW value makes it easier to see which stocks show the most volatility or opportunities for trading. When I sorted the table in Figure 7 by PHW total, Visa (V) came out on top. In Figure 8 you see the daily chart of V. Notice how many yellow dots are on the chart. Each one of those represents turning points. With each of these dots you could take the reversal trade, which would make for a total of 19 trades, as opposed to the buy & hold approach, which would create one trade, buying at the left-hand edge and continuing to hold all the way to the right-hand edge. With more trading opportunities comes more potential profit.

When the moves between dots are meaningful, for instance, more than a point or two, then there is money to be made with each trade. Also be mindful of the scaling feature in your charting program. If the scaling is distorted and the difference between points is exaggerated, then the scaling can fool you into thinking there is money when in fact there is not.

### TRADER OR INVESTOR?

I hope my attempt at covering the basics of what it means to be a trader versus what it means to be an investor has helped you decide which camp you want to be in. If you are an investor, you look for value and then you buy and hold on, waiting for retirement (or some other measurable goal). If you are a trader, you look for value over and over again, buying and selling and then buying and selling again, picking up smaller returns, but frequently.

*Sunny J. Harris is an author, trader, computer programmer, and mathematician who has been trading since 1981. The first printing of her book, Trading 101, sold out in two weeks*

Symbol	Interval	Last	Net Chg	Net %Chg	Bid	Ask	High	Low	Volume Today	PHW Total	#Trades	
Dow Jones Industrial Avg (31)												
1	AAPL	Daily	130.14	1.37	1.06%	130.14	130.18	130.72	128.36	50,722,697	118.97	8.00
2	AXP	Daily	80.17	-0.05	-0.06%	79.91	80.55	80.55	79.78	4,579,850	29.23	11.00
3	BA	Daily	146.99	0.11	0.07%	146.72	147.25	147.24	146.30	2,153,183	131.79	8.00
4	CAT	Daily	88.15	0.28	0.32%	88.16	88.39	88.50	87.65	3,074,585	82.38	6.00
5	CSCO	Daily	29.75	0.20	0.68%	29.75	29.78	29.90	29.42	23,895,147	27.31	8.00
6	CVX	Daily	106.66	-1.37	-1.27%	106.58	106.66	107.51	106.58	6,367,239	113.44	7.00
7	DD	Daily	69.95	-0.30	-0.43%	69.88	70.10	70.42	69.92	5,366,859	36.91	12.00
8	DIS	Daily	110.40	0.10	0.09%	110.17	110.64	110.74	110.01	4,867,845	45.38	10.00
9	GF	Daily	27.31	0.04	0.15%	27.31	27.32	27.39	27.21	22,453,982	23.20	8.00
10	GS	Daily	204.49	-1.52	-0.75%	204.22	204.99	205.18	202.64	2,154,315	85.19	11.00
11	HD	Daily	114.41	1.06	0.94%	114.41	114.70	114.60	113.16	6,849,321	48.16	11.00
12	IBM	Daily	173.06	-0.20	-0.11%	173.06	173.19	173.49	172.30	1,928,014	148.48	7.00
13	INTC	Daily	33.37	0.38	1.15%	33.37	33.40	33.41	32.85	23,593,147	14.62	8.00
14	JNJ	Daily	103.43	1.13	1.10%	103.42	103.53	104.34	102.32	10,467,196	88.19	10.00
15	JPM	Daily	66.43	0.55	0.83%	66.38	66.63	66.54	65.80	10,505,661	25.09	9.00
16	KO	Daily	41.31	-0.21	-0.51%	41.26	41.35	41.49	41.25	11,440,299	37.24	8.00
17	MCD	Daily	98.28	0.24	0.24%	98.02	98.30	98.25	97.62	4,093,047	133.31	6.00
18	MMM	Daily	163.00	-0.30	-0.18%	162.80	163.49	163.59	162.31	1,748,124	140.71	10.00
19	MRK	Daily	60.16	-0.07	-0.12%	59.61	60.22	60.45	60.01	7,190,826	16.91	8.00
20	MSFT	Daily	48.08	-0.21	-0.45%	48.01	48.09	48.22	47.61	23,918,021	45.35	10.00

**FIGURE 7: SCREENING THE PHW INDICATOR.** Sorting the columns based on their PHW value makes it easier to see which stocks show the most volatility, or opportunities for trading.



**FIGURE 8: PHW ON A CHART OF VISA (V).** With each of these dots, you could take the reversal trade, which would give you a total of 19 trades. With more trading opportunities comes more potential profit.

and continues to be a financial bestseller; her second book, Trading 102, also achieved record sales. In early 2000, Harris released Electronic Day Trading 101, followed by Getting Started In Trading in 2001. Her latest book is TradeStation Made Easy. She may be contacted at MoneyMentor.com.



### FURTHER READING

Harris, Sunny [2012]. “First, You Design The System,” *Technical Analysis of STOCKS & COMMODITIES*, Volume 30: June.

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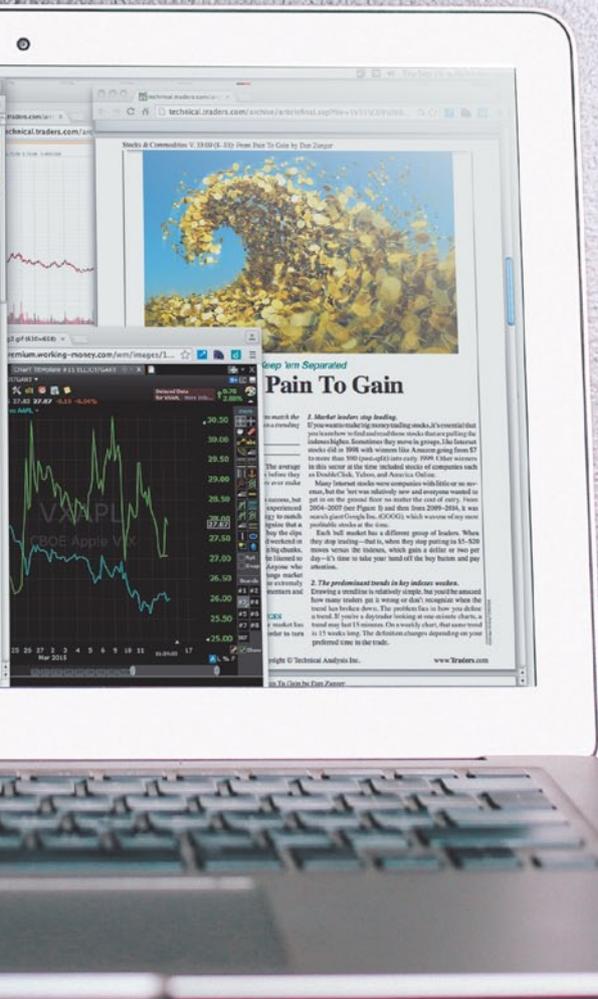
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