Evolution of a Trader

Fundamental Analysis and Position Trading

Thomas N. Bulkowski

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THOMAS N. BULKOWSKI

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Preface

Are you like John?

He learned early in life to save his money for a rainy day. Instead of putting it into the bank, he p
it into the stock market. He bought Cisco Systems in mid-1999 at 35 and watched the stock soar to 8
in less than a year.

"I'm looking for my first 10-bagger," he said, and held onto the stock.

In 2001, when the tech bubble burst, the Cisco balloon popped, too, and it plunged back to 35. H
was at breakeven after seeing the stock more than double.

"It'll recover," he said. "It's a $200 stock. You'll see."

The stock tunneled through 35 then 30, then 20, and bottomed at 15, all in *one* month. When it h
10, he sold it for a 70 percent loss.

"I should have sold at the top. Buy-and-hold doesn't work." But it did work. Cisco more tha
doubled, but he held too long.

Next, he tried position trading to better time the exit and chose Eastman Chemical. He bought it
2003 at 14, just pennies from the bear market bottom, and rode it up to 21 before selling. He made 5
percent in a year. Was he happy?

"I sold too soon." The stock continued rising, hitting 30 in 2005. He disliked seeing profits mou
after he sold, and wanted to profit from swings in both directions.

He switched to swing trading in 2005 and tried his old favorite: Cisco. The stock bounced from 17
20 to 17 to 22 over the next year, but he always bought too late and exited too early. He made mone
but not enough.

He took a vacation from his day job and watched Applied Materials wave to him on the comput
screen, inviting him to come day trade it. So he did. He made $400 in just 15 minutes. "If I can mal
$400 a day for a year, I'll make"—he grabbed his calculator and punched buttons—"$146,000! N
that's not right. How many trading days are there in a year?"

He redid the math and discovered that he could make $100,000 a year by nibbling off just 40 cents
share on 1,000 shares every trading day. "Wow. Count me in."

After paying $5,000 for a trading course and more for hardware, software, and data feeds, he too
the plunge and started day trading full time.

It took a year to blow through his savings. Another three months took out his emergency fund. H
moved back in with his parents while he looked for a real job.

Now, he is saving again and putting it to work in the market. "After reading the manuscript for th
book," he said, "I found a trading style that works for me. I'm a swinger—a swing trader. And I'
making money, too." He handles not only his own money but his parents and siblings as wel
providing them with extra income and building a nest egg for their retirement.

EVOLUTION OF A TRADER

John represents an amalgam of traders, a composite of those searching for a trading style that they ca
call their own. He suffered through many failed trades before finding a trading style that worked f

him. I wrote the Evolution of a Trader series to help people like John.

Evolution of a Trader traces my journey from a buy-and-hold investor to position trader to swin trader to day trader as I searched for styles that worked best when markets evolved. However, thes are not autobiographical. Rather, it is an exploration of what has worked, what is supposed to work b does not, and what may work in the future.

This series dissects the four trading styles and provides discoveries, trading tips, setups, and tacti to make each style a profitable endeavor. I have done the research so you do not have to. I show wh is needed to make each style work.

CONTENT OVERVIEW

The three books in the Evolution of a Trader series provide numerous tips, trading ideas, and setu based on personal experience and that of others.

Easy to understand tests are used to confirm trading folklore and to illustrate ideas and setups, ar yet the books are an entertaining read with an engaging style that appeals to the novice.

Each section has bullet items summarizing the importance of the findings. A checklist at chapter end provides an easy-to-use summary of the contents and reference of where to find more informatio

At the end of each book is a topic checklist and reference.

Trading Basics

The first book in the series begins with the basics, creating a solid foundation of terms ar techniques. Although you may understand market basics, you will learn from this book.

How do I know? Take this quiz. If you have to guess at the answers, then you need to buy this boo If you get some of them wrong, then imagine what you are missing. Answers are at the end of the qui

From Chapter 2: Money Management

1. True or false: Trading a constant position size can have disastrous results.

2. True or false: A market order to cancel a buy can be denied if it is within two minutes of the Nasdaq's open.

3. True or false: Dollar cost averaging underperforms.

From Chapter 3: Do Stops Work?

1. True or false: Fibonacci retracements offer no advantage over any other number as a turning point.

2. True or false: A chandelier stop hangs off the high price.

3. True or false: Stops cut profit more than they limit risk.

From Chapter 4: Support and Resistance

1. True or false: Peaks with below average volume show more resistance.

2. True or false: Support gets stronger over time.

3. True or false: The middle of a tall candle is no more likely to show support or resistance than any other part.

From Chapter 5: 45 Tips Every Trader Should Know

1. True or false: Fibonacci extensions are no more accurate than any other tool for determining where price might reverse.

2a. True or false: Only bullish divergence (in the RSI indicator) works and only in a bull market.

2b. True or false: Bullish divergence (in the RSI indicator) fails to beat the market more ofter than it works.

3. True or false: Price drops faster than it rises.

From Chapter 6: Finding and Fixing What Is Wrong

1. True or false: The industry trend is more important than the market trend.

2. True or false: Holding a trade too long is worse than selling too early.

3. True or false: Sell in May and go away.

The answer to every statement is true.

Fundamental Analysis and Position Trading

This book explains and describes the test results of various fundamental factors such as book valu price-to-earnings ratio, and so on, to see how important they are to stock selection and performance.

The Fundamental Analysis Summary chapter provides tables of fundamental factors based on ho times of one, three, and five years that shows which factor is most important to use for tho anticipated hold times. The tables provide a handy reference for buy-and-hold investors or for oth trading styles that wish to own a core portfolio of stocks based on fundamental analysis.

Chapters such as “How to Double Your Money,” “Finding 10-Baggers,” and “Trading 10-Baggers put the fundamentals to work. The chapter titled “Selling Buy-and-Hold” helps solve the problem when to sell long-term holdings.

Position Trading The second part explores position trading. It introduces market timing to help remove the risk of buying and holding a stock for years.

Have you heard the phrase, *Trade with the trend*? How often does a stock follow the market high or lower? The section in Chapter 19 titled, “What Is Market Influence on Stocks?” provides th answer.

This part of the book looks at how chart patterns can help with position trading. It discloses the 1 most important factors that make chart patterns work and then blends them into a scoring system. Th system can help you become a more profitable position trader when using chart patterns.

Six actual trades are discussed to show how position trading works and when it does not. Consid them as roadmaps that warn when the road is bumpy and when the market police are patrolling.

Swing and Day Trading

The last book of the series covers swing and day trading. The first portion of the book highligh swing trading techniques, explains how to use chart patterns to swing trade, swing selling, eve patterns (common stock offerings, trading Dutch auction tender offers, earnings releases, rati changes, and so on), and other trading setups.

It tears apart a new tool called the chart pattern indicator. The indicator is not a timing tool, but sentiment indicator that is great at calling major market turns.

Day Trading Day trading reviews the basics including home office setup, cost of day trading, day trading chart patterns, and the opening range breakout. It discusses research into the major reversal times each day and what time of the day is most likely to set the day's high and low—valuabl information to a day trader.

An entire chapter discusses the opening gap setup and why fading the gap is the best way to trade Another chapter discusses the opening range breakout setup and questions whether it works.

Ten horror stories from actual traders complete the series. They have been included to give yo lasting nightmares.

INTENDED AUDIENCE

The three books in this series were written for people unfamiliar with the inner workings of the stoc market, but will curl the toes of professionals, too.

Research is used to prove the ideas discussed, but is presented in an easy to understand and ligh hearted manner. You will find the books to be as entertaining as they are informative and packed wit moneymaking tips and ideas. Use the ideas presented here to hone your trading style and improve yo success.

Whether you are a novice who has never purchased a stock but wants to, or a professional mon manager who trades daily, these books are a necessary addition to any market enthusiast's bookshelf.

Acknowledgments

Smany people are involved in bringing a manuscript to life, and I play a small role. To all of thos workers at John Wiley & Sons, I say thanks for the help, especially to Evan Burton and Meg Freebor They ironed the wrinkles and made the trilogy presentable, even fashionable

CHAPTER 1

Introduction to Buy-and-Hold

I started dabbling in the markets by researching companies using their annual reports. I pored over th numbers and checked the ratios to make sure the company would not fold anytime soon.

In those days, I learned to love cash dividends and stock dividends as well. They added to the bulg in my wallet and slowly increased my net worth one share at a time. During the bull market of th 1980s, I had a win/loss ratio of 63 percent and made an average of 39 percent per trade. I achieved th without knowing what I was doing.

For example, I bought a stock called Sparton Corp. This was a wonderful stock that never heard going up while I owned it, but it paid a huge dividend. That is, until they stopped paying it! I bought three times and lost 23 percent, 39 percent, and 53 percent of my money.

I grew to mistrust the method of holding a stock forever (well, 3.6 years was my average hold tim for stocks bought in the 1980s). I was tired of seeing a stock like ASA Holdings (acquired by Delta which I bought four times in the late 1990s at an average price of 23.36, more than double to 51 ar then drop to 34 before I sold it.

Nevertheless, I still like investing, which is a synonym for buy-and-hold. You can make a lot o money with little work. The hardest part is ignoring the daily rollercoaster movements of the market.

As I mentioned in *Trading Basics*, Chapter 2, under “Hold Time: My Trades,” my best hold time between three and four years. Research a company, buy the stock, and then hold it until it realizes i full potential. Then sell it.

WHAT IS BUY-AND-HOLD?

You probably know what buy-and-hold means, but let me tell you how I define it. If I buy a stock wit the intention of holding it for years, then that is a buy-and-hold position. I expect bumps along th way, such as a quarter or two of weak earnings, but I am focusing on their long-term potential fo growth.

Despite the name, I do not interpret it as buy-and-hold *forever*. Buy-and-wait is a better descriptio My guess is that I will never hold a stock as long as I did Michaels Stores. Some of those shares bought in 1990 and sold in 2006 when the company went private. Now, my inner voice—call it th voice of experience—sees that I have doubled my money and will want to capture profits before dead-cat bounce pattern takes away 70 percent of it in one session.

Often that voice speaks only after the stock has given back too much from a peak, such as in the ca of Interface (IFSIA), where I sold 25 percent below the high, or Steelcase, down 26 percent. In fact, thought we were sliding into a bear market in July 2010 and sold over half of my portfolio in a flig to cash.

I was wrong.

The market bottomed and then went on to new highs. I am more sensitive to price fluctuatio because of the recent 2007 to 2009 bear market, especially when I have good gains.

I began concentrating on buy-and-hold positions because I found it more difficult to make money b short-term trading. That was in 2007, just months before the bear market started. Big mistak Fortunately, it took only nine months after the bear market ended to recover my losses.

That brings up an important question: Who should buy and hold?

WHO SHOULD BUY AND HOLD?

Trading Basics, Chapter 2, “A Better Way? Portfolio Composition,” discusses my thinking abou diversification. Build a core portfolio of stocks from the buy-and-hold category and pepper it wi other trading styles that fit your needs, such as swing trades or position trades. Diversify yo holdings not only by industry, but trading style as well. That way, when the market favors swin trading over other styles, you will have positions ready to take the lead to greater wealth.

This guidance applies to day traders, too. I have heard that day traders tend to burn out after sever years of trading (four years comes to mind, but I do not know if that is true). The constant pressure perform each day coupled with lack of exercise and inability to relieve stress tends to fry the adren system. Having buy-and-hold positions available in which to place excess cash will create a cushion the pressures of day trading become too much to bear. Swing and position trading can give the da trader a more relaxed ride in which to recover while still having the emotional feel of being in th game.

Regardless of your trading style, consider adding to your portfolio positions held for the long term These are not buy-and-forget positions, but they need not require constant attention, either. Thin long-term growth.

MY NUMBERS: BACKGROUND AND TERMS

In the pages that follow, I use almost a thousand stocks covering the period from 1992 to 2007. Not a stocks covered the entire period and dividends were not included unless noted otherwise. The te period includes the 2000 to 2002 bear market.

I refer to year 0 through year 5. Year 0 refers to the first year in which fundamental data and price for a particular stock were available. It serves as the base year in which other years are compare Year 5 is the last year. Year 0 through year 5 use the closing price at year's end.

Since I use 16 years worth of data but present only a five-year-wide window, the analysis uses da like a moving average. I use the fundamental number from the new year and drop off the old yea Year 1 becomes year 0, year 2 becomes year 1, and so on in a series of overlapping years as the fiv year window slides from 1992 to 2007.

In this manner, each year 0 has the opportunity to see how price behaves during the next five years

I am sure that none of this makes much sense and you may be asking, “Who cares?” but that is fin When I start discussing tests, it will become clear and you will understand my thinking.

NOW WHAT?

If technical analysis tells you what will happen in the short term, fundamental analysis tells you wh to expect in the long term. Both are useful tools for making money, but a brief review of importa ~~fundamentals will help when selecting companies to buy and hold. Those chapters follow.~~

Even if you are a day trader, some of the discoveries discussed in the coming chapters are wor learning. They may help you select stocks to trade. They may spark a new avenue of investigation th may well send you on a path to greater riches.

CHAPTER 2

Stock Selection

This chapter is about selecting stocks for investors using methods that have proved helpful. Other ti follow in the coming chapters, so you can create selections that are ideal for your situation.

When I created my website (http://thepatternsite.com) in late 2006, I started receiving emails fro people asking how I selected stocks in which to trade or invest. I thought back to the 1980s in t public library when I hunted for stocks in Value Line to populate my watch list. I took my picks hom and then typed the quote information into my computer each day from the *Wall Street Journal* . Th was easy enough to do until the list grew to 500 stocks, but it usually took less than an hour to upda my database manually.

Some old timers will claim that you get a better feel for the stock if you manually type in the quo information. My reply to that is hogwash. With 500 stocks, there is no way I can keep them separate my mind. I am not that smart.

Anyway, here are the Value Line criteria I used, and they still apply today.

- The stock needs a heartbeat. That means in two of the past five years, the yearly high must be at least twice the yearly low.
- If the stock was too expensive, I threw it out. The preferred price range is $10 to $20. In fact, a study I conducted (see http://thepatternsite.com/prices.html) shows that chart patterns in stocks priced from $0 to $10 outperformed the other ranges, but I did not know it back then.
- The stock must have a price-to-earnings ratio, meaning I tossed any stock with NMF (not meaningful) showing in the P/E box.
- I selected stocks with high three- to five-year price appreciation potential. Triple-digit percentages are tasty, but unrealistic. I relied on it anyway.
- I selected at least five stocks per industry, so I had to relax my requirements to admit some of them. Having many stocks from one industry gives me a better feel for how they are doing as a group.
- I checked the list of insider buying and selling. I wanted to see many insiders buying and few selling. I will discuss this later in the chapter.
- Fundamental factors included a low P/E ratio, climbing sales, positive earnings for the past several years, low debt, and so on. The chapters in this volume will tell you what works best.

WHAT COMES AFTER LARGE PRICE MOVES?

In the first bullet item in the list—the yearly high price must be twice the year low—I interpreted th as price doubling, but it could have been cut in half, too.

I decided to do some research to see if price doubling or cut in half led to better performance t following year. I used 567 stocks from 1990 to 2008 in the test. Not all stocks covered the enti range. For each stock and each year during the test period, I found the yearly low, the yearly high, a the close-to-close move the following year. I sorted the results into two buckets (stocks more tha doubling versus not doubling) by years, giving 19 annual performance contests.

The median rise a year *after* a stock doubled beat the median rise of those not doubling 53 percent the time. Yawn. Summing the median gains or losses of those 19 contests gives gains of 385 percen versus 165 percent for year-ahead performance of stocks doubling (or better) versus not doublin respectively. Substituting the *average* gain instead of the *median* gives 916 percent versus 27 percent, respectively. In other words, stocks that do well continue doing well.

- Stocks that double substantially outperform the following year 53 percent of the time.

Here is the exciting news. Stocks that drop by 50 percent or more tend to zip higher the followi year. They win 13 of 19 performance contests, or 68 percent of the time. The cumulative median ri of those 19 annual contests is 253 percent for those stocks dropping in half (or more) compared next year gains of 152 percent for those not dropping by at least 50 percent. Substituting averages f medians gives cumulative gains of 588 percent versus 293 percent, respectively. In other word stocks that drop in half tend to not only bounce back the following year, but also do so with gusto.

- Stocks that drop 50 percent or more outperform the following year 68 percent of the time.

Let me issue this caution about my studies. They are not academic quality, meaning I did n include stocks that went bankrupt or merged out of existence. However, it has been my experience th the conclusions of the studies will match those from the academic world. We will see that later in th volume.

When selecting stocks for a watch list, pick those that have made large moves in the past, either u or down. Compare the yearly low to the yearly high and look for a ratio of at least 2 to 1.

If stocks are coming out of a bear market, buy stocks that have declined the most. They tend recover further.

MYTH: STOCKS THAT DROP LEAST IN A BEAR MARKET THEN SOAR

One of the things I take pride in is that I prove what I say. How many times have you heard that stoc that drop least in a bear market tend to soar most after the bear market ends? A financial consulta said that to me just two weeks ago. That belief is wrong. Here is the proof.

I used 472 stocks from my database that stretched back as far as the 2000 bear market and followe them through the 2007 bear market plus a year later, tracking their performance into 2010. I found th stocks that declined most bounced highest. Stocks that declined least bounced, but not nearly as hig **Table 2.1** shows the results.

Table 2.1 Price Recovery After a Bear Market

Market	Median Bounce 1 Year Later	Average Bounce 1 Year Later
Bear market 3/24/2000 to 10/10/2002		
Above median 49% decline	107%	158%
Below median	29%	45%
Bear market 10/11/2007 to 3/6/2009		
Above median 57% decline	145%	223%
Below median	61%	69%

For example, in the 2000 to 2002 bear market, the median decline of all 472 stocks in the test was 4 percent. ~~Those stocks that dropped more than 49 percent bounced a median 107 percent a year~~ later (an average of 158 percent, if you prefer). Those that dropped less than 49 percent during the be market bounced only 29 percent (median) and 45 percent (average) a year after the bear market ende

The 2007 to 2009 bear market follows the same trend with stocks that dropped more than the medi 57 percent bounced higher than did those with shallower drops during the bear market.

This agrees with a finding mentioned in Fosback's book (The Institute for Econometric Researc 1976). He writes, “At major bear market troughs, for example, relatively weak stocks tend to boun up faster, while stocks which have failed to decline much in the preceding bear market are ofte stodgy issues which rarely provide outstanding profits in any kind of market.”

- Stocks that drop most in a bear market bounce higher one year after the bear market ends. Stocks that drop least perform worse.

STOCK SELECTION THE EASY WAY

One financial adviser I know watches television for her stock leads. When the news reports on a exciting drug breakthrough, she is at her computer, researching the company for a possib investment. When BP had a rig explosion in 2010 that blasted oil into the Gulf of Mexico, she boug the stock near the bottom, hoping for a recovery.

Some of these stock picks are gold and some are pyrite. Overall, though, she does well. One of h favorite techniques is to monitor Yahoo! Finance to see what stocks are making big moves. If they ar biotech companies, she researches them and waits for them to come back to earth. Then she pounce That is where she gets her most promising leads.

For more mundane stocks, she pounds the pavement looking for goods or services she likes, a visits stores with crowded parking lots.

Let me give you a personal example. Near the end of the 2007 to 2009 bear market, I kept reading the letters to the editor section of the local newspaper how customers loved Steinmart. The people town wanted more stores just like that one. In late March 2009, I started my research on the stock for possible investment. They announced earnings on the 19th and the stock shot up and then move sideways in an event pattern I call an earnings flag. My trading notebook says that I wanted to buy March 31, which would have filled near 2.82, the opening price the next day.

Just over five months later, the stock peaked at 13.75. Unfortunately, I watched it all from th sidelines, because I never bought the stock.

The moral of this anecdote is to buy stocks you know and like. Finding retailers is easy since the are where you shop. You can check how full the parking lot is and how full the shopping carts ar Visit a few outlets. Are the stores clean? Do the shoppers look happy?

This method was how I found Michaels Stores, the best-performing stock I have ever owned. I ha just bought my house and had bare plant ledges. I stopped in at Michaels MJ Designs and boug several baskets of silk plants. I visited the store often for more decorations.

When I researched the company, I discovered that Michaels and Michaels MJ Designs we different companies. They used to be part of the same company but split up and divided the wor between them. The first chapter in *Trading Basics,* describes what happened to my investment.

If you like a company, why not buy a piece of it? That is what happens when you become shareholder.