Short-Term Futures Trading

SECRETS

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Volume 1

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Preface

There are thousands of traders that aspire to become successful day traders and unfortunately, the overwhelmingly vast majority fails to succeed. I have found most of these unsuccessful traders tend to do the same wrong things. It is the goal of this book to share my knowledge to help you become a better trader.

Packed in these pages are trading principles that I have long followed and refined over many years. The indicators discussed in this book are widely accepted trading indicators. While I tend to put a twist on the strategies (typically trying to do the opposite of what most people would do), there are no guarantees expressed or implied by this book. These are for educational purposes for you, the reader.

These indicators are a tool to aid you in your decision making process and hopefully through this book and future installments I can share my philosophy on trading. My philosophy is very simple: most traders lose money because they tend to do the same things. It is fundamental human behavior.

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Chapter 1: Trading Basics

Over the years I have heard statistics on the percentage of traders that are successful. Usually this number varies, but it is common for people to throw out a number that 5-15% of traders are successful. This implies that 85-95% of traders are unsuccessful and losing money.

There is no concrete number of the success rate, but I think those numbers, even the 5%, are optimistic. To be successful, in my view, is to have longevity and not just make money in one month or one year.

To make a profit one month or one year does not make one "successful". If your plan is destined to fail at some point in the future, then it is not a successful plan.

Discipline is a pre-requisite for any successful endeavor. Even traders that trade discretionarily, from "the seat of their pants" have some form of discipline. They know when to cut their losses and they know what rules to follow to exit the trade.

You must have a similar plan for your trading. Getting into the market is only half the strategy; the most important part is when to exit. I have long held that you can simply flip a coin (heads you buy; tails you sell) and enter the market with a 50/50 chance of knowing the day's direction. But with proper discipline to exit the position, you could actually become a successful trader. It is not just entering the market, but exiting the market that is just as important.

Some traders will analyze the markets in depth, execute a trade, see a quick $100 profit and take it. Their rationale might be "I just made $100 in 30 seconds. Let it dip back down 2 minutes from now and I'll just get back in." And then the market slips away from them because it never bounces back so they can re-enter at the original price. They took a $100 profit from the markets, but left potentially thousands on the table.

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Chapter 2: What to Trade

I have long favored the futures and futures options for short-term trading for the following reasons:

- Liquidity: the E-Mini S&P 500 is currently trading near 1200. Each point represents $50 and therefore the contract represents approximately $60,000 of notional value (1200 x $50). Most days it will trade over two million contracts per day. This represents over $120 billion dollars a day of stock value. And this is just one of the stock futures contracts. It trades more value than all the stock exchanges combined.

  Further, the spreads are extremely tight – spreads are typically 0.25 which is only $12.50. If we were to trade stocks, and we were to trade 3,000 shares of a $20 stock (to obtain the same $60,000 leverage) with a spread of 0.01 that is $30, almost 2.5 times the spread of the E-Mini S&P 500. The tighter the spread, the more liquidity, and the less money you are giving to the markets when you utilize stop loss orders.

- Market hours: the E-Mini S&P 500 trades virtually 23 ½ hours per day. You can formulate an opinion on the market for the next 2-3 days and have opportunity to capitalize it when the other financial markets are closed. This opens the door to situations where you might be bullish the market and during the night session the market is down 5 or 6 points and it allows you an opportunity to enter at a better price – a price that may no longer exist when the New York stock market opens in the morning.

- Tax considerations: the tax rate on short-term futures transactions is a blended tax rate composed of long-term and short-term capital gains. Since short-term gains are taxed at the highest tax rate, if you day trade stocks and show a profit, you are subject to the highest tax rate. If you trade futures, you are subject to a blended rate of long-term and short-term gains putting more money in your pocket. Specifically, 40% of your profit is charged at the long-term capital gains rate which today is only 15%. The other 60% of your profit is charged at the short-term gains rate. This is a substantial tax savings for the serious day trader. As with any business transaction with tax consequences, you should speak to your tax advisor for specific details.

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To begin trading futures, I recommend that you start with $25,000 or more to invest.

The reason why I recommend $25,000 is that is affords you the flexibility to dollar cost average your short-term trades. If you have only a few thousand dollars then you do not have the ability to incrementally add to your position to average your price.

In the book, all indicators and snapshots are from the Firetip® trading platform. (www.firetip.com). I recommend using the Firetip platform because it is a comprehensive day trading system – it has all of your quotes, charts, news, and account information at your fingertips. You can use any trading platform that you desire but many brokers offer Firetip and it does everything discussed in this book.

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Chapter 3: Our First Indicator: ADX

The ADX indicator stands for "Average Directional Index". The ADX indicator measures the strength of a trend. This indicator can be useful to determine whether a trend is weak or strong. High readings indicate a strong trend, while low readings indicate a weak trend.

If the ADX is between 0 and 25, then the market is in a trading range. The when ADX begins to move up, and gets above 25, the beginning of a trend will be visible to you at this point. Big up or down moves tend to occur around this point. Remember, the ADX is a reflection of "strength", it does not tell you the direction. We need to look at the chart to get a sense of the direction.

There are two ways to use the ADX:

- When the ADX is rising from a low level and gets above 30, then the market is showing a strong trend. We will generally want to trade with this trend.

- If the ADX falls to 20 or lower, then we can reasonably believe the market is now in a trading range and we can trade the ranges.

Trading is an art and not a science, so you do not want to mechanize the idea that "if ADX gets to 30.01, I will go with the trend and if it is below 20 then I will trade the ranges".

Here are some additional concepts for ADX:

- Watch the strength of the increase in ADX from below 20 to 30+. If it slowly moves from 20 to 30, then it is not as strong of a trend as if ADX jumped from 20 to 35 very quickly. The first move to 30 in Figure 1 [Point A] illustrates this.

  In our example [Point A], while the ADX never moved over 30 officially, it would have been perfectly acceptable if you went long the E-Mini S&P in anticipation of a rally. Remember, trading is not an exact science, so buying in anticipation of the move up (especially since it was showing some strength) would have been acceptable.

  However, when the next few bars showed that the market was not gaining momentum and losing stream (ADX was unable to break above 30), you should have

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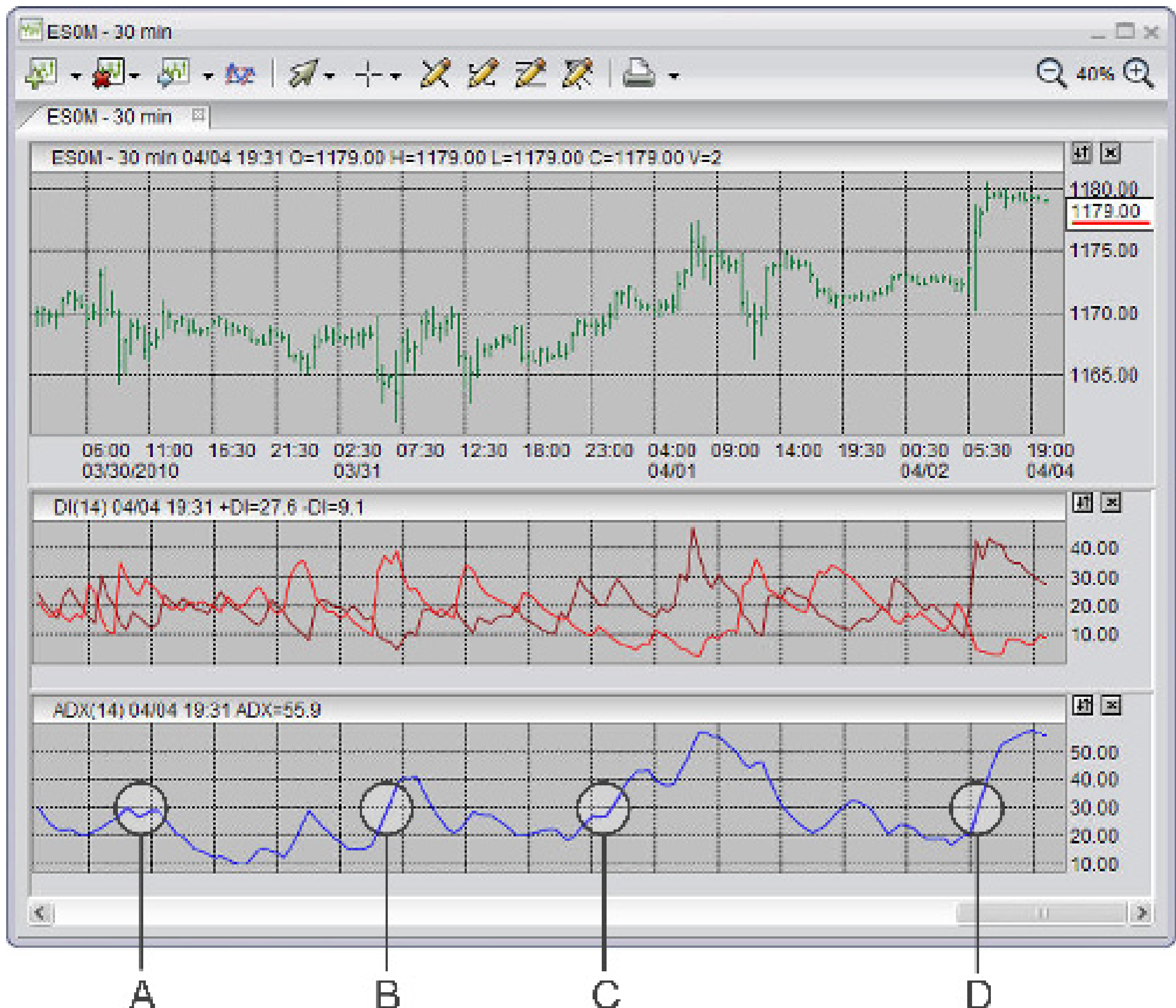
exited the trade for a small loss or gain.

- Be wary of news driven events. Trading before and after the news is very risky. We do not want to rely on the ADX (or any other indicator) when there is news. In Figure 1 [Point D], we illustrate the March Unemployment number that came out and its impact on ADX. This would have been easy to avoid as you should have known what economic reports would coming out and thus you should have avoided trading into the report.

- In Figure 1 [Points B & C] we show two healthy moves in the market that resulted after the ADX moved to 30+. These are the type of ADX moves you should be looking for and trading off of.



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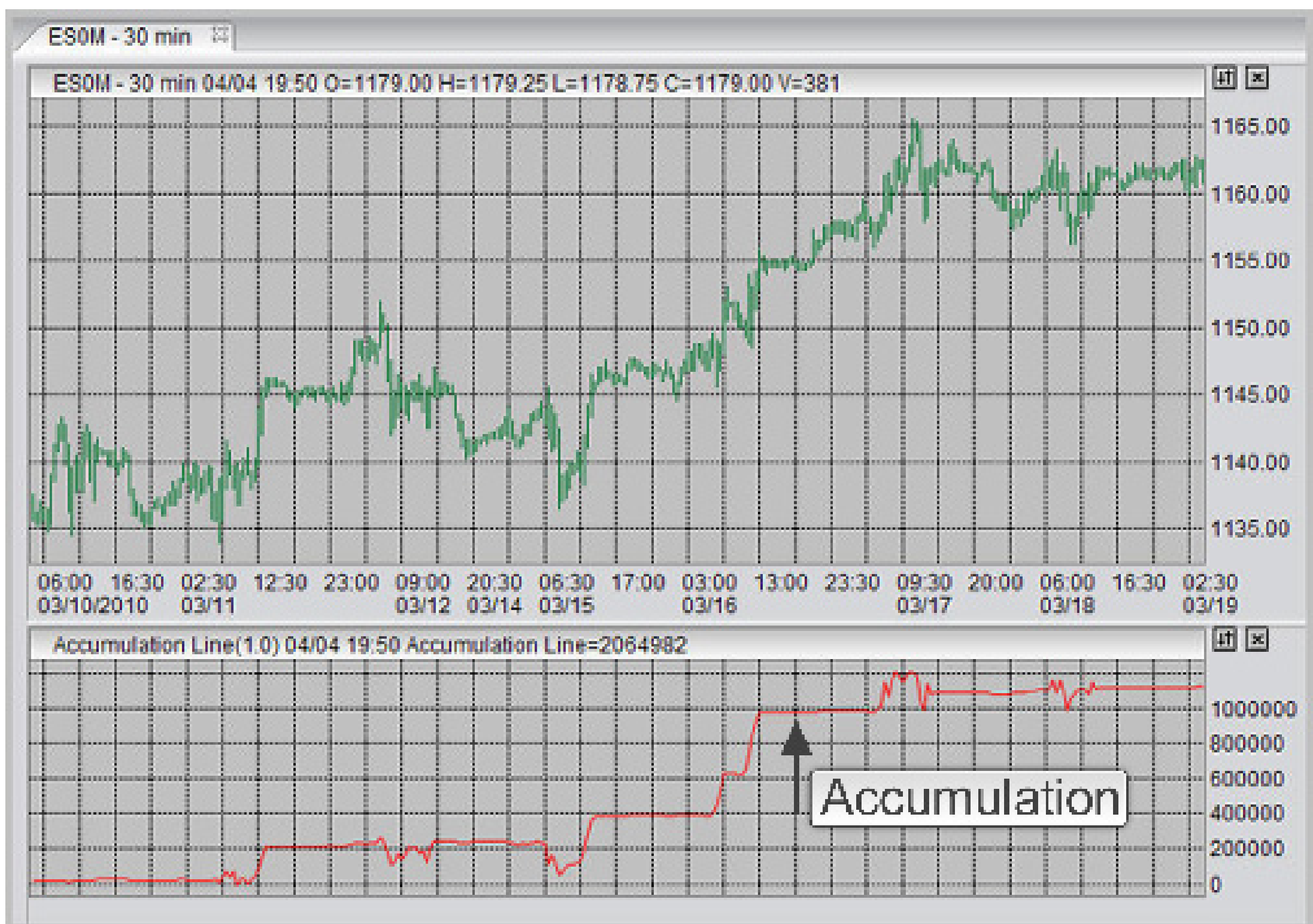
Chapter 4: Accumulation Line

One of the most popular volume indicators is the Accumulation line. The premise behind the Accumulation line is that volume precedes price. Volume reflects the amount of contracts that are traded in a particular market and therefore is a direct reflection of the money flowing into and out of the security.

Volume or money flow indicators are designed to identify early increases in positive or negative volume flow to gain an edge before the price moves. By using the Accumulation line as a volume indicator, this will help to determine if the volume in a security is increasing on the advances or declines. Also, the Accumulation line can be used to gauge the general flow of money. An uptrend indicates that buying pressure is prevailing, and a downtrend would therefore indicate that selling pressure is prevailing.



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- The accumulation indicator is best used on a longer term time frame (minimum 30 minute chart). This is because we have little desire to change our opinion of the market due to short-term accumulations or distributions in the market. If we know that a large institutional customer has purchased a substantial number of contracts over a five or ten minute time frame, we have no idea if there are more purchases looming or if those contracts will hit the market (sells) in the next hour or day. For this reason, this indicator has little to no value for me on a short-term (3-15 minute) chart.

  This is an effective tool to watch on a 30 or 60 minute chart.
-

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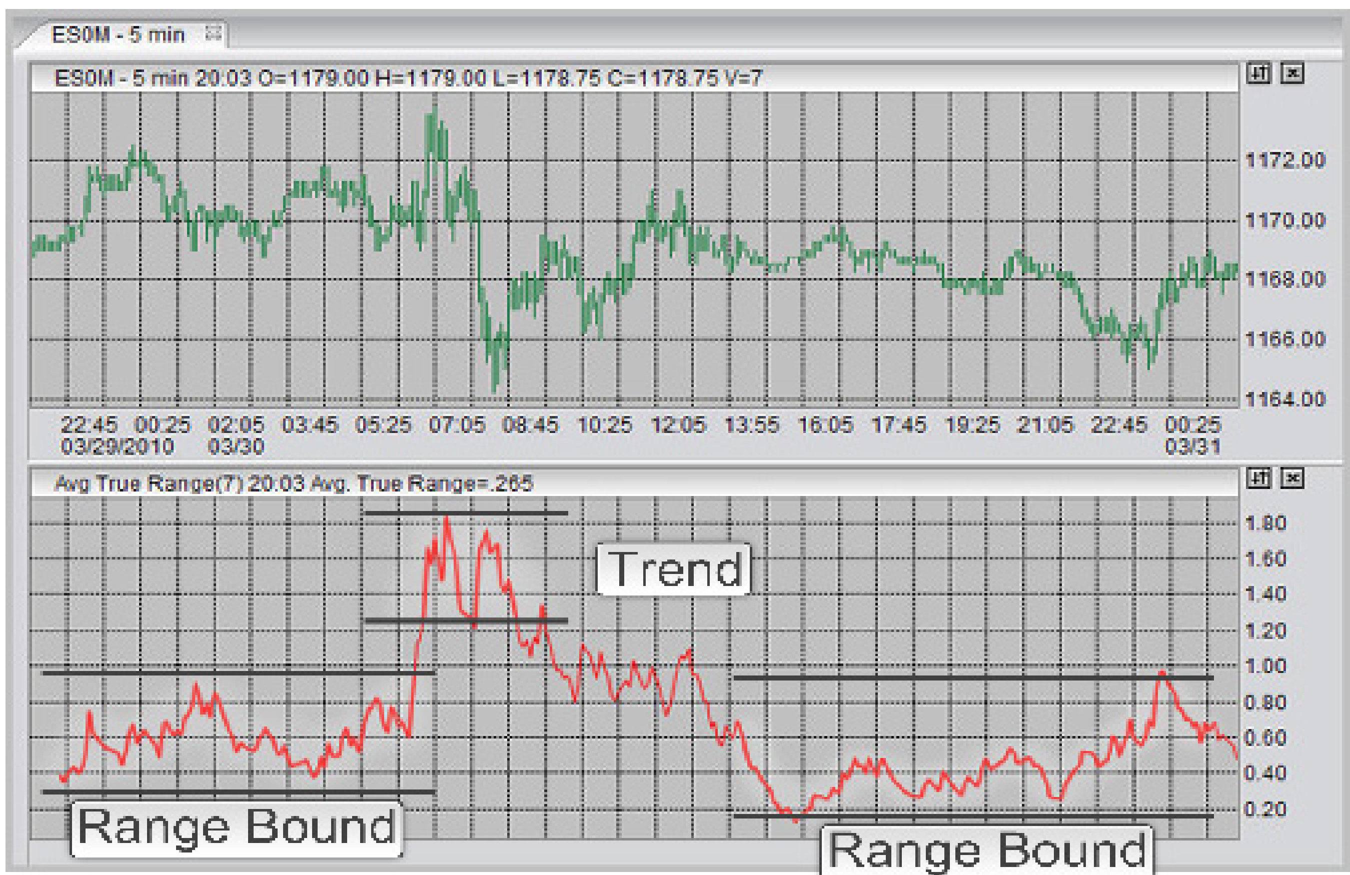
Chapter 5: Average True Range

The average true range is a technical indicator that is based on trading ranges. The range of a trading bar is its high minus its low. The average true range determines a security's volatility over a given time. The average true range is the moving range of the true range for a certain given period. We use the default smoothing value of "14" in our example.

The true range is the greatest of the following:

- The difference between the current high and the current low
- The difference between the current high and the previous close
- The difference between the current low and the previous close

The average true range is then calculated by taking an average of the true ranges over a set number of previous periods.



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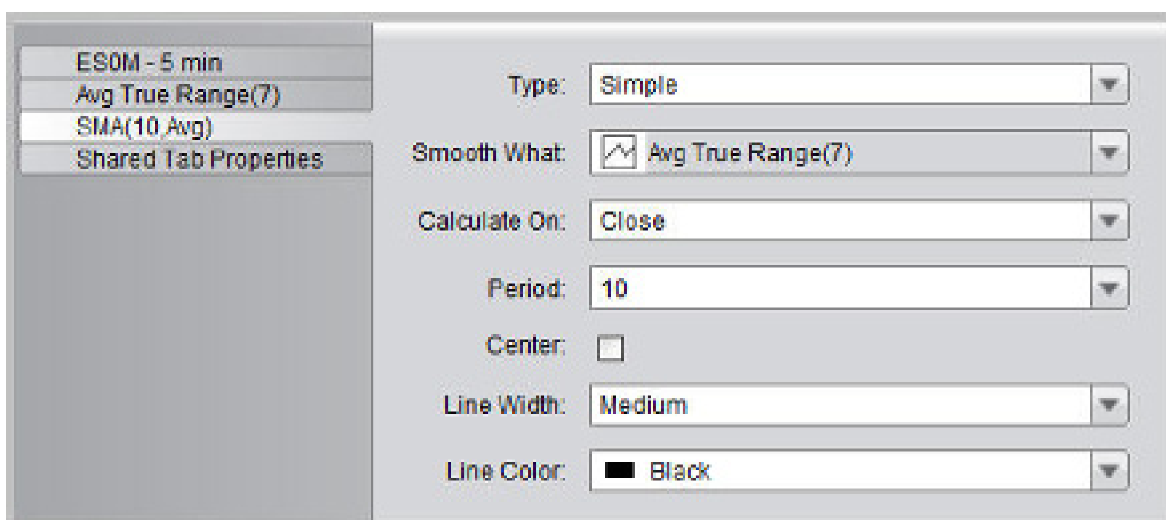
- One important aspect of day trading is determining when the market is in a "trading range" or in a "trend". Look for changes in the Average True Range to isolate when the market may be expanding its trading ranges (meaning there is an imbalance between buyer and seller) and a subsequent move (up or down) may be in the works.

- The average true range will not tell us if the market is going up or down, but it will give us a good idea on market imbalance so we can determine our trading strategy (do we go with the trend? Or do we trade against the trend?)

  If we believe that the market is in a trading range, we are more apt to sell rallies and buy dips. A viable strategy for a trading range market would be to accumulate contracts as the market drops and selling those contracts into an anticipated rally later in the day.

  If, however, our indication is that the market is poised to trend and move in a consistent direction, then we will want to position ourselves for the trend and add contracts going with the trend as the market moves in our favor.

- With Firetip, you have the added feature of adding a Moving Average to any of the indicators. In Figure 4, I add a 10 bar moving average and "Smooth" the Average True Range. Now we can see (Figure 5) when the moving average starts to turn up that the market is getting more volatile and when it is turning down, the market is calming down.



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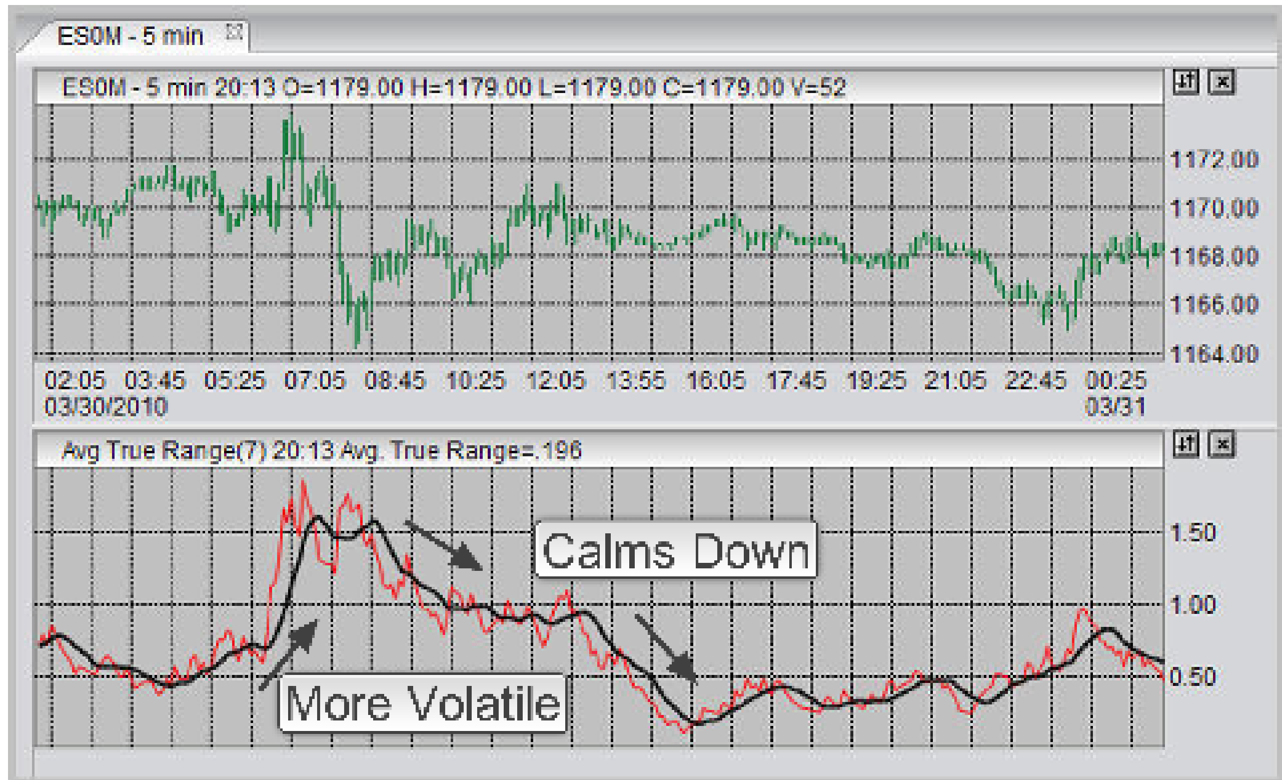
- Look for changes in the direction of Average True Range. Use a 3-minute or 5-minute chart to help pinpoint these changes.



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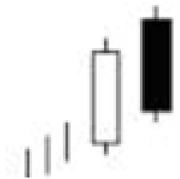
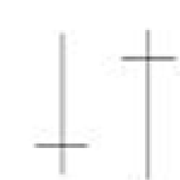
Candlesticks

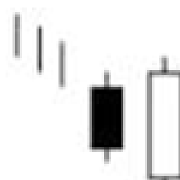
Candlestick patterns have become an extremely popular source and one of the most widely studied means of identifying the current state of price action. A candlestick pattern is simply a way of reading data on the chart. Here are the top candlestick patterns that traders universally agree on and use:



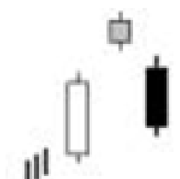
Stomach Reversal:



Doji: When the opening and closing price are essentially the same, the candlestick formed resembles a plus sign, cross, or inverted cross and is referred to as Doji. It represents indecision on the part of the market, and is interpreted by traders that a turning point is imminent.



Engulfing Pattern:



Evening Star: Commonly regarded as a bearish reversal pattern, this three-day pattern consists of a long white body, followed by a smaller gap up candlestick, with the third and final day closing below the midpoint of the first day.

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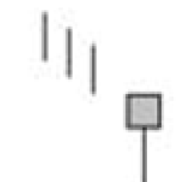
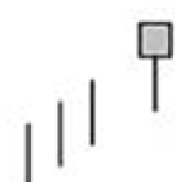
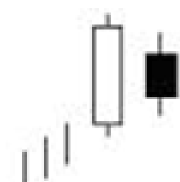


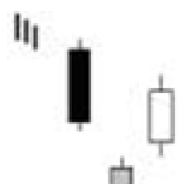
Evening Star: When trading occurs significantly below the open, but ends well above the low and closes as its high, the candlestick formed has only one tail below its body. When this formation occurs during a downtrend, it often signals a reversal.



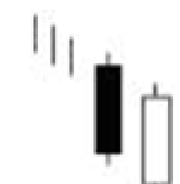
Hanging Man: Identical to the Hammer, this candlestick pattern occurs during an uptrend, and signals a continuation of the price movement.



Harami: This is a simple two day candlestick pattern that has a relatively small body on the second day that is completely surpassed on both sides by the previous day's candlestick and is always of the opposite color. It usually occurs during a minor correction in a bear or bull market and signals that this temporary uptrend or downtrend is reaching an end, and the underlying trend will continue. It is especially considered a strong indicator when it appears together with low trading volume.



Morning Star: This formation is considered a three day bullish reversal pattern that consists of a long bodied black first day, a short gap down second day, followed by a third long white bodied candle, which closes above the midpoint of the first day.



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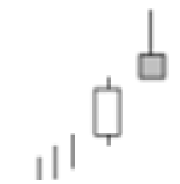

Shooting Star: The opposite of the Hammer, this is a one-day formation and occurs in an uptrend. Trading opens higher and trades much higher but prices end near the low. This pattern is viewed as a bearish reversal.

One benefit of Firetip in trading Candlestick is that Firetip can do all of the work for you to find these signals. If you are bearish and looking for a sell entry and there is a bearish Stomach Reversal or bearish Engulfing Pattern, you can let Firetip monitor the chart for you and inform you when a pattern has been achieved.

Figure 6 shows a chart with various bullish Candlestick patterns. In Firetip, simply click the green up-arrow and it will tell you what candlestick pattern it has recognized. Note that we are using candlesticks on a 30-minute chart. I recommend using them on short-term (3-minute & 5-minute) as well as longer-term (30 & 60 minute) charts.

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Figure 7 shows a chart with various bearish Candlestick patterns:

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Chapter 7: MACD

MACD stands for Moving Average Convergence/Divergence, and is a technical analysis indicator. MACD shows the difference between a fast and slow exponential moving average of closing prices. The standard periods are 12 and 26 days.

There are a few ways to use the MACD. One popular (and common) way is to buy the instrument being charted when the fast line crosses the slow line. Unfortunately this is somewhat of a lagging indicator (basically similar to a moving average cross-over) and only works if you are confident that a trend is established and is going to continue for a while.

My preferred method is to follow the MACD histogram. Follow the trend of the MACD histogram when the histogram is away from the zero line. Go with the trend of the histogram assuming it has trended in one direction for the last 3 histogram bars.

Let me explain in other words using Figure 8 as an example. On the first signal [Point A], we see that the histogram is at -200 but it starts to trend higher. In fact, there are 3 bars where the MACD histogram is increasing. This is a buy. A good time to exit is when the histogram moves 1 bar in the wrong direction [Point B].

- This is most effective the further away MACD is from zero because this tends to indicate an established trend and it is my view that trends generally follow trends.

- Do not try to trade contrary to a substantial trend. While this would have worked and appears to be have profitable on [Point D], this would have been a risky move to "fight the trend", especially such a strong trend. Good day traders will fight the trends all the time, but not the strongest move a market has made in a week.

- We must learn to tweak the "3 bar" rule. If you find it is generating many false signals, then change it to whatever is working given the market conditions (for example, requiring 4 or 5 bars to follow the same direction). This is part of the discipline of day trading. Use what is working for the market conditions today.

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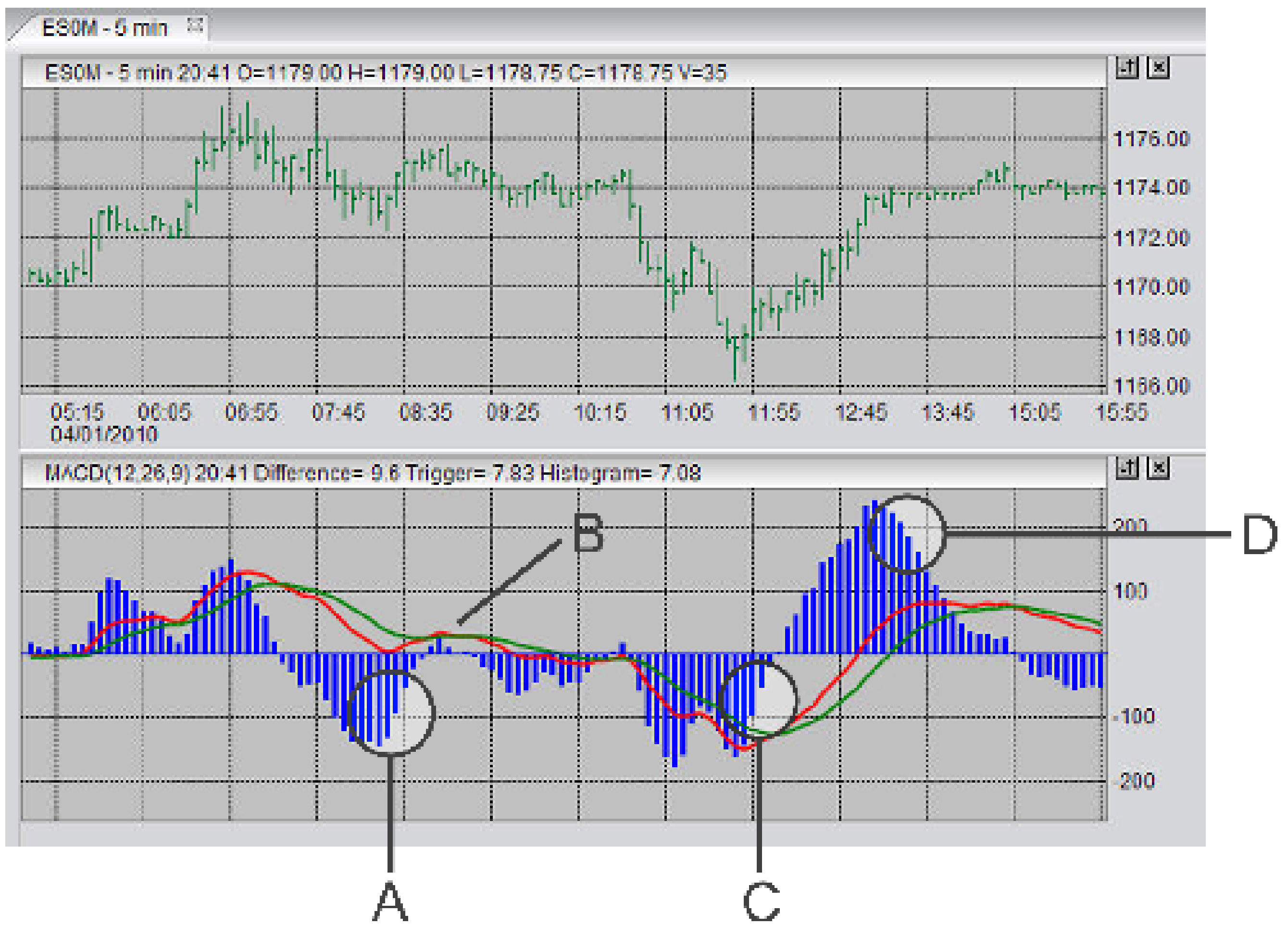

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Chapter 8: Moving Averages

Moving averages are the most popular and easiest trading tool to use. The two most common types of moving averages are the Simple Moving Average (SMA) and the Exponential Moving Average (EMA). A simple moving average is formed by computing the average price of a security over a specified number of periods. Most moving averages are created using the closing price. For example: a 10 day simple moving average is calculated by adding the closing prices for the last 10 days and dividing the total by 10. The EMA's apply more weight to recent prices relative to older prices. The shorter the EMA's period, the more weight that will be applied to the most recent price.

- Moving averages give an easy reference to market conditions. You can glance at the chart, so a rising moving average and conclude that the market has recently staged a rally. The distance that the prices are from the moving average help identify the strength of the recent movement.

- The moving averages are there to help you formulate the view of the market. Do not try to trade off the moving average.

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Chapter 9: Keltner Channel

This indicator is the heart and soul of my trading methodology. The Keltner provides an updating moving average of recent price history (the yellow line in Figure 10) along with price bands (red lines).

The Keltner is value to me in that it provides a visual representation of market movements and enables you to confidently trade a market like the S&P 500.

When using the Keltner, the first thing we want to do is identify the trend of the market. The Kelnter will help us determine which direction the market is trending or, if it is not trending, what the bands are for the trading range.

First, watch for market movements as they react to the red price bands. If prices are trading above the red price band, then the market is bullish. You should look to buy the market on a slight pullback. Conversely, if prices are trading below the lower red price band, it indicates a weak market and you should look to sell a small rally.

If prices are not reaching either of the two red price bands, then it means that the market is in a trading range and you can sell the market as it approaches the upper band and buy when it approaches the bottom.

In Figure 11, note that prices have breached the upper red price band at [Point A]. This gives us an indication that the market is bullish. Subsequently, we would seek to go long the S&P 500 as prices pulled back. I like to use the yellow center line (the moving average) as a reference point. Since the market rallied decisively above the upper red price band, I would now want to watch how the market reacts to the yellow moving average and accordingly look to buy. This is illustrated at [Point B]. Based upon this methodology, we would have bought at point (B).

Again, we would have triggered another buy (meaning the rally is continuing) at [Point C]. The market remains bullish and we should still look to buy. A good place to buy would have been [Point D]. Note that the trade at [Point C] produced either a small gain or a small loss as the market essentially languished for the next few hours.

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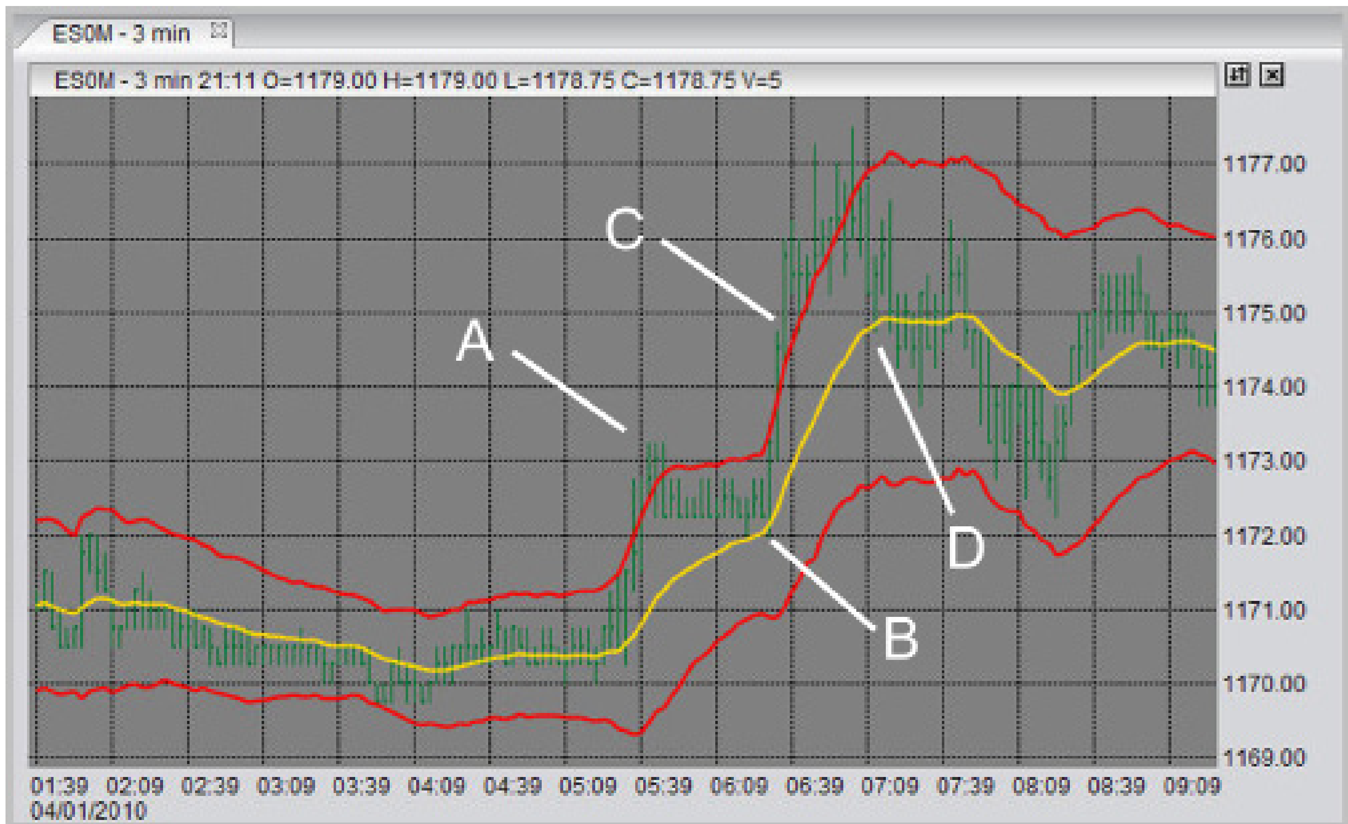
As the market has been unable to break the red price bands from 07:00 AM (PT) to 09:00 AM (PT), it would have been prudent that this time to trade the ranges – buying on dips and selling rallies.
This methodology and the Keltner are not to be mechanized. You need to incorporate some common sense trading discipline and use the other indicators to come up with a confluence of indicators. If the Keltner is rallying above the upper red price band, and the ADX is showing that a trend is established, then you need to look for your buy entry point.



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Chapter 10: Putting It Together

There are a few common sense caveats when it comes to trading:

- Do not trade minutes before or after news. If you are trading into a news story you are betting on the news report and not on your trading tools and experience.

- Understand the impact of news: Markets tend to be very choppy in the minutes after an announcement, so it is best to avoid trading at that time. But understand that if the news was significant, there may be an established trend that will last for hours or days post-announcement.

- Before news is announced, markets tend to be quieter and range bound. Since everyone is waiting for the news to be announced nobody is making major shifts in their positions. You can use this to your advantage by trading the ranges in the market before major announcements.

- <u>Always use a stop loss. In Firetip, you can place "Bracket Orders"</u>. A bracket order is an order where you set your profit target and your stop loss at the same time. It doesn't matter if you decide to use a $500 stop per contract or a $100 stop. But pick a stop that you are comfortable with and that fits with your trading time frame. If you plan to hold a trade for 10 minutes, then a $100 stop is adequate. If you intend to hold the trade for 3 days then maybe you need a $750 stop.

- The liquidity of the E-Mini S&P 500 is very good such that you should always use a stop. You can always re-enter the market one second after your stop is hit. But trading without a stop can cause devastating losses when the markets are volatile. Likewise, you can put market volatility to your advantage and set a target limit order (hence, my suggestion to use the "Bracket Order"). If the market gets to your limit price, fills your order, and then retreats you will have made the profit. You can put volatility to your advantage by having a target order ready.

Please trade from a longer-term time horizon. Do not place a trade with the intent that it will last three minutes or ten minutes. This is very hard to do. You limit yourself to small profits and small

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losses. It is hard to be successful making a few dollars at a time.

The best methodology is to formulate an opinion of the market for the next two or three trading days. If you think about it, the fund managers that move these markets are not looking to get in and get out in a few minutes. They are planning to deploy their capital over a period of a few days. And it is these bigger movements that will make you more money. You might only stay in the position for an hour or three hours, but at least you have enough of a time horizon that short-term movements won't impact your trade.

One reason I recommend starting with a larger capital position ($25,000 or more) is so that you can scale into a trade. Since it is difficult to time the exact second or minute to enter a long or short position, I find it more appealing to be able to enter the market gradually over a thirty minute or one hour window and build up my position in anticipation of a move.

In the next installment of Short Term Trading Secrets, I will explain various concepts and strategies as such:

- Understanding market volume and price movements. How I look at price movements in relation to volume. If there is a surge in volume, I would expect to see a significant price move to indicate a new direction. A small price move could be the precursor to a change in trend.

- Using Fibonacci retracements to identify popular short-term support and resistance levels.

- How day traders typically use retracements and how we can set-up trades contrary to the established use of these signals. In other words, we look for popular support or resistance levels and when breached, we go with the market trend knowing that many short-term traders were betting on the support or resistance and now they need to liquidate their holdings now that it is against them.

- Understanding market depth: how to use large bid and ask sizes (depth) to your advantage in trading.

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Taking the Next Step…

Now that you've reviewed this valuable information, why not take the next step and open your own commodity futures trading account?

Since 2001, Insignia Futures & Options has been dedicated to providing professional commodity futures brokerage services to every level of investor. Whether you are new to futures trading or a seasoned veteran, we have an account plan to serve your individual investment goals.

With Insignia Futures & Options, you will benefit from our state-of-the-art trading platforms; extremely competitive commission rates and most importantly, the professional customer service and market expertise that today's investors demand. Insignia Futures & Options can accommodate your commodity futures investment needs.

Contact an Insignia Futures & Options investment advisor today to discuss how commodity futures can enhance your investment portfolio…

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