

Swing, Swing, Swing

Alan Farley Of *HARD Right Edge*

What are the big differences between swing trading and momentum trading? Alan Farley can tell you. Farley is a private trader and the publisher of *HARD Right Edge* (www.HARDRightEdge.com), a comprehensive online resource for trader education, technical analysis, and short-term trading techniques. He is the author of the McGraw-Hill bestseller *The Master Swing Trader* and is a popular columnist for *TheStreet.com*. Farley has been on the market scene for more than a decade as a private investor, advisor, and author. He speaks and lectures on swing trading, including original strategies and tactics illustrated throughout *HARD Right Edge*.

Farley has also been featured in *Barron's*, *SmartMoney*, *Active Trader*, and *Online Investor*, among other publications. He consults regularly with industry leaders on issues facing today's traders, and is a strong voice for the Internet revolution changing the face of our modern markets. *STOCKS & COMMODITIES* Editor Jayanthi Gopalakrishnan spoke with Farley on November 21, 2002, via telephone.



CARMELO BLANCO

Alan, when did you first get involved in the markets?

It was in the late 1980s, after the 1987 crash. I started out using mostly the Value Line Investment Survey and a very expensive brokerage account, which had commissions of more than \$100. I looked at Value Line's one-year and five-year data, and tried to pick plays for three to six months. I wasn't too good at it in the beginning.

How long did you do that?

I did it for four or five years. I think my real christening came when CompuServe's investing board started to pick up about 1992 or 1993. There was a section in there called the Investors' Forum, with members like Jimmy Rogers and John Bollinger. There were full-time bond traders, full-time Treasury traders, and currency traders, and there was an incredible wealth of information. I joined that organization's staff in 1993 or 1994 as a volunteer. One of

my duties was to read everything that was posted to make sure it conformed to CompuServe's comment policy. I must have read more than a million posts. So it was a tremendous way to build up an education at a time before there was an Internet the way we know it today. This was even before AOL!

I also went down to the bookstore every Saturday morning and read John Murphy's books, and read just about everything I could get my hands on. I did that for a long time, and that's when I started to build up my love-hate relationship with technical analysis.

So your trading methods are pretty much self-taught.

Completely self-taught. I've always been a private trader. I've never run a hedge fund; I've never managed

Swing traders live for the wiggle. They live for the waves, the pullbacks, the turnarounds and reversals.

anybody's money except my own. I love what I'm doing, and that's not likely to change.

Have you been swing trading all the time, or is it something you discovered?

I was swing trading in about 1993. I did position trading early on. As commissions dropped and I opened my first E*Trade account, I started swing trad-

ing and tried to hold my positions for two, three, four days. When the daytrading boom hit, I switched over to daytrading. I did that exclusively for a few years. For the last two and a half years I've been back to swing trading again and holding positions overnight, because there's so much money to be made in the overnight markets.

Daytraders will tell you, "I don't want to assume risk," but it's a reward-risk equation. You get less risk, but most of the time there's much less reward in daytrading. So much of the market movement is made overnight, and so much is made when you hold through times when nothing's happening. That's one thing about swing trading. It lets you be in a move when it's happening, and I'm very much an advocate of that.

I try not to chase the market like a momentum trader, but try to *anticipate* where the moves are. I do a lot of volatility breakout stuff, the Larry Connors

or Toby Crabel things, where you buy and sell in narrow bars. You're essentially buying into a quiet market or that pattern because you see potential there that is going to trigger substantial price movement. I've been pretty good at that.

What exactly is the difference between momentum trading and swing trading?

Momentum trading is buy high, sell higher, sell low, cover lower. Swing trading is just the opposite. Swing traders like to buy weak markets and sell in strong markets. I'm selling a lot of my positions today because this is the perfect environment for me to sell. The market's really moving. There are a lot of big expansion bars, and I like big up days to sell into. It's that backward mentality the swing trader lives in, taking his or her move out of the market and not getting attached to where the market's headed in the long term.



hat else?

Swing traders are very risk-oriented, while momentum traders are reward-oriented. Swing traders want to pick their long entry spots very close to support levels, so if the support gets broken, they can get out at a cheap price. In the same way, they want to sell short very close to resistance levels, so if it goes through, they can get out at a cheap price. I think we're just natural-born cowards in a lot of ways.

Is that what you look for when you look for risk and reward?

Absolutely. You know, the risk-reward peaks right at a support level or at a resistance level. Let's say you're buying on a selloff down to support. You're trying to buy into that support level, because your reward will maximize right there. At the next swing, which you expect to be upward, you're going to get the large part of the swing, because you're right at the reversal.

On the other hand, your risk is at its smallest, because you're going to place your stop right behind the support level and get out of the market at a very cheap price. In fact, the way commissions are these days, sometimes when you get short-term breaks through support or resistance, you can enter and exit several times, and the commissions won't really hurt you. So if you miss one trade, you can try it again after others get shaken out.

Is there a difference in your approach between trading short positions and long positions?

I like going with the market flow. I'm less likely to short a very strong market like today's, where if I do short, I'm likely to lose money. For shorting, I prefer dull markets. I like weak uptrends. They're sometimes the best times to go short, because if you get your bid and get in there at a decent price, there's not a lot of danger of stocks running away on you. And of course, there's a completely different mindset between shorts and longs. They move differently, and you see that. Both kinds of price charts

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look similar, but the actual price action is different. When shorts move against you, it's a kind of water torture event — you're going crazy, but slowly. When your long positions move against you, at least you still feel smart. Even when you're losing money, you still feel smart because you feel like you're going to get your reversal. With shorts, though, you're never quite sure. They can just grind along for hours.

What's an example?

Just yesterday, I was watching Brooks Automation, and we were right in the middle of a big short squeeze on semi-conductors. Brooks, on a 15-minute chart, had 11 up bars in a row. That's three hours of nothing but white bars. That's just amazing! There was no wiggle in it! Swing traders live for the wiggle. They live for the waves, the pullbacks, the turnarounds and reversals, and looking at these pullbacks is part of what gives you the ability to read the landscape. You can see how price tests different levels, which is very similar to the way Elliott wave technicians look at things.

I'm assuming you look at charts, charts, and more charts. What exactly do you look for?

Over the years, I have looked for potential more than anything. I go through a lot of the same setups that other folks write about. I look for pullback trades. I look for cup-with-handle type breakouts, long candlestick reversals, dojis, hammers, that kind of thing. I look for gaps in interesting places. I look for climactic events. You want all the market dynamics, because the market inefficiency is right at the edges. That's where you get your opportunities. That's where people buy too much, and that's where they sell too much.

Anything you particularly like?

I like to take the first pullback after a breakout. There are always those people who got in earlier, and whose disbelief causes them to dump their positions on the first pullback. It's a perfect opportunity for a swing trader to go in and pick up positions, because the next wave up

is the confirmation of the rally. And so over the years, I've put together a toolbox of all these different market patterns you see over and over again — not just one or two or 10 or 20 times, but dozens and dozens of times. I like working off of those dynamics.

What about indicators?

Over the years I've added indicators. I know STOCKS & COMMODITIES is a

very systems-oriented magazine, with lots of indicators. My indicators are very simple. I've added them over the years, and they've added value to my trading, but I spent the first 10 years trading without even using stochastics. I figured the price pattern could tell me everything I needed to know. Finally, though, I just couldn't work that way anymore, and now I use stochastics and everything else. I just don't feel as smart

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interpreting the price pattern. I want some help.

What do you use to help your trading?

I use stochastics to give me that kind of help. I use on-balance volume to tell me what's going on at new highs and new lows. I've learned to listen to those indicators over the years. And you know, the funny thing is I've become more in tune with and more interested in market

cycles. I've become fascinated by the simplicity of the market. I think that's why often when you're starting on your second decade or 15 years or so of trading, you start getting interested in Elliott waves and Gann. I don't know whether these guys were great traders, but they were the philosophers of the market. They looked at the structure of the market, and determined how every twist and turn meant something. That type of math-

ematics becomes much more interesting as you grow in experience.

You place a lot of emphasis on timing your trade, and avoiding the open. Why is that?

They say the open is the time of the amateur, and the close is the time of the pro. The closing bar on the daily is very important. Often, the open gets faded. Look at Larry Pesavento's work on the opening price principle: Many times, the opening price is the extreme of the day, and you have to be careful.

What are you more likely to do?

I'm more likely to fade an open — that is, buy a dowgap or sell an upgap — than I am to go with it. Over the years I've put together my own recipe book on what to do with the morning gaps, and that keeps me honest. I want to know where price is after 15 minutes, and what the dimensions of support and resistance are after those first three five-minute bars — do prices zip off to a new high or low when price trades through that gap? That gives me more confidence to get into a position. I'm more likely to let the market work out this stuff before I go chase it, because I know who's buying and selling at the open. It's usually momentum traders, or people who can't watch the market at other times, so they're fixated on that hour. I think there's a lot of money to be made during the rest of the trading day.

Because of the nature of swing trading, you recommend that swing traders should develop a disciplined personal trading plan. What should such a plan include?

This sounds so simple, but it confuses people to no end: always pick a holding period in advance, and know what your time frame is before you get into a trade. You can do this by saying, "I'm going to hold one to three days and I'm going to sell at the end of three days, even if my trade's doing nothing, because I want to be disciplined in this time frame."

Why do that?

The reason for doing this is that the

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Ron DeVille, C.R.N.A., Louisiana

Frequently Asked Questions

Q. Does this method work on stocks and futures?

A. Yes. It works on both markets equally well.

Q. Does it matter which way the market goes to be successful?

A. No. We trade both sides of the market.

Q. What time frame does this method work on?

A. You can day trade or trade longer term, they both work.

Q. How long has this method been around?

A. We have been trading for over 25 years successfully!

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market tends to move in three-day swings. So you have to pick a time frame that works with the markets. Some folks work on a three-week cycle; some work on a three-day cycle. The holding period is the first thing to include in your trading plan, because if you don't know how long you want to be in a position, as soon as it starts moving in your favor, you get giddy. Or as soon as it moves against you, you get nervous.

It gives you discipline.

What surrounds the discipline is your sense of what you are trying to get out of this market move. You bought at support, and you want to sell at resistance. Where's resistance? How many days, or how many bars, do you think it'll take for prices to get to that resistance level? This mindset helps define your holding period. It helps define what your opportunity cost is, whether your money could be better invested elsewhere.

What else would a trading plan include?

Another aspect of a trading plan, which is something I still have a problem with, is to honor your stops. A systems trader will theoretically honor stops because the stop is going to be part of the system. But a discretionary trader often uses mental stops, which becomes much more of a head game. If you're a discretionary trader, you will often find yourself watching the market and saying, "If it drops to 24.5, I'm going to sell it." Then it goes to 24.5, and you say, "Well, let me try 24.40 or 24.30."

That's a common problem.

No. 3 in the trading plan, especially for new traders, is to stop trying to make money! Everybody comes to the markets to make money, and that's what clobbers them. You've got to come in to do the dance. The dance, of course, is trading well. The dance is like learning to play the piano — playing chopsticks over and over again until it sounds good. You've got to get into the rhythm of the markets, so maybe you want to trade a

minimum amount: maybe a hundred shares, or even odd lots. You'll still get some of the same psychological ups and downs you do with bigger positions, but it's not going to wipe out your trading account.

What are some of the reasons traders fail?

The main reason? A lot of people think trading is an easy way to *make money*, and so they go in with a big play right away. But in reality — and you realize this after a year — your concentration has to be on the risk side of the business much more than the reward side. The reward side is going to come, but if you don't focus on the risk going out, you'll never get to the reward.

So you have to realize it's like any discipline: you have to learn to do it well. You also have to be patient and realize it's going to take years to trade well. There's no speedy way of doing it. I love how there are still some trading schools around, even after the bubble burst, that'll tell you how to scalp and say that in six months you'll be making money. But that's not the way things work. You've got to be in it for the long haul, and you have to be willing to experiment in what I call the dark corners of the markets before you really know what it is that you're interested in.

What are some of these "dark corners"?

I spent 1995 and 1996 trading nothing but stocks on the American Stock Exchange. I did it because it was a corner of the world nobody knew anything about. I would just sit there and trade something like Prepaid Legal, which was just a \$4 stock back then. It was just little stuff that's either now gone or been moved over to an exchange where it has more liquidity, and I just traded that. Then I moved to Nasdaq, then to Level II, and then to the New York Stock Exchange (NYSE) to trade slow, \$50 stocks. You've got to explore a lot of different parts of the market to see how each operates.

At one time a lot of traders got caught up in the Level II thing, and when that happened I turned my focus to the NYSE.

When you make this switch you have to know what the specialists[†] are like. When you're trading with Level II screens, you know what market makers[†] are like. When you switch markets, you have to go through the process of understanding how that specific market operates, how price moves up and down in that market, how the book is held, how the different types of games are played, and how things get passed through support and resistance.

If you hit enough of these spots, you start to see the same situations over and over, and that saves you money. I could select a slow blue-chip company to trade on any given day. That comes from watching the specialists and seeing how they operate. So get your train ticket and visit a lot of different destinations before you decide where you want to live.

I take it you don't look at the most-actives.

I like the middle. I think General Motors often appears on my stock scans, and occasionally Intel or Microsoft, or one of the big ones will show up. But the best trades come in about the one million daily volume range on the Nasdaq, and about the 300,000 or 400,000 daily volume range on the NYSE. It's just a less-traveled path. I know people worry about spreads in some of these markets, but there are different ways to get around spreads.

Like what?

For example, in the Nasdaq you can cut the spread in how you do the order; in the NYSE, you've just got to be patient. You'll get your price if the specialist wants you to get your price, because of the way the spreads move on some of these thinner stocks. Sometimes you can put in a hundred-share order at a point below the market in the NYSE, and if the specialist is bored enough, he or she will drop the market a point and go get it!

It's weird, but those little things help you get your price. Swing trading is extremely price-sensitive, so you're trying to get in at the best entry price. You want to keep your slippage down to a minimum. You want to keep your transaction costs down so you're minimizing

the risk side, because you're not taking trades for the long haul. You may be trying to make a point-and-a-half trade. So it's very important what price you get in at.

When you do your stock scans soon after the close or before the next day's open, and look at the charts of the stocks that show up on your scans, how far back do you go?

If you're looking at a setup and you have an idea how far you expect price to move, then you look back as far as you need to in order to find out what price did the last time it went through that level.

As you said earlier, knowing your time frame prior to making a trade is really important.

Exactly. If you're doing a new high breakout trade, or at least an intermediate high breakout, you want to know if there was a major high two points above

that price, even if it was in 1996. That could be a big deal, because someone is going to see it. Markets trade off of those points, and there's going to be someone who will sell that market because price got up to a seven-year high. So you've got to be aware of those points.

Stock scans are like going to the produce counter in your supermarket. You're squeezing the fruit, and you're looking for the fresh vegetables, but the meal's not served yet. The best stock scans are the ones where you say, "This is interesting." But you're not necessarily going to trade it the next day.

Then when?

Often, you've got to put those stocks on a list and watch them, and maybe a day later or maybe a week or a month later, all of a sudden, everything lines up. Newer traders especially want scans to tell them what to trade. But the stock scans are only the first step. You've got to watch these things carefully. It's like stirring a pot, and waiting until it's about to boil, and *that's* when you've got to throw the stuff in to cook.

What makes a trader successful?

Traders almost have to have a disinterest in the market, because the excitement itself is one of the biggest ways people fail. This is because they're getting so much secondary reinforcement from the market.

After a few years you have this whole routine that surrounds 9:30 to 4:00 Monday through Friday. When that routine is broken, you feel it. I go through postpartum on Friday nights, you know? You have a sense of emptiness, a sense of unfinished business that has to wait until Monday. The most powerful traders are the ones just taking that giant step back, and they're seeing that organism a little farther back than some other folks, and they're able to just go in there and pick their spot wisely. I also think the smartest traders are those who trade less. One of the ways we bleed capital is by making too many mediocre trades. It's not the bad trades; we're all going to have bad trades. It's the mediocrity that is much worse than bad trades

in terms of long-term success, because you're just going to bleed capital.

Why is that?

Your profits may be there, but in the end you're losing because of all of the money you've thrown away on small losses and all the time you've wasted on small gains. It's important to take that giant step back. That's hard to do, because the market is like the sirens in the Greek epics. It just keeps calling you. And there's always something new. The market's always surprising you, and it's always doing something that gives you an emotional reaction. That's detrimental in the long run if you can't shut it off.

Do you have any closing remarks?

In the years I've been doing this, I think the current market is the best one I've seen for learning how to trade. If you learn how to trade well — not even successfully — but learn how to trade well in this market, I believe you're set for life.

Thanks for speaking with me, Alan.

RELATED READING

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