We Don't Need No Stinkin' Indicators

Supply & Demand Based Trading

By Kevin Baker

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Chapter 1

Technical Indicators

Technical indicators are the tools used by traders to aid them in the decisions of when to enter and exit a trade. They vary from oscillators, moving averages, and trend lines to complex mathematical formulas. Indicators are divided into two categories: leading and lagging. Generally speaking, oscillators like RSI and Stochastic are considered leading indicators, while indicators derived from moving averages, like MACD are considered lagging indicators. Lagging indicators get you into the trade late and leading indicators are prone to false signals. There are more than 100 different technical indicators available to traders, but you could spend all the time and money in the world learning these and you would not be much better off than when you started. You may be able to understand what Jim Kramer's guests are saying when they say the RSI shows oversold and MACD just made a bullish crossover, and you may have a cool looking screen, but it will not make you a better trader.

An analogy to this would be trying to predict the weather. The following comes straight from Wikipedia.

Weather forecasting is the application of science and technology to predict the state of the atmosphere for a given location. Human beings have attempted to predict the weather informally for millennia, and formally since the nineteenth century. Weather forecasts are made by collecting quantitative data about the current state of the atmosphere on a given place and using scientific understanding of atmospheric processes to project how the atmosphere will evolve on that place.

Once an all-human endeavor based mainly upon changes in barometric pressure, current weather conditions, and sky condition, weather forecasting now relies on computer-based models that take many atmospheric factors into account. Human input is still required to pick the best possible forecast model to base the forecast upon, which involves pattern recognition skills, teleconnections, knowledge of model performance, and knowledge of model biases. The chaotic nature of the atmosphere, the massive computational power required to solve the equations that describe the atmosphere, error involved in measuring the initial conditions, and an incomplete understanding of atmospheric processes mean that forecasts become less accurate as the difference in current time and the time for which the forecast is being made (the range of the forecast) increases. The use of ensembles and model consensus help narrow the error and pick the most likely outcome.

Sound familiar? In my part of the country, weather predictions are usually about 50% accurate.

I could waste a lot of your time writing about the disadvantages of technical indicators, but that is not what this book is about. If you are new to trading, there is a better way. If you are a seasoned trader and you disagree with me, you can still apply the concepts you learn in this book to improve your percentage of successful trades while still utilizing your favorite indicators.

I am sure there are some technical traders that consistently make money, but they are the exception and not the rule. The reason these traders are successful has nothing to do with technical indicators, but everything to do with risk management. The best professional traders stick to their trading plan and never deviate from it.

If you used the same strict risk management rules and your trading plan stated, "I only buy in an uptrend after a pullback and short in a downtrend after a pullback," I would argue that you could still achieve the same results.

In many cases, amateur traders use technical indicators in the same way superstitious gamblers commit to absurd rituals. Have you ever played in a craps game at a casino? From time to time, dealers will go on break and be replaced by a new set of dealers. This is apparently "bad luck," according to the superstitious gamblers. Whenever this happens, you will witness one of the strangest phenomena—these players will suddenly take back all their bets and sit out. If the dice shooter's next roll is a seven, causing everyone to lose, which will happen one in six rolls, these players immediately attribute it to the new dealers coming in. If the dice shooter's next roll is not a seven, they will jump back in because they weathered the storm. Obviously nothing changed—the roll will be a seven 16.7% of the time no matter what—but they are confident that they have some sort of control over the whole thing.

There are many psychological terms for this—confirmation bias, gambler's fallacy—but the point is that people are behaving irrationally.

This might seem ridiculous to you, but it happens in trading, too. A trader might look for a MACD crossover before making a buy, and then if that trade turns out to be profitable, the trader will credit the MACD crossover. If the trade turns out not to be profitable, they will blame that on some other externality.

Another negative of using technical indicators is that professional traders know what technical indicators are telling people. This makes you a target for professional stop hunters. How many times have you entered a perfect trade set up only to be stopped out right before the price turned and went in the direction of your original trade? Professional traders know what strategies are popular, and they know how to exploit that. They also know where the nearest supply or demand zone is, and if it is far enough away from the current price, they have more than enough capital to move the market against you and take out all the stops, allowing them to enter at a better price. By always placing your stop below a demand zone or above a supply zone, it makes you more immune to stop hunters.

But I am getting ahead of myself. We will talk more about supply and demand zones in Chapter 3.

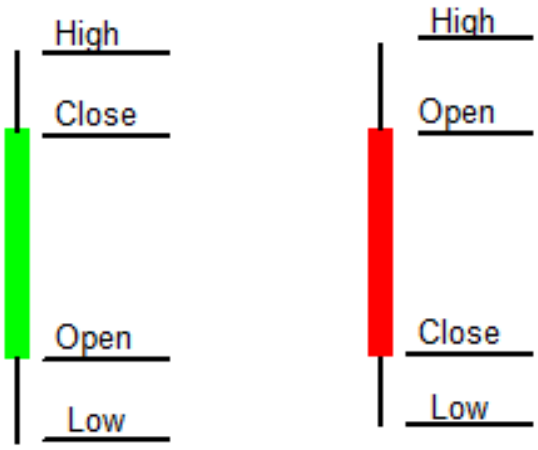
Before we jump into supply and demand let us go over the basics of candlestick patterns.

Chapter 2

Candlestick Patterns

What are candlesticks?

Candlestick charts provide the same information as the traditional bar chart–open, high, low, and close prices–but do so in a way that is a more visual depiction of price action during a single time period or series of time periods.

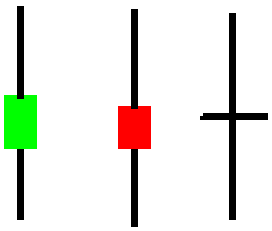


One candlestick can provide important information about the strength or weakness of the market during a given time interval, visually portraying where the close is relative to the open. A candlestick can represent a month, week, day, or intraday time interval. A green body indicates prices moved higher from the open to the close for the period and is a bullish sign. A red body indicates prices moved lower from the open to the close for the period and is a bearish sign.

Although the color of the body generally sets the bullish or bearish tone of a trading session, the wicks are also important, showing how far traders were willing to push prices during the period before coming back to close in the body.

If you study candlestick charting you will find there are several candlestick patterns that chartists use. Most of them can be classified as either indecision patterns or reversal patterns. Most patterns consist of multiple candles, but we are only interested in three patterns. All three of these patterns consist of one candle and the color of the candle is not important to us.

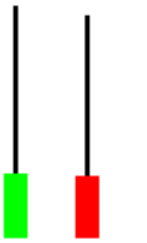
Doji Candles



Doji's

There are several names for various types of doji candles, but the three shown on the left are the only ones we are interested in. As long as the body is small relative to the wicks and the body is basically centered, we use this candle to represent as a candle of indecision. On all three of these candles, you can see that the market opened, price went above and below the open, and then closed fairly close to the open. This tells us for the moment supply and demand are in balance.

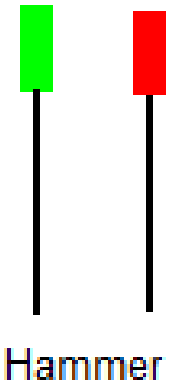
Shooting Star



Shooting Star

The shooting star is a bearish reversal pattern. The long wick at the top shows the buyers were in control until it hit the price indicated by the top of the wick. At this point, sellers were in control and pushed the price back down close to or below the open. This candle may have a small wick on the bottom.

Hammer

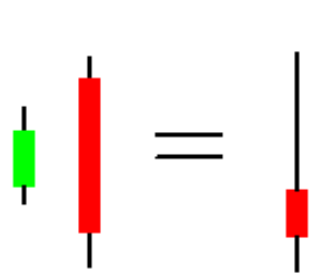


Hammer

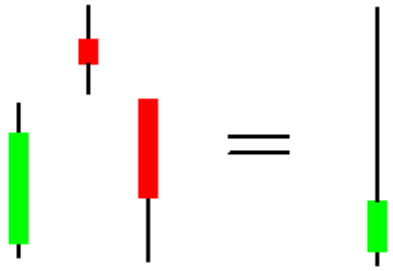
The third pattern is the hammer. This is a bullish reversal pattern. At the open, sellers were in control until the price reached the point indicated by the bottom of the wick. At that point, buyers took over and pushed the price back close to the open or higher.

There are several other candlestick patterns, but there is no need to learn them. If you analyze all of the candlestick reversal patterns, you will find that if you add the candles together, they will form a hammer for the bullish reversal patterns and a shooting star for the bearish reversal patterns, except they are just forming over a longer period of time

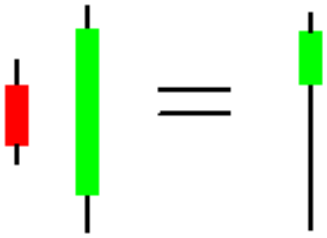
In later chapters when talking about supply and demand trading, you will learn that the faster the price moves in and out of a pivot point, the stronger the imbalance of supply and demand. For this reason, we only want to use the hammers and shooting stars for our trade set ups. The following shows a few of these reversal patterns. To add the candles together, you take the open of the first candle, the close of the last candle, and the highest high and lowest low in the pattern to draw the wicks. If the close is lower than the open, you have a red candle, otherwise you have a green candle.



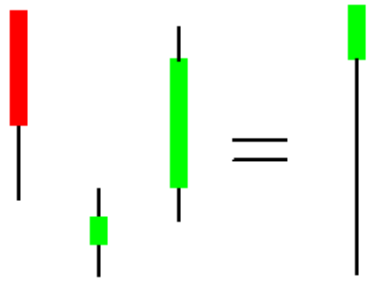
Bearish Engulfing Pattern



Evening Doji Star



Bullish Engulfing Pattern



Morning Star

Chapter 3

Introduction to Supply and Demand

This is the most important chapter in the book. So make sure to read this several times. Do not skim! Make sure you fully understand it. You are about to learn the secret to the markets.

There are generally two schools of thought when it comes to the markets. The first is the Random Walk Theory, sometimes referred to as the Efficient Market Hypothesis, which states that price movements in securities are unpredictable. Because of this random walk, investors cannot expect to consistently outperform the market as a whole.

Proponents of the Random Walk Theory will argue that applying fundamental or technical analysis to attempt to time the market is a waste of time that will simply lead to underperformance. Investors would, according to this theory, be better off buying and holding an index fund.

This theory argues that stock prices are efficient because they reflect all known information (earnings, expectations, and dividends.) Prices quickly adjust to new information, and it is virtually impossible to act on this information. Furthermore, price moves only with the advent of new information, and this information is random and unpredictable.

Opponents to the Random Walk Theory believe that future price action can be predicted by previous price action. They tend to buy into technical analysis and believe that technical indicators, chart patterns, and trend lines can help predict future price action.

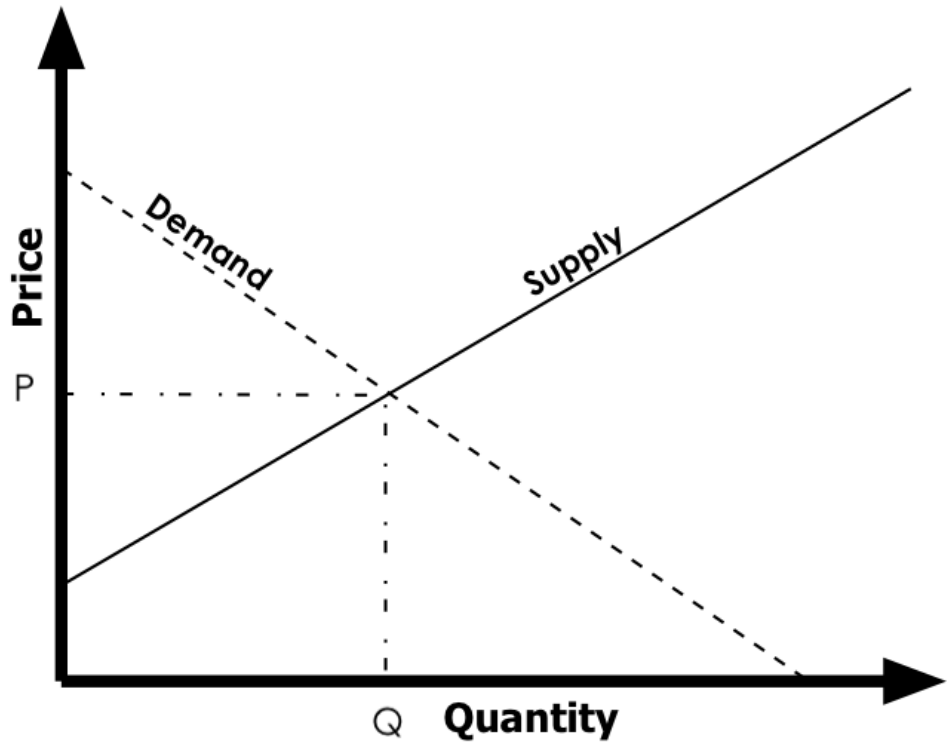
The opponents to the Random Walk Theory have it partially right—you can predict future price action based on previous price history, but not using technical indicators. We use previous price action to show us where areas of excess supply or demand are.

The forces that drive price action in a market are supply and demand.

In this book, you will learn how to plot these areas of excess supply and excess demand. When you know there is a high probability of excess supply or excess demand, you can utilize this information to make better decisions when making a trade in any type of market.

The good news is that you will find this book useful regardless of your investing beliefs. Whether you buy into the Random Walk Theory or believe in technical analysis, what you learn in this book will make you a better trader or investor.

Now let us get to the core of what this book is about—supply and demand. Supply and demand are the forces that drive price in any market.



If you have ever taken a microeconomics course, you know that supply and demand is an economic model of price determination in a market. It concludes that in a competitive market, the unit price for a particular good will vary until it settles at a point where the quantity demanded by consumers (at current price) will equal the quantity supplied by producers (at current price), resulting in an economic equilibrium for price and quantity.

The four basic laws of supply and demand are:

1. If demand increases and supply remains unchanged, a shortage occurs, leading to a higher equilibrium price.
2. If demand decreases and supply remains unchanged, a surplus occurs, leading to a lower equilibrium price.
3. If demand remains unchanged and supply increases, a surplus occurs, leading to a lower equilibrium price.
4. If demand remains unchanged and supply decreases, a shortage occurs, leading to a higher equilibrium price.

Applying this to trading, supply represents willing sellers and demand represents willing buyers. Look at the following chart. Every time price direction changes, the relationship between supply and demand changed. The areas marked with a red dot are points where supply became greater than demand and the areas marked with blue dots are areas where demand became stronger than supply forcing a trend reversal. When markets are trending upward, demand is greater than supply, and the opposite is true for markets trending down.

Areas where the stock trades sideways in a tight range are areas where supply and demand are in balance.

We can gain a competitive edge as traders if we know where these areas of supply and demand are. We plot them on our charts as supply zones and as demand zones.
We can determine where these areas of supply and demand are by looking at previous price action. We need to first learn how to plot these zones, and then we need to learn how to identify the zones that have the highest probability of giving us a profitable trade setup.

Plotting zones

Let us start with the different methods of identifying and plotting areas of supply and demand.

The easiest zone to spot is when you have an obvious change in the direction of the trend. The candle that forms the pivot is the candle that is used to plot the zone. The following chart illustrates an example of a supply and a demand zone using this method. Simply place a horizontal line on the top and the bottom of the candle that forms the pivot, and fill the zone in with a rectangle tool if your trading platform has one.

Many times a daily candle will form too large of a zone. When this happens, simply bring up your hourly chart for the day that the zone was formed, place your zone around the hourly candle, and transfer that information to your daily chart. The top of the supply zone and the bottom of the demand zone are always going to be plotted at the extreme price point, but by using the hourly chart we can plot a narrower zone. You will see the importance of this when we discuss how to trade using supply and demand zones.

The next method of identifying zones is to look for an area where price has been trading sideways and in a tight range for several bars, and then dramatically shoots away from that range. On the left side of the chart, we see price trading in a tight range for 6 bars and then drops dramatically. The next time price came into the zone the trend reversed, giving us a short opportunity.

On the left side of the chart, we see price trading in a tight range for several bars and then shoots up dramatically. The next time price came into the zone the trend reversed, giving us a great buy opportunity.

The third method of identifying a zone is to look for areas of indecision roughly halfway through a strong downtrend for a supply zone, or vice versa for a demand zone. The easiest way to spot areas of indecision is a doji candle. After XOM opened, the price rallied one direction, reversed and rallied past the open in the other direction, and then reversed again closing close to where it opened.

The last method of identifying zones is by looking for gaps. When a stock gaps either up or down, there has been a sudden change in the balance of supply and demand. The price it gapped from is very likely to be a strong support or resistance line. You need to keep this in mind when managing your trades, but plotting the actual zone is the same as the above techniques. You need to look at the chart as if the gap was one big candle. The following chart illustrates this. There are actually two gaps. For clarity purposes, I drew the candles in blue instead of red so you can see where the gap was on the chart before I drew the candle. The two areas that price gapped down from will likely provide resistance on the way back up, but we still draw our supply zone as if the candles were as shown.

Determining the strength of the zones

Every time the trend changes direction, it is because of a change in the balance of supply and demand, but to use this to our advantage we need to know the likelihood of that imbalance being there the next time price returns to that zone. Supply and demand zones are similar to support and resistance lines in that supply zones provide resistance and demand zones provide support. When price breaks through a supply zone it becomes a demand zone, and when price breaks through a demand zone it becomes a supply zone—the same way a resistance line turns into support when broken and a support line turns into resistance.

The similarities end there, though. A support or resistance line requires at least two points separated by time to be drawn, where a supply or demand zone can be plotted from one candle. Most traders will tell you that you should have three points for a support or resistance line to be drawn. Traders are also taught that the more times price bounces off of a support or resistance line, the stronger that line is. The opposite is actually true.

Think about what causes a supply or demand area. It is an excess of sellers or buyers at that price point. Every time price moves into that area, that excess of sellers or buyers is being used up until eventually they are gone and the price breaks through.

When we look for areas to plot a zone, we look for areas where price has moved away quickly. If price moved into the area quickly that is even better.

Notice how price moved into and away from this zone quickly, indicating there is a strong excess of supply at that price point. Chances are extremely high that when price returns to the zone, the sellers will still be there.

Next, we want to look at how many times price has tested that zone. Your highest percentage trade is a fresh zone that has never been tested. When you plot a supply or demand zone, move to the left on your chart to see if the candle that created the zone is not actually a retest of a previous zone. If it is, then it is not a fresh zone. I like to go back at least five years on my charts when I do this.

We have a supply zone where price moved away quickly, but when price returned it actually broke through the zone. If we look to the left of the bar that we used to define the zone, we see that this bar was actually the second time price returned to the zone. This appeared at first to be a strong supply zone but by looking a little further we see that it is not a fresh zone. Our high probability trades are the first time price returns to the zone. The following chart shows us the same zone with more information. The original supply zone was colored blue for clarity.

This example is obvious, but many times we have to look a little harder to make sure it is not a retest of a previous zone. This is extremely important because a fresh zone is always the strongest zone.

Let us recap. When looking for a strong zone, we want to see price move quickly into the zone and quickly out of it, and we want to make sure the zone is a fresh zone, i.e. a zone that has not been tested before.

If the zone was created by a reversal in the trend of the price, then we also want to see the price remain in the zone a short amount of time—the shorter, the better. If the zone was created by price trading sideways in a tight range followed by a break out, then three to six candles in the zone is acceptable.

If, after reading this book, you decide to continue with your current strategy, then at least get these three concepts down. If you follow these rules you will pay for the cost of this book many times over.

- Do not buy into supply. In other words, if there is a supply zone directly above your entry price, you must either wait until the price breaks through the zone or do not take the trade.
- Do not sell into demand. If you are shorting a stock and there is a demand zone directly below your entry price, then either wait until the price breaks through the demand zone or do not take the trade.
- Look for the nearest supply or demand zone, depending on whether you are going short or long, and set your stop a few pennies above the supply zone or a few pennies below the demand zone. If doing this creates too much risk, then do not take the trade.

Now would be a good time to take a break from reading this book and try plotting several supply and demand zones. Look for strong zones, and then look where price came back to that zone for the first time. Do this on several different equities and several different time frames. You will begin to see the power of trading zones. Try plotting your zones on the last five losing trades you had and see if applying the concepts above would have kept you out of the trade. Spend at least one hour with this before returning to this book.

Go on. I will be here when you get back.

Chapter 4

Trading Using Supply and Demand Zones

Now that you understand what supply and demand zones are and how to plot them, it is time to look at how we use them in our trading.

Like the title of this book suggests, by using supply and demand zones you do not need to use any technical indicators. Whether you are a long term investor, a swing trader, or a day trader, applying supply and demand strategies will make you a better trader.

Long term investing

If you are a long term investor, you will use a weekly chart. Long term investors usually trade more on fundamentals than technical data, but by looking at where the long term supply and demand levels are you can find better entry prices and also know when it is appropriate to hedge your position to protect profits. This is a weekly chart of Exxon Mobile. In the middle of 2010, XOM developed a strong demand zone around $56.00 to $59.00. Let us say that you thought XOM was a good long term buy, and you bought somewhere around the point "A." Because you understand the concepts of supply and demand, you know that if XOM drops below $56.00, you want to exit your position because chances are extremely high it will continue to drop. You also know the major supply zone for XOM is around $92.00 to $95.00, leaving a lot of room for growth. The area around point "B" formed a fresh demand zone, and the area around point "C" created a fresh supply zone.

When price returned to the supply zone at point "D," you now have a decision to make. This is a strong supply zone, so chances are high that the price will drop from here. You could just sell your stock and lock in your gains, but if you are subject to paying capital gains tax you may not want to sell because you have not owned the stock long enough for the gains to be long term capital gains.

You could also buy a put contract that would protect your gains. The best option would be to buy a JAN 12 95.00 put. This will protect you up to the third Friday in January of 2012. If price broke through the top of the supply zone, you would sell your put for a small loss. The reason you would buy the $95.00 strike price is to keep the cost of the time premium low. When the stock reached the demand zone formed by point "B," you would execute your put option and sell your stock at $95.00. This would now qualify as long term capital gains. You could now repurchase the stock below $70.00 with a stop below the demand zone around $64.50.

If the only reason you would not want to sell your stock at point "D" is capital gains taxes, then you could sell a JAN 2012 90.00 call and use the proceeds from that to buy a JAN 2012 90.00 put. The prices would be about the same, so you are basically getting your put for free or at a very low cost. If the price breaks through the zone and stays above it, you will eventually lose your stock at $90.00, but by then it would qualify as long term capital gains instead of short term. Options can be executed at any time, but it is unlikely they would be executed before the expiration date unless the price went up dramatically.

If you bought back in around point "E," you would repeat the same strategy at point "F" that you did at point "D." At point "G," you would close out your hedge position because of the strong demand zone formed a few weeks earlier.

Point "H" is a major supply zone, and I would close all positions. I would then wait for price to break through the top of the demand zone to re-enter the trade—assuming I still thought XOM was a good buy.

Swing trading

Swing traders would use a daily chart to look for trade setups. There are two basic swing trading strategies we can use by applying supply and demand principles.

I am sure you have heard the phrase "The trend is your friend." When you trade with the trend, you enter your trade on a retrace of the current trend. Many traders like to use moving averages or Bollinger bands to find their entry points. By applying what we now know about supply and demand, we can use that knowledge to find our trade setups. For a short trade, we want to look for a bearish candle where the top wick is in a supply zone. For a long trade, we are looking for a bullish candle where the bottom wick is in a demand zone.

When trading this method, we do not necessarily care how strong the zone is, we just want to make sure a zone is there. Your stop should be a few pennies above the top of the supply zone for a short trade and a few pennies below the demand zone for a long trade.

This chart shows Microsoft (MSFT) in a strong downtrend. The price then rapidly moves up into a supply zone, giving us a bearish candle. We would enter the trade after the formation of this candle, placing our stop a few pennies above the supply zone.

Here are two long opportunities from the same demand zone. Note that the demand was a supply zone that turned into a demand zone when price broke through it. These trade setups are shown by the two green arrows.

It is important to note that not all retracements are going to be into an existing supply or demand zone, but the ones that do retrace into a zone are a higher probability trade and they allow us to define our stop price.

We can also trade against the trend. When trading against the prevailing trend, we are only looking for strong supply and demand zones. We enter the trade as close as possible to the bottom of a demand zone and as close as possible to the top of a supply zone. This gives us a higher reward to risk ratio because we are entering the trade closer to our stop price. The following charts show examples of a long and a short trade using this strategy.

The red and green arrows show where price moved into our supply and demand zones. We do not wait for a confirmation candle—instead, we just take the trade and set our stop a few pennies above the supply zone and a few pennies below the demand zone. Since our risk is determined by the difference between our entry price and our stop you can see that this strategy has a considerably higher reward to risk ratio.

This chart shows another short setup and also shows the price breaking through the supply zone. The supply zone is now a demand zone, and the next day, indicated by the green arrow, we had an extremely low risk, high reward trade at the bottom of the new demand zone.

Day trading

This is where trading with supply and demand zones gets really exciting. If you are currently day trading stocks or options, you will throw away your indicators after reading this. The same principles apply to Forex and futures trading, but most people do not have the patience to wait for a good trade setup. If you are currently day trading forex or futures, I would still encourage you to trade with supply and demand zones. Be sure to realize you may not get as many trade setups as you might receive using indicators. Your trade setups will be higher quality setups, and you will make more money if you have the patience.

First, I would like to talk about the differences I have in regards to day trading compared to what is being taught in most day trading courses.

Diversification . Most day traders will tell you to spread your risk out among several positions. I disagree with this. It is harder to manage multiple positions in a day trading environment. There is nothing wrong with being in a few positions but no more than two or three at the same time.

Only trade stocks with high average daily volume . This seems logical, but a stock that normally trades low volume can very easily trade several million shares on a day with news. You will miss out on a lot of quality trades by only monitoring stocks with high volume.

Only trade stocks with a price between twenty dollars and one hundred dollars. I cringe every time I hear this one. There is absolutely no difference between trading 1000 shares of a $50.00 stock and trading 100 shares of a $500.00 stock. If you eliminate stocks under $20.00, you are going to miss out on a lot of great trades.

Only trade stocks with a high ATR. ATR, or average true range, is the average amount a stock moves in one day. I often hear traders say, "I like to trade $100.00 stocks because they have a higher ATR.". Think about this for a minute. What you really want to look for is the average true range as a percentage of the stock price. A $10.00 stock with an ATR of twenty cents would be a better day trading stock than a $100.00 stock with an ATR of one dollar. The ATR as a percentage is two percent on the $10.00 stock and only one percent on the $100.00 stock.

Ok, now that I got that off of my chest, let us look at how we can apply our supply and demand knowledge to day trading.

In order to day trade, you need a minimum of $25,000.00 equity in your account. You really need to start with more than that because if you lose money on your first trade, your account equity will drop below the minimum required.

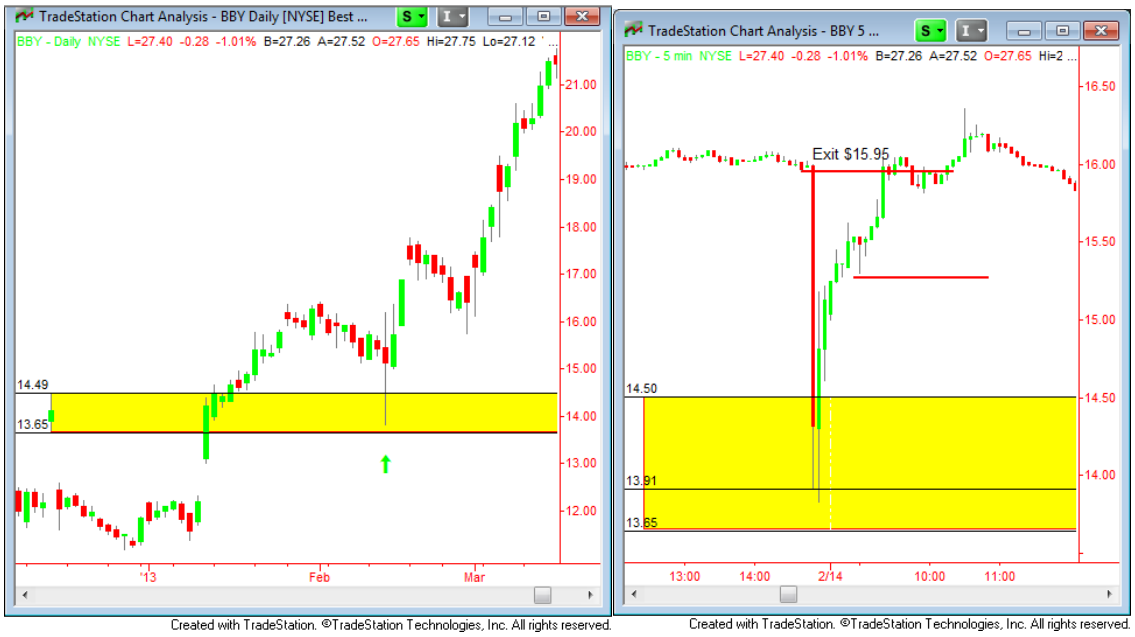
With the exception of liquid options with less than three days until expiration, I would highly recommend trading the stock and not the options when day trading. Your brokerage firm will give you four times the available cash to trade with. This is based on the cash balance in your account at the start of each trading day. If you have $30,000.00 cash in your account at the start of the day, you will have $120,000.00 in buying power. You can trade as many times as you want during the day, but

you can never hold more than $120,000.00 in stock at any one time. If you make $10,000.00 profit on a trade, your buying power would still only be $120,000.00 for that day. Profits for the day do not count towards your buying power until the next day.

When we day trade, we want to use daily charts for our entry, and hourly or even down to 5 minute charts for our exits. The reason we use daily charts for our entry is the zones will be a lot stronger. When trading in this manner, we want to make sure they are strong zones and fresh zones, meaning price moved in and out of them quickly and they are not part of another zone. These zones have never been tested. Look at the following example.

In the daily chart, you see a fresh zone formed on the left side of the yellow rectangle. Six days later, price moves back up into the zone. We see a bullish candle very close to the top of the zone on the five minute chart. If you entered the trade after the close of that candle, you would have gotten an execution of $67.90. Your stop would be placed at $68.03. As the price started moving down, you would adjust your stop on every retrace. The horizontal red lines indicate where the stops would be moved to as the price went down. You would have eventually been stopped out at $66.11, leaving you a profit of $1.77 per share after commissions, assuming one penny in and one penny out for commission. If you had a $30,000.00 balance in your account, you would have been able to short 1750 shares, leaving you a profit of $3,097.50. If you would have been stopped out of the trade initially, you would have lost $262.50. This trade resulted in a reward to risk ratio of almost 12:1.

Many times price is moving rapidly towards a zone, and it can be a little scary to enter the trade. You have probably heard the saying, “Do not try to catch a falling knife.” Once you start to get the hang of plotting zones, you will realize that these are actually the best trades to take, and often times the trades with the best reward to risk ratios. Look at the following example.



On the daily chart, you can see a demand zone that started as a supply zone. It has never been touched as a demand zone. On the 5 minute chart, you can see price dropping rapidly down into the zone. The price hit $13.91 and reversed back up. You could take the trade as soon as it started back up, or you could wait until price came back down. The reversal shows you there is some demand there, and it is worth taking the trade.

Most of the time you will receive a second chance to enter the trade like we did here. You would have bought the stock at $13.91 or better on the second bounce, placing your stop at 13.62, three cents below the bottom of the demand zone. We place our exit at the bottom of the supply zone, based on the 5 minute chart, and move our stops like we did on the last trade. Again, the red horizontal line shows where we move our stop. You would have exited the trade 60 minutes later with a profit of $2.02 after commission. Your risk would have been 30 cents. Again, with a $30,000.00 account, you could have traded 8,500 shares for a profit of $17,170.00 in one hour. Your risk would have been $2,550.00, leaving you a reward to risk ratio of almost 7:1. As you will see in the next chapter, if we followed our risk management rules, we would not have traded that many shares. If our trading plan says we only risk 1% of our account on each trade, we would have only purchased 1000 shares, and our profit would be $2002.00 risking $300.00. The closer you can enter the trade to the bottom of the zone, the lower your risk would be, and the higher the number of shares you can purchase.

Let us look at one more day trading strategy using supply and demand zones. This is based on the fact that when a supply zone is pierced it turns into a demand zone, and when a demand zone is pierced it turns into a supply zone. The trade setups for this strategy are found pre-market. We look for stocks that have pierced a zone pre-market, indicating that the stock will gap up through a supply zone or gap down through a demand zone. When the market opens, we wait for a small pullback, and then when the price turns and continues in the direction of the gap we enter the trade, setting

our stop a few pennies below the low for the day on a long position and above the high of the day on a short position. This is the only time we do not set our stops based on the supply and demand zones. The pullback shows us where the current supply or demand is, and if it breaks those levels we want out of the trade. Here is an example of this type of trade.

Notice how the price opened above the supply zone and then pulled back before continuing up. This is a typical candle when price gaps up through a supply zone. The reason for this is that a lot of limit orders are triggered at the open, causing the price to pull back temporarily.

Many times price will break through a zone on a daily chart, but there was still a day trading opportunity available.

Price opened up in the supply zone. If you took a short trade as a swing trade and set your stop above the supply zone, you would have been stopped out in the afternoon but as a day trade you could have made over $1.00 on the trade. This is not a bad day trading profit off of a $26.00 stock.

What if the stock price is at an all time high or all time low?

When price is at an all time high or an all time low, we do not know where the supply or demand zone is located. In these situations we wait until a strong zone is formed and then take the trade the

first time price returns to the zone. A new zone will always be a fresh zone because price has never been there before.

It is important to make sure it is a strong zone, with price moving into and out of the zone rapidly. We do not want to be making trades against a trending stock unless we have a strong zone. The following charts illustrate this.

In this daily chart of Amazon (AMZN), a strong supply zone was formed designated by the yellow shaded area. The red arrow shows where price returned to the zone two days later, giving us a great short trade opportunity.

In this daily chart of Buffalo Wild Wings (BWLD), price moved up to the zone slower that AMZN did in the chart above. Even though price moved away rapidly, it was not as strong of a zone. As you can see, when price returned to the supply zone, it continued through the zone.

In the next chapter, we are going to talk more about risk management and how using supply and demand zones can minimize our risk and maximize our reward.

Chapter 5

Risk Management

We have talked a lot about risk management in this book, and that is because it is incredibly important. Even the best trader with the best trading strategy is doomed to blow through his account if he uses poor risk management.

A friend of mine plays poker for a living, and we had a long discussion about risk management a few months back. I will let him tell this story:

"I can't tell you how many times I've busted my bankroll because I failed at money management, especially in my youth. Everyone is susceptible to swings, good and bad, and if you do not prepare for the downswings, you will eventually lose everything. It took me a long time to learn that. I would think that I could just depend on my skill, assuming I would always be able to beat my opponents, but even skill-based games like poker involve incredible variance. I used to be the type of guy that would put everything he had on the table. Now, I will never risk more than 1% of my bankroll in one sitting."

The same concept applies to trading. Our goal in trading is to always take the highest probability trades, just like the goal in poker is to take the highest probability gambles. But we are still talking about probability, and that means that sometimes, even in what seem like the best situations, we are going to lose. It is inevitable.

The only way for us to stomach the losing is to prepare for it. These are the rules I follow in order to do that:

Preserve your capital and manage your money.

This is the cornerstone of stock trading—you should always be planning for a worst case scenario. Before asking "how much can I make?" you should ask "how much can I lose?" This is astute stock trading risk management. A smart businessman only takes risks that will not put him out of business even if he makes several mistakes in a row.

Define your risk.

As a stock trader, you are in the business of trading. You need to define your risk—the maximum amount of money you will risk, or lose, on any single trade. This is defined as a percentage of your portfolio. Most traders will risk between .5 % and 2% on a single trade. I personally do not like to risk more than 1% of my portfolio on any trade but that does not mean 1% is the magic number. It is important to note that risk and position size are two different subjects. If you have a $30,000.00 account and you are willing to risk 1% or $300.00 per trade that does not mean you will only buy $300.00 worth of stock. You could trade $10,000.00 and risk $300.00 or you could trade $30,000.00 and still risk only $300.00. Your risk is the amount you will lose if the trade goes against you.

Be aware of emotional trading.

Trading is so exciting that it often makes stock traders feel high, and then suddenly very down. Nobody can get high and make money at the same time. Emotional trading is the enemy of success. Fear and greed are bound to destroy a stock trader. A real professional stock trader does not get too excited or upset about wins or losses. This is proper psychology, both for stock trading and for maintaining a healthy, enjoyable life, hopefully with a few profits from stock trading, but worthwhile enough even if one happens to have losses.

Focus on being a winner, not a loser.

The goal of a successful professional in any field is to reach his personal best. To be a winner, you need to concentrate on trading the right way. Each trade has to be handled like a surgical procedure—seriously, soberly, without sloppiness or shortcuts. This is a stock trading risk management plan, not a trip to the casino.

A loser struggles to cut his losses quickly. When a trade starts going sour, he hopes and hangs on, and his losses start piling up. And as soon as he gets out of a trade, the market comes roaring back.

Trends reverse when they do because most losers are alike. They act on their gut feeling, instead of using their heads. The emotions of people are similar, regardless of their cultural background or educational levels.

Emotional traders go into risky gambles to avoid taking certain losses. It is human nature to take profits quickly and postpone taking losses. Emotional trading destroys those who lose. Good money management and timing techniques will keep you out of the hole. Losing traders look for a "sure thing", hang on to hope, and irrationally avoid accepting small losses.

Think about the reward-to-risk ratio.

Risk is part and parcel of trading. The reward to risk ratio is an important risk management and trading tool that is used to determine if a trading system is likely to be profitable consistently. It is a measure of risk versus reward, calculated by dividing total potential profit of a trade by the loss you will incur if the trade goes against you. Your reward to risk is calculated using your first exit price.

It is important to understand your level of risk with every trade that you do. The challenge is to manage risk within your portfolio to achieve maximum benefit from your trades. Experienced traders know that the reward-to-risk ratio is critical when it comes to trading. However, this is often overlooked by new and inexperienced traders.

Another important consideration in determining the reward-to-risk ratio that is acceptable to you is the percentage of winning trades you have in your trading system. The higher that percentage is, the lower the reward-to-risk ratio needs to be. For example, if 50% of your trades are winning trades, then any reward-to-risk ratio greater than 1:1 would make you profitable. Any trading strategies with a winning rate greater than 50% would be profitable with a reward to risk ratio of 1:1 or better. I like to see a reward-to-risk ratio of at least 3:1, with a probability of being successful of at least 75%.

Trading using supply and demand zones will allow you to find reward-to-risk ratio trades higher than 10:1 or even 20:1 with very high probabilities of success.

When we enter a trade, we will usually have three price targets for exiting the trade. The first target price is the price that is used to calculate the reward. If the profits made after closing the trade at the first target price does not fall in to our defined reward to risk ratio, then we do not take the trade.

Using stop loss orders

When you enter a trade, you have to know where your exit is going to be if the trade turns against you. This defines your risk. Most trading platforms allow you to place your order and your stop order at the same time. This is not as important for swing traders as it is for day traders, but it is still a good idea. As a day trader, your internet could go out right after you entered your order. If you did not have a stop order entered at the same time, and the trade turned against you, then your losses could easily exceed the defined risk by the time you got your internet back or called the trading desk. This is especially true if you are trading any type of leveraged market, like E-Mini index futures or Forex.

I cannot stress this enough: risk management is critical to being a successful trader. If you are not willing to commit to a money management system, you will likely fail. Be smart, be committed, and be professional, and then you will succeed.

Chapter 6

Applying Supply and Demand Zones to Risk Management

When I set out to write this chapter, I wondered how traders that trade only using technical analysis determine where to place their stops, so I googled "Where do I place my stop" and found some interesting forums. Here are a couple examples I found.

Michael,

This is a serious question you might want to address in the trading room, or maybe write an article about it. Most of the so-called forex teachers have drilled into my head that it is important to set stops, and suggest that the position of stops is critical in that the stop limits the amount of risk for the trader. However, it has been my experience that this practice only enriches the broker, for I have more often than not been stopped out only to see the price reverse and move to the point where I would have enjoyed a good profit if I had not been stopped out. You have indicated in the trading room that you have had similar experiences. A few evenings ago I noticed that Tim set a wide stop for a relatively small profit target, and I asked him about it. He stated that he just tries to set stops where they make sense on the charts, without regard to a ratio between stop and target. I know none of us want to suffer catastrophic losses, but continual small losses have the same effect. So my problem, and that of many traders, is how do we determine where to set a stop to prevent undue losses, but at a point where we are not just surrendering pips to the broker. I know you are too busy to answer each email, but if you could deal with this in an article, or a special training video, or in the trading room, it would be of great value to we who are struggling to improve our results. I appreciate you greatly, both for your trading skill, your care for each of us, and the example you set in your personal life.

Thanks, Fellow trader (name withheld by request).

Michael answered his question with a very lengthy response that really did not answer his question but the following is part of his response.

You are not alone! This is the trouble that plagues every trader, the times you stop out, you were right and the times you do not you were wrong. Or worse, you adhere to stops constantly and suffer death by a hundred or a thousand small stop outs, till you are totally discouraged. How do you know when to stop and when NOT to stop, that is the question. This is a tough call and I wish I had an easy answer. I will provide you with the best answer I can muster, but this is NOT easy. If trading was easy we would all be millionaires. It is a tough business.

Here is another one I found.

WHEN DO YOU EXIT A TRADE?--The biggest question that I have been asked is when do I exit a winning trade and when do I exit a losing trade? The rule of thumb that I use is placing my stop loss at the ten day high if I am short or a 10 day low if I am long. The other rule of thumb is to place your stop loss at the 2% maximum loss allowed in your account for any given trade. If you have any questions or are looking for a futures broker please call me at 800-615-7649 and I will review many basic trading rules with you.

Here is yet another response from a professional trader.

As for the placement of stops, my personal view is that a stop should be put at the point where, if reached, the market has told you that the move you were expecting to happen is probably not going to, at least the way you anticipated. I do not use arbitrary fixed stops. Nor do I employ "stop loss" orders. My stop exit is placed on the basis of my overall strategy.

Okay, enough of the madness. The internet is full of examples like the ones I listed above. One of the greatest benefits of trading with supply and demand zones is you always know where to place your stop. With a demand zone, your stop will always be a few pennies below the bottom of the zone, and with supply zones it will always be a few pennies above the top of the zone. This allows you to define your risk before you enter the trade, and it also gives you a way to determine the size of your position. We also use supply and demand zones to determine where we are going to take our profits.

Let us look at an example trade setup.

Realty Income (O) has been in a strong downtrend for the last two weeks. The price has just moved into a demand zone, so we want to take a long position. The first thing we are going to do is determine where we are going to place our stop. The bottom of the demand zone is 43.15, so our stop would be $43.12. Next, we need to determine the price targets for our three exits. Five days back, there was bullish candle with a long wick showing there was temporary demand at the bottom of the wick. That demand is now potential supply, so that would be a good place to place our first exit price.

The bottom of the wick is $45.84, so we will set our first exit at $45.83. We have a supply zone between $49.39 and $50.54, so we will set our second exit price at 49.38, one penny below the

bottom of the zone. Our third target price will be $54.85, which is one penny below the top supply zone.

Our position size and our reward-to-risk ratio is now based on our entry price. Remember, there are two ways to trade a demand zone. We can either buy when the price is in the zone, or we can be a little more conservative and wait until price breaks through the top of the zone, giving us more of an indication that the demand zone is holding. If we take the first option and buy at the open, our entry price would be around $43.25. Our stop was set at $43.12, so our risk would be determined as follows.

- If our stop is set at $43.12, our likely execution will be $43.11, so we would have a loss of $43.25 minus $43.11, which is 14 cents.
- Our cost of commissions will be at most two cents, one penny in and one penny out.
- Total risk per share would be 16 cents.

If we are willing to risk 1% of our account on each trade, then our total risk would be $300.00. We take the total risk and divide it by our risk per share to determine our position size. In this example, our position size would be 1,875 shares. ($300.00 divided by 16 cents.)

Next, we want to look at our profit potential based on our first exit price. In this example that would be $45.83, so $45.83 minus our entry of $43.25 is $2.58 per share. If we divide that by our risk of 16 cents, we get a reward-to-risk ratio of 16:1. We want a reward-to-risk ratio based on our first exit to be at least 3:1, so this is definitely an acceptable reward-to-risk ratio.

When I was searching for articles explaining where to set your stop, the most common method was to use Average True Range, or ATR. This is the average, usually over the last 14 days, the price moves in one day. Using this technique, our stop would have been set at $43.25 minus the ATR of $1.59, which is $41.66. Adding our commission and slippage, our risk per share would be $1.62. With a total risk of $300.00, we can now only purchase 185 shares instead of 1,875 shares ($300.00 / $1.62), and our reward-to-risk ratio based on our first exit is now less than 2:1, which is less than our 3:1 minimum. We know that if price breaks through the bottom of the zone, we need to get out and not sit around and lose more money.

Let us run the same numbers with the second scenario, entering the trade after the price breaks through the top of the zone. Our entry now would be about $43.63. Our stop is in the same place, so our risk would be $43.63 minus $43.12, which is 51 cents. Adding the commission and slippage, we would be at a total risk per share of 54 cents. Our reward-to-risk ratio now is almost 5:1, which is still acceptable, and our position size would be $300.00 / .54, which equals 555 shares. As you can see, the closer your entry price is to the bottom of the demand zone, the higher your reward-to-risk ratio is, and the number of shares you can trade is higher.

We could do this same trade using "in the money" options. If you are not familiar with options, be sure to check out chapter 8 to fully understand this concept. Our stop would be based on the price of the stock, not the option. If the stock price dropped to $43.12, breaking our demand zone, we

would simply sell the option contract and take our loss. Most trading platforms give you a way to do this automatically, but you need to be careful you do not get a bad execution selling your options. Remember, when a stop is triggered, it turns your order into an order to sell at the market price. If the options trade at a wide spread, you will likely get a poor execution.

You could also buy "out of the money" calls. When I buy "out of the money" calls, I consider the entire premium I pay on the calls as risk, so we would purchase $300.00 worth of calls. This is usually only practical if you are expecting a quick move in the stock, and the stock either has weekly options available or there is only one week left until the call expires.

One more important thing to consider when buying options is the spread between the bid and the ask price. It is important to watch this to make sure you get executions where you want them. The spread between the bid and the ask price is almost always higher when trading options. This spread is important when calculating your risk. For example, if the bid on an option is .45 and the ask price is .50, you must add in that 5 cents to your risk per share. The reason for this is because you are buying the option at the ask price and selling at the bid.

There was a lot of material in this chapter, so if you did not understand everything, be sure to read it over again and make sure you fully comprehend it.

Chapter 7

Developing a Trading Plan

Establishing a trading plan is an integral part of being a successful market trader. Whether trading stocks, currencies, or commodities, a detailed trading plan helps to solidify a trading strategy and encourages adherence to a well-developed trading system. An effective trading plan details the steps that a trader must follow when entering and exiting trades. Without a trading plan in place, traders are more susceptible to trading mistakes, overtrading, and making impulsive decisions in volatile markets, particularly when trading online. Here are the steps for writing a trading plan.

Decide which financial instruments you will trade.

You may be strictly a stock or currency trader, or you may be trading multiple markets. Create a separate category in your trading plan for each financial instrument.

Determine which stocks, currencies or other financial instruments to trade.

For example, if you are a day trader you may compile a list of stocks that have an average true range percentage of over 3% and trade at least 10 million shares per day, or if you are a swing trader you may want to compile a list of stocks that have options available and have an open interest of over 10,000 contracts showing they have some liquidity. Maybe you are trading currencies, you might trade only one currency pair or all pairs related to the Great British Pound (GBP). List the names of the specific companies, currencies or commodities you plan to trade.

Determine which timeframe you are going to use.

For example, if you are a long term investor you would most likely use weekly charts. A swing trader would use daily charts and possibly hourly charts and a day trader may use a combination of daily and intra-day charts. If you are going to do more than one then create a separate category for each timeframe.

Identify your trade setups.

For example, if you are day trading you may decide you are only going to take trades that enter a strong supply or demand zone based on a daily chart or you may decide to trade off of the hourly chart. If you are a swing trader you may decide you only want to take trades with the prevailing trend so you may look for reversal patterns on pullbacks that are in a supply or demand zone. Write down the exact conditions that must be met before you can enter a particular trade.

Decide ahead of time how much you will risk on each trade.

By knowing how much you are willing to risk on each trade you can determine your position size when you enter the trade. Remember that the closer your entry is to the bottom of a demand zone or top of a supply zone, the larger your position size can be.

Decide your minimum reward to risk ratio.

Your reward to risk ratio is based on the profit at your first exit price divided by your risk. For day trading, you may set this at a minimum of 3:1 and maybe 5:1 for swing trading. The higher your percentage of winning trades, the lower your reward to risk ratio can be and still remain profitable.

Write down the process of how you will monitor each trade.

When day trading, for example, you may move your stop every time a new pivot is formed. You may also move your stop to a small profit after a certain percentage move.

Decide on the parameters for trade exits.

Documenting your exact strategy for trade exits prevents last minute or impulsive trading decisions, such as exiting a trade too early or holding it for too long. If you have a well-tested and profitable trading system with a strict money management plan, exiting your trade based on set parameters will yield the best results.

Write the exact conditions that must be met before you can exit your trade. This may be an exact price point, a trailing stop, or a specific time of day.

Include a section for trading times.

If trading the 24-hour foreign exchange market, trading can be a nonstop event. Decide on a trading schedule and write it into your trading plan. When day trading stocks, you might work for 4 hours each day starting at the daily open. If you trade in longer time frames, your trading schedule may involve only a 15-minute daily commitment to check prices and read relevant market news.

Evaluate your trading plan.

Include a section in your trading plan for evaluating your trades. This can be a comment box where you write down whether you adhered to your trading plan. Alternatively, it may be a list of steps you must check off while trading.

Chapter 8

Options Basics

Options can be a valuable tool to manage risk. If you are going to hold a position overnight then using an option instead of shorting or buying a stock is always less risk. Currently there are over 2000 stocks that have options available and most ETF's have options available. Do not be misled by the statement that options are risky. If used properly they are always less risky than holding the same position with stock.

What is an option?

An option is a contract giving the buyer the right, but not the obligation, to buy or sell an underlying asset (a stock or index) at a specific price on or before a certain date. Listed options are all for 100 shares of the particular underlying asset.

An option is a security, just like a stock or bond, and constitutes a binding contract with strictly defined terms and properties.

How is an option different from a stock?

In order for you to better understand the benefits of trading options, you must first understand some of the similarities and differences between options and stocks.

Listed Options are securities, just like stocks. Options trade like stocks, with buyers making bids and sellers making offers. Options are actively traded in a listed market, just like stocks. They can be bought and sold just like any other security. Options are derivatives, unlike stocks—that is, options derive their value from something else, the underlying security. Options have expiration dates, while stocks do not. There is not a fixed number of options, as there are with stock shares available. Stockowners have a share of the company, with voting and dividend rights. Option holders have no such rights.

What types of options are there?

There are only two kinds of options: Call Options and Put Options.

A Call Option is an option to buy a stock at a specific price on or before a certain date. In this way, Call Options are like security deposits. If, for example, you wanted to rent a certain property, and left a security deposit for it, the money would be used to insure that you could, in fact, rent that property at the price agreed upon when you returned. If you never returned, you would give up your

security deposit, but you would have no other liability. Call options usually increase in value as the value of the underlying instrument increases.

When you buy a Call Option, the price you pay for it, called the option premium, secures your right to buy that certain stock at a specified price, called the strike price.

If you decide not to use the option to buy the stock, and you are not obligated to, your only cost is the option premium.
Put Options are options to sell a stock at a specific price on or before a certain date. In this way, Put options are like insurance policies. If you buy a new car, and then buy auto insurance on the car, you pay a premium and are, hence, protected if the asset is damaged in an accident. If this happens, you can use your policy to regain the insured value of the car. In this way, the put option gains in value as the value of the underlying instrument decreases. If all goes well and the insurance is not needed, the insurance company keeps your premium in return for taking on the risk.

With a Put Option, you can "insure" a stock by fixing a selling price. If something happens which causes the stock price the fall, and thus, "damages" your asset, you can exercise your option and sell it at its "insured" price level. If the price of your stock goes up, and there is no "damage," then you do not need to use the insurance, and, once again, your only cost is the premium. This is the primary function of listed options—to allow investors ways to manage risk.

Option symbols vary from broker to broker, but the symbols are derived from the stock symbol, called the underlying stock, the strike price, and the expiration date, and a designation of whether it is a put or a call. For example, if we wanted to purchase the right to buy one hundred shares of Alcoa at $8 by the third Friday in May, the symbol in TradeStation would be AA 130518C8. The AA is the stock symbol for Alcoa. The 130518 is the expiration date, May 18, 2013. The C means it is a call, and the 8 means it is an $8 strike price.

How are options valued?

Let us say that the price for this option is 34 cents, Alcoa is trading at $8.27, and there are three weeks left until the option expires. If we purchase 1 call contract, the total cost will be $34.00 plus commission. The reason the cost is $34.00 is because option prices are listed as a per share cost, and there are 100 shares per contract, so 100 x 34 cents equals $34.00.

Let us take a look at the breakdown of the option price. An option price consists of the sum of two values—the intrinsic value and the extrinsic value. The intrinsic value on a call is calculated by subtracting the strike price from the current price of the stock. The intrinsic value on a put is calculated by subtracting the current stock price from the option strike price. In our Alcoa example, the intrinsic value of the call would be the current price of $8.27 minus the strike price of $8, which gives us 27 cents. The remaining 7 cents is the extrinsic value or time value of the option. The

extrinsic value of the option is determined by several factors, but the main ones are volatility and the time remaining on the contract. The more volatile the underlying stock is, the higher the extrinsic value will be. The amount of time left on the contract also factors into the extrinsic value. As time winds down, the extrinsic value affected by time will decrease. It is like a life insurance policy. If you wanted a policy for 1 year, you would not have to pay as much premium as you would if you wanted the policy for five years.

Options are always in one of three states. These states are "in the money," "at the money," and "out of the money."

An "in the money" call means the strike price is lower than the current value of the stock, and an "in the money" put means the strike price is higher than the current price of the stock. "In the money" options are the only options that have intrinsic value.

"At the money" options are options where the strike price is the same as the current price of the stock. "Out of the money" calls have a strike price greater than the current stock price, and "out of the money" puts have a strike price lower than the current stock price. Since "at the money" and "out of the money" options have no intrinsic value, they are worthless upon expiration.

In our Alcoa call example, the option is in the money because the strike price is $8.00 and the current value of the Alcoa stock is $8.27. If Alcoa is trading at $8.27 when the options expire, they will be worth 27 cents. If Alcoa is trading at $7.98 when the options expire, the call contracts will be worthless.

Let us look at the Alcoa put option for the same strike price and the same date. The TradeStation symbol would be AA 130518P8, which is identical to the call except there is a P for put in place of the C for call. The current price of this put contract is 7 cents. Since the strike price is lower than the current stock price, the put option is out of the money and the entire 7 cents is extrinsic value, sometimes referred to as time value. Notice the extrinsic value of both the put and call option is the same—seven cents.

How do we use options?

Now let us take a look at how we can use options. I am sure you have heard that options are extremely risky. Maybe you have even been told to stay away from them. But I cannot stress this enough—the opposite is true. If used properly, options have less risk associated with them than purchasing the underlying stock.

Let us say we thought Alcoa was going to run up to $9.00 by the third Friday in May. We could buy 100 shares of Alcoa for $824.00, and if it ran up to our target of $9.00, we would make a profit of $73.00. If Alcoa dropped down to $7.50, we would lose $50.00.

Now, if we were to instead purchase one Alcoa call option with a strike price of $8.00 and an option price of 34 cents, our cash outlay would be $34.00. If Alcoa ran up to $9.00 by the third Friday in May, our option would be worth $1.00 x 100 shares, which equals $100.00, which leaves us a profit of $66.00. This is $7.00 less than the $73.00 we would have made buying the stock, but what happens if the trade goes against us?

If Alcoa dropped to $7.50, we would have lost $50.00 on our stock trade, but since we only paid $34.00 for the call contract, $34.00 is the most we can lose. If Alcoa somehow dropped to $5.00, we would lose $300.00 on the stock trade, but still only $34.00 on the option trade. If you have proper risk management strategies in place, you would have a stop loss in place in case the trade went against you, but what if Alcoa gapped down to $5.00 overnight and you had a stop loss order in at $7.50? You would not get the $7.50 execution—you would lose your stock at $5.00, giving you an unintended $300.00 loss. By using the option, you guaranteed yourself a maximum loss on the trade of $34.00.

We also could have guaranteed a maximum loss of $34.00 by buying the stock and then buying a put contract at the same $8.00 strike price. The cost of this option would be $7.00, or 100 x 7 cents. If Alcoa ran up to $9.00, you would make the $73.00 profit on the stock, but you would have to subtract the $7.00 cost of the put option, which would net you the same $66.00 profit that you had by replacing the stock with the call option. If Alcoa dropped below $8.00, you would exercise your put option and sell Alcoa at $8.00, giving you a loss of $34.00, a $27.00 loss on the stock and the $7.00 loss on the put. It does not matter how far Alcoa drops—you have the right to sell it for $8.00. Whether you buy the stock and a put option for insurance, or just replace the stock with a call option, by using options you guaranteed yourself a maximum loss on your trade of $34.00.

When it comes to risk management, there is no better way to secure your capital and give yourself significant profit potential than by trading options.

By now, you should understand the basics of put and call options and how to use them in your trading. There was a lot we did not cover—including the use of spreads. I personally do not use spreads very often, but I know that many professional traders are able to use them quite profitably. If you are interested in further reading on options, I recommend "Options as a Strategic Investment" by Lawrence G. McMillan. McMillan's book goes into great detail discussing some of the advanced calculus of options valuation, and it also covers every type of spread you can imagine.

Chapter 9

Where do we go from here?

This concludes our book on supply and demand. I hope you enjoyed it and learned from it. Trading using supply and demand zones can be very lucrative, but it takes time to become proficient at it.

If you want to learn more about supply and demand based trading go to www.zone-trades.com and sign up. The website is free and it is packed with articles to help you to be a better trader.

I look forward to seeing you on our site.