

Active Trading

Online Manual

by Alan Hull

The information contained in this document should be employed on a hypothetical basis, in real time, until satisfactory results of statistical significance are achieved.

Revision August 2018

Active Trading Online Manual

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Introduction

The Active Trading strategy uses a weight of evidence approach. This simply means that we're looking at 'evidence' from a range of different indicators and sources from which to draw our conclusion(s). In fact Active Trading takes trend trading to the extreme as I'm looking for trends within trends within trends within trends. That's four layers of trends to be precise!

I'm looking for a rising market, then a rising sector, then a rising share and finally, a rising week. Now I'm going to explain each of these four layers and then in I'll introduce the tools I use to measure each one of them. The logical place to start of course is with the top layer; the state of the entire Australian Stockmarket.

Rising Market Indexes

The Active Trading strategy analyses the broader market using both the All Ordinaries and the Small Ordinaries indexes. My first layer of evidence is to make sure that the broad market represented by the All Ordinaries index is rising. I then also need to make sure that the particular index that represents the small to medium capitalisation shares such as the Small Ordinaries is, is also rising.

This is my first layer of evidence...rising market indexes. The following weekly charts are examples of these two indexes, showing a time when they were both trending up together. Of course this would have been an ideal time for short term trend traders to be in the market.

Weekly Candlestick chart of the All Ordinaries index



Weekly Candlestick chart of the Small Ordinaries index



Dominant Sectors

When the broader market is just starting to rally, individual shares start to run before the relative sectors start to run. So to identify the most dominant sectors as quickly as possible, we can analyse how many shares from each sector appear on the rising equities list.

ActTrade Rising Equities - SAMPLE DATA ONLY

Share Code	Closing Price(\$)		Central Cord(\$)	Upper(\$) Deviation	Lower(\$) Deviation	ROAR (%)	Weighting for 2% risk	Industry Group
ACL	0.425	Dn	0.464	0.545	0.362	139	14	Pharmaceutical & Biotechnology
ACN	0.200	Dn	0.234	0.276	0.158	132	9	Energy
AGI	1.300	Up	1.431	1.662	0.968	228	8	Consumer Services
AGS	0.380	Dn	0.541	0.691	0.295	279	9	Materials
AKI	0.555	Dn	0.593	0.621	0.578	207	5	Materials
BRU	2.700	Up	2.615	3.094	1.608	151	5	Energy
BTR	1.745	Up	2.006	2.417	0.897	186	4	Materials
CCV	0.645	Up	0.640	0.720	0.523	121	11	Retailing
CHM	0.053	Up	0.054	0.063	0.033	228	5	Materials
COF	0.645	Dn	0.722	0.817	0.617	174	20	Commercial & Professional Services
CWK	0.780	-	0.855	0.971	0.714	155	20	Energy
DLS	1.255	Dn	1.575	1.823	1.226	193	20	Energy
DMG	0.510	Up	0.517	0.536	0.499	102	20	Materials
DMX	0.044	-	0.047	0.050	0.039	154	18	Commercial & Professional Services
DRG	0.470	Dn	0.561	0.645	0.512	370	5	Energy
EKA	0.350	Up	0.381	0.450	0.288	159	11	Materials
EXE	0.160	-	0.206	0.254	0.154	192	20	Energy

FAR	0.042	Dn	0.055	0.066	0.033	147	9	Energy
FMS	0.300	Up	0.300	0.311	0.287	157	20	Materials
GCN	0.031	Up	0.035	0.047	0.031	123	5	Software & Services
GGP	0.021	Dn	0.024	0.030	0.020	85	20	Energy
GMR	0.220	Dn	0.261	0.329	0.178	177	11	Materials
HAR	0.460	Up	0.474	0.560	0.354	152	9	Materials
HOR	0.300	Dn	0.348	0.425	0.254	99	13	Materials
ICN	0.250	Dn	0.301	0.360	0.198	131	10	Energy
IVA	1.845	Dn	1.929	2.215	1.705	229	20	Materials
IVR	0.335	Dn	0.418	0.543	0.239	194	7	Energy
JAL	0.360	Dn	0.430	0.512	0.316	174	16	Materials
JIN	0.910	Dn	1.080	1.322	0.597	233	6	Retailing
LDW	11.300	Up	12.432	14.200	10.109	231	19	Capital Goods
MAD	0.750	Up	0.926	1.160	0.594	257	10	Energy
MMX	0.485	-	0.497	0.528	0.454	209	20	Materials
MNM	0.120	Dn	0.181	0.236	0.103	245	14	Materials
MYE	2.420	Up	2.543	2.873	1.883	133	9	Capital Goods
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NGE	0.065	Dn	0.082	0.098	0.052	138	10	Energy
NMR	0.040	Dn	0.045	0.058	0.040	147	5	Materials
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RUM	0.375	Dn	0.385	0.459	0.321	129	14	Energy
SEA	0.760	Up	0.790	0.936	0.611	134	10	Energy

From this sample data we get the following frequency table for the leading sectors...

Industry Group	Number of shares
Materials	20
Energy	16
Retailing	3
Capital Goods	2
Comm & Professional Services	2
Software & Services	1
Pharmaceutical & Biotech	1
Consumer Services	1

Using this table we can categorically confirm what's leading the charge and then zero in on shares from these particular sectors.

Rising Share

My third layer of evidence is that of a rising share. The shares that are going to be part of my Active Trading portfolio will firstly need to be shares that are trending upwards in the short term with low volatility. Secondly, they will also need to be rising at an acceptable rate and we'll look into this in more detail shortly.

Suffice to say that not only do we want upward trending shares, we also want them to be going up nice and quickly! Here is an example of a relatively smooth, yet rapidly upward trending share that we would consider acceptable...

Candlestick Chart of a rising share

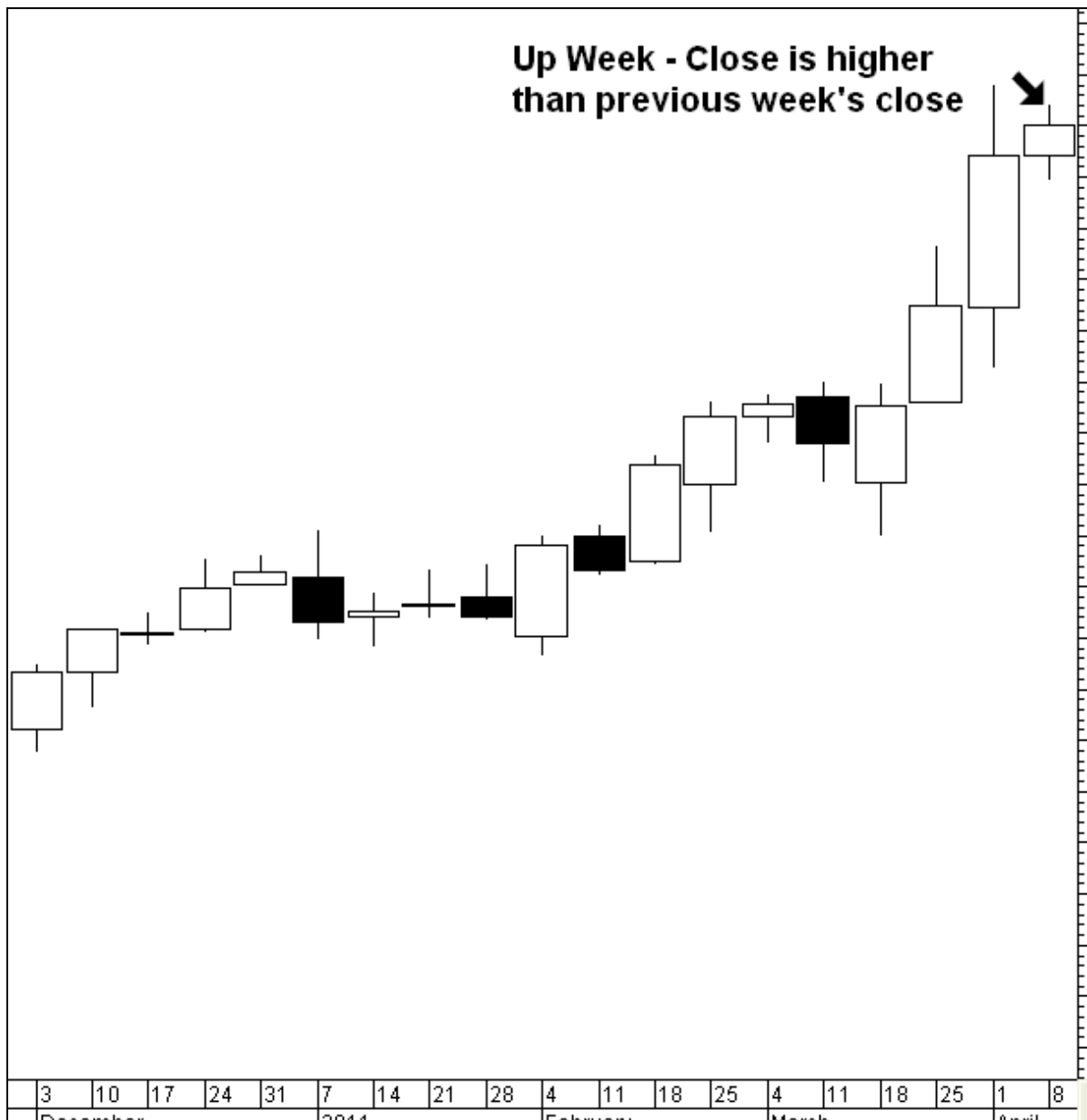


Rising Week or Upweek

This is my last layer of evidence...that of a rising week. After getting through the previous three layers and having identified a particular share or shares, I will now only enter the market when a share has been rising for at least the last week. I'm doing this because I don't want to buy a share when it is falling in the very short term.

I want a share that is showing immediate strength and so I want to witness what we call 'buyer support'. Thus, one obvious way in which buyer support is evident is when a share closes at the end of the week higher than it closed at the end of the previous week, ie. an 'upweek'. See the chart at the top of the next page.

Candlestick chart showing an upweek



Putting this altogether and to summarise, with my Active Trading system I'm seeking :

1. a rising market as indicated by both the All Ords and Small Ords
2. the most dominant sectors
3. a rising share that is trending up very rapidly but with relatively low volatility
4. an upweek where the closing price is higher than the previous week's closing price

The Active Trading strategy is very much a top down approach to trading where we start off with the big picture and then work our way down from there. So there we have the four layers that form the basis of my Active Trading system. Now we'll take a look at the tools I use to assess each of these layers.

The Active Trading Toolbox

Now I'm going to explain how I measure each of the four 'trends' that make up the system. Thus, we will examine all of the tools I'm going to employ in detail, which are as follows :

Rising Indexes – we'll use moving average crossover charts, namely 10 and 30 day EMAs

Dominant sectors – we'll use the Data Tables to identify the most dominant sectors

Rising Share - we'll use share MMA Charts and my Rate of Return (RoR) indicator

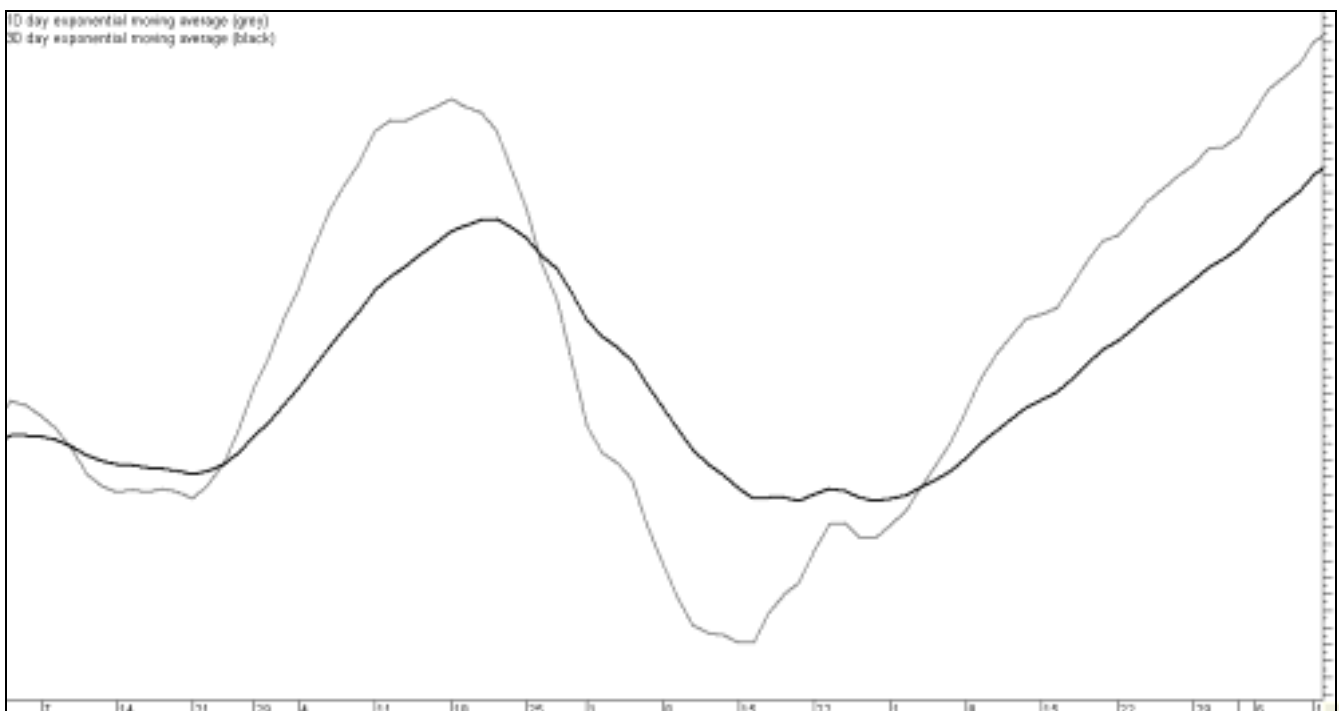
Up Week – we'll simply analyse weekly price data to determine this condition

These are the indicators and tools I'm going to use although I'll also be introducing my Range indicator a little later on when we get to the discussion on trade management. So once again we'll start at the upper or outer most layer, being the analysis of the All Ords and Small Ords indexes.

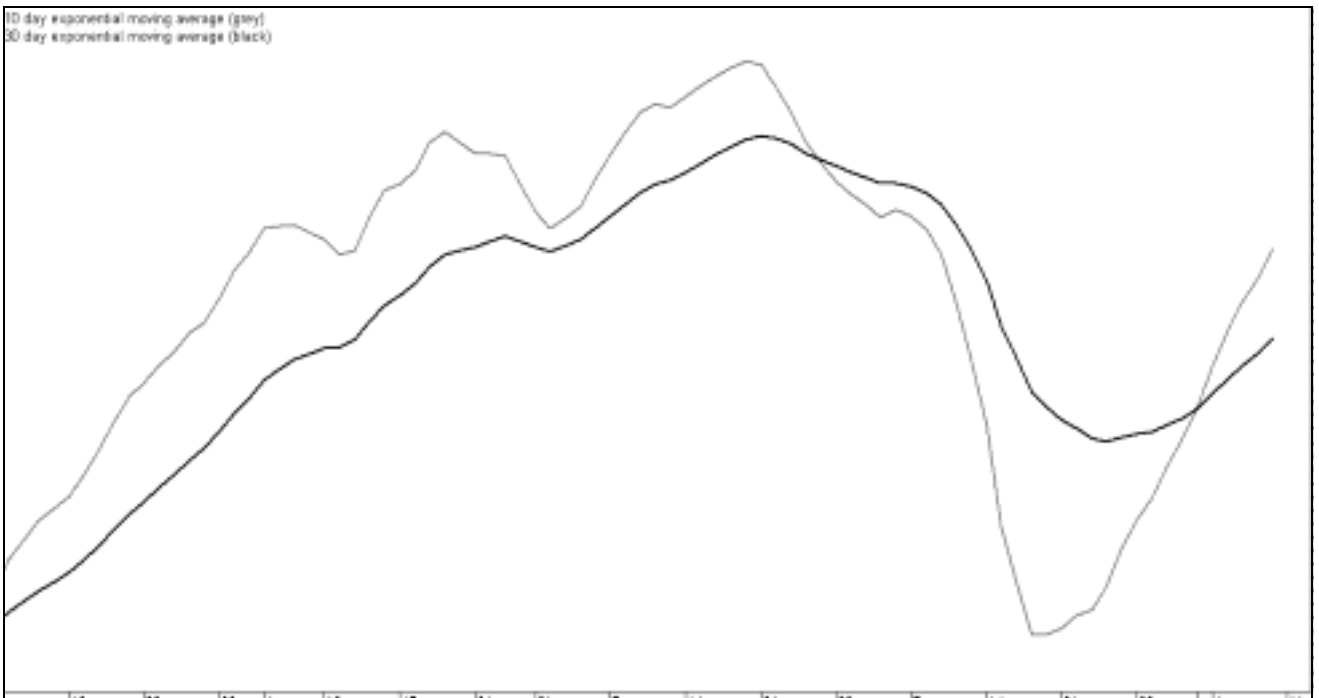
Rising Index

What I need here is a way to determine the direction of the trend of both the All Ords and the Small Ords, the two indexes relevant to this strategy. My tool of choice is the simple yet very effective Crossover Chart and shown below are the Crossover charts for the two indexes. Note that I have turned the index itself off in each case so you can only see the two moving averages...

All Ords Crossover chart



Small Ords Crossover Chart



Here I'm looking at two short term moving averages applied to daily charts of the All Ords and the Small Ords. The lighter of the two lines (the fast moving average of the two) is a 10 day Exponential Moving Average (EMA) and the black line (the slower moving average) is a 30 day Exponential Moving Average.

I chose these moving averages and particular periods because I have determined through many years of trialling different combinations that this is most suitable combination for assessing the direction of the Australian Stockmarket, for my given timeframe. The rules for interpreting the Cross Over Charts are VERY simple :

BOTH of the charts must be crossed to the upside, ie. the grey line must be above the black line at the right hand leading edge of the chart, in both cases.

So a chart is 'crossed' in a particular direction when the grey line (the shorter of the two moving averages) is ABOVE or BELOW the black line at the right hand leading edge of the chart. So if you can see the grey line above the black line, then the chart is crossed to the upside. If the grey line is below the black line, the chart is crossed to the downside. If the two lines are sitting right on top of each other at the right hand leading edge then they are not crossed in either direction.

These charts are my starting point and so we need to be very clear on their interpretation. Although that doesn't stop us *trying* to make them say what we want them to say; one might even zoom in on the chart for a better look! Of course even if you do utilise that sort of functionality from your computer software....if it's still not crossed to the upside...then it's NOT crossed to the upside!

If I can look at BOTH charts and see a grey line above the black line and I am looking to buy shares, I know that the indicator is telling me that I have the green light for go.

This is the first stage of the system and is a vital step because if we attempt to countertrend the broad market by trading against it we will surely fail. So the crossover charts provide us with clear unambiguous signals.

Dominant Sectors

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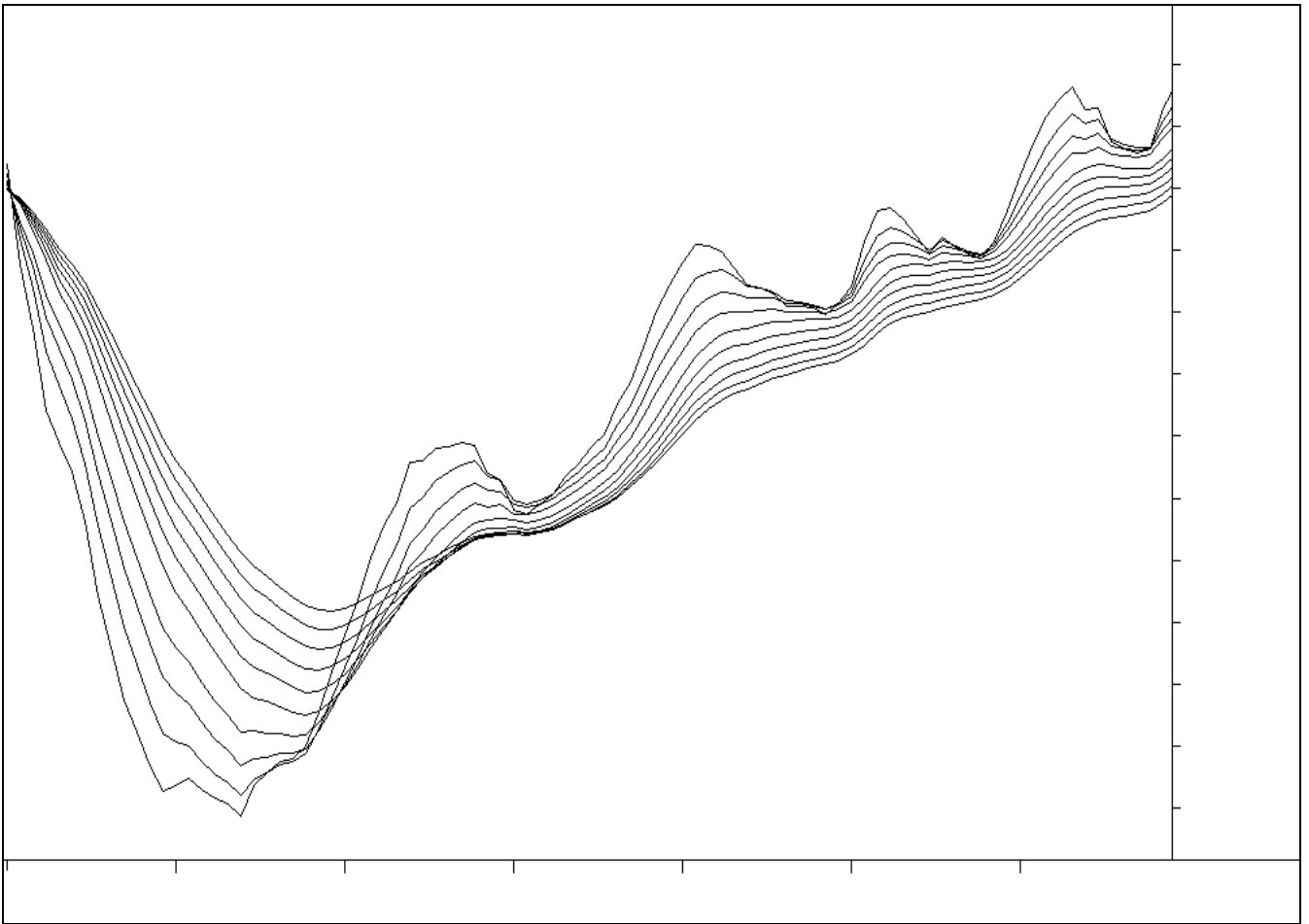
Rising Share

The two tools to be used to determine a Rising Share will be MMA charts and the RoR indicator. At this point I'm trying to find the most suitable shares in the sectors I've identified in the previous step. The MMA charts will show me the shares with the valid trends and the RoR will let me know which ones are rising the fastest. So now, let's look at the two tools we need in detail.

Multiple Moving Averages (MMA Charts)

Multiple moving averages, as the name implies, are a series of moving averages all drawn on the same chart with different but usually evenly spaced periods. And when creating an MMA chart it is a common practice to hide the underlying financial instrument as I have done in the following chart (ie. the actual price activity isn't displayed, only the MMAs)...

MMA chart created using 10 evenly spaced periods

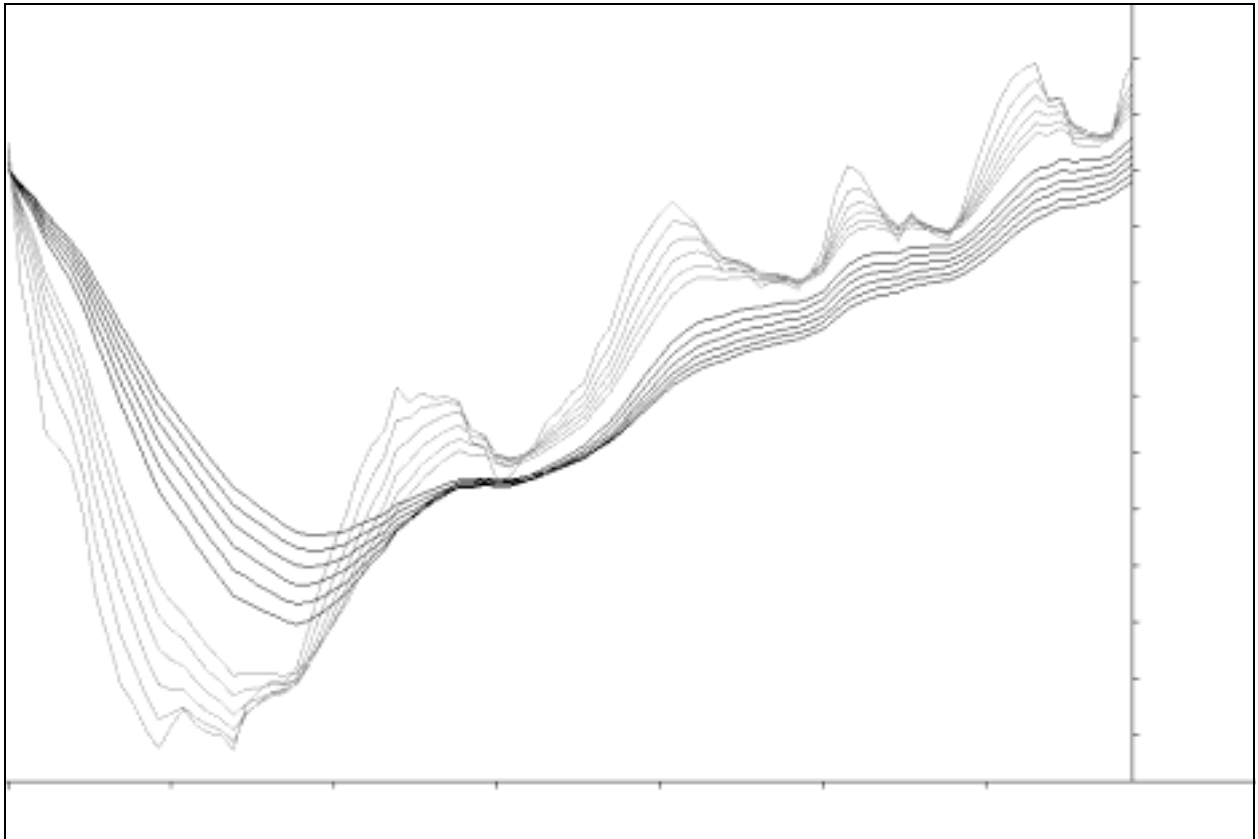


As you can see by placing a series of moving averages on the same chart with evenly spaced period values, it forms a ribbon that filters out the short term price movements but highlights the underlying trend. This technique was adopted several decades ago by Daryl Guppy, an internationally renowned share trader and best selling author, who came up with the idea of splitting the ribbon into two distinct groups.

Thus the shorter term group of averages would represent the shorter term traders in the market whilst the longer term group would represent the more conservative, longer term traders and investors. Daryl prefers using exponential moving averages and employs MMA charts in a variety of different ways but principally for trend analysis.

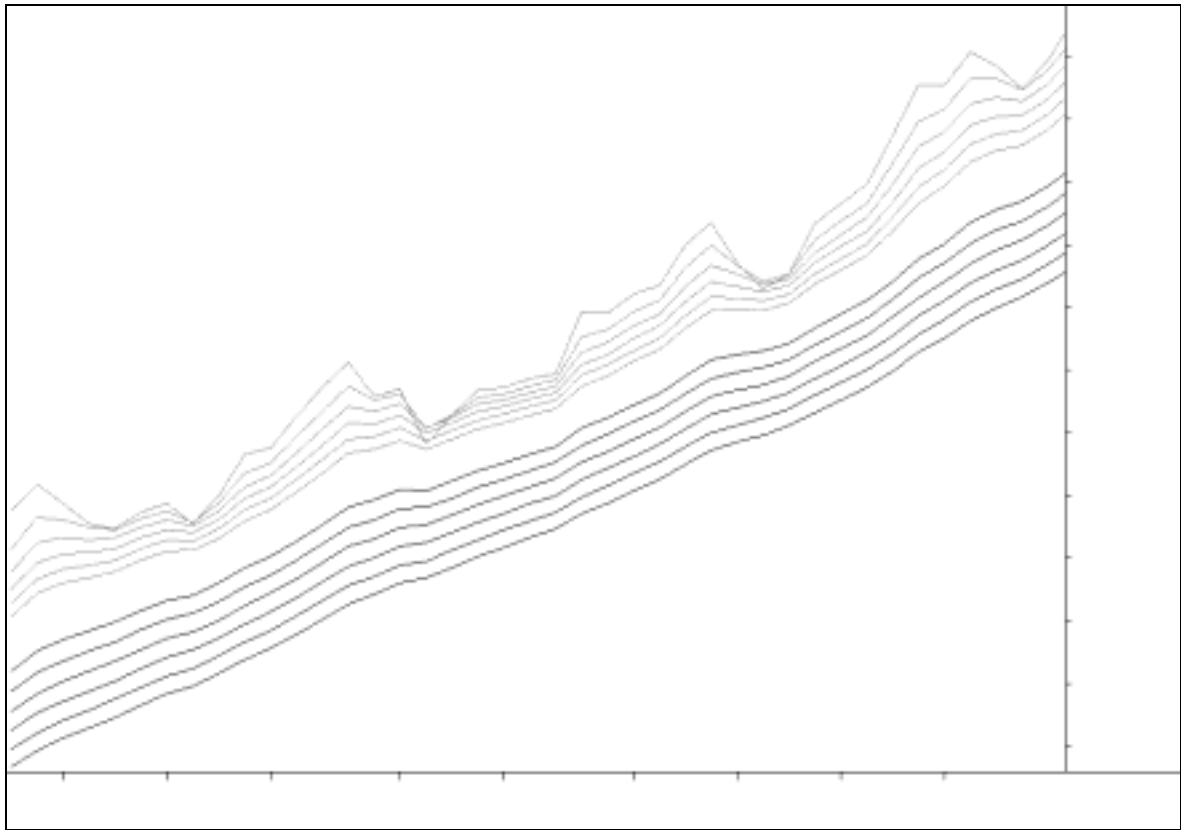
However the one way in which Daryl and I differ is that he trades with daily charts whilst I use weekly charts. Because of this we invariably use different periods for our EMAs.

Weekly MMA chart created using EMAs, with the shorter term group in grey and the longer term group in black



Now that I've covered how they are constructed, let's now turn our attention to their application which is qualitative as opposed to quantitative. Essentially I use MMA charts to judge the quality of a trend, my principle concern being the degree of volatility in the price behavior. Let's start by looking at an ideal trend where there is a little bit of short term volatility but all the longer term lines on the chart are remaining relatively straight, evenly spread out and parallel to each other.

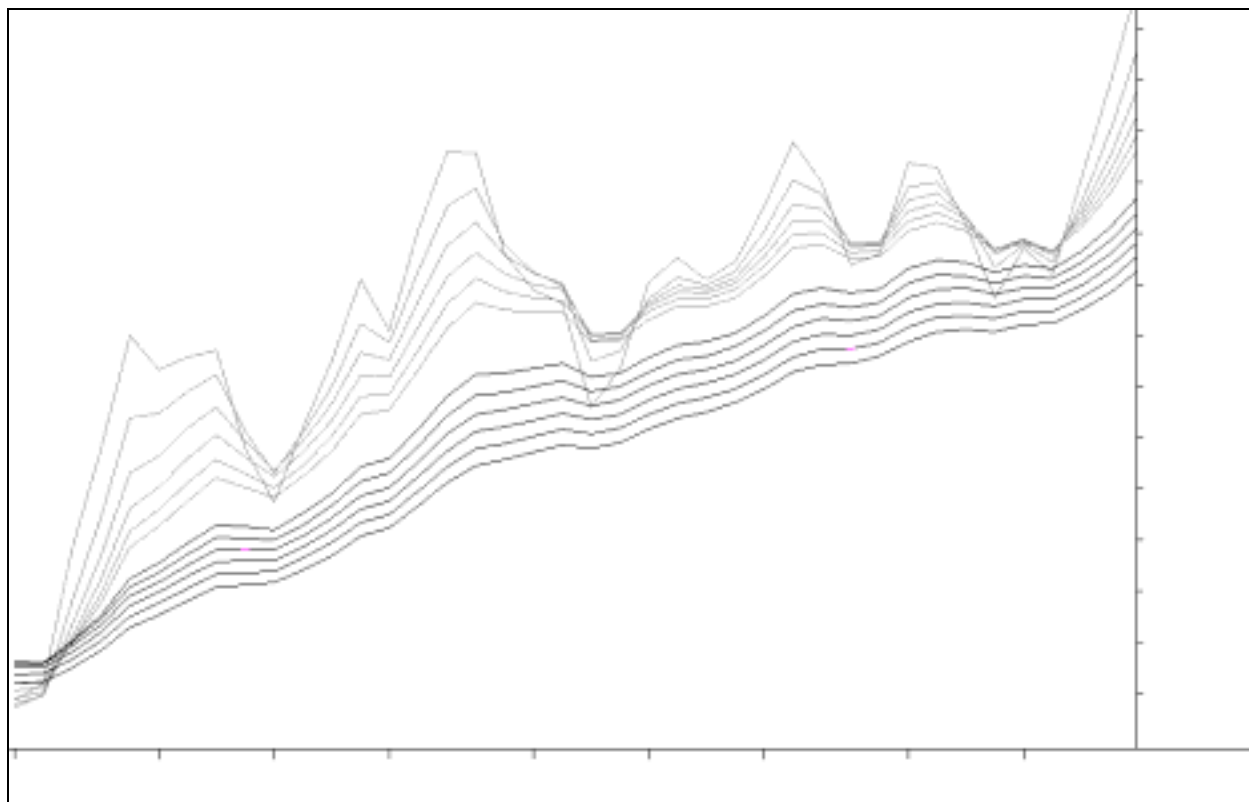
MMA chart showing an ideal trend with very low volatility



Looking at the short term group of averages, you can see how the market runs and then pulls back, over and over again. This is normal trending behavior as markets constantly rally and then rest, repeatedly. But it should be a nice even and regular pattern that isn't too violent.

If it is very aggressive then it indicates that the very short term traders have a strong influence over the market and, as a result, the trend is inherently unstable. So let's look at this type of situation where the price activity has far too much short term volatility and would therefore be considered as unstable.

MMA chart showing an unstable trend



In this instance you can see how the long term group of lines aren't straight and look like their being pushed around by the shorter term group. So I would buy into the ideal trend but not into the unstable one as it is far less likely to survive, in my opinion. And there's the kicker...in my opinion.

Analysing MMA charts is entirely discretionary and requires a considerable amount of practice if you want to do it well. Hence MMA chart interpretation is more akin to an art than a science.

Rate of Return Indicator (RoR)

The rate of return indicator is used to calculate the annual rate of return of a share given its current rate of climb or fall. It achieves this by calculating the annual increase in price activity and then dividing it by the current share price. The result is then multiplied by 100 to convert it to a percentage.

Example

- Let's assume that a share is climbing at a rate of \$2 per year.
- The current price of the share is \$5.
- The 'Rate of Annual Return' would be 0.4 (\$2 divided by \$5).
- Converting this to a percentage we get $0.4 \times 100 = 40\%$.

The rate of return indicator can be seen in the chart at the top of the next page. The RoR indicator uses linear regression for measuring price activity as opposed to moving averages.

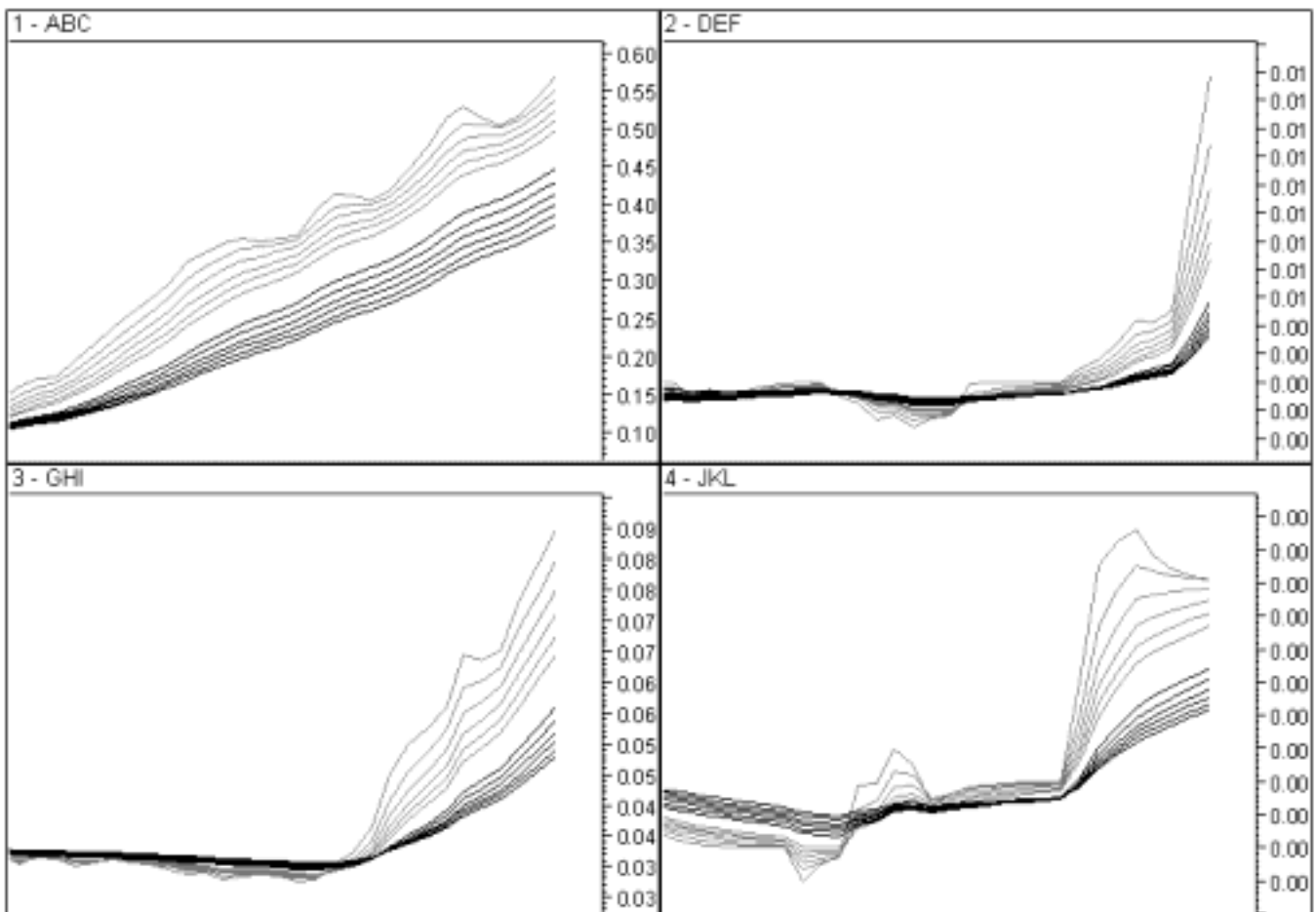
Share Chart showing Rate of Return Indicator (RoR)



Searches can be performed using the Rate of Return indicator to sift out shares that only have a rate of annual return higher than a certain cutoff.

Now, let's take a look at some share MMA charts....

Share Charts with Multiple Moving Averages

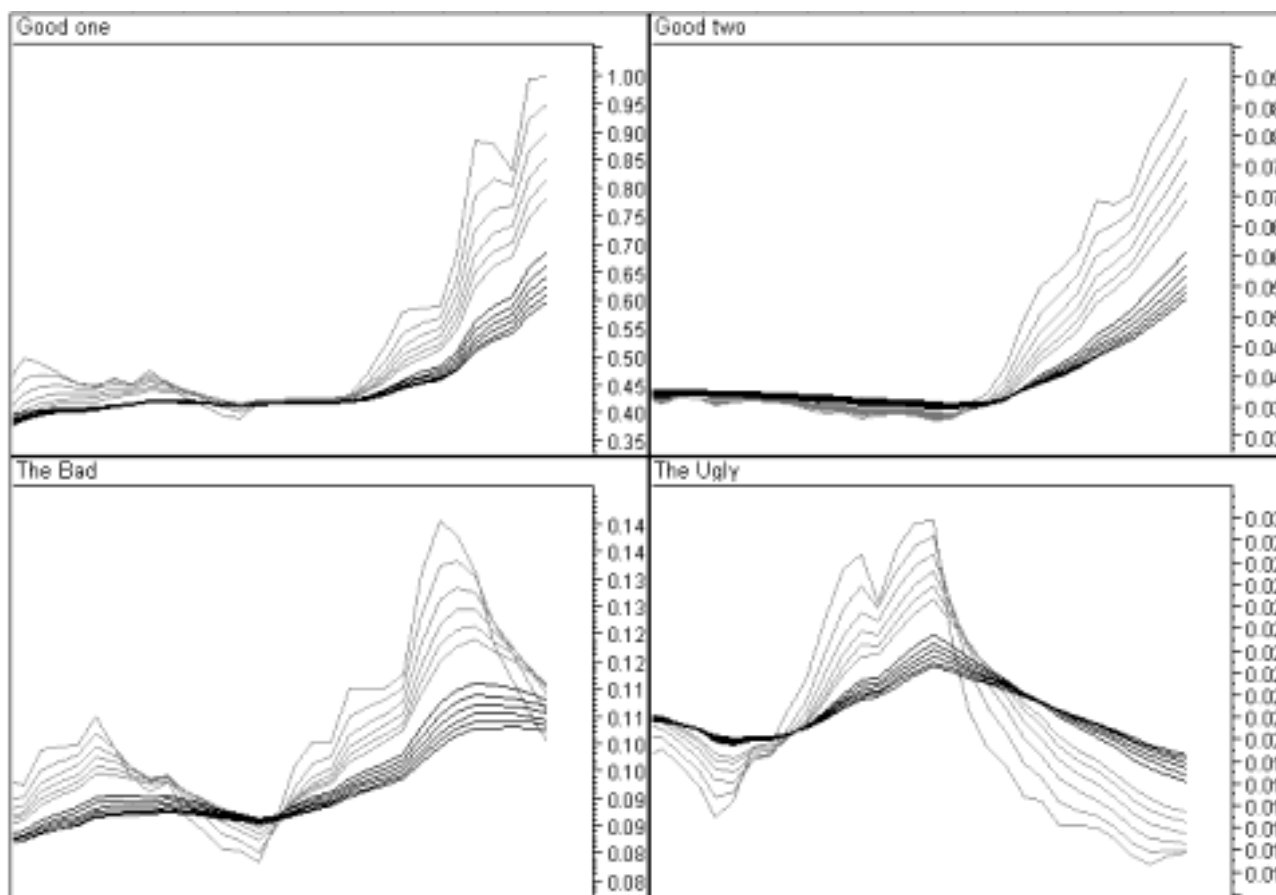


Here I'm using weekly charts with the following exponential moving averages :

- Short term group (grey lines) are 3, 5, 7, 9, 11 and 13
- Long term group (black lines) are 21, 24, 27, 30, 33 and 36

Here's a few examples of the good, the bad and the ugly!

Sample of various Share MMA charts with appropriate titles!



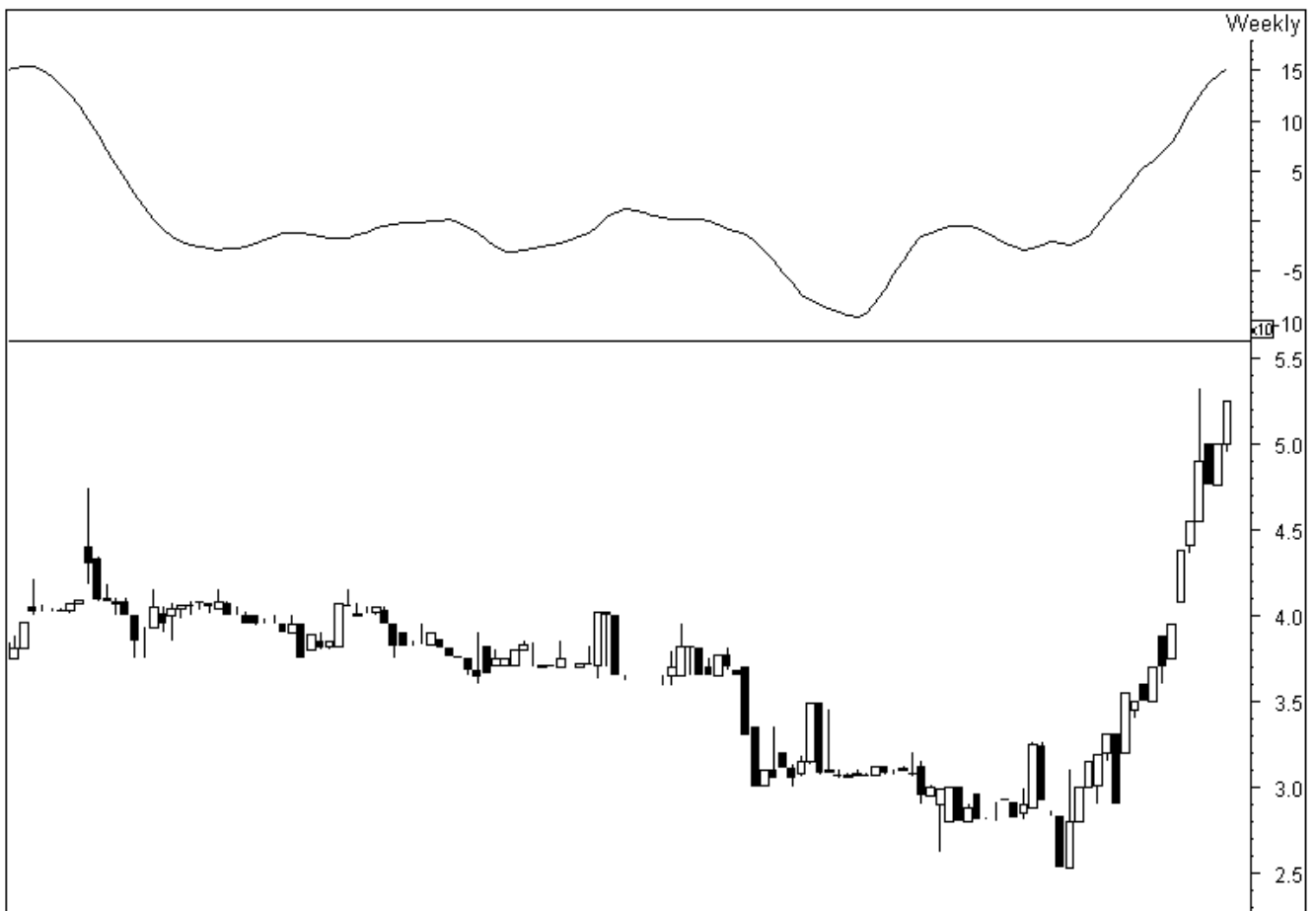
Now we apply the RoR indicator to the shares to make sure the trends are rising fast enough. Because this is a short term system, we want fast moving shares with high Rates of Return.

Thus, my minimum Rate of Return is set at 80%. This means that if I check the weekly value of a share's RoR and it is below 80%, I'll sell that share and replace it with another one, if there's a suitable opportunity.

This ensures that my money is always working hard for me and I'm not holding onto shares that are just drifting sideways. Now one further thing I need is a minimum entry RoR to ensure that I'm not whipsawed in and out of the market if a share's RoR hovers just above and below 80%. Thus my minimum entry RoR is set a comfortable distance away at 120%.

Having a minimum entry RoR of 120% provides a buffer zone of 40% (120% - 80%). Here's a chart of a share with the RoR indicator (in the uppermost window) so you can see how it changes over time...

Candlestick chart of Share and Rate of Return Indicator (RoR scaled by 10)



Applying the RoR to the shares with valid trends will give me a list of the best possible candidates for my portfolio. Once we've narrowed the search down to this degree, we're ready to complete the last step in the process and find the shares with rising weeks or upweeks. Once we've done that, we can fine tune our entry and call the broker!

Rising Week or Upweek

And, very shortly, I'm going to introduce another tool...the Range Indicator. The Range indicator, along with plain old end of week closing prices, will enable us to find the shares with a valid entry.

Finding if a share has had an upweek is really very simple. All we need to do is look at the current end of week closing price (remember our analysis is weekly) and then look at the closing price from last week.

If this week's closing price is greater than last week's closing price, then this week is an upweek. And please note; if the prices are the same, then it is not an up week!

Anyway, I've listed a few examples at the top of the next page, so see if you can pick out the shares with an upweek...

Table of Shares showing this week and last weeks closing price

<i>Share Code</i>	<i>This weeks Closing Price (\$)</i>	<i>Last weeks Closing Price (\$)</i>
MNO	3.220	3.000
PQR	0.230	0.310
STU	0.355	0.354
VWX	0.625	0.625
YZA	1.135	1.250

Yes...there were only two (MNO and STU), the others are either down or neutral. Once we've sorted out which ones have had an upweek then we can then use the Range Indicator to find out if we have a valid entry.

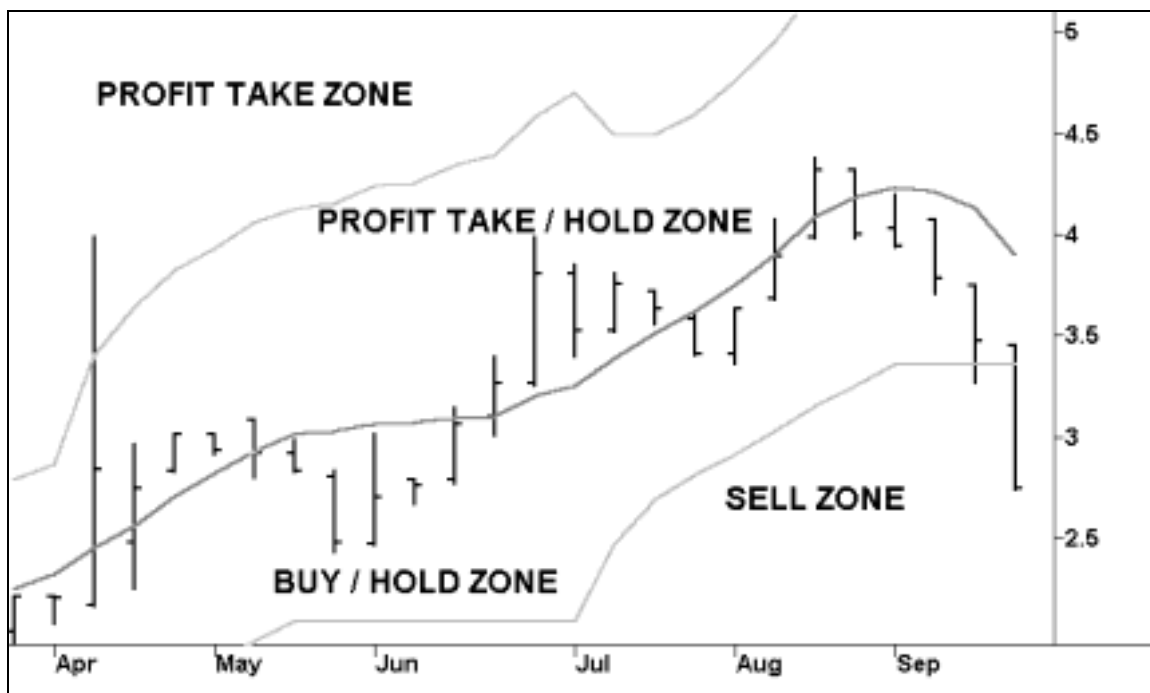
Range Indicator

The Range indicator provides us with a series of price ranges that tell us when to buy, sell, hold or take profit. Although simple in construction, it tells us when the price activity is pulling back, rallying up or the trend is reversing. And like the RoR indicator, its construction is based on the Hull Moving Average, referred to in this context as the central cord.

We then use Average True Range (which measures price volatility) to position upper and lower lines based on the central cord. These lines are referred to as the upper deviation line and lower deviation line. These two lines create an envelope that defines our tolerance towards price volatility.

The central cord, upper deviation and lower deviation lines create four distinct price zones that tell us when to buy, hold, profit take or sell. The following chart illustrates how the Range indicator is used to set buy, hold & sell zones.

Share chart showing Range Indicator



Rules for the Zones

Sell Zone	Sell if the share closes at the end of the day in this zone.
Buy/Hold Zone	Buy the share if it has closed at the end of the week in this zone and the price is higher than the previous week's closing price. The share must be purchased at a price between the lower deviation and the central cord. Hold if already owned.
Profit Take /Hold Zone	Hold if the share price is in this zone or take profits if the position is up strongly from its initial purchase price (eg. maybe sell half the position)
Profit Take Zone	Mandatory - Take profits if the share price closes at the end of the week in this zone. (in this instance sell the entire position) Optional - Take profits if the share price is in this zone at any time.

By using the range indicator to control our entry and exits we can avoid buying overpriced shares and sell when a trend reversal occurs. Although the Range Indicator is applied to weekly charts (ie. weekly analysis), the buy and sell signals are applied on a day-to-day basis (ie. daily execution).

Here's a list of shares where you can see whether or not they have had an upweek by looking at the third column from the left. It also shows the Range and RoR indicator values and so we can work out which ones have a valid entry and which ones don't. Note that the RoR indicator measures a share's 'rate of annual return' which I refer to in the table as the ROAR value.

List of shares showing weekly direction, Range indicator and RoR indicator values

<i>Share Code</i>	<i>Closing Price(\$)</i>		<i>Central Cord(\$)</i>	<i>Upper(\$) Deviation</i>	<i>Lower(\$) Deviation</i>	<i>ROAR (%)</i>
AAA	0.255	Up	0.258	0.266	0.244	184
BBB	0.670	Dn	0.791	0.923	0.579	157
CCC	3.610		3.688	3.922	3.309	110
DDD	0.096	Up	0.102	0.120	0.074	137
EEE	0.620	Up	0.748	0.860	0.568	116
FFF	0.435	Up	0.516	0.607	0.370	174
GGG	0.715	Dn	0.821	1.009	0.517	248
HHH	3.220	Up	3.350	3.508	3.094	81
III	0.230	Dn	0.256	0.305	0.175	137
JJJ	0.355		0.462	0.555	0.311	204
KKK	0.625	Up	0.822	0.978	0.569	231

Share FFF, among others, is a valid entry as long as we purchase it at a price between the lower deviation and the central cord. Unfortunately the share price may suddenly take off and we may not be able to purchase it in the 'buy zone' and therefore we will have to wait for another opportunity. Hence, it is quite normal to spend several weeks or more waiting for entry signals to completely fill an Active Trading portfolio.

Trade management

And once you've found a share you want to buy then you need to work out your position size. To do this you will need to know your buy price and your initial stop loss in order to apply risk management (more on this shortly). Of course the lower deviation will be your stop loss.

Now we already know that if a share's RoR drops below 80% then it has to be sold. But there are other times when we will have to sell a share too. And as you saw a little earlier, the Range Indicator has a 'Sell' zone. Thus, if a share has an END OF DAY close below the lower deviation then we must sell that share. And there is no negotiating with this rule!

So that's the Active Trading system; the hows and whys behind it and the tools needed to implement the system. Of course I appreciate there's a lot to digest and so it probably take multiple readings of this manual to fully grasp all the workings of the strategy.

Now, we'll look at the risk management requirements.

Risk Management

Share Traders can only manage the risks involved in share trading if they use clearly defined entry and exit prices. As Active Traders these are defined for us by the Range Indicator.

Position Risk

The potential loss in owning each share is referred to as position risk. Traders normally use the 2% risk rule that states;

‘The total loss for any single trade must not exceed 2% of total capital’

Your total capital is the current value of all shares held plus the total amount of cash on hand. By risking only 2% of our total capital on each trade it would take well in excess of 150 consecutive losses to lose all of our money.

Statistics from the U.S. indicate that 20% of Traders use risk management which coincides with the fact that only 20% of Traders survive.

An Example of the 2% Risk Rule

- We are trading with \$20,000 total capital and using the 2% risk rule
- Assume that the closing price of a share is 12 cents & the stop loss is set at 10 cents. (It is assumed in this example that the closing price is the probable entry price.)
- The potential loss per share is $12 - 10 = 2$ cents and 2% of $\$20,000 = \400
- Divide $\$400$ by 2 cents to get the number of shares we can buy = 20,000 shares
- Multiply 20,000 by the closing price of 12 cents to get the position size = $\$2,400$
- Divide $\$2,400$ by $\$20,000$ and multiply by 100 to get the percentage of total capital that can be spent on this position = 12% (This is the maximum position size)

The ‘Port. Weighting for the 2% risk’ column in the ActTrade Newsletter is calculated using the Range indicator’s lower deviation value as the stop loss. The amounts shown are the maximum weightings for your total capital, ie. a 10 in this column means 10% of your total capital. This column will display a maximum value of 20 because the largest allowable position size is 20%.

Sector Risk (Also referred to as Industry Risk)

We want to be able to capitalise on strong sectors without being overly exposed to sector 'Fads'. To limit our exposure we will only allocate a maximum of 40% of our total capital per sector and a maximum of 6% position risk per sector, ie. 3 positions/sector ($3 \times 2\% = 6\%$).

Portfolio Risk

Portfolio risk is the sum total of our position risk. Therefore we must limit our maximum number of positions at any given time in order to control our total exposure to the market. A maximum of 20% portfolio risk will yield a maximum of 10 positions ($10 \times 2\%$). In fact it is

a good idea to operate well within this limit at say a total of 5 positions. This is because most of us will find even just 5 positions difficult to manage on a day to day basis if the market suddenly turns volatile. An example of such an event was the impact on markets by S11.

Capital Allocation

The Active Trading strategy is a short term, medium risk approach that often identifies relatively low liquidity shares. It has been designed to work alongside and compliment well proven Trend Trading strategies such as the *ActVest* Newsletter and the Blue Chip Report.

The following guidelines are strongly recommended to investors/traders for capital allocation. Within these guidelines the Active Trading strategy would fit in as medium risk strategy.

Guidelines

- 60% Blue Chip shares (the Blue Chip Report and the *ActVest* Newsletter)
- 30% Medium risk strategy (the *ActTrade* and the Breakout Trading Newsletters)
- 10% Speculative strategy (leveraged instruments; CFD's, Forex, Futures, etc.)

General Considerations

The following points, whilst not critical for success, will undoubtedly enhance your performance as an Active Trader.

Don't 'Make the Market'

The ROAR indicator used to generate the weekly ActTrade newsletter tests market liquidity by testing money flow. The benchmark used by the ROAR indicator equates to an average daily minimum of \$150,000.

However it doesn't ensure that you won't 'Make the Market' by buying or selling too many shares, thus moving share prices significantly up or down. A good rule of thumb is to ensure that your daily transactions in any market don't exceed 5% of the total volume of shares being traded.

Different Market Segments

Different market segments (ie. Blue Chip shares, small capitalisation shares, etc) represent differing degrees of risk and reward. They also have non-correlating performance which means that while large capitalisation shares are enjoying a strong rally, usually in unison with their offshore cousins, small capitalisation shares may be suffering a general decline.

So to ensure exposure to the entire market it is a wise idea to allocate capital to several market strategies that are targeted at different market segments, ie. Active Trading for small to medium capitalisation shares and Active Investing for Blue Chip shares. Furthermore, the capital allocation guidelines outlined on page 24 should always be strictly adhered to.

Fundamentals

Whilst 'Active Trading' is a technical approach (analysis of price activity), it certainly doesn't hurt to analyse a company's fundamentals as well. Our objective is to shift the balance of probability as far as possible in our favour and seeking good fundamentals as well as rising share prices will only assist us in this endeavour. Thus there is no reason why we can't analyse the market using a top-down approach and a bottom-up approach at the same time.

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