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Trading in Tumultuous Markets

Pro strategies for volatile times

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Traders have to adapt to rapid changes in market conditions to thrive. Sometimes, technical tools that worked well in the past don't perform as expected in a new market environment. *Fidelity Investor's MonthlySM: Active Trader* sat down with professional traders to gain insights on how they trade in a volatile market environment. The traders discussed what could happen in the intermediate term and how to help protect your assets while looking for profitable opportunities.

The trader's playground

Extremely volatile conditions provide opportunities to skilled traders such as Linda Raschke, president of LBRGroup, who was profiled in the best-selling book *The New Market Wizards* (Collins, 1992).

Nevertheless, even Raschke admits that trading in this market hasn't been easy. "You have greater profit potential but higher risk in this environment," Raschke said. But she likes the volatility because "it creates uncertainty — which creates trading opportunities."

To find those opportunities, Raschke studies charts at night to assess the current technical situation. She notes areas of support and resistance as well as any significant chart formations. She looks for spots where she can enter on a breakout of a chart formation or looks for resistance areas to go short in a downtrend or areas of support where she can go long in an uptrend.¹

Although the market has made huge drops, Raschke believes it is "never too late to go short. Sometimes it is better to short in a well-established downtrend than when a market is in the process of forming a top."

Managing risk

Dr. Alexander Elder, psychiatrist and author of his most recent book, *Sell & Sell Short* (Wiley, 2008), has changed strategies from swing trading to day trading when the market lacked a clear trend. "I'm a day trader for now but will turn into a swing trader when market conditions are right," he said. "The market is feverish right now, and there is no established trend." One signal Elder looks for that indicates the environment has become favorable to swing trading is when his intraday trading profit could have tripled if he hadn't taken money off the table. "Then

maybe we'll have a sustainable trend."

Although Elder believes that technical tools are important (he uses moving averages, the NYSE new high-new low (NHNL) indicator, and channels that he views on a daily or weekly chart), one potential key to success in the market is managing risk.

"We are in a storm," Elder said, "and as every sailor knows, you have to take in your sails. With volatility being what it is, you have to trade with much smaller size." In addition, Elder always enters the market with three numbers: an entry price, a profit price, and a projected stop. "If you don't have all of these numbers," he warned, "you are gambling."

Dr. Brett Steenbarger, associate professor of psychiatry and behavioral sciences at the State University of New York and author of *The Psychology of Trading* (Wiley, 2003), believes you have to be patient to profit in this market. "I want to wait for sellers to drive the market down in a panic before buying," he said. Conversely, he waits for buyers to rush into the market before selling. "Many of the sharp market moves occur because short-term sentiment gets skewed too far in one direction. You may benefit from the unwinding of these overly pessimistic or overly optimistic trades."

Like other traders interviewed for this article, Steenbarger says it's essential to cut trading size during volatile market conditions. Keeping a small position also reduces the emotionality of trading, he says. "This allows the market to gyrate without whipsawing me out of positions. But once the stop is hit, that tells me the position is wrong, and I get out of it." Getting married to an idea can cost you money, he adds.

A selling climax

Jim Rogers, also profiled in *The New Market Wizards*, and bestselling author of several books including *Investment Biker* (Random House, 2003), is watching and waiting for an old-fashioned selling climax. Although not a trader or market timer, he does anticipate going long after people are forced to sell.

"If there is a selling climax," Roger said, "an event we haven't had in a long time, I hope I am smart enough to recognize it and brave enough to act." He says that October is frequently a period when markets make bottoms, either temporary or permanent, "and it appears to be one of those times." When the excesses of the markets are eventually cleaned out, he will look to invest in China, Taiwan, and commodities.

Dr. Marvin Appel, a trader and author of *Investing with Exchange-Traded Funds Made Easy* (FT Press, 2008), is also looking for signs of a selling climax. One indicator on which he relies is the NYSE new high-new low (NHNL) indicator to determine when to enter or exit the stock

market. "If the NHNL gets above 15%, this would be an initial entry indicator," for him. Though he warns that this indicator could be stuck in or near oversold conditions for months in a severe bear market.

Appel also follows the four to eight week oscillator of the S&P 500® weekly price. "When this oscillator has fallen below -2.5% and then recovered to above that oversold level, it historically has been a good intermediate-term entry signal," Appel said, although it doesn't mean the bear market is over.² Appel agrees that swing trading is not currently working in this fast moving environment. "Holding positions overnight has been risky, but the current high volatility has been good for active traders."

The dead cat bounce

Compared to markets in the past, Elder believes this is a milder environment. "The kind of violent bottom you've seen recently seldom marks the absolute low of the bear market. Often, we have a violent decline, the dust settles, and there is a "dead cat bounce" — a short-term rally in the midst of a falling market. "People don't stay in a panic forever," he notes.

Like most of the traders interviewed for this article, Appel also believes the market could experience a short-term rally. Although he anticipates a fourth quarter rally, he expects the market will again retest its 2008 lows at some point in 2009.

A new trading environment

If a dead cat bounce occurs, it's possible the market will retest or perhaps take out the lows. Often, in a market trending down, the worst of the downturn comes at the end of the move. "The market will keep going down until you hit a level where long-term buyers perceive value," said Raschke. Right now, however, the technical indicators are atrocious, she says. "There is no base — there is no support right now."

"What typically happens is the market approaches a low area," Raschke explained, "although no one knows when it will happen. The volatility will die and reactions up will be dead cat bounces. Ultimately bear markets end in a very, very dull way."

Finally, once those lows are taken out, some traders believe a new sustainable uptrend could be created. During these periods of rallies and declines, there are numerous trading opportunities if you are flexible and disciplined.

As traders, it's essential that you prepare for an ever-changing market. "We are experiencing a new trading environment," Raschke said, "and that makes people uncomfortable." You should consider doing things to protect your money, including raising cash. "Those with cash can scoop up equities at deeply discounted prices when the time is right," Raschke said.

For Raschke, the right time might be when price/earnings ratios (P/E) are between 10 and 14. "There is nothing wrong with using the P/E as a yardstick for entering or exiting the market." For now, she trades one day at a time, capitalizing on short-term swings using intraday technical indicators.

To survive in this changing market environment, you really need to keep an open mind to short-term trading opportunities. This means not chasing stocks to the upside or downside. In addition, says Raschke, each trader has to assess his or her own comfort level. "It is not necessary to rush into anything. More important than anything is your health, family, and happiness."

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Michael Sincere is a freelance writer and author of five books on investing and trading, including Understanding Stocks (McGraw-Hill, 2003) and Understanding Options (McGraw-Hill, 2006).

1. In order to short sell at Fidelity, you must have a margin account. Short selling and margin trading entail greater risk, including but not limited to risk of loss and incurrence of margin interest debt, and are not suitable for all investors. Please assess your financial circumstances and risk tolerance prior to short selling or trading on margin. Margin trading is extended by National Financial Services, Member NYSE/SIPC, a Fidelity Investments company.

2. *How to Recognize the Next Market Bottom*, Marvin Appel, PhD, http://www.systemsandforecasts.com/Article_of_the_Month/March01.pdf.

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