on

Swing Trading

A guide to profitable short-term investing

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Marc Rivalland on Swing Trading

by

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For L and L-F

About the author

After graduating with a Bachelor of Commerce in 1975, Marc Rivalland was employed as a share analyst for one of South Africa's leading merchant banks. At the same time he undertook his Bachelor of Laws degree. In 1979 he emigrated to the UK and worked in the futures industry, first as an analyst and then as an account executive. He was team leader for Conticommodity on the LIFFE floor when it opened in September 1982. After a stint as a floor trader and arbitrageur, Marc was called to the English Bar by the Middle Temple in July 1987. He remains a practising barrister in the Chambers of Edward Faulks QC.

For 2 years Marc wrote educational articles on point & figure charts for London's Evening Standard. He also writes 'The Trader' column for *Investors Chronicle*, as well as giving seminars on technical analysis.

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PREFACE

Exploiting swings

One can tell from the great popularity of newspaper and magazine articles about obscure little companies that there are still hordes of investors out there trying to discover the next Cisco (before supernova). And a very worthwhile search it is too. Even though Cisco has fallen more than 80% from its highs, if you had invested £6,038 on the day it floated you'd be a millionaire today. This book will not help you do that for the following reasons:

- Swing trading is more about exploiting swings in share prices, both upswings and downswings, than trying to discover unperceived value.
- I imagine that some swing trading can be done in the little known, small capitalisation stocks which fascinate so many investors. However this book embraces a strictly chart-based approach to swing trading. Charts work best with well-known stocks which already enjoy high visibility and high volume.

Unearthing gems is no part of this book.

Why swing trade?

At the beginning of 2002, the financial press was trying to reassure investors that the FTSE was unlikely to go down, because it is statistically rare for it to fall 3 years in a row. As I write however (FTSE 100 = 4200), the FTSE will have to go up 19% in the second half of the year merely to breakeven. More than one Cassandra is suggesting that it has further to fall. If you're a long term buy and hold investor, what will you do? Probably nothing. That is what most investors do, persuading themselves that "It will all turn out all right, equities are a sound long term investment".

That may be true, but whereas many people think of 15 years as long-term, equities are a good investment only when you select a particularly lucrative phase (like 1982-1999) or when you measure returns over a period of more like 30-40 years. For example, adjusted for inflation, the Dow Jones peaked in 1966 and it went sideways or down for 16 years. It was the 1990s before it surpassed its 1966 highs on an inflation-adjusted basis, which means that those who invested near the peak in 1966 had a long wait for real returns.

What happens if the FTSE oscillates for a decade or more between about 3600 and its December 1999 highs of 6950? It is by no means impossible. By swing trading you can do something about it. You don't have to be a passive victim. I think of swing trading as the proactive way of approaching the markets.

There is not only a sound argument for swing trading. It is also exhilarating. I don't need to explain that. It's either true for you or it's not.

Swing charts and point & figure charts

Many traders already use charts as an integral part of their decision-making, and a good proportion of them will have heard of the particular trading method known as swing trading. Not many, however, know that there is a type of chart, a swing chart, which is tailor-made for swing trading, and even fewer will be actively using these swing charts. One of the main aims of this book is to introduce you to swing charts and to enable you to harness their power.

Some readers may be so convinced that they come to use swing charts as their primary tool. Others will prefer to stick to the charts they have used hitherto. I invite them to use the swing chart in conjunction with their existing techniques, or, at the very least, not to ignore the message conveyed by the swing chart. I use a combination of swing charts and point & figure charts.

For those whose swing trading depends more on value judgments than on charts, I offer this middle ground: if you must be led by a value judgment, why not use charts as a filter? Act only on value judgments when the share has a supportive chart; do not act on those value judgments when the share does not have a supportive chart. If your value judgment is correct, the chart is bound to reflect that in time.

Audience

I have my doubts whether the book will be wholly intelligible to those who have only a passing interest in the market. Recently, I tried to explain one of the simpler concepts to a legal colleague, but he professed total bewilderment (although I suspect him of brutish obstinacy). The book should appeal to a wide range of market participants and would-be participants.

a) Amateur Traders

There are private investors who come close to swing trading even though they don't know it. Take for example those who see a tip in a newspaper, buy the shares, and then, after the share price has gone up 20%, cannot resist bagging a profit. Unwittingly they have much in common with swing traders. They have exploited an upswing in price and, for whatever reason, have not held on in the way that a long term investor would. In addition, there are legions of private investors whose explicit intention it is to exploit price swings of various durations. This book should appeal to such swing traders.

b) Professionals Traders

This book is also suitable for professional traders, who could skip Chapter 1 and who probably know everything contained in Chapters 6 and 7 and most of what is contained in Chapter 10. Chapters 4 and 5 cover new ground the like of which has never, at least to my knowledge, been published before now.

c) Long Term Buy and Hold Investors

My publisher says I'm wasting my time trying to pitch to long term buy and hold (LTBH) investors. I know he's right, to an extent. Many people are simply too busy to devote time to the stock market, and many are too uninterested or daunted by it. It's true that if you don't know what you're doing, every decision you make is just an opportunity to make another mistake. Much better to make no decisions at all other than to drip-feed an amount from your monthly pay into a retirement fund. If you fall into this category, this book is not for you.

However it seems to me that there is a subset of reasonably active, market-oriented long-term investors who ought to read this book. Even if it doesn't persuade them to take up swing trading, it may persuade a few of them to look at a chart every now and then. If you are an LTBH investor, and you doubt the value of charts, consider the one below showing the collapse in Enron's share price. I've done it in point & figure format, but much the same comment would flow from a swing chart.

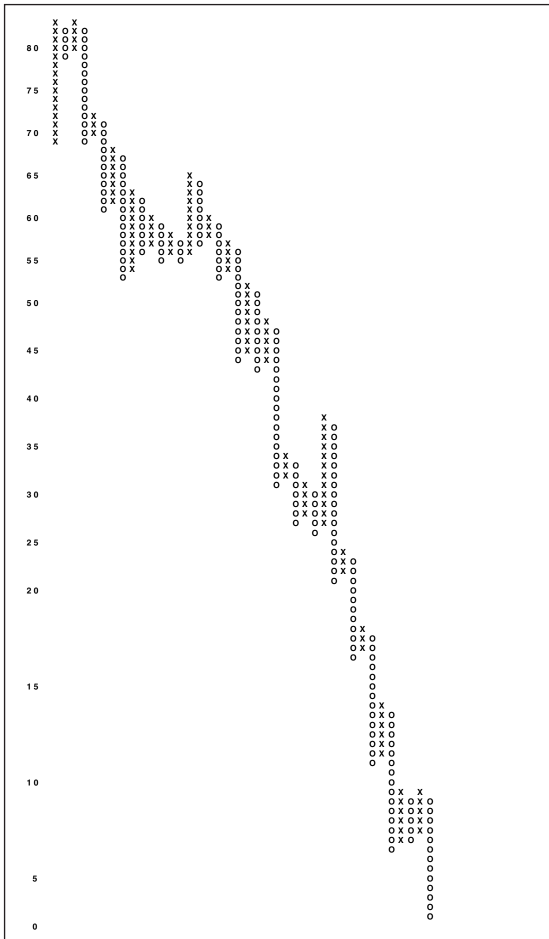

fig 0.1

After it peaked at over $80, Enron gave one buy signal at $58. As you will see from reading Chapter 7, that signal was the least trustworthy of all point & figure signals, and a sell signal was generated the next month (June 2001) at $53. Another sell signal, one of my favourites, occurred at $41, and other sell signals were given on the way down. At no time before reaching 12 cents did Enron give a buy signal. Need I say more?

In Chapter 11, I show how the occasional use of swing charts could assist LTBHs to hedge their holdings, to protect them from the sharp falls in the markets which have dismayed so many recently.

Structure of this book

The book is structured to cover my two favourite types of chart: the swing chart in Chapters 3 to 5 and the point & figure chart in Chapters 5 to 8. Chapter 9 explains how to use these charts together and Chapter 10 deals with the RSI. Chapter 11 covers LTBHs and Chapter 12 draws all the threads together.

The rather grand title of this book may suggest to some that I consider myself a 'guru' in this subject. Nothing could be further from the truth. My publisher's motive in choosing that title was to make it plain that the book is my subjective view of certain aspects of charting technique and interpretation, rather than a distillation of well-worn rules. The book can't cover everything I know, but I believe it does cover the most important techniques to enable you to make money out of swing trading.

I hope the book provokes thought. Any constructive criticism or ideas can be sent to me by email at info@marcrivalland.com or at m.rivalland@no1serjeantsinn.com.

1 INTRODUCTION

- Early lessons
- What is a swing trade?
- What is the point of swing trading?
- What makes a swing trader?
- Who swing trades?
- Swing trading and charts
- The logic underlying the use of charts

Early lessons

From an early age I was fascinated by how bad my father and his acquaintances were when it came to investing in the stock market. I remember listening to the radio with my father as we marked off the closing prices in a jotter or on a newspaper. I seem to remember most of the news being adverse. Resigned disgruntlement seemed to be the order of most days. But when there was an upward run, well … transports of delight. Midas had competition. My father had known it all the time. That idiot market had been wrong, as it so often was, but now it was starting to get the hang of things. There was still a faint hint of disappointment that more of the particular wonder stock had not been purchased.

In time he gave up, and concentrated on making money in something that he was skilled at. But he, and almost every adult I met in the late 1960s and early 1970s, had tales to relate of an occasional exciting financial killing, interspersed with considerable woe. They were very clear that stock market speculation was only for insiders and fools, and that it was impossible to make money out of the market other than by buying a mutual fund and leaving the money there for a lifetime. As a rebellious adolescent with the usual contrarian instincts, it seemed to me that they must be wrong.

I decided to do a first degree in commerce to learn all about the stock market and to find out what made it tick. I saw my first point & figure chart in 1973, my freshman year at University. It electrified me, and, judging from the letters to the newspaper, it roused considerable public interest. But I had studies to attend to. A couple of years later I did manage to obtain, almost by accident, a copy of A.W. Cohen's seminal work on point & figure charting[1].

After graduating I decided to do my law degree part-time so that I could get a job with a merchant bank and further my understanding of the stock market. A few months later, filled with the confidence of youth, I bought my first share, Tedelex, a manufacturer of televisions. In the repressed South Africa of the 1950s and 1960s it was thought that television would corrupt the morals of the people. Later on the government relented. Most South Africans saw their first television broadcast in about 1973. In mid-1976, as I was working in the research department of the merchant bank, Tedelex was due to report its results. It was a small company which had managed to secure one of only five (I think) licenses to manufacture/assemble televisions. Our research department expected its profits to rise over 200%. We were all standing over the ticker when the news came out that profits had in fact increased 600%. Nearly everyone in the office immediately bought the shares.

What is more, I bought far more than I could afford, on margin, because this was, after all, a sure thing. And so it proved, momentarily. The shares ticked up, then down, then up again. It seemed as if every fourth or fifth trade crossing the tape was Tedelex. Even the old hands had never seen anything like it. By the end of the day, on record volume, the share price was down about 1% from my purchase price. Nothing to worry about, save that my manager was peering at the ticker with a grim expression on his face. It's churning, he said. He explained that there

1. *How to Use the 3-point Reversal Method of Point & Figure Stock Market Trading* by A.W. Cohen (Chartcraft Inc.1947)

was too much selling. I didn't understand that at all. There was just as much buying, so it seemed to me. He sold out the next day. I held on and naturally lost a lot.

• It was my first real time lesson in the message which price action delivers. In a bull market, expanding volume makes prices go up. If it doesn't, question your premise. Perhaps the bull market has ended or is about to.

What is a swing trade?

Unlike day trading or long-term investing, swing trading is not a well-defined term. Broadly, it fits between day trading and long-term investing, in terms of time horizon and in other respects. A definition which I find useful is:

A swing trade is one which seeks to capitalise on the short-term downswings and upswings in share prices.

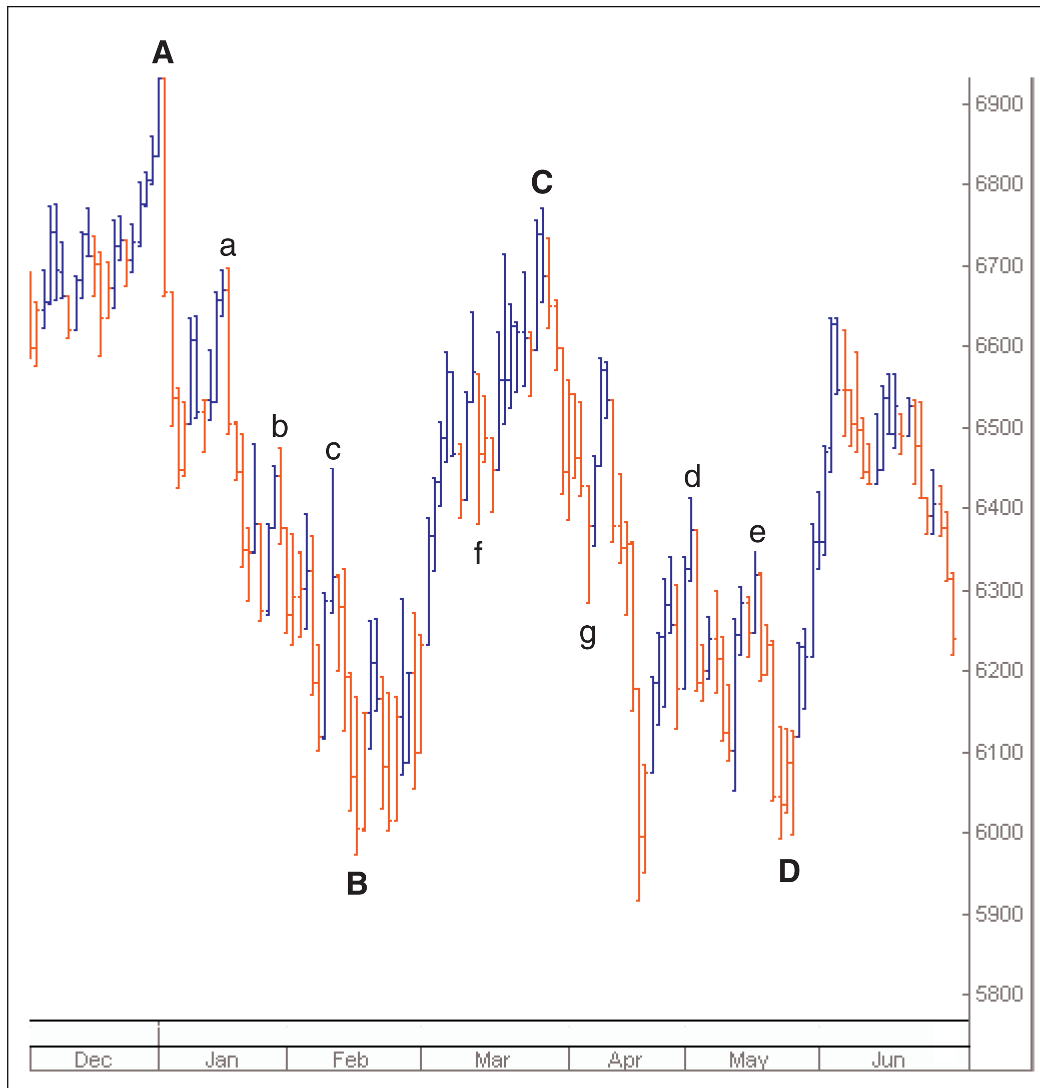

fig 1.1

You can see from the chart opposite that the FTSE moved from a high of 6950 on 30th December 1999 down to a low of 5973 on 15th February 2000, a move of 970 points (13.9%) in 6 weeks. Thereafter it moved up, virtually in a straight line, to 6770 by 27th March 2000, a move of nearly 800 points (13.3%) in just short of 6 weeks. Those two swings accounted for 1770 FTSE points or the equivalent of a return of over 27% in just 3 months. Yet somebody who bought and held a basket of stocks similar to that in the FTSE 100 index would have been showing a loss of 180 points (2.5%) on the 27th March 2000 when compared to 30th December 1999.

The broad swings were:

- down from point A to point B
- up from point B to point C
- down from point C to point D

The swing trader attempts to profit from each of those swings, which plainly represented the short-term trend of the market. But within those broad swings there were many lesser swings which amounted to corrections (brief movement counter to the trend) which also provided attractive opportunities to the swing trader. So an aggressive swing trader would aim to sell short at points a, b, c, d and e, and to go long at points f and g.

In this book, I use the term 'swing' interchangeably to refer to the broad swings and to the lesser mini-swings. It should be obvious from the context what I am referring to, and even if it isn't, I doubt whether it will make much difference to the point I will be trying to make.

Short-term trends tend to last about 4 to 16 weeks. That is the time horizon of the swing trader. Plainly it differs from the time horizon of the long-term buy and hold investor.

But it is not only time horizon which separates the swing trader from the buy and hold investor. Their attitudes to adversity differ fundamentally. The buy and hold investor will ride out downturns in the market in the confidence that his stock purchases were made at 'rational' prices and that the market will, in due course, reflect the full value of the shares. From this point of view, a market downturn may be an opportunity to buy more shares below their true value and to profit when they recover. Warren Buffett, the ultimate LTBH investor, expressed this approach most eloquently when asked by Forbes magazine in 1974 how he felt about the bear market:

> "Like an oversexed guy in a harem. This is the time to start investing."

But until the LTBH investor thinks it is time to "start investing", he will bear his paper losses with apparent stoicism.

By contrast, the swing trader will admit defeat when the market moves against him and he will alter his trading stance to take advantage of the newly perceived market direction.

What is the point of swing trading?

Why bother, you may ask. Why not try to emulate Warren Buffett, who has not done badly to say the least. Why not re-balance one's portfolio once or twice a year and sit back and watch the money roll in. Well, it is perfectly true that the 18 year bull market from 1982 onwards gave investors a relatively easy ride, and has altered, for the worse I suspect, their approach to the markets. Putting money in the markets has been a sure thing, until the last 2 years.

Reverting to the above chart: although the buy and hold investor might have consoled himself in late March 2000 that he was only 2.5% worse off than at the beginning of the year, the truth of the matter was that the year had already provided two glorious trading opportunities for the swing trader to make a killing. Being 'not much worse off' in March 2000 amounted to a waste of one of the few easy phases to make money which the market presents. When the stock market finished the year at 6222, another 8.1% down from the highs of March 2000, the long term buy and hold investor could only hope for better times, which, so far, have not materialised.

Why should a market which goes broadly sideways or down imprison one's capital? Trading the swings is not only fun, it is profitable. 2000 and 2001 were good years for swing traders, and I don't mean only because they fared better than buy and hold investors. What I mean is that the charts had several clear swings with consistent and profitable chart signals.

You may say: so what? This is a post-bubble pause. Normal service will be resumed, and making money by armchair investing will once again become easy. That may happen. But what if it doesn't?

I have already mentioned the 16 year period between 1966 and 1982 as a leading example of share price stagnation. It is not the only example. After the 1937 highs, it took the Dow 8 years to make new highs, and those were still well below the 1929 highs. Those who bought shares near the top in 1929 had a 25 year wait for new highs in the Dow.

Finally I suppose swing trading is, to some extent, born out of leverage, at least for the private investor. The ability to buy futures, options and contracts for a difference means that trading a broad swing successfully can yield substantial profits, out of proportion to the capital employed. W.D. Gann said:

> **"A study of swings in active stocks will convince a man that he can make far greater profits in swings than in any other way of trading."**

However true that may be, please note that Gann was not suggesting that long-term investing is less profitable. He didn't address that issue at all. Of course buy and hold can be more rewarding than swing trading in certain market conditions. I am certainly not suggesting that swing trading is the only way to approach the markets. But unless (and even if) you foresee another long and sustained bull market of the type that happened in the period 1982 to 1999, swing trading does have much to commend it.

What makes a swing trader?

Swing trading is not something to be undertaken lightly. Anyone who enjoys and is good at playing cards, particularly a game like bridge, should be a good swing trader. The same skills are used, namely drawing inferences from incomplete information.

But whether or not you like playing cards, swing trading needs more than ability. Shortly after I started writing about point & figure charts for the *Evening Standard*, my head of chambers Edward Faulks QC approached me and said "Catherine and I sat down last night to read one of your articles but I'm afraid we could make no sense of it at all". Of course, it was just a tease. If Edward had been briefed in a case involving point & figure charting he would have mastered his brief within days and he would have been ready to cross-examine an expert on the subject.

The true message was that he was not sufficiently interested in speculating on the stock market. No doubt he owns shares, but trading in and out of them is not something that fires his imagination. On the other hand, I am and always will be gripped by price action. To be a swing trader, you need to love playing the markets.

Who swing trades?

There is an army of short-term private investors who are trading swings, even though some may not realise it. Anyone who is not intending to open and close a position in a day or so, nor intending to ride out whatever valleys may be encountered, is attempting to capitalise on a favourable swing. Indeed, in part, this book is aimed at those who have the ethos of the swing trader (in that they bag a good profit when they see one) but who may not have made clear to themselves a method for repeating their successes.

In addition, much hedge fund trading is effectively swing trading. The same is true of proprietary trading by investment houses.

Swing trading and charts

Many swing traders are avid users of charts. Some swing traders, although they decry the use of charts, draw inferences from sentiment indicators and use the price action of the market or a particular security to time their entries, which to my mind means they use similar skills to the chartist. It is possible to swing trade without using a chart at all, but I'm not sure how successful it would be. At any rate I wouldn't attempt it.

Last year I gave a talk to a private investment club of about 10 members. They were struggling. They had made money in the technology media and telecom sector as it stormed up until March 2000. They had prudently sold out at the first sign of trouble and even more prudently they had had the discipline not to dive back into the sector for about six months. But the temptation had

become too great to resist. They showed me seven purchases they had made and invited me to comment on where they had gone wrong. They did not use charts at all.

To my astonishment, every single purchase had been timed excellently. Within days of each purchase they were showing profits. It was plain on analysis what they were doing. They were catching falling knives. They had chosen well-respected companies. And each time that company took a battering which appeared overdone, they leapt into the stock. Their judgment was rewarded when the stock bounced, sometimes over a period of several weeks. They were making a value judgment, and the market confirmed, temporarily, their beliefs. When the stock later fell below their purchase level, it must have seemed as if another bargain was on offer. In two cases, they did add to a losing position, which at least had the virtue of logic, although it would be anathema to a swing trader.

Effectively they were failing to take their profits quickly enough. Their profit expectations were more aligned with their previous happy experience. But they did prove that it is possible to use purely value judgments to initiate swing trades.

The trouble is, value judgments are subjective, and if they are not shared by the rest of the market participants, you will suffer losses. Losses arising from value judgments can be bewildering, annoying and most importantly, discouraging. Like my father, you cannot understand why this dunderhead of a market has got it so wrong. Of course the chartist also suffers losses, but they are entirely explicable, and although they are not to be welcomed, once you become case-hardened they are not discouraging. I suspect too, although I cannot prove it, that the size of the loss suffered by the chartist on each transaction is much smaller than that suffered by the non-chartist.

I commend the use of charts. Indeed although I have in the past made precisely the same mistake of catching falling knives, I would no longer dream of doing what that investment club did. If you have a full-time job, it seems to me the playing field is not level if you base your decisions on value judgments. The leading banks and brokers have legions of highly paid, highly trained investment analysts to research companies and to work out the value of a stock. When you, a private investor, buy a well-known stock based on your own value judgments, you are impliedly suggesting that the market, or those analysts, have got it wrong or in some way they have missed a trick. That seems like a pretty bold idea when you are devoting the majority of your time to pursuits other than the market.

This book will put forward a disciplined way of swing trading. You will not have the thrill experienced by the aforementioned investment club of seeing your value judgments almost instantly rewarded, because you will not buy stocks in a downtrend, however cheap they may seem. Cheap and expensive will not be part of your lexicon.

On the other hand, you will not suffer the same losses as the investment club. Of course, you will suffer some losses, but you will feel in control. Your losses will not paralyse you. You will have insight into both profits and losses and, to paraphase Kipling, you will treat those two

imposters the same (no, not really, but you will at least be sanguine about losses).

No doubt there are a few canny investors who are able to trade swings based purely on their reading of the mood of the market, but it is a rare (and, I suspect, transient) skill. Sentiment indicators are successfully based on the very idea that the majority are overly bullish at the highs and overly bearish at the lows.

My approach to swing trading is purely as a chartist. When you use a chart at least you get to see a picture which sums up the judgments, beliefs and expectations of all the market participants. It seems to me that not to use a chart is deliberately to give up a useful piece of information.

Of course, since I read and view the financial news, I can hardly avoid having an opinion on the present and future state of the economy, but I try to suppress these opinions. Analysing swing charts, point & figure charts and using the tools I enlarge upon in this book means that you need never take any meaningful account of fundamental information again. Your value judgments will be a backdrop to your trading, but they will not mislead you in the way that they so often do. Of course if you prefer to use fundamental information in addition to charts, that is a matter for you.

The logic underlying the use of charts

Here I intend to be brief. My publisher has rightly told me not to bore readers by indulging in lengthy academic discussion, and defending the use of charts is something that has come to exhaust me. Too many people, including some very bright friends of mine, have an obdurate visceral response to charts. I am convinced it is because they elect not to think in this respect.

Perhaps their minds close because they fail to realise just how limited and modest are the claims of the thinking chartist. For example:

- All chartists accept that the chart describes past price action, the relevance of which may yield to future events.
- No-one sensible suggests that charts foretell the future. The chartist accepts this limitation, but since second sight is not yet commercially available, there are not too many alternatives.
- When an unforeseeable event occurs, it was not ‘foreseen’ in any way by the chart. It is pure coincidence if a disastrous event occurs in the middle of a bear market.
- Point & figure charts and swing charts do not predict what will happen to the share price. They merely portray an imbalance of supply and demand which it is *assumed* is likely to continue until a new balance is found.

> • Charts do *not* work because a pattern which occurred in the past is occurring again. That is just the sort of nonsense that makes people dubious about charting. It has nothing to do with history repeating itself. How could it? Everyone knows history does not replicate itself exactly (same demographics, same climate, same product, same demand, same supply). Broad themes may repeat themselves, but that's about it.

A chart is simply a pictorial representation of the forces of supply and demand. Those forces are not static. What makes share prices move? It is disequilibrium. If there were exact equilibrium between buyers and sellers of a share, the price would stand still.

Of course exact equilibrium is of no interest. It is periods of broad equilibrium which are most revealing. When buyers step in to reverse a fall in price, one can infer that the dominating view of the market is that the shares are cheap at that point. When sellers or buyers dominate repeatedly at the same level, a relevant inference may be drawn. The battle lines between the forces of supply and demand emerge. When one side is overwhelmed, you will see it in the chart. Join the winners.

Naturally future events are going to have an impact upon the share price. But the process of finding a new equilibrium, either higher or lower, tends to be an evolving one. Take a look, for example, at *Investors Chronicle*. Each week it publishes the views of various brokers and investment houses on a particular share. Usually three different views are given. Quite often the views cover the entire spectrum. One brokers says buy, the other broker says hold, and the third says sell. What do you think happens when the price starts going up? The clients and/or followers of the broker who said buy are filled with confidence, and may buy more. The clients and/or followers of the broker who said sell are filled with doubt. If they are short they may look to cover. If they are not short or if they are underweight they may look to re-balance their portfolios. The pressure to do so grows as the price advances. And so it is seen that apart from shock announcements, prices adjust by a process of evolution, not by step-change.

It is that evolutionary process which the chartist is relying upon when he acts on a buy or sell signal. He trusts the forces of demand (or supply) which have just won a battle to keep winning battles until the market arrives at a new consensus about the value of a share.

Of course sometimes when one has drawn a proper inference from a bullish looking chart, and bought the share, a future event such as a profit warning will happen that will crush the share price. That doesn't mean that the chart is useless or invalid. The chart is bound to produce some losses. What one is trying to do with the chart is to improve one's chances by drawing the best inference that one can about likely future price movement from an impeccable (but not clairvoyant) source - the current picture of supply and demand.

Marc Rivalland on Swing Trading

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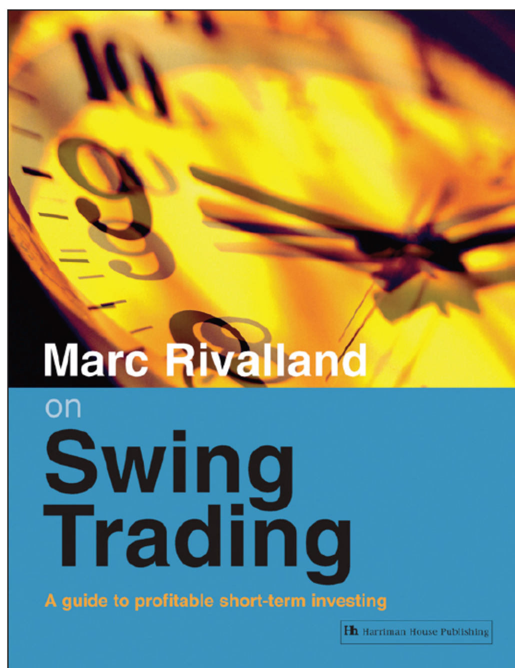
Marc Rivalland



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