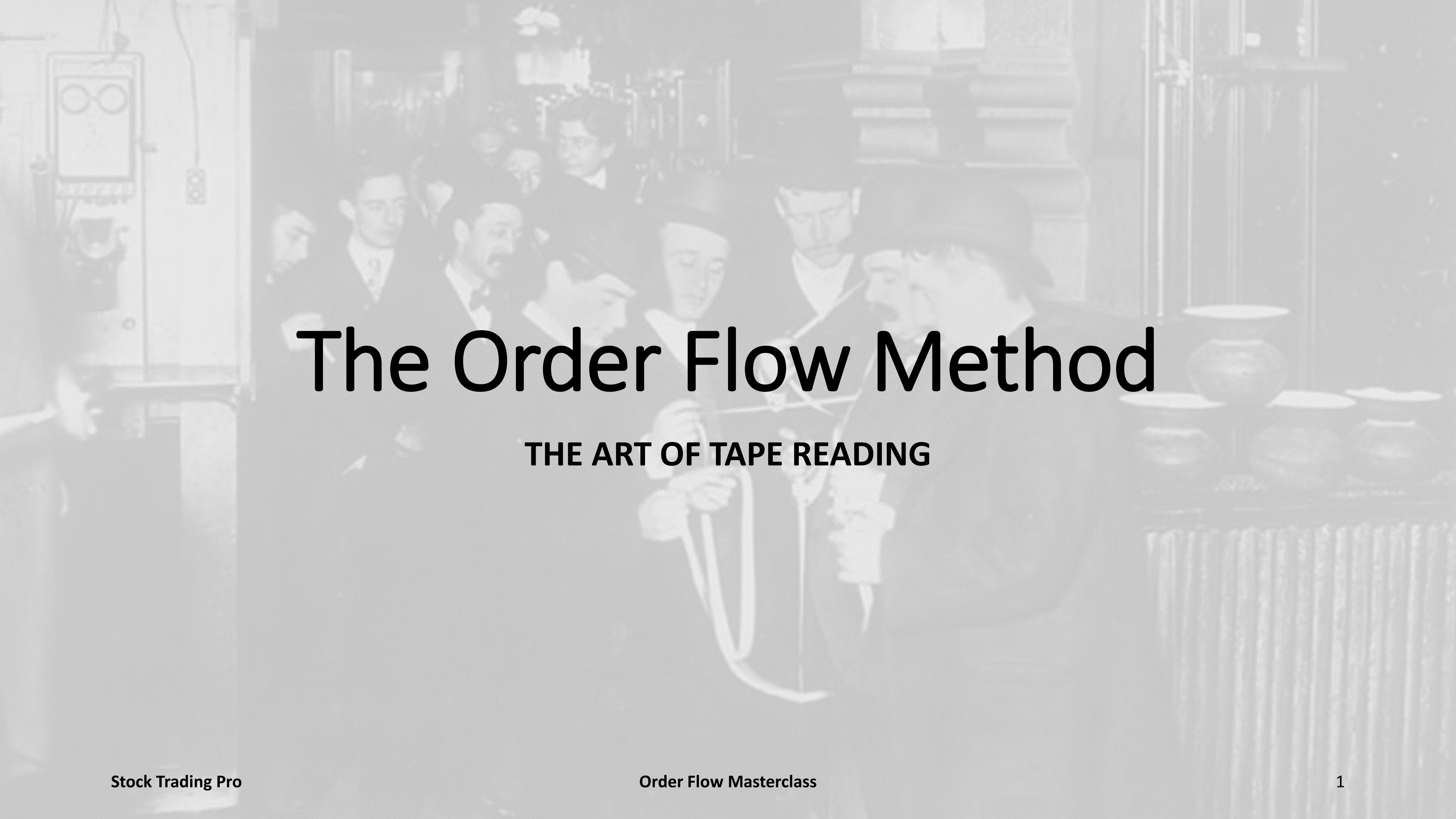

The Order Flow Method

THE ART OF TAPE READING

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Part Three:
Trade Management

How to Make Money: Entries, Exits & Trade Adjustments

Trade Management:
How to Make Money and Preserve Capital

#1 Goal

Part Three:
Trade Management

Entry Tactics & Patterns

Profit Targets & Trailing Stops

The Stop-Loss & Planned Re-entries

Oscillators & Order Types

Entry Tactics & Patterns

How to Identify and Time Entries

**Note: entry signals can also be used as exit triggers

Entry Signal Foundations

- Entries without an edge are simply a low probability guess and a poor decision. Every trade needs a good reason to risk money.
- Entries combined with an edge creates a better decision but still does not guarantee a winning trade ** this mindset is crucial!
- Entries should only be considered when you have a clear scenario of how the entire trade will unfold; in other words using multiple time frames the potential reward is clear and justifies the first entry risk.
- ***Expect*** to make trade adjustments; whether adding shares, reducing shares or getting “stopped-out” and re entering.

Entry Planning: Share Size

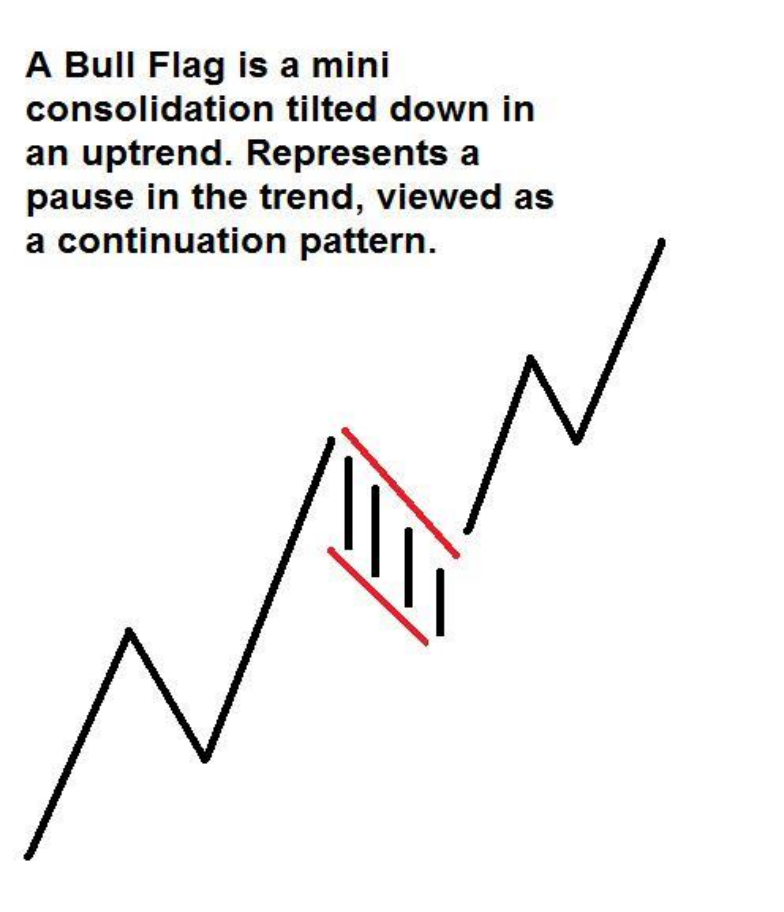
- Each market condition, probability and scenario is unique, there is not and never will be one size fits all entry plan regarding share size.
- Money management will dictate a certain amount of capital per idea, risk management will dictate how to translate that dollar amount into shares. (more on this later).
- There are three entry conditions and two share size techniques:

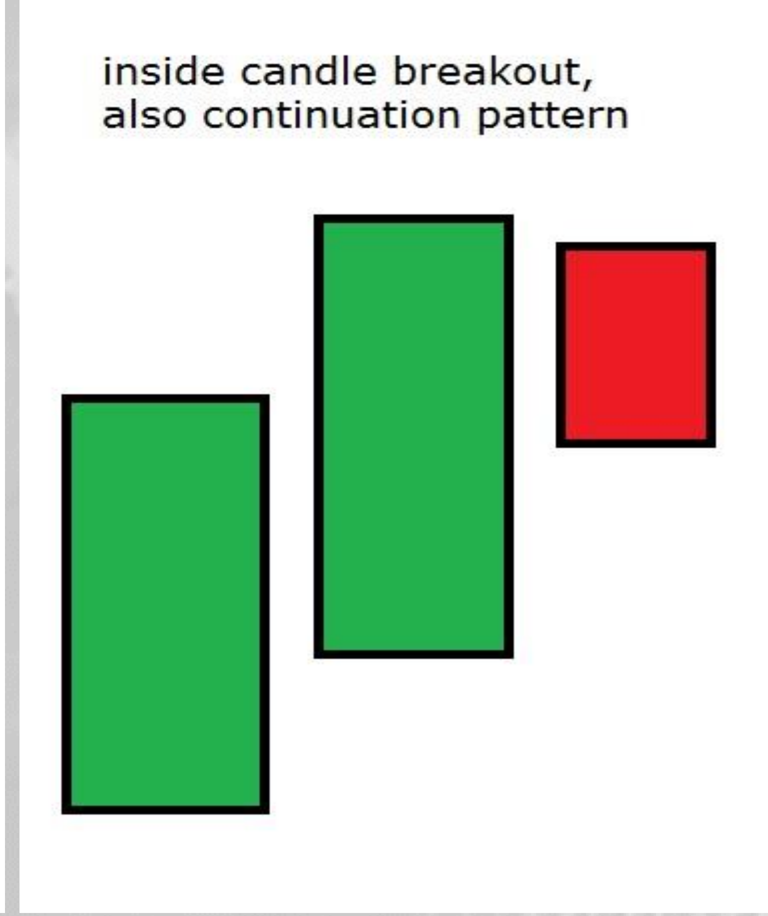
1. Continuation
2. Breakout
3. Bidding into support or short-selling into resistance

three entry conditions and *two* share size techniques

- Continuation patterns are entries in the direction of the most recent momentum and trend.
- Breakout entries are after a consolidation in the direction of a new trend or the continuation of an existing trend (more detail shortly)
- Share size in this case should always be the largest amount first and adding additional shares in fewer increments as price moves in your favor.
- A 1,000 share trade would be: 500-300-200.
- Bidding into support or short-selling into resistance dictates you build a position with the fewest shares first and increase share levels the closer you get to the significant price level you believe will hold.
- A 1,000 share trade would be 200-300-500.

Continuation Patterns: 5-3-2 entry criteria

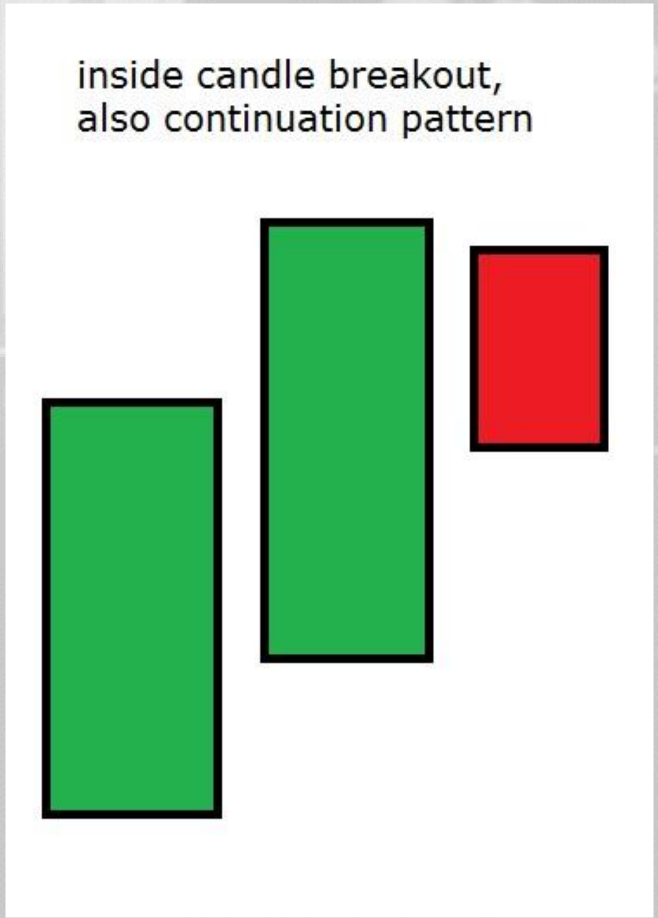


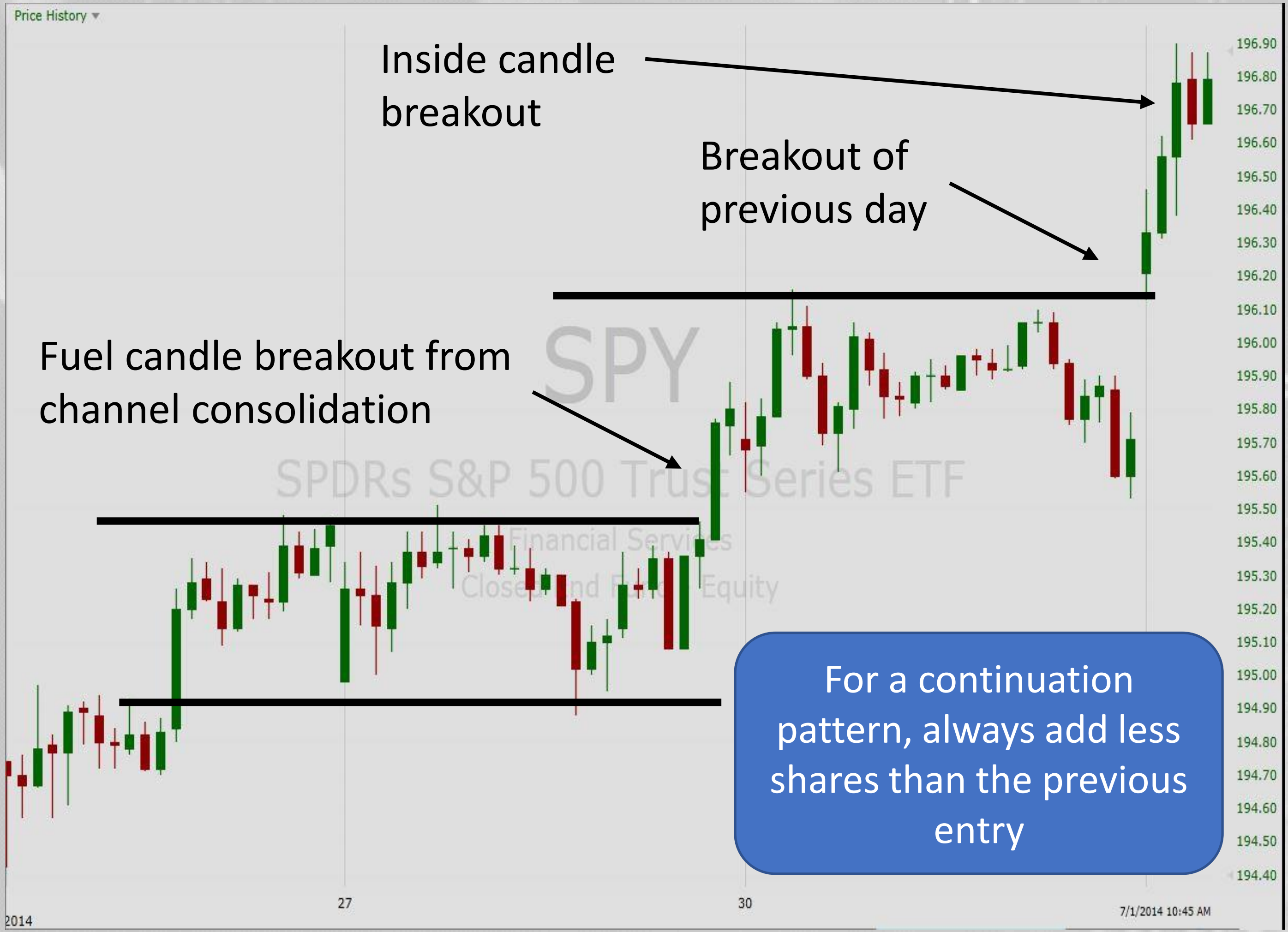


500-300-200
500 shares initial entry during the flag
300 shares on the next pause
200 for final share size

** You may choose to add only once…
The point is, add less than the previous entry

Three Breakout Patterns: 5-3-2 entry criteria





Bidding into Support or Short-Selling into Resistance: 2-3-5

200 shares first entry
300 shares 2nd
500 shares @support or resistance level

Trade Entry and Trade Management Q&A

- Q: *Should you always add to trades?*
- A: These tactics are planning guidelines not strict rules.
- Q: *When should you add to trades?*
- A: If your chosen strategy dictates it. (Position trading builds a position into a pause versus momentum exiting into a pause)
- A: When the potential profit target as identified on your higher time frames shows the trade scenario warrants a second or third entry.
- Q: *What does that mean?*
- A: Using both experience and indicators such as stochastics and previous significant price levels, you would only add to a position if your analysis indicates the current price action shows room to continue.

Trade Management Considerations

- Identifying a trade entry is simple. Waiting for a good trade to enter is the challenge. Patience is required for risk reward potential to be valid.
- Justifying an entry into a low probability scenario with less shares does not change the fact that the idea is not good. ***This is a very common and costly mistake…***
- Getting "stopped-out" (taking an acceptable loss) on a valid idea is simply trading for a better position. This is a common scenario.
- New trades very rarely move quickly in your intended direction in a straight line. Be prepared to "work" a position. This means adjusting share size.
- The gray area when little price action happens after entry is the most challenging scenario to manage. Use your skills in multiple time frame analysis and market analysis to help form a probability.

Entry Tactics: recap and how to time entries

- Recap:

✓We have discussed defining your edge with order flow and trends and to be clear on which trend you are trading.

✓Multiple time frames determine institutional order flow, significant support and resistance levels and when various market participants are in sync to increase the odds of follow-through.

✓Patterns represent a story in price action that identifies anticipated future price movement; broadly defined as continuation, reversal or consolidation.

✓Entry tactics are short-term price action identifying an entry trigger with acceptable risk in exchange for the reward defined by our edge and higher time frames.

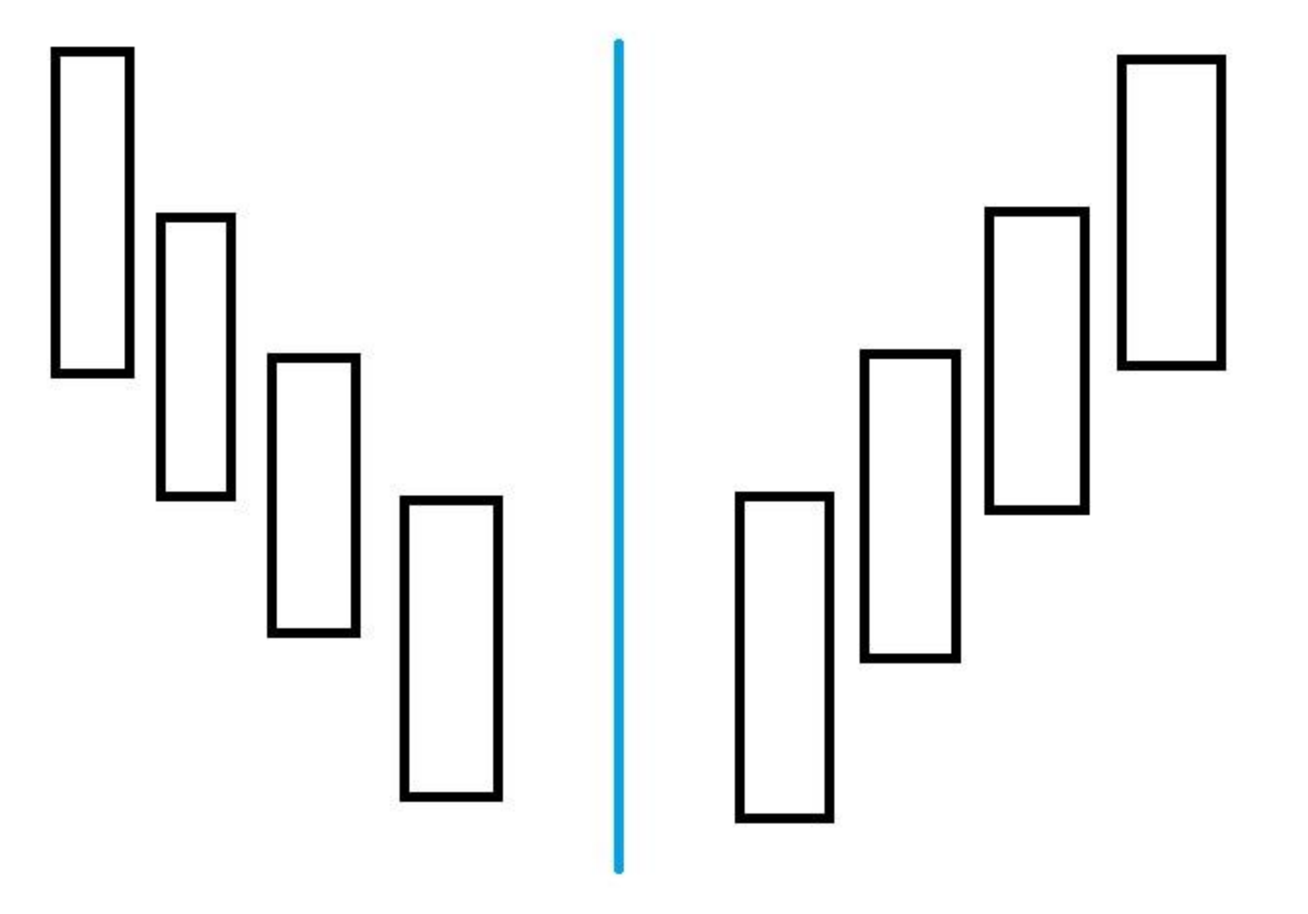
✓******Entry signals are also the same signals we will use to consider an exit!***

Entry Tactics: When strategy and the current condition are in sync to enter…

- Candlesticks
- Moving Average Cross Over
- Stochastic Pull Back
- Break Outs
- Gaps

Entry Pattern #1 Candlestick entries:

Short-term reversals from the most recent “Momentum Move”

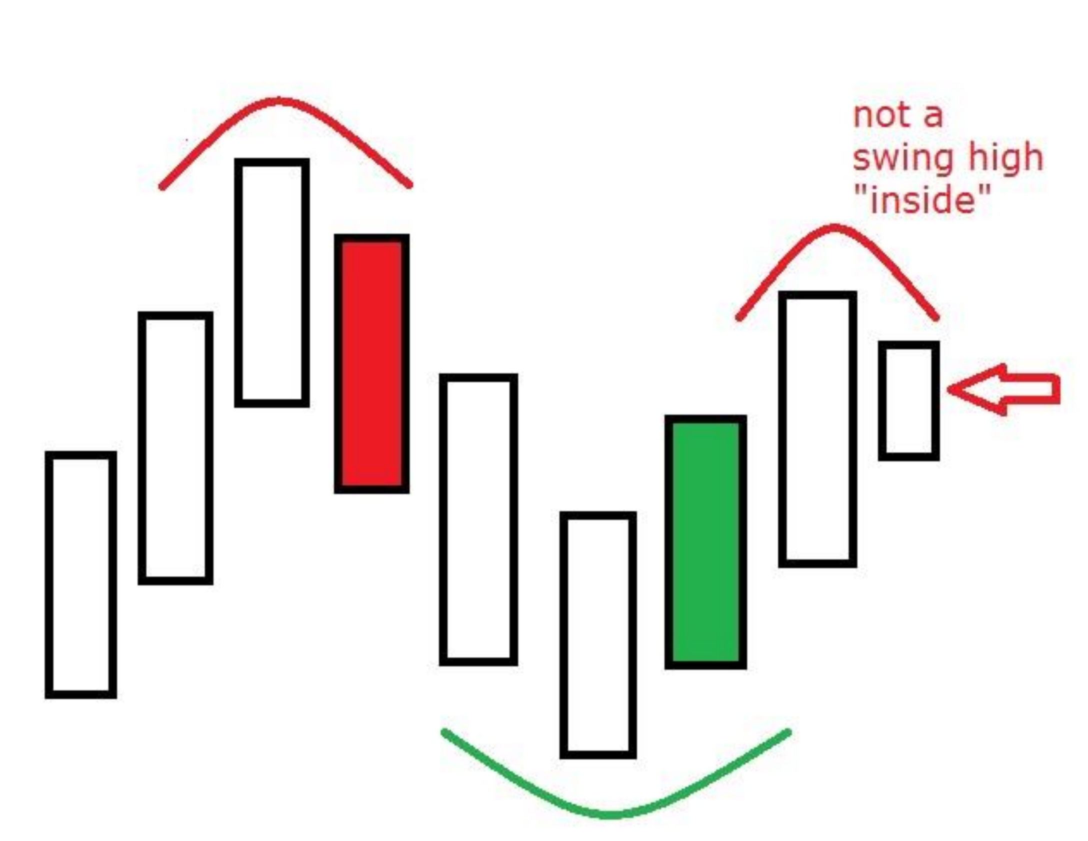


“momentum” is 2-6 well-bid or well-offered candles

- Swing Points
- U-Turns
- Melted Candles
- Hammer
- Shooting Star

Swing Points: Conservative Change of Momentum Entries

- Swing High Short-Sale Entry: Candle with a lower high on each side and the third candle is not an inside candle
- Swing Low Buy Entry: Candle with a higher low on each side and the third candle is not an inside candle
- ** In the direction of the trend!



Swing Points in action: UAL 7.10.14

Higher time frame: 60 minute

Trigger time frame: 5 minute

U-Turn candlesticks

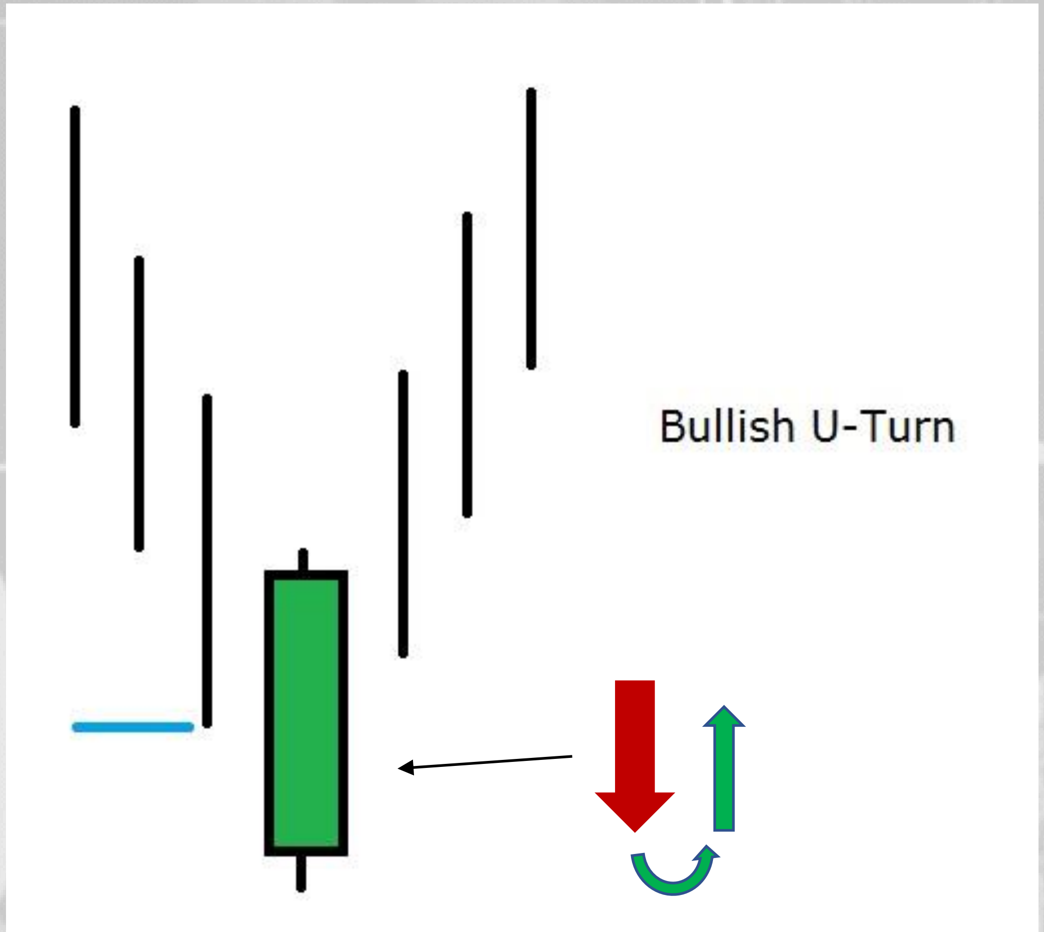
- Similar to melted candles, U-Turn candlesticks display a potential change of short term momentum.
- Much like a melted candle, look for the U-Turn after:

1. two or more consecutive higher highs or lower lows. (momentum)

- The closer you get to six consecutive candles, the more potent the reversal will be.
- U-Turns are a very effective entry and exit pattern because they trap many participants on the wrong side, this is why we named it U-Turn.

Bullish U-Turn

- A Bullish U-Turn will occur after two or more successive lower lows.
- The current candle must trade below the prior candlestick low, the further below the better.
- The current candle must now reverse and close above the open and above the prior candles low.



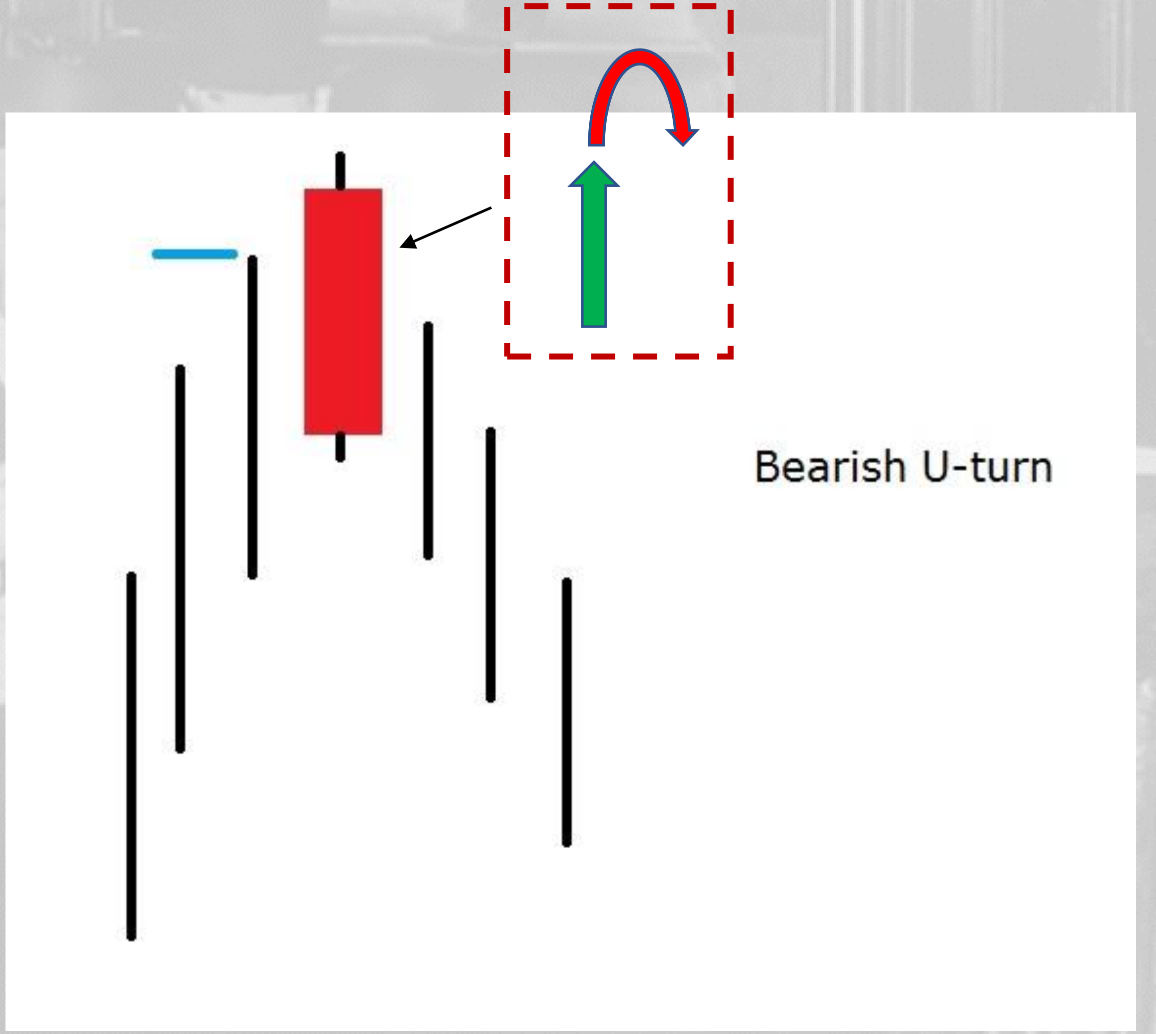
Bullish U-Turn Candles in action

Higher time frame

Trigger time frame

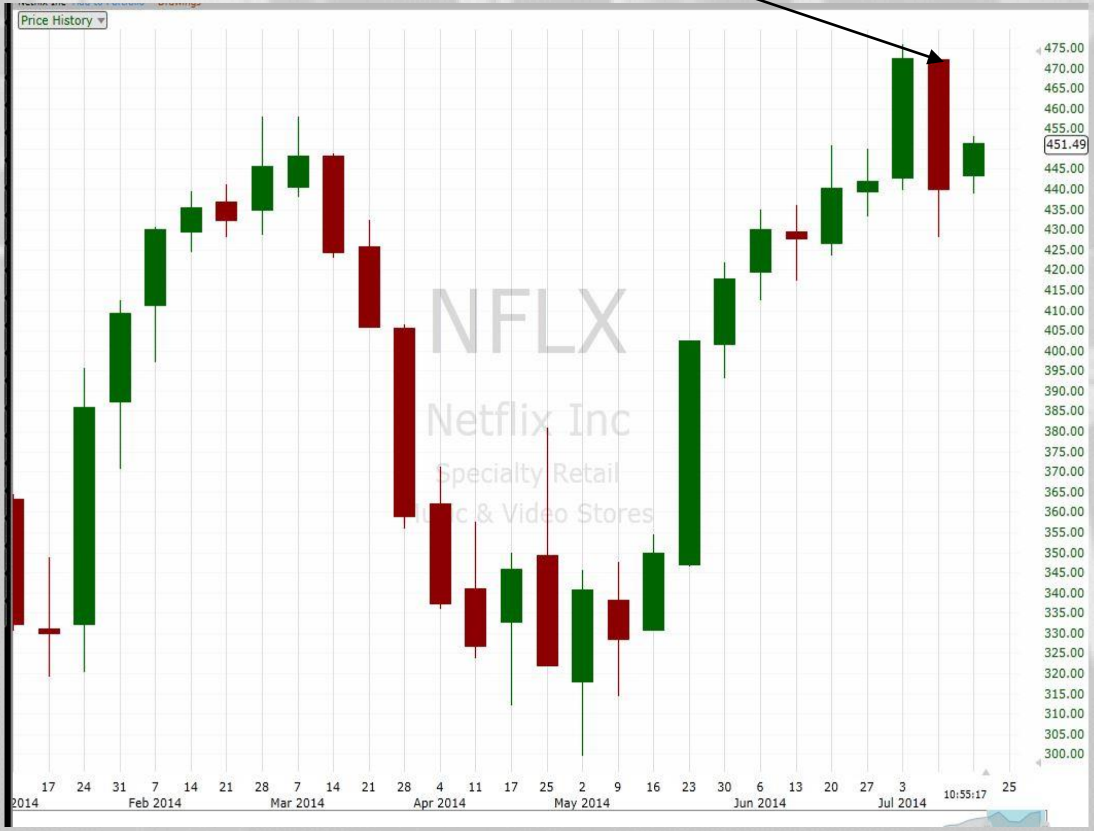
Bearish U-Turn

- A Bearish U-Turn will occur after two or more successive higher highs.
- The current candle must trade above the prior candlestick high, the further above the better.
- The current candle must now reverse and close below the open and below the prior candles high.



Bearish U-Turn Candles in action: NFLX weekly and daily July 2014

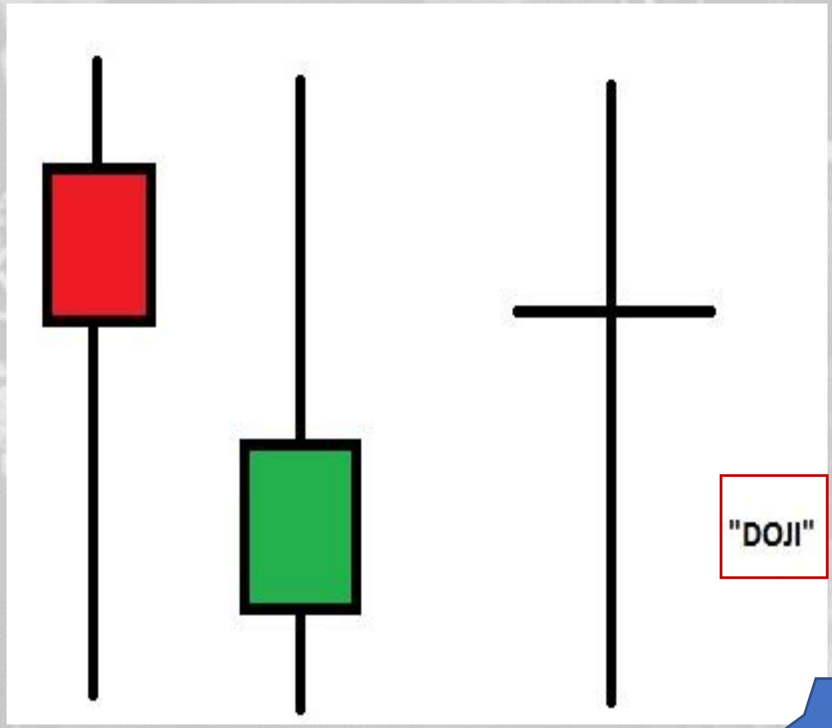
Higher time frame



Trigger time frame

Melted Candles: Indecision Entry

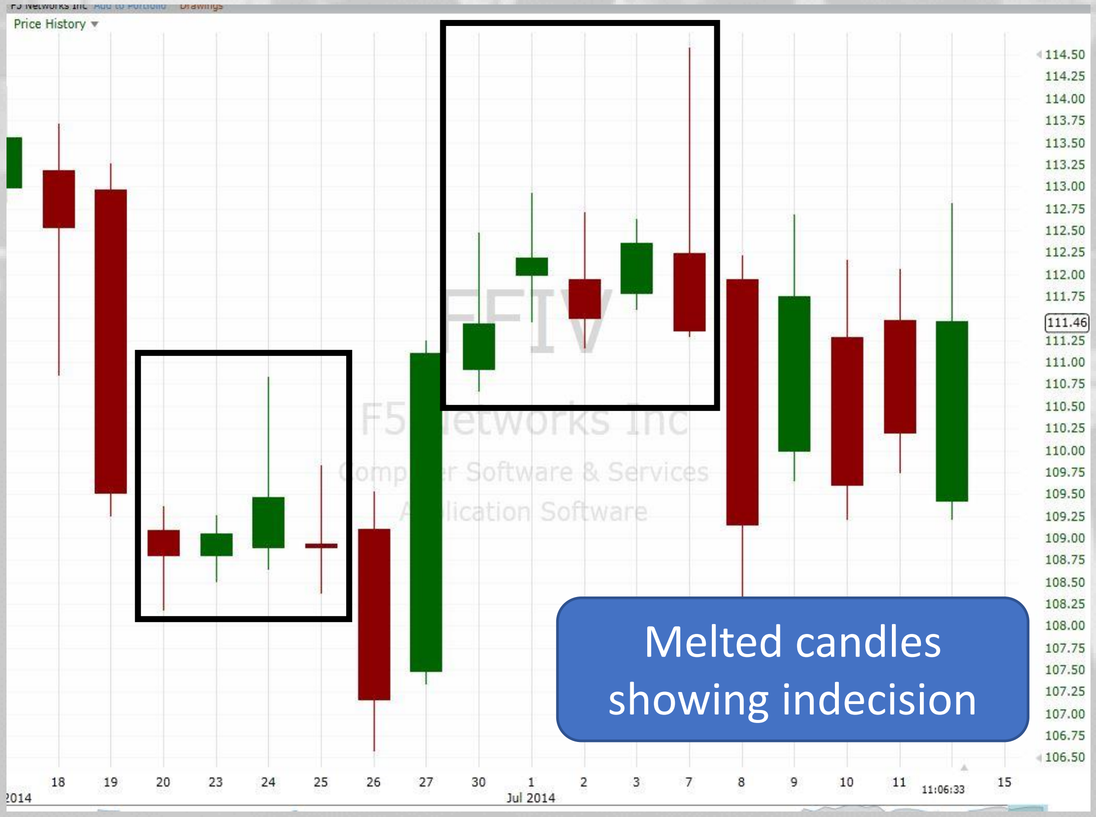
- Once again, to be clear, we are looking for this entry signal after a momentum move…
- The melted candlestick is one with a smaller body, which shows indecision
- The color of the body is not as important as the fact that there is a small body
- As we will see shortly, where the body occurs is significant



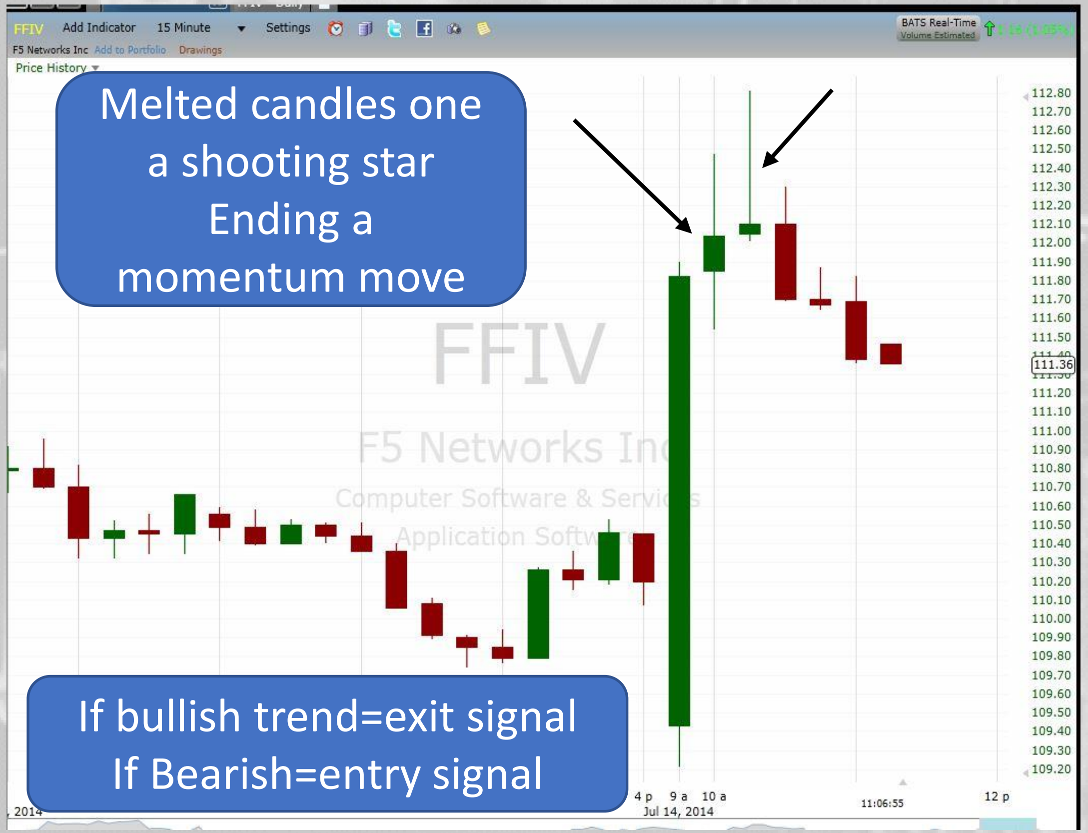
Doji= candle with no body

Melted Candles in action: FFIV July 2014

Higher time frame: Daily

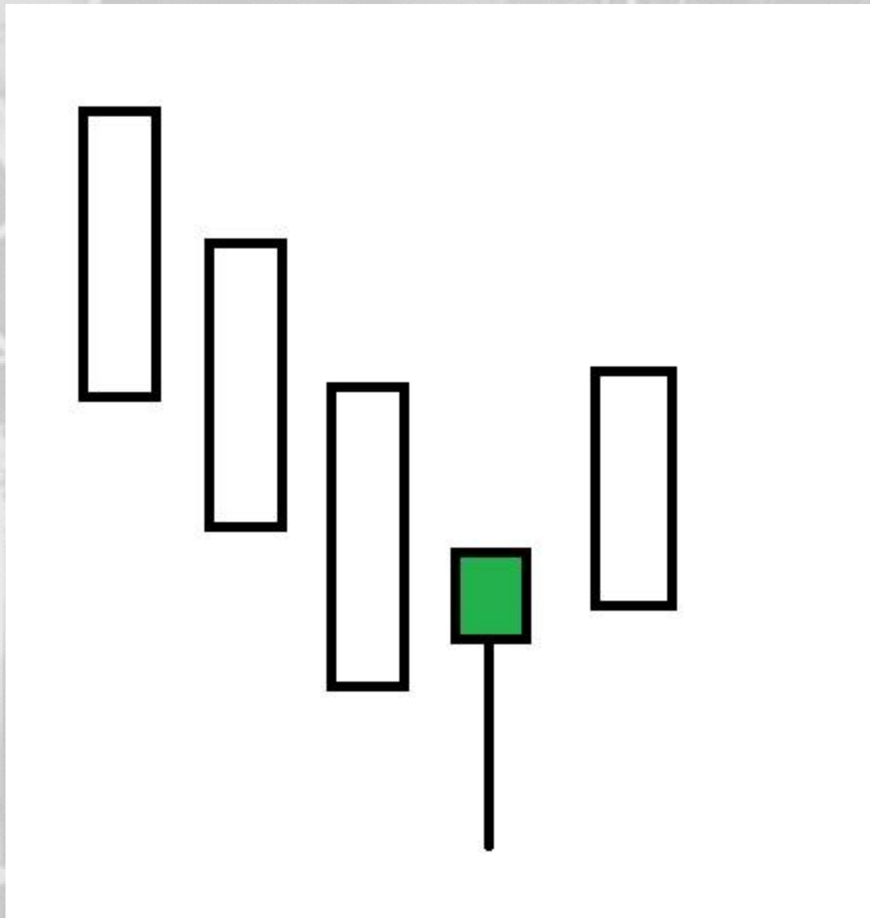


Trigger time frame: 15 minute



Hammer Melted Candles

- Represents a bullish reversal candle
- Only significant after a momentum move lower of 2-6 candles
- The color is not as significant as the relation of the body to be away from the low of the price range
- The entry or trigger is when the candle completes and the next candle trades above the high of the hammer candle

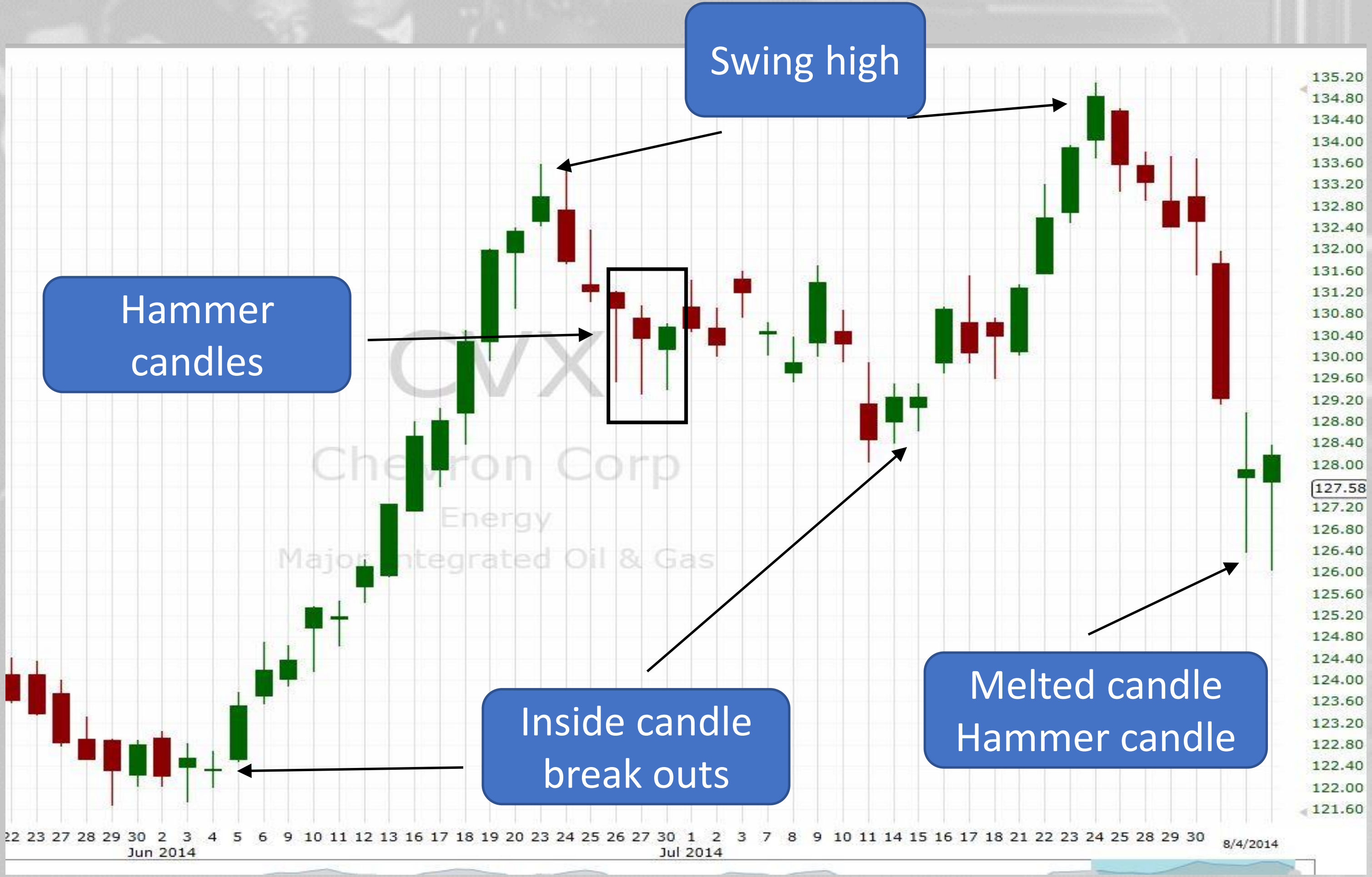


Hammer Melted Candles in action: CVX: August 2104

Inside candles= breakout trade

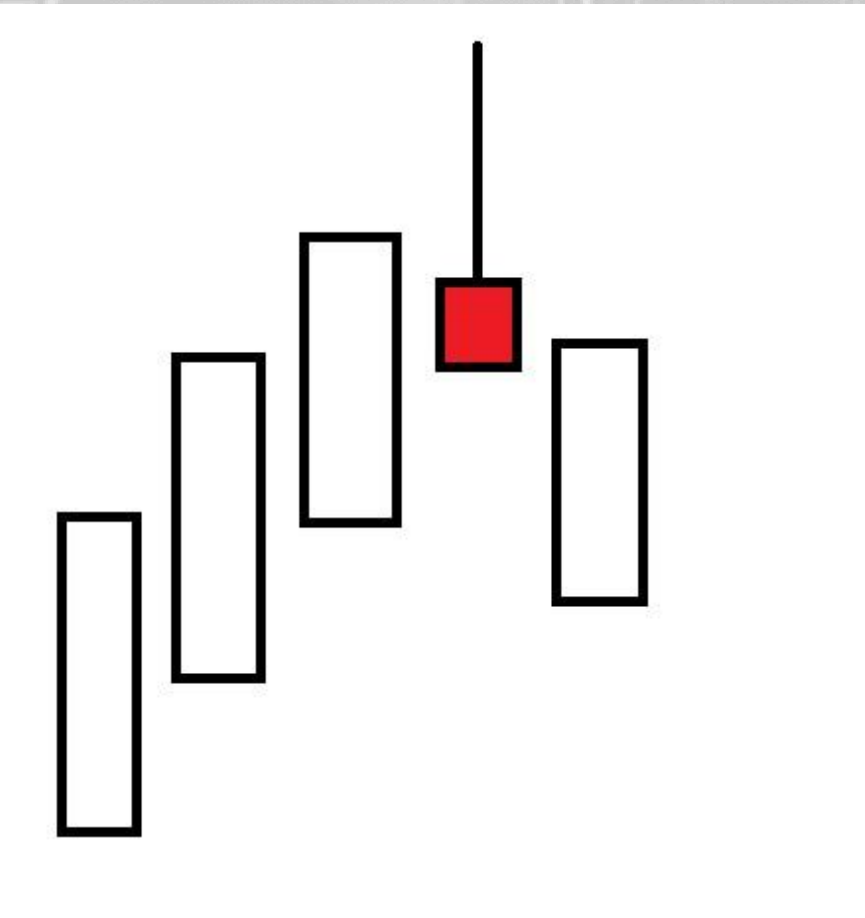
Hammer and melted candles signaling the end of a momentum move

Swing high reversal of momentum



Shooting Star Melted Candles

- Represents a bearish reversal candle
- Only significant after a momentum move higher of 2-6 candles
- The color is not as significant as the relation of the body to be away from the high of the price range
- The entry or trigger is when the shooting start candle completes and the next candle trades below the low of the S.S.



Shooting Star Melted Candles in action: WDC 7.14.14

Higher time frame **Trigger time frame**

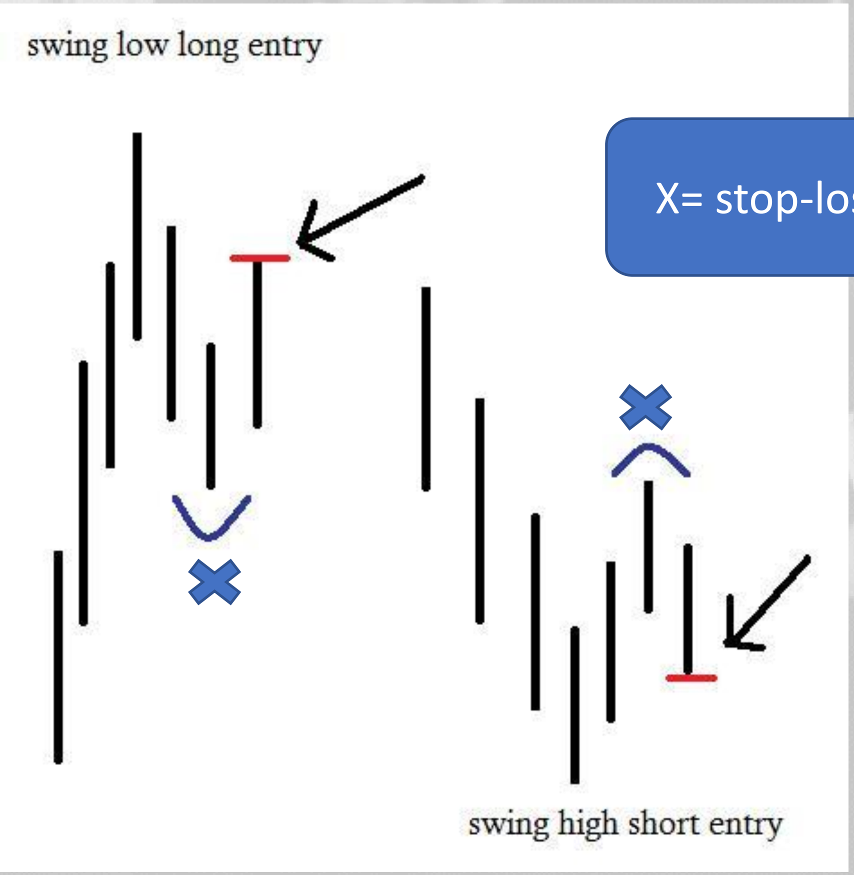
Melted candle, shooting star

Followed by

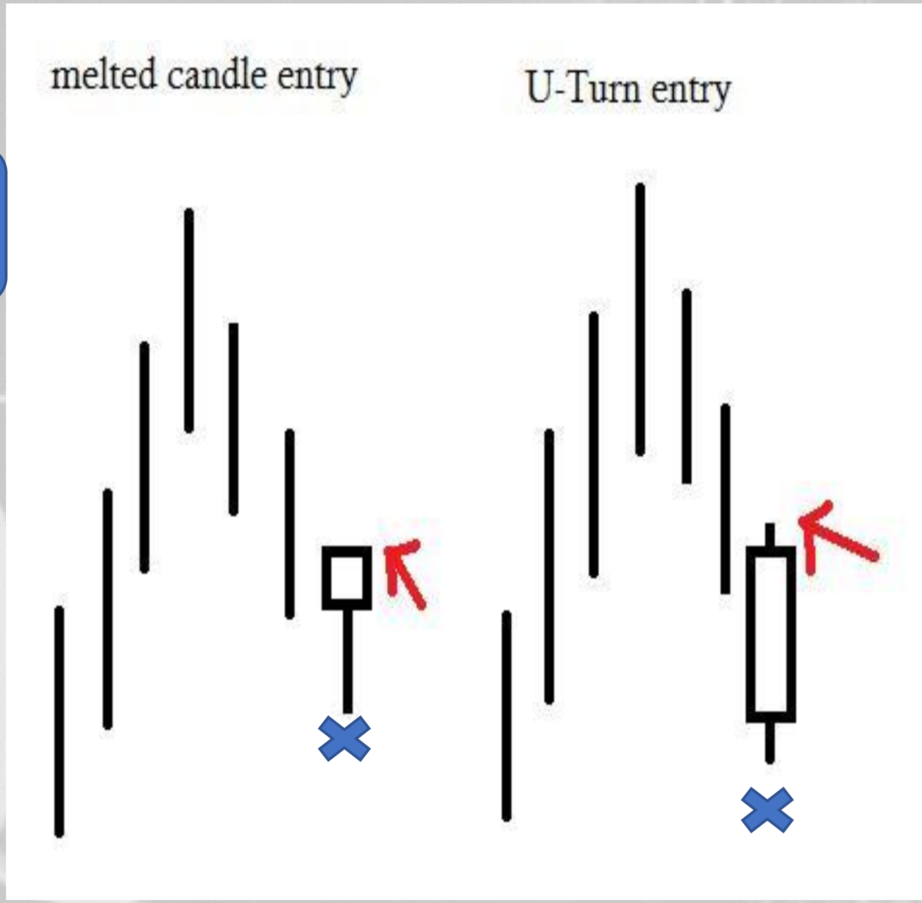
Inside candle (breakout signal)

Occurring at resistance from the previous days high

Entry area



X= stop-loss area



Entry Pattern #2
moving average cross-over

- Entry signal combining a:

✓A "trend" moving average (longer) to identify a pull back.

✓A "trigger" moving average (shorter, generally exponential).

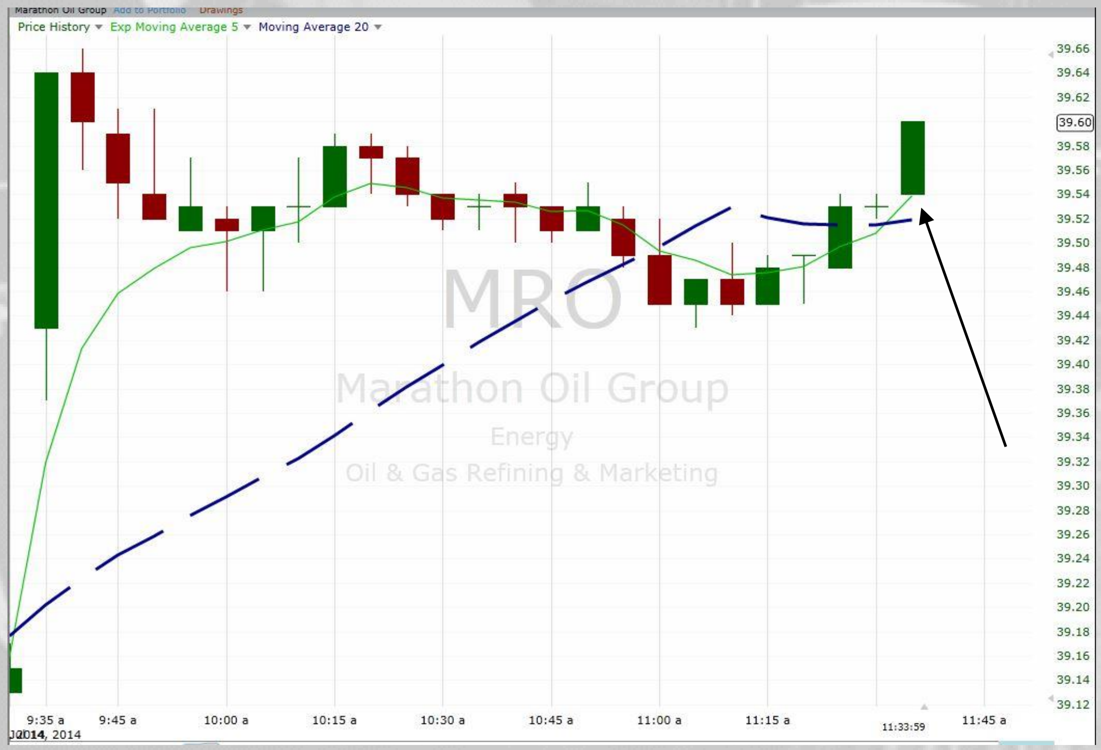
- Only to be used when the higher time frames or institutional order flow has an obvious trend. (multiple charts).
- Using a 3 moving average combo on one chart is a common setup. This gives you order flow, trend and triggers.
- Advanced: combine candlestick cross over with a moving average cross-over for more precise entry timing.

Combining Moving averages for a cross-over signal

*we are waiting for a pull back in price action to trigger an entry

MRO Daily: 20 & 50 sma

MRO 5 minute: 5ema/20sma



Combining a moving average cross over with candlestick cross-over: MRO 5 min

- Price action of the candle occurs before the moving average

1. The candle crosses (and closes) above the 20sma first.
2. Then the 5EMA cross follows.

- Two entry signals, also reduces risk if the 5ema does not cross as you will have less shares

Entry #3: Stochastic pull-back

- Stochastic Definition: AKA “oscillator” used to determine trend direction and strength, as well as potential reversals. (in this case entry and exit signals)
- Direction and trend strength is identified on higher time frame stochastic charts
- Shorter time frame used to time entries (reversals) into the direction of obvious order flow (exits will be discussed shortly)
- Stochastic readings: Charted between 0-100 with 20 and 80 being the significant trigger numbers
- Stochastic averages charted using a %K (fast) and a %D (slow)
- The default setting for the Stochastic Oscillator is 14 periods, which can be days, weeks, months or an intraday timeframe.
- A 14-period %K would use the most recent close, the highest high over the last 14 periods and the lowest low over the last 14 periods.
- %D is a 3-day simple moving average of %K. This line is plotted alongside %K to act as a signal or trigger line

Stochastic Readings

- Typically identified with the terms “over bought” and “over sold”
- This means the current time frame and price action being measured is reaching an area of extreme movement.
- During a move lower in prices, the stochastic reading will move toward a reading of 20, this indicates the current move lower is nearing a level that under normal market conditions will be difficult to maintain.
- The speed of prices moving lower in relation to the closing prices are nearing an extreme. (over sold)
- During a move higher in prices, the stochastic reading will move toward a reading of 80, this indicates the current move higher is nearing a level that under normal market conditions will be difficult to maintain.
- ***It does not however mean it will reverse***, this is very important. It acts more as a warning or alert significant levels have been reached


Price History
BA
Boeing Co
Aerospace/Defense
Aerospace/Defense Products & Services
Stochastics 15 %K 3 %D 3
80 overbought
%K
%D
20 over sold
138.60
137.70
136.80
135.90
135.00
134.10
133.20
132.30
131.40
130.50
129.60
128.70
127.80
126.79
126.00
125.10
124.20
123.30
122.40
102.00
96.00
90.00
84.00
78.00
72.00
66.00
60.00
54.00
48.00
42.00
36.00
30.00
24.00
18.00
13.36
6.00
0.00
7 14 21 28 5 12 19 27 2 9 16 23 30
May 2014
Jun 2014
Jul 2014
7/10/2014

stochastic

Stochastic Buy Readings

- ***Assuming an uptrend on your main time frame***
- As stochastic readings move below 20 and towards 0 this is a spot to anticipate a new buy entry

1. When stochastic readings move back above the 20 line from over sold this triggers the entry signal
2. When the fast %K crosses above the slow %D this is also a trigger entry

Stochastic: 5 min sell-short trigger WMT: Hourly Bearish Bias

- ***Assuming a down trend on your main time frame***
- As stochastic readings move above 80 and towards 100 this is a spot to anticipate a new short sale entry

✓When stochastic readings move back below the 80 line from over sold this triggers the entry signal

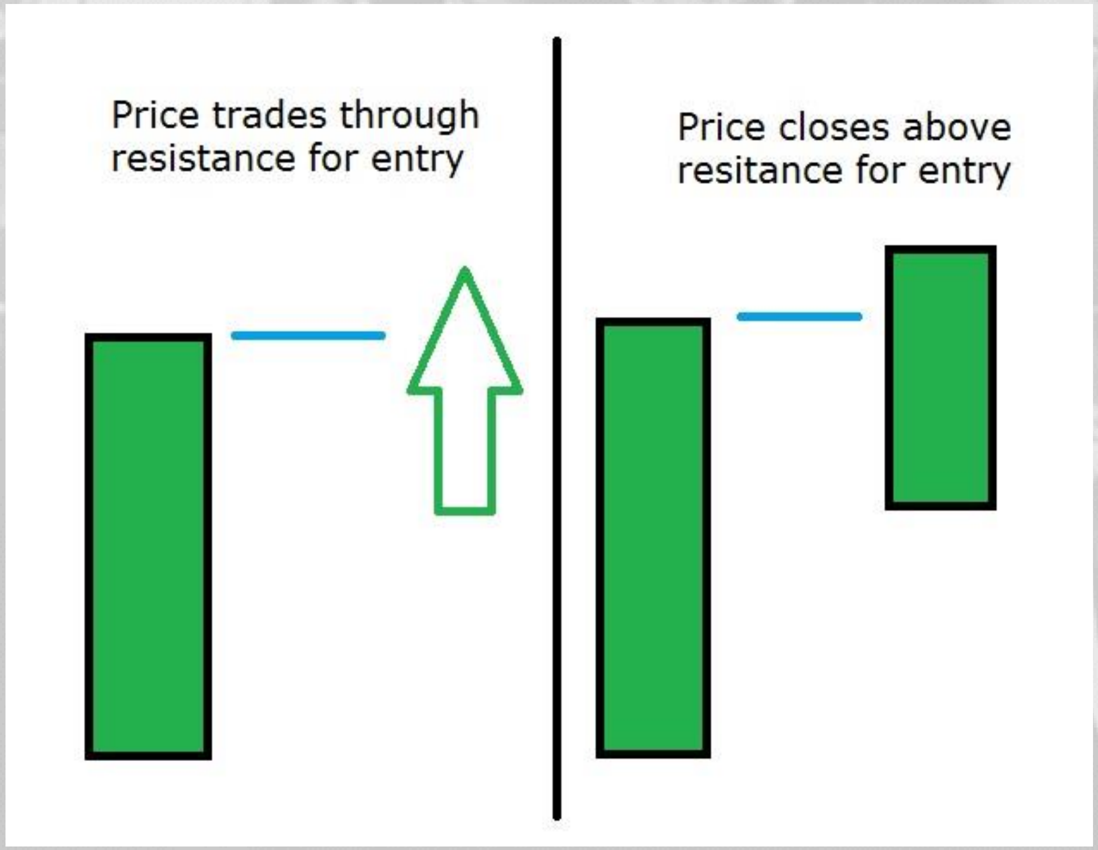
✓When the fast %K crosses below the slow %D this is also a trigger entry

Entry #4: Breakouts

- ➢Break out or Break down definition: Enter when price trades through a significant reference point and the charts show profit potential.
- ➢Two types of break out entries: price cross or price close

1) Inside candles
2) Opening range breakout
3) Higher time frame break out
4) Previous days high or low break out
5) Significant support or resistance break out

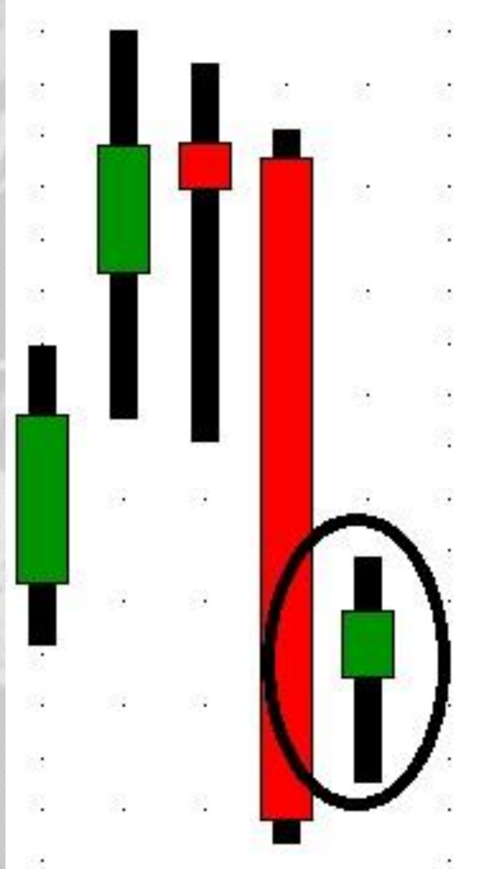
Two types of break out entries: price cross or price close- subtle but huge



- Many traders place "buy-stops" or "sell-short stops" to enter new positions when a specific price level is reached.
- In today's trading world most of these will be false signals because of computerized trading.
- It is a prudent trade to wait for the price to close outside of the break out before entry for confirmation
- The only time to consider entering sooner is when you have massive conviction in the order flow set up

The Inside Candle Breakout

- The current candle is completely inside the previous candle
- Represents indecision or pause in price action.
- The correct play is to wait for a breakout from the inside candle
- Typically an entry signal.

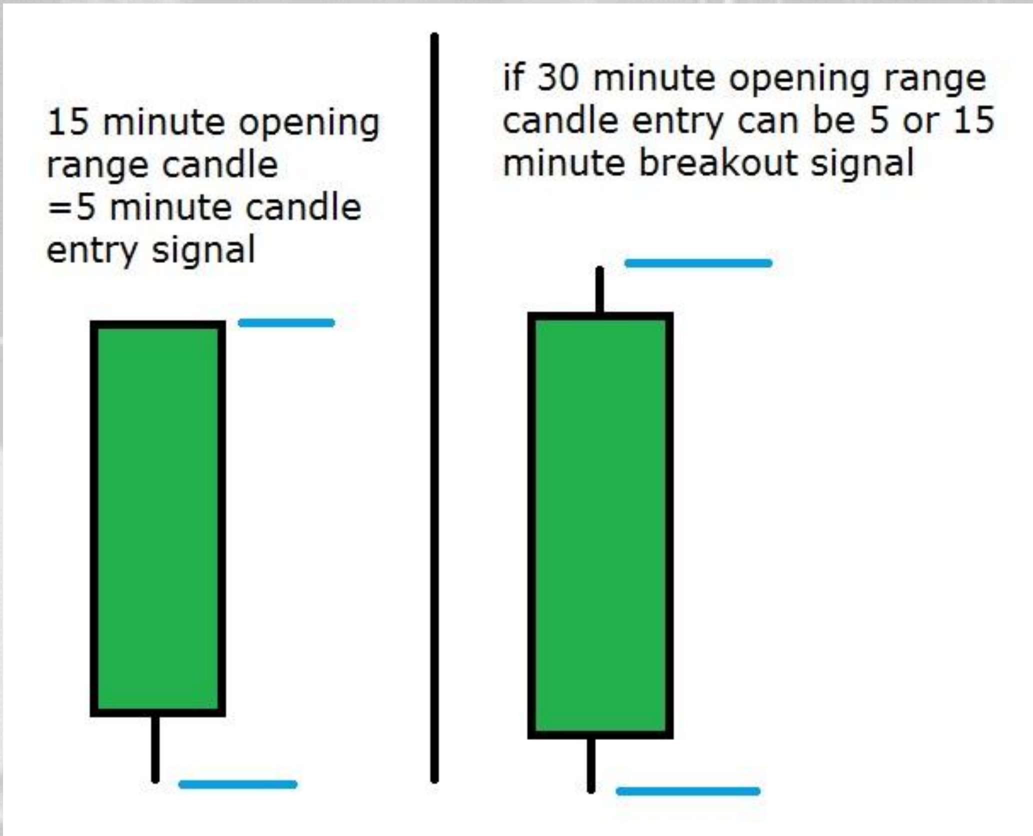


Inside candle break outs

Opening Range Break out: 15 or 30 minute

- Opening Range Breakout

a. Enter (for a long) at the high of the opening range.
b. Initial stop loss should be the low of day.
c. Use your judgment if the candle has an abnormally large high-low range for initial stop loss.
d. Add to the position each entry signal on the 5 minute chart.



MNST July 10, 2014: Open Range Breakout of 30 minute or 15 minute candles

5 minute entry triggers

Higher Time Frame Break Out

- There will be many times when your stocks move ***quickly higher or lower*** <u>without</u> a clear pause on your entry time frame.
- No flag, no inside candle, no moving average cross over, no stochastic signal.

✓Assuming an established trend

✓Assuming profit potential

✓Choose any previously completed candle on a time frame lower than your trend and enter on a break out of that high or low

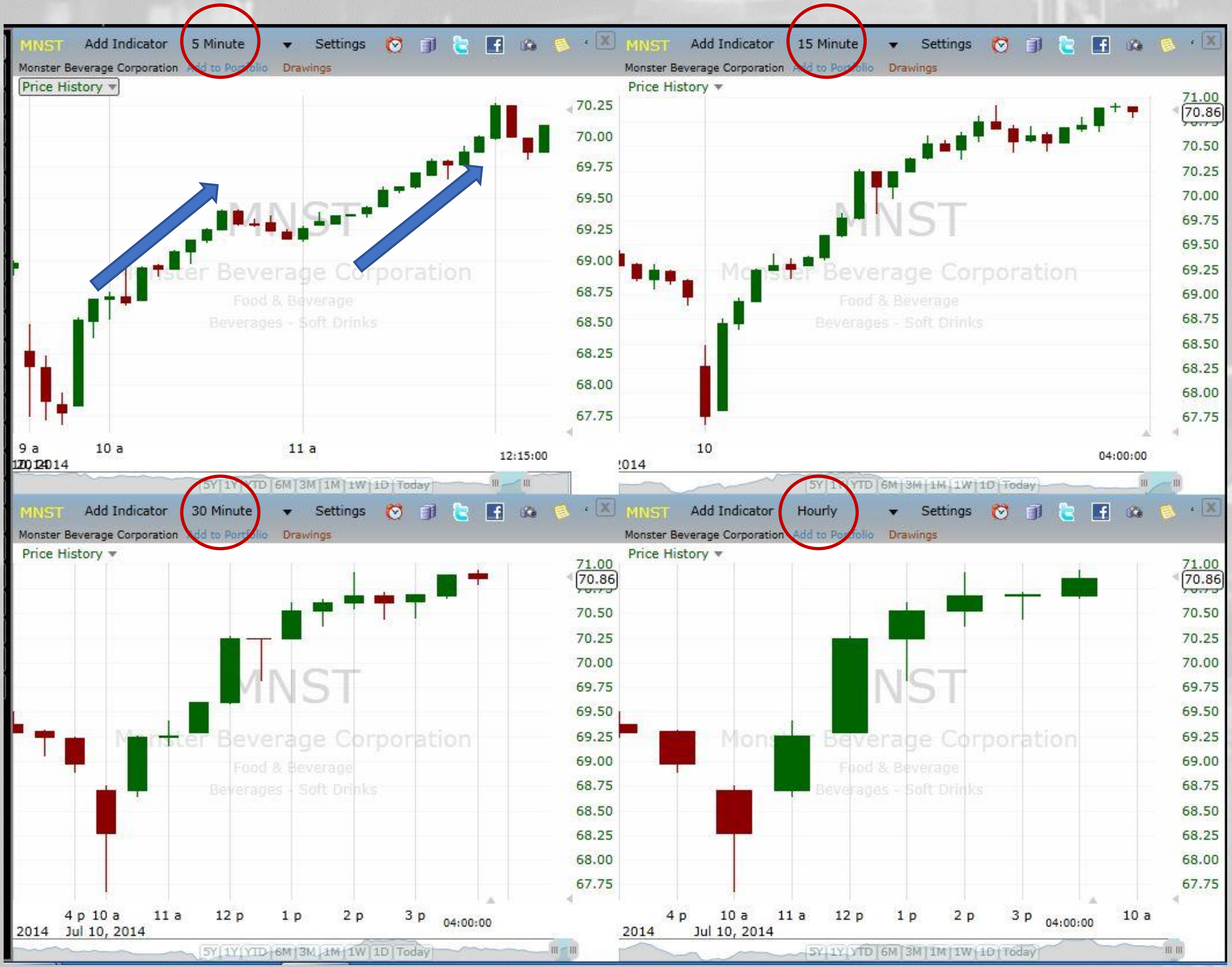
✓For example: If a fast rising 15 minute momentum move.

✓When the most recent 15 minute candle is completed, enter a breakout on the 5 minute chart above the high of that 15 minute candle.

How to trade the Higher Time Frame Break Out

If your entry time frame does not offer a clear trigger in the direction of a fast move without a pause.

Enter a breakout of a completed candle on a higher time frame



Previous days high or low break out

- The previous day's high and low are the most significant reference points for an active trader.
- These areas represent *yesterday's* order flow, when price trades outside of this range you have ***new*** order flow.
- Here is the key: Better trades occur outside of yesterdays range, new money is involved and you tend to get better follow-through.

➢There are two trade scenarios:

- Set alarms or draw horizontal lines at the yesterday's high or low.

1. Trade the breakout on your entry time frame.
2. Identify a breakout and wait for a pause to get confirmation.

Significant support or resistance break out

- Daily chart of the SPY from 2014
- Interesting to note here two failed break outs before the follow-through
- This is a good example of what we discussed about the entry choice of waiting for confirmation
- The more obvious the order flow and trend prior to a break out the more conviction to enter sooner (not waiting for a pause)

Gaps: Entry #5

- A gap occurs after a stock has opened much higher or lower than the previous close. A true gap occurs above or below the previous day high or low.
- Gaps typically occur after a significant fundamental story about a company is released. Usually an earnings surprise, upgrade/downgrade, competition, legal issues or a change of executive leadership.
- Here is the most important point to remember when trading a gap: you do not need to interpret the news to make money trading the gap!
- Let your knowledge of the open price range breakout give you clues to who created the gap.
- You need to decipher if it was institutions or retail overreaction.

Classifying the Types of gaps

- Retail Gaps: When nothing fundamentally about the stock has changed overnight no significant volume is trading. Maybe a popular TV host mentioned a stock or the futures are trading up or down significantly. Either way nothing about the stock has changed to justify the gap.
- Professional Gap: Associated with heavy volume and significant fundamental or economic news. For this to be a Professional Gap you should see block prints trading and pre market volume should be significant.

How to trade the Gaps

- **Retail Gaps** are gaps that the specialist or market makers WILL be able to bring the stock back to a level where they can recover the risk capital they lost taking the other side of the retail order flow.

✓ If volume is light and price starts to trade in the opposite direction of the gap after the open range you can join the specialist fading the gap.

- **Professional Gaps** are gaps where there is **institutional order flow** and heavy volume involved in the gap.

✓ You will see block prints consistently printing on the tape in the direction of the gap.

✓ After the open price range has formed, as long as volume continues to be heavy, you will trade the direction of the gap.

✓ Many traders make the mistake of fading every gap. Do not make this mistake. Read the gap, the open range and volume, be a pro!

✓ Technical trading gap basics: in an established downtrend short sell a gap up below the open range, in an established up trend buy a gap down above the open range.

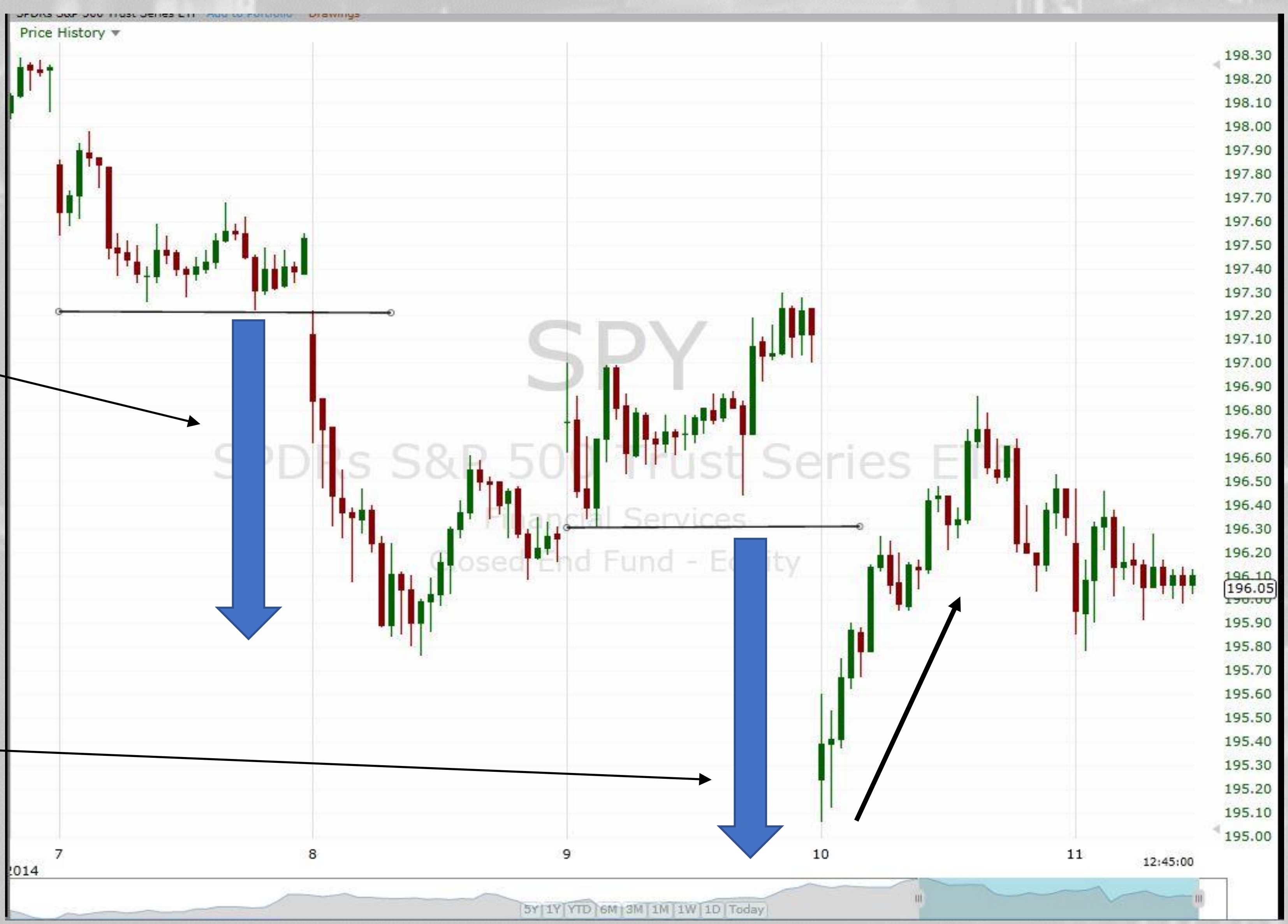
- ✓ SPY July 11, 2014

15 minute chart

Professional Gap Follow-through

versus…

Reversal & open range breakout entry (Retail Gap)



The Stop Loss & Planned Re-entries

How to Preserve Capital and Make Trade Adjustments

perspective on the stop loss

- *"EXECUTING A STOP LOSS IS NEITHER GOOD OR BAD, IT IS SIMPLY A PART OF DOING BUSINESS."*
- When you adjust your share size down while in a trade that moves against you, or when you execute a stop loss you are doing nothing more than managing risk!
- *It is NOT an assault to your ego!!!!*
- Easily the single biggest reason a trader will **not** make it as a professional trader is because he or she personalizes a trade that is not making money.
- When you personalize a losing trade you turn a reasonable small loss into career ending disaster.

Stop loss mindset

- Proper management of your losing trades will dictate what you TAKE HOME every month, not how much you make on winning trades.
- Notice we said “take home.” Anybody can make money on a trade or on a given day, but your ability to manage risk and deal with losses with the proper mindset will earn you a consistent income.
- As we have said, the stop loss must be a dollar amount you accept **before** you place the trade.
- You have “accepted” the risk, you have accepted the fact that there may be a loss on the trade. This acceptance is crucial to flawless execution.

Trading Smart

- You are accepting putting money at risk as a part of doing business just like any other business owner. You are spending money to make money.
- What this translates to is that when it comes time to execute a stop loss you will do it unemotionally because you understand it is a part of doing business.
- The most common reasons traders blow up their accounts are too much leverage relative to their skills and not truly accepting the risk.

Stop loss strategies

1. Initial Stop Loss: Risk point as defined by your original entry.
2. Risk reduced stop Loss: Exit a partial amount of shares as opposed to the entire position.
3. Break Even Stop Loss: When a position moves in your favor, you move the stop loss point from the original spot to your break even area.
4. Trailing Stop Loss (profit taking): Used to protect profits on a winning position. Objective is to lock in all or part of profits.

Initial stop loss

- For short term trading, you will determine the area to place the initial stop loss from technical analysis.
- The proper area is just beyond the significant reference point you have identified from the charts, **never place it exactly at the number.** You want to be taken out of a trade because the circumstance has changed, NOT because price just barely touched a number!
- This area must be determined before you enter the trade, not after! This will ensure accepting the risk.
- ** Reduced Risk Stop Loss: Remember your initial assessment of risk does not have to be your final one.
- You DO NOT have to remain in your full original share size if the position should happen to move against you quickly.

Initial stop loss area: First Entry

- For a TEST of support or resistance: When bidding into support or short-selling into resistance, the correct initial stop loss area is just beyond the support or resistance you were expecting to hold. (for example: if you are bidding @$20, your stop loss would be $19.85, it would not be the exact price)
- For a FLAG: The proper stop loss is just beyond the swing point, the U-Turn or melted candle entry signal. (just beyond the low (if long) or high (if short-selling) of the flag.
- For a Breakout or Breakdown from a consolidation: Price should NOT trade back into the support or resistance area. If it does you may need to make a judgment call if it is a failed break or simply “noise.” It is better to be disciplined while you are learning, simply exit and reenter.

Breakeven stop loss

- When a trade that has moved in your favor, has clearly made an attempt to get back to your entry price, but could not do so. This is a very good sign for your position.
- Your intention here is to get a ***“risk free ride”*** on your profitable trade and a worst case scenario of no cost except commissions on the trade.
- There is of course the possibility of getting stopped out for break even and the trade moves in your intended direction. This is fine, you will simply re-enter the trade.
- Remember it is very important to follow our plan, that is what we always have control over. Getting stopped out and re-entering is part of the business.

trailing stop/stop loss

- Used when your position has produced an acceptable profit.
- As a trade moves in your favor you will continue to set a price level or dollar amount that you will not allow to be penetrated (in the other direction) without booking the profit.
- Helps you overcome one of the biggest problems new traders face… holding on to winning trades! Setting a trailing stop provides a systematic method to let your profits run.
- Scaling out of trades as it moves in your favor takes the pressure off getting the exit "perfect."
- Melted candles, swing points, U-turns, support, resisntace and exhaustion are the signals for getting ready to set a trailing stop.

Stop loss areas and trade management thoughts

A=stop loss area for the bearish swing high entry

B=stop loss area for a bullish swing low entry

C=breakout entry. Initial stop loss exit would be a close below the trend line.

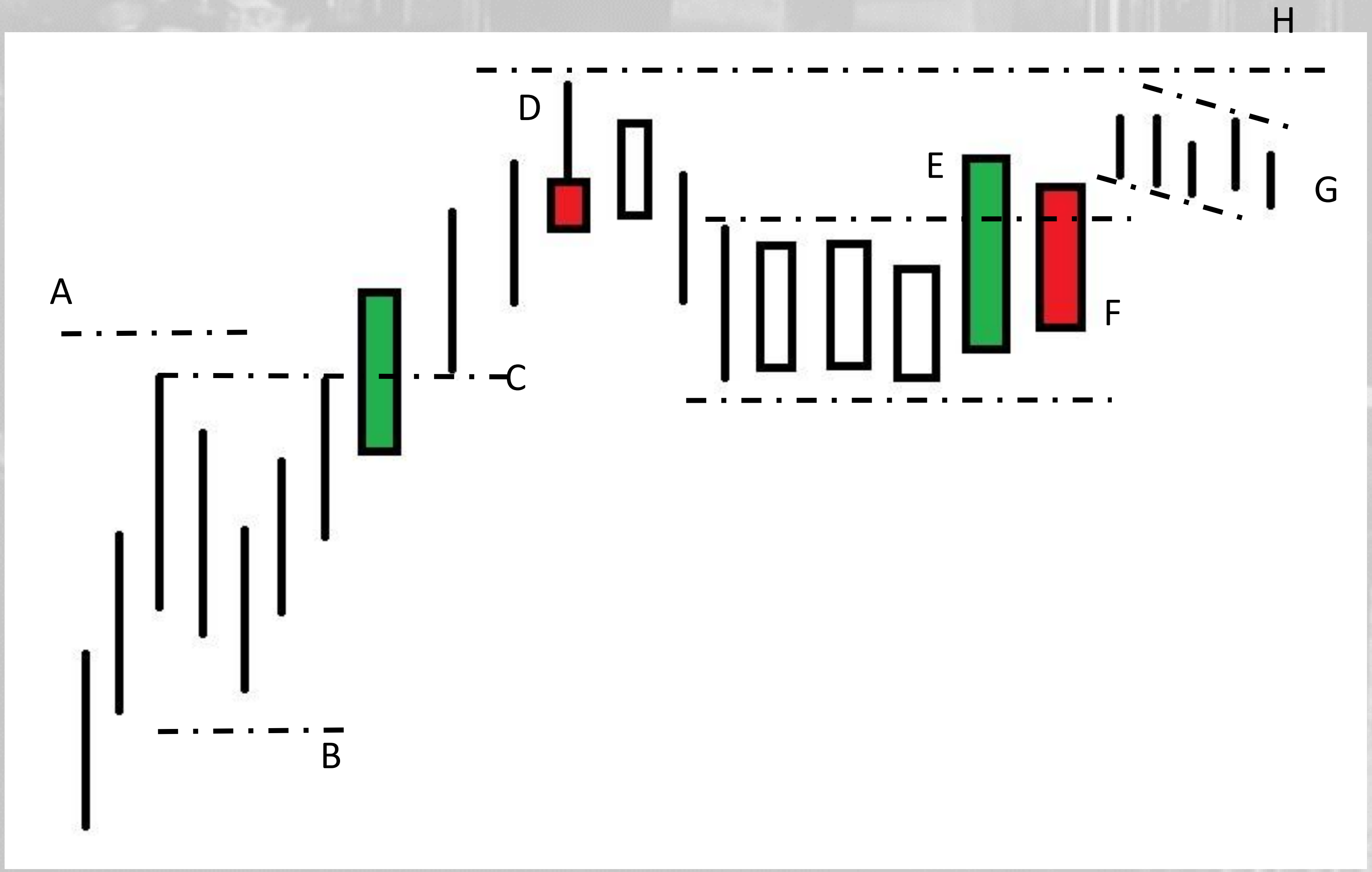
D=shooting star is a reason to consider a profitable exit, to scale out or to tighten up a trailing stop.

E=trading range breakout entry

F=stop loss exit when the stock trades and closes back in the range

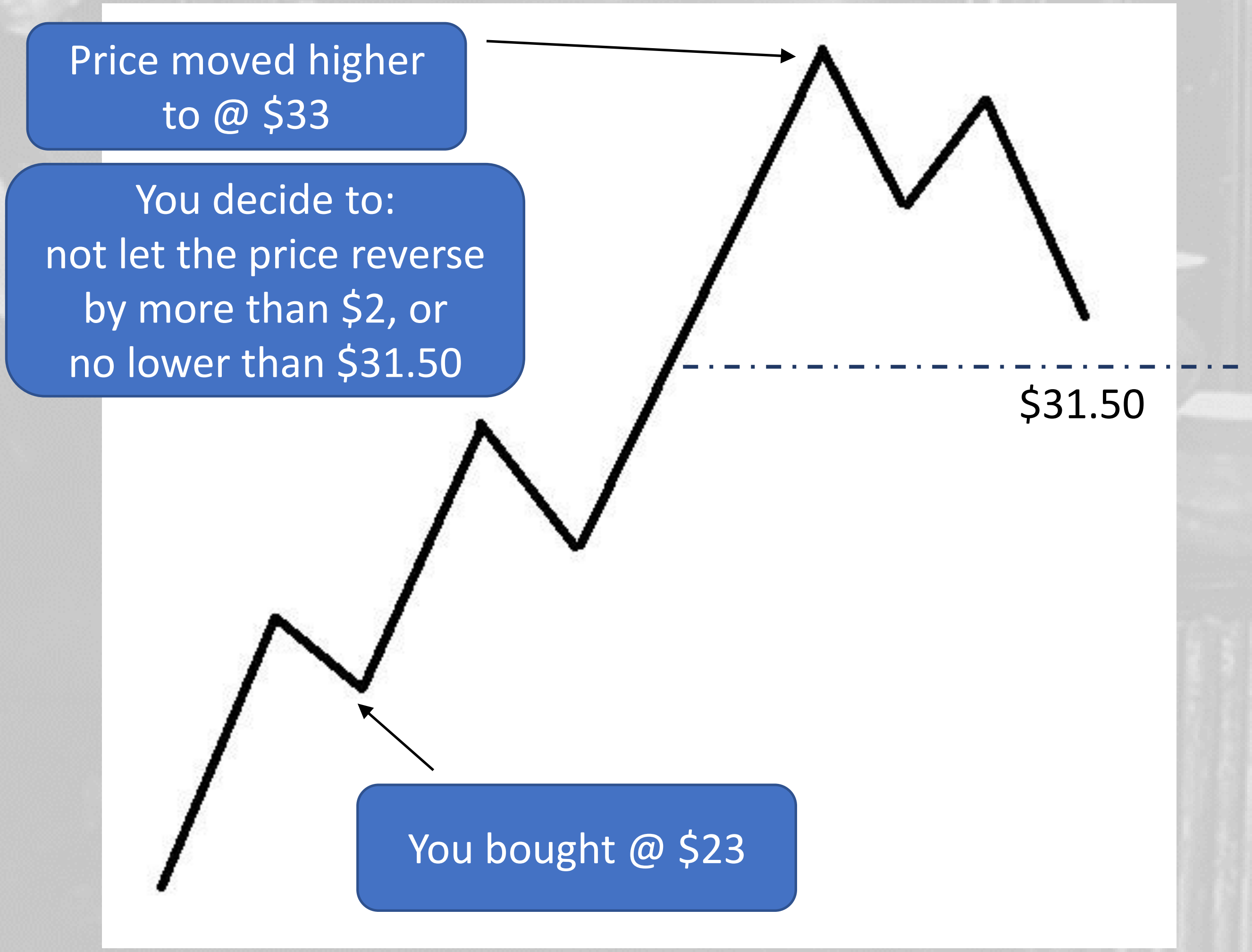
G=a good pause to consider entering a new trade because it held above the consolidation

H="G" is not a good trade YET because it is too close to resistance.



“tighten up a trailing stop”

- You will use a trailing stop loss when you are in a profitable position.
- The goal is to not allow price action to reverse by a predetermined amount in order to “lock in” profits.
- If the lower price is reached you will exit the trade.
- If it is not, you will continue to “follow” prices as they move in your favor, thus “trailing” profits.



Managing risk while in the trade

- Your goal for every trade is to manage risk and leverage before and during the trade, not only before the trade.
- *** Your initial assessment of risk does not need to be your final decision.
- It is very important that you understand you can and should adjust risk during a trade.
- It can be very common to adjust share size up or down while in a trade
- It would be terrific if a trade did exactly what you wanted it to after your entry and moved “cleanly” in your favor quickly, but that is just not real world trading.

Real world trade sequence: price discovery and trade adjustments

- Initial share size 1000 shares
- Moves against me cut 500 shares (prior to stop loss)
- Moves past initial entry add 500 shares
- Moves further in my favor add 300 shares
- Moves back down to my initial entry, current risk is only the 300 new shares on my second entry.

1. Moves against me get out of trade
2. Moves in my favor in a big way, scale out and trade around core position

Holding the Winners

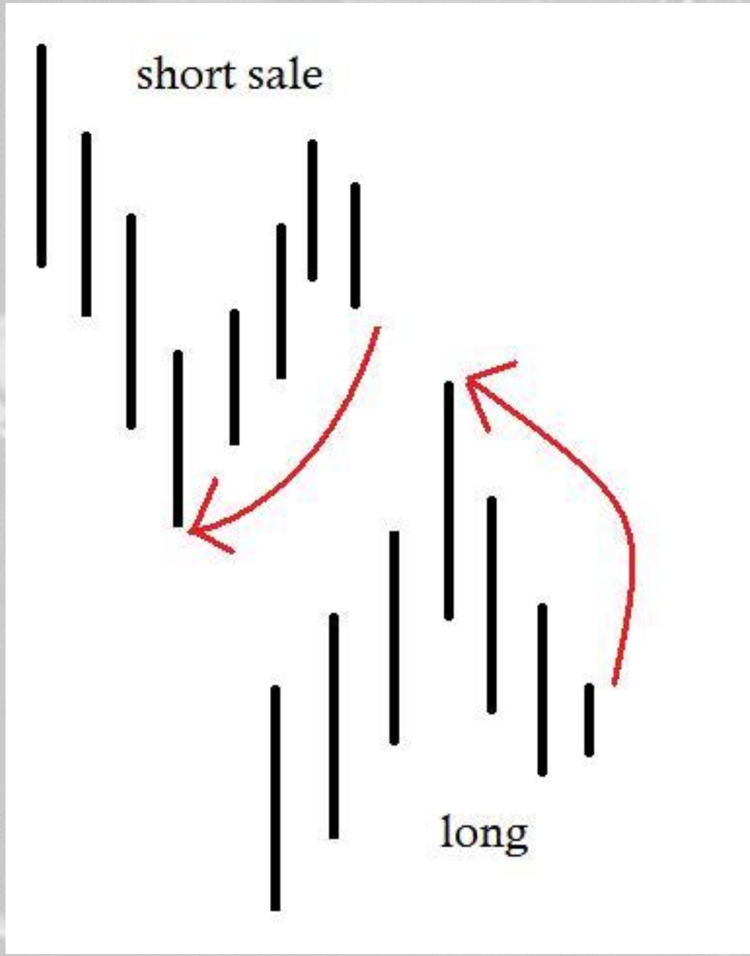
How Big Traders Make the Big Money

5 possible profit taking scenarios

1. Exit at a clearly defined support or resistance point on a chart, such as a previous high or low. *We recommend this be your primary profit target as you learn the business.
2. Scale out of a good trade, if you still like it, you can always get back in with profits in pocket.
3. Exit into momentum moves such as **exhaustion** as viewed with candlesticks and volume.
4. Exit when you have identified the stochastic reading on a higher time frame has reached extreme levels
5. Exit or tighten a trailing stop when a swing point, melted candle or U-Turn candle has formed.

Basic Initial Profit Targets

- The skill of booking profits believe it or not is the hardest one to teach.
- The reason for this is it can be more subjective than setting a stop loss.
- We teach that the previous support or resistance should be your initial target

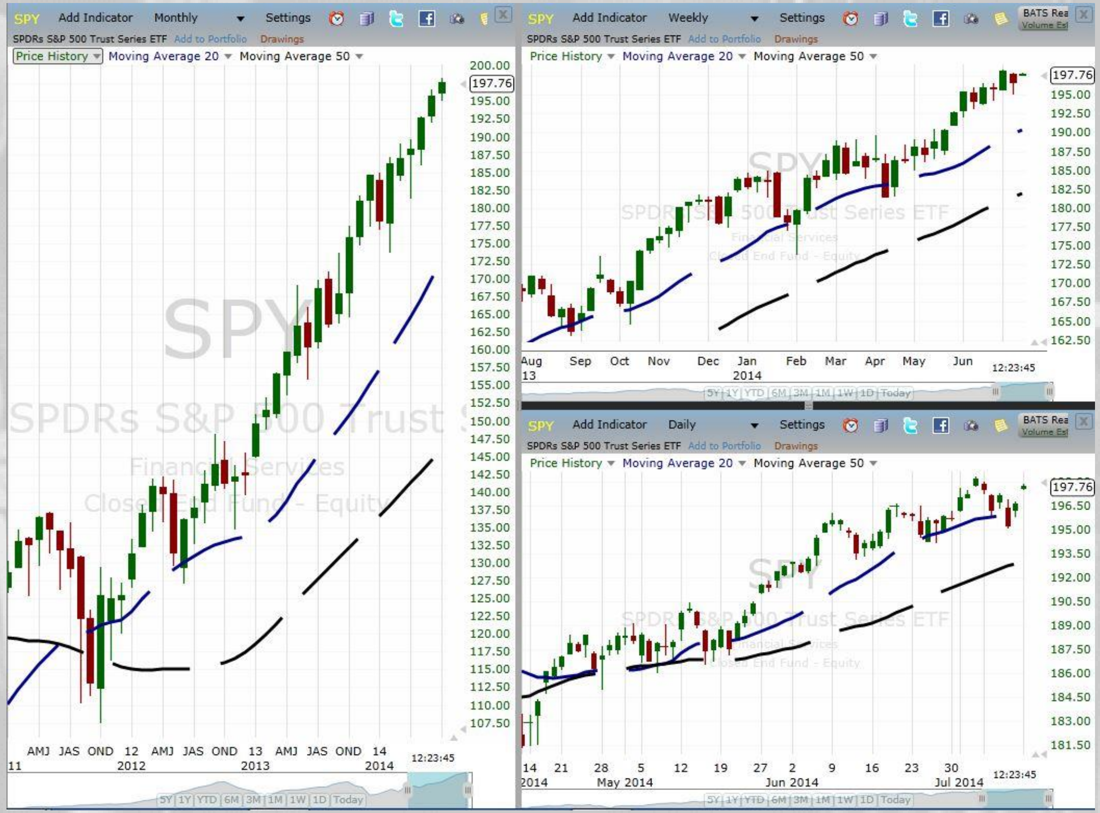


Big Money Trades & multiple time frame analysis

- The big money is in the higher time frames.
- This is where you assess profit potential.
- Trade with follow-through are when multiple higher time frames are in sync.
- These are your “A+” opportunities:

✓Must be identified.

✓Must be traded aggressively.

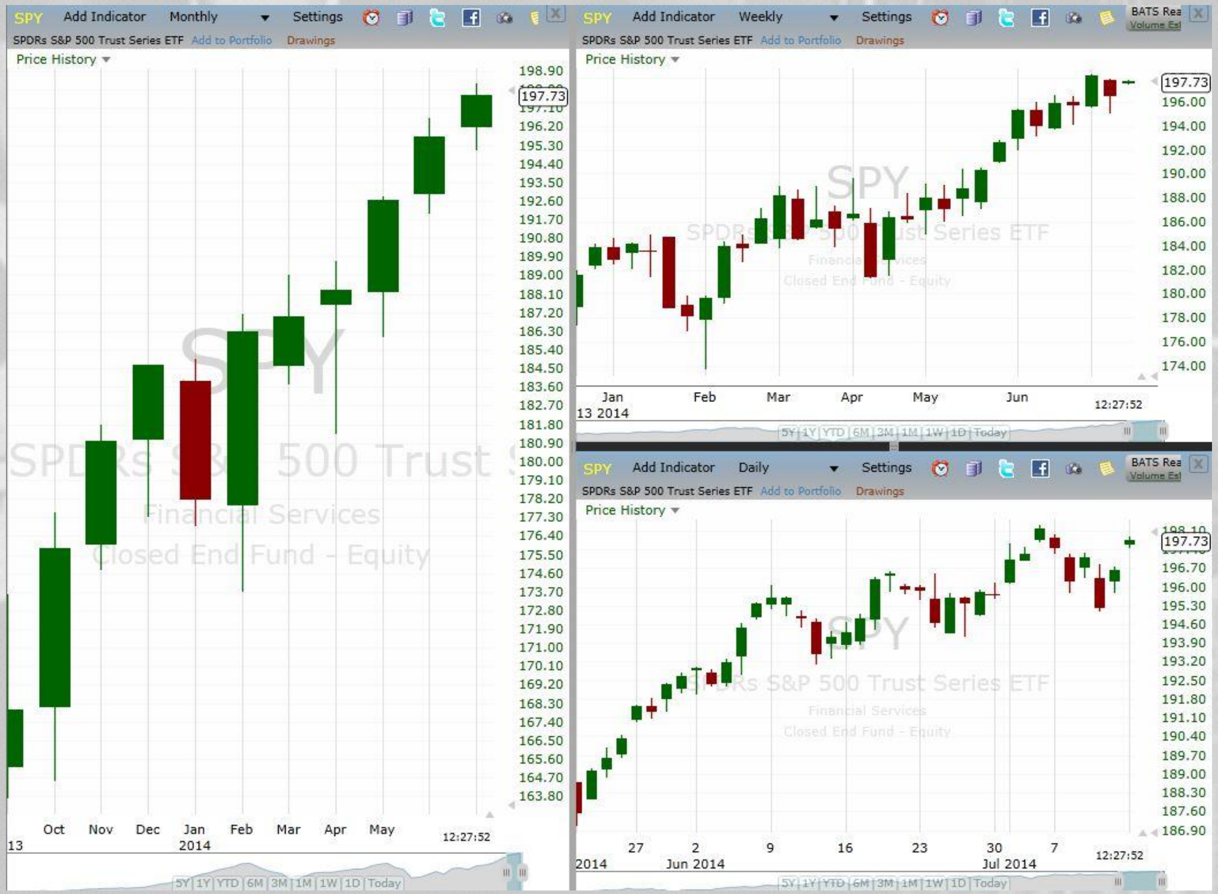


Big Money Trades, Multiple Time Frame Analysis & Candlestick Analysis

- Bullish & Well Bid Months
- Bullish and Well Bid Weeks
- Translates into PRIME setups for aggressively traded days
- These are your “A+” opportunities:

✓Must be identified

✓Must be traded aggressively



Understanding what "Aggressive" means

- When the current trend and order flow are in sync
- When the current higher time frames show acceptable profit potential to the next significant reference point of support or resistance

❑ More initial share size.

❑ More total position share size.

❑ More positions.

❑ Held longer through normal market gyrations in pursuit of your profit target.

Stage of Trader Sophistication

- New traders will tend to focus on losing trades.
- They need the money and each trade to be profitable to they simply do not understand trading for probabilities over time yet.
- Experienced traders will absolutely focus on “money left on the table.”
- They have accepted there will be losses on a trade-by-trade basis and have a new challenge of holding good trades longer.
- You will position yourself to become an experienced trader to overcome this challenge with your skills of trade management and understanding the market conditions to hold profitable ideas to your target.

Assessing profit targets: Comparing two $8 targets

Acceptable risk/reward

Unacceptable 1-1 risk/reward

Stochastic & higher time frames

(as opposed to using as an entry signal on lower time frames)

- Reflects the speed at which prices change
- Are measured on a scale from 0-100
- As the reading rises, between 80-100 is considered over-bought.
- As the reading declines, between 20-0 is considered over-sold.
- Stochastics are used to:

1) Time entries on a pull-back in prices on lower time frames.
2) *Alert us to profit potential on higher time frames by determining the relative stochastic trend and its relation to over bought or over sold*

Stochastic on higher time frame assessing trend and profit potential of entries on lower time frames.

A=GOOG moves into "overbought" zone and remains so for 4 months. This means to buy a buyer.

B=Mid March-mid April stochastic in a down trend. Short-selling is the right game plan.

The probability of a short sale is diminished as it dips below "20"

C=trades above 20 and is a solid buying scenario until it becomes overbought at "D"

Level 2 and direct access trading

Understanding
quoted prices & executed trades

Learning direct access routing strategies

Goals

- To understand the difference between online trading and direct access trading.
- Learning the difference between level one quotes and level two quotes.
- Introduction to Time and Sales
- Determining where your routing skills are now and where you want them to be.
- To review the choices for direct access order routing and how to use them.
- To understand how true direct access trading can **and should** significantly lower your monthly operating costs through proper routing decisions.

Key Knowledge:

- In general, listed securities *(NYSE traded)* are large capitalization companies that have a historical record of earnings.
- Stocks listed on the NYSE have **3 symbols** or less. For example: F= Ford, HPQ= Hewlett Packard, FB= Facebook
- Stocks listed on *NASDAQ* have symbols of **four** letters and are more often than not, technology companies.
- DELL, MSFT, GOOG, AAPL
- ** FB Facebook is listed on the NASDAQ. In 2007 companies were allowed to pick their symbols regardless of which exchange they were listed on.

Most common orders

- Limit order: an order to buy or sell at a specified price or better. A specific price is entered.
- Market order: an order to buy or sell at any price available in the marketplace. No price is entered.
- Stop limit: a limit order is triggered once the specified stop price is reached.
- Stop market: becomes a market order to buy or sell once a specified price is reached. (price above or below the current market)
- Trailing stop limit: a sell order for a long position sets the stop price at a fixed amount below the current market price.

Understanding your online retail orders vs. direct access

- Self directed online accounts are most likely not direct access.
- Most retail brokerage houses route your orders to a trading desk or to a third party.
- Some exchanges and market making firms actually pay retail brokerages for the privilege of filling their customers orders. This is called “payment for order flow.”
- This is one of the ways your broker can make money executing your trade for only $9.99
- More often than not these firms can fill your retail order from their own inventory and make a profit.

Direct Access orders and routing

- Your direct access orders will be sent directly to the specialist, market maker or an ECN or “dark-pool.”
- The most popular (liquid) ECN today is ARCA who has recently merged with the NYSE.
- Direct access to the markets gives you fair access to the true market, you will receive the best execution and you can actually receive price improvement if available.
- A true direct access professional trader will route his order to a specific route at a specific price (for the lowest cost as your skills improve)

Level one quotes: inside market

bid ask
3,000 @ 20.55 X 5,000 @ 20.56

- Level one quotes give the trader a snapshot of advertised supply and demand. **Advertised** was used very intentionally.
- The bid side shows the total amount of shares and the highest limit price traders are willing to buy stock.
- The ask side shows the total amount of shares and the lowest limit price traders are willing to sell stock.
- Bid and Ask quotes are **advertisements** to buy or sell. They are no different than price tags on a pair of shoes at a store.

Level 2 quotes

- Shows the same basic information as level one **but with more detail.**
- How many shares are available to buy or sell at each price on a particular routing destination
- The depth of where and how many will help us decide where to route our direct access orders.
- Where refers to the specialist, market maker or ECN.

Level 2 and routing orders

- How many shares quoted at a price are very important information when deciding where to route your own orders.
- **Who** is quoting those shares is not as important as it once was when trying to decipher if a specific market maker is a big buyer or a seller.
- Who is quoting those shares however ***is*** important when it comes to making a routing decision based on cost, not all routes cost the same to access.
- Many bids or offers with size presents you with liquidity which increases your chance to buy or sell shares if you are urgent.
- Few shares quoted on the bid/offer presents you with an opportunity to advertise your buy or sell order at the best available price. Shares are filled first come first served, if you are first you are the front of the line on that route.

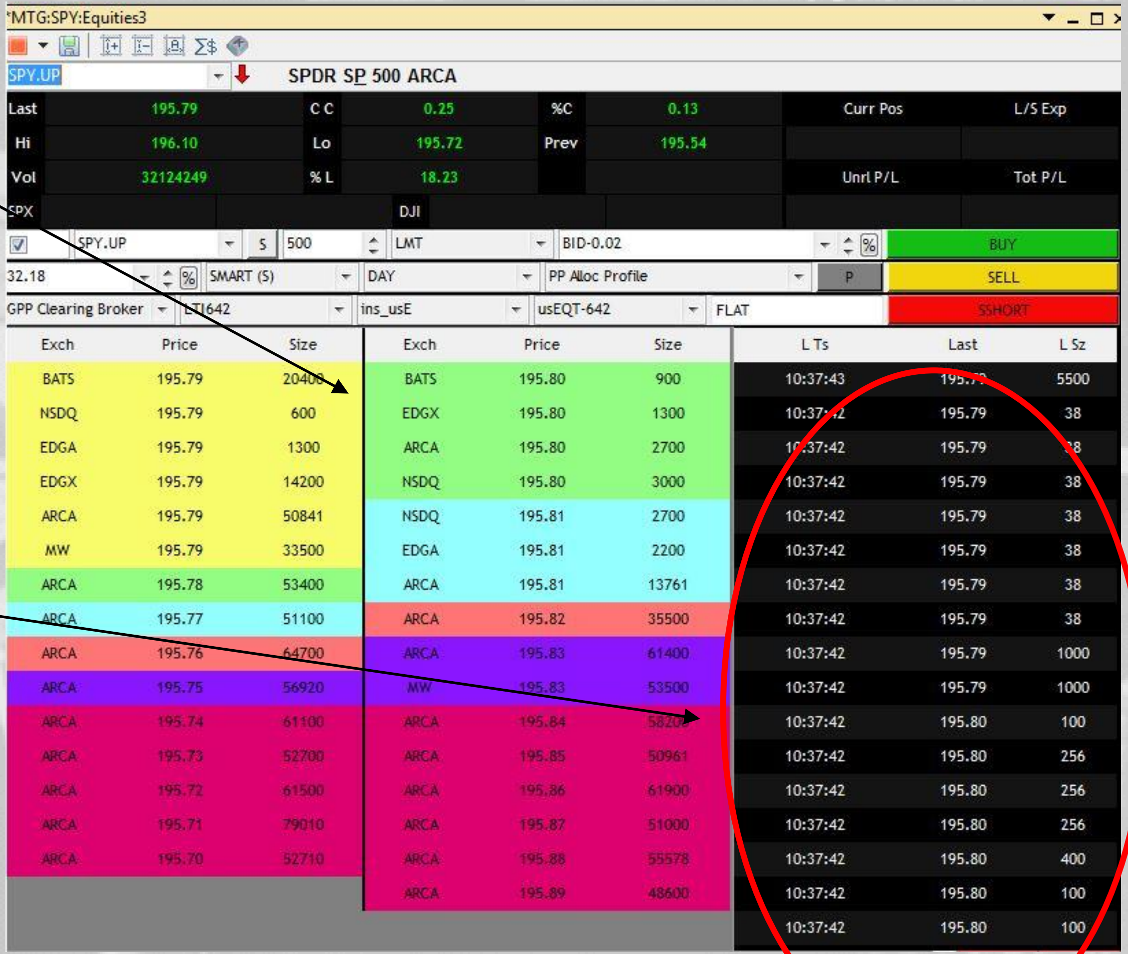
Time and Sales: urgency in action

- Level 2 shows advertisements. Time and sales shows actual trades.
- L2 is the passive part of a trade, time and sales shows the active part of the trade, urgency to get in or out. These trades are called the “prints.”
- Time and sales tells us:

a. how many shares traded,

b. the price those shares traded

c. The routing destination the trade was executed



Interpreting level 2 / time and sales

- If someone is advertising to sell stock and he is able to sell the stock, it is because another trader bought it from him.

a. The other trader did so because he felt he felt urgency to buy now. He paid the higher price. He most likely tried to advertise and could not get filled.

- If someone is advertising to buy stock and he is able to buy the stock, it is because another trader sold it to him.

a. The other trader did so because he felt he felt urgency to sell now. He sold at the lower price.

How time and sales will affect your activity level

- If time and sales is busy and consistent:

a. Traders are displaying more urgency

b. The more obvious the urgency (buying or selling) the more obvious what other traders feel about the future price of the stock.

c. ** the more consistent the prints and more obvious the urgency (trades occurring on the same side and the larger the size of those trades) the busier you should be.

- If time and sales is slow and sporadic, you should not be actively trading that stock (nobody else is either!)

What to focus on

- Level 2 is advertisements, times and sales is the active part of the trade.
- Level 2 action can be confusing for a new trader, focus on liquidity for routing purposes.
- The level 1 quote is also known as the "inside market"
- Action in time and sales that is red is active selling, green is active buying. Active = urgency.
- When you have more experience and can make quicker decisions you will be able to quickly read level 2, time & sales and direct a trade for better fills and lower costs.

ECN executions

- ECN= Electronic Communication Network.
- It is a routing destination we can use for both NYSE and NASDAQ trading.
- The most liquid (popular) are: ARCA, EDGX and NSDQ. BATS ecn recently became an exchange
- ECN’s make money by charging you to remove shares (urgency) from their liquidity pool.

a. ECN’s pay you to add shares (advertise) in their liquidity pool.

b. *When you reach higher levels of trading mastery you will be able to reduce your trading costs significantly using ECN’s properly.

Understanding your orders and liquidity: the **bid**

BID			ASK		
NYSE	17.33	4,000	NYSE	17.34	4,000

- **The bid: 17.33 advertisement to buy**
- If you try to **buy** 1,000 shares on the **bid** routing your order to NYSE, the 4,000 will become 5,000. You *added* liquidity.
- If you **buy** 1,000 shares at the **ask** using NYSE, the 4,000 shares will become 3,000 shares. You *removed* liquidity.
- *** you can buy on the bid AND buy at the ask.

Understanding your orders and liquidity: The **Ask**

BID			ASK		
NYSE	17.33	4,000	NYSE	17.34	4,000

- **The ask: 17.34 advertisement to sell (also known as the offer)**
- If you try to **sell** 1,000 shares on the **ask** routing your order to NYSE, the 4,000 will become 5,000. You *added* liquidity.
- If you **sell** 1,000 shares at the **bid** using NYSE, the 4,000 shares will become 3,000 shares. You *removed* liquidity.
- *** you can sell on the ask AND sell to the bid.

ECN Routing Part 2: Breaking Down the Fee and Rebate Costs

- You can buy on the bid or buy on the offer.
- You can sell on the offer and sell to the bid.
- When you buy on the bid or sell on the offer you GET PAID the ECN fee for adding liquidity.
- When you buy on the offer or sell to the bid YOU PAY the ECN fee.

BID	OFFER
$20.05	$20.07

If you buy on the bid or sell on the offer you get paid on average $2.75/1,000 shares

If you buy on the offer or sell to the bid you pay on average $3.00/1,000 shares

The better you get at routing your orders using ECN's you will have a $5.75/1,000 net difference in your pocket…

** never let an ECN rebate or cost factor in when you have urgency

ECN rebates

- You can significantly reduce your monthly fees by routing orders properly to ECN's to get paid a rebate.
- You should do this when the momentum is in your favor or if you have no urgency to get in our out of a trade.
- When you ADD liquidity you get paid by the ECN. This will increase your net profitability. *adding liquidity and getting the rebate applies to the bid or the offer
- When you REMOVE liquidity, you get charged by the ECN.
- You can and should use ECN routing for both NASDAQ and NYSE stocks

Placing orders in NYSE stocks

- Direct access traders should place orders for NYSE stocks using DOT, Hybrid or an ECN.
- DOT stands for Direct Order Turnaround. This order is sent to the specialist and he will literally look for a match.
- The specialist will look for a match in the pool of existing orders he has.
- These orders are limit orders compiled in what is called his **open book**.
- Orders displayed in the specialist **open book** are limit orders to buy or sell at a certain price through the specialist.

NYSE hybrid executions

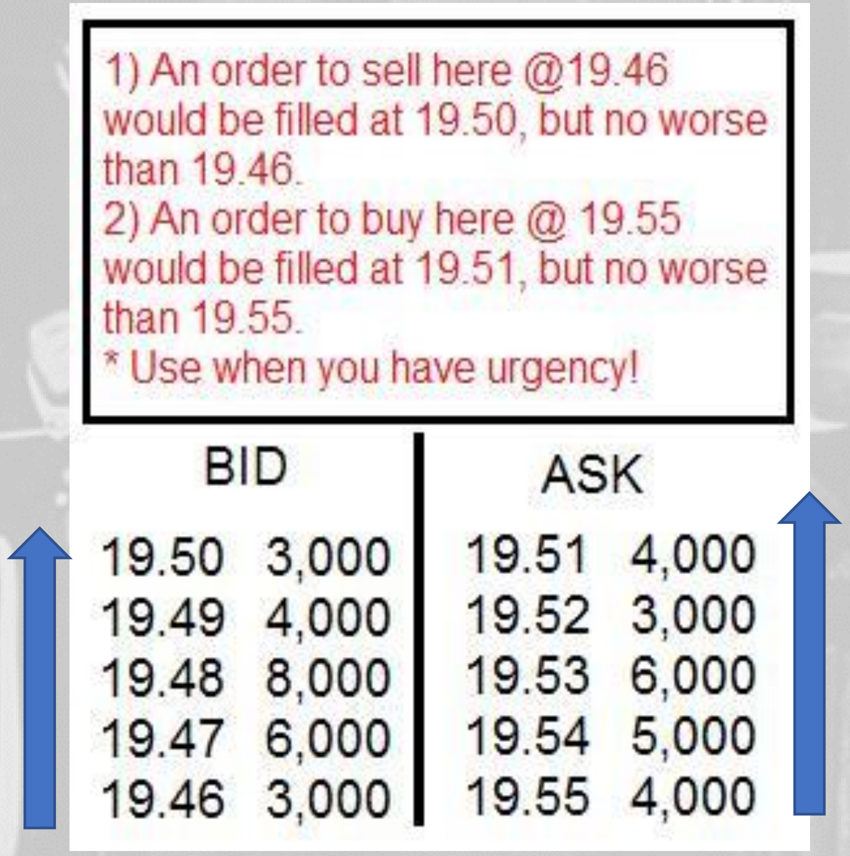
- Hybrid: is the next generation of the Direct+ execution. It is essentially the same functionality wise but has no restrictions.
- **** Hybrid executions have changed the responsibilities of the specialist dramatically (2007). Since the specialist now has unlimited exposure for his quotes, it has affected a traders ability to get a consistent, quality limit order fill from his open book quotes.
- The reason for this is that the liquidity is removed much quicker than before. It is hard for the specialist to keep up.
- Most specialist Open Books are now monitored by computer algorithms, The majority of intra day quote management is done by machines.

Placing orders in NASDAQ stocks

- Direct Access traders can place orders for NASDAQ stocks by using an ECN or Super-montage.
- Super-montage is the next generation of SOES executions. It is a method of executing a trade against a market makers quote. (sell at the bid, buy at the ask. An active order.)
- The routing fees for ECN’s when trading NASDAQ stocks are all very similar, we recommend you take advantage of the tremendous liquidity on the ECN’s ARCA, EDGX or NASDAQ
- *SOES= small order execution system

The buy limit and sell limit. Important orders to learn for getting tough fills.

- ***Used in place of market orders.***
- Intention is to take advantage of liquidity and get price improvement.
- Helps get filled in “fast market” conditions, but cannot get a worse fill than the limit price entered (as is possible with a market order).
- An active buy limit placed **above** the current best offer will price improve to the best available shares for sale
- An active sell limit placed **below** the current best bid will price improve to the best available shares to buy.



routing clues from Level 2

- Level 2 quotes can provide us with valuable information to help get the best fills.
- **The main question we need to ask before we route an order is this: Do I need to get filled immediately?**
- This has implications on two levels:

1. The less urgent you are, the better the price you will get AND the lower the cost for the trade. (because you advertised your price)
2. The more urgency you have, the more you will need to pay attention to WHERE you will route your order. You will be looking for liquidity. (because you paid someone elses price)

Making a routing choice: less urgency

- Less Urgency: (long: selling stock you own)

1. If you are in a profitable trade you can advertise to sell on the offer and get the best price available.
2. If you advertise on the offer to sell stock because you believe you have a very good chance to get filled (the momentum is in your favor), **you should use an ECN** to do so.
3. You will get a rebate from the ECN which will reduce your commission cost.
4. In the previous example you would be advertising to sell on the ask @ 17.34, adding liquidity to the offer.

Making a routing choice from Level 2 information: *Urgency*

- **Urgency!** (long: selling stock you own *or* taking a loss)

1. If you are in a trade that you need to exit quickly you will sell your stock actively to traders advertising to buy on the bid. This is called “hitting the bid” in trader talk.

- When you need to exit a trade quickly, Level 2 will help you decide WHERE to route your order. When you need to be active, you want to choose the routing destination that has the MOST shares quoted.
- To take this one step further, when you become more skilled at reading the tape, you will choose the destination that is the cheapest for you to do so.
- In the previous example, you would be hitting the bid @17.33

Direct access recap

- You have the choice to route your order to a particular destination.
- Level 2 shows us where liquidity is or where it isn't.

a. You want more liquidity when you need to be active. (Level 2)

b. You want less liquidity when you are going to advertise. (L2)

c. You want momentum in your favor and the busier destination when you are going to advertise. (you will see this in time and sales)

d. A skilled direct access trader can reduce his or her costs by thousands of dollars a month simply by properly routing to ECN's.

e. You should always negotiate a deal that allows you to take advantage of those pass through fees offered by the ECN's.