The Order Flow Method

THE ART OF TAPE READING

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Active Trading Masters Program:
How to Trade with Conviction

<u>Part Four:</u>
Trading Strategy

The
Trading Plan

Money Management
& Risk Management

Searching for Trade Ideas
& the Game Plan

Assessing and Applying
Probability
Risk & Reward

Recap: Path to a Trading Plan

Entries
Trade Management
Exits

Trend Lines
Moving Averages
Candlesticks

Multiple Time Frames:
Getting in Sync
Assessing Potential

Institutional
Supply Or Demand
Is Order Flow

Accumulation or Distribution
are Periods of
Consolidation with Volume

Mark Up or Mark Down are
Trends with
Light Volume Pauses

….For Developing Your Trading Plan

- Price action phases within Institutional Order Flow occur in all time frames (mark-up, mark-down, accumulation, distribution).
- To make the high probability trade you ***must choose:***

✓ *Which time frames of order flow and trend will be your universe.*

✓ *A singular method to identify opportunities (trend lines, moving averages or candlesticks).*

- ***<u>Order flow</u>*** and ***<u>trend</u>*** are generally the two higher time frames above your ***<u>entry</u>*** time frame.
- To trade with conviction you must choose how you plan to win.

Trading Plan: Strategic Choices

Combination of:

Conditions that match your concept, entries, exits and money management parameters

Strategic Elements

- Strategy points you in the right direction, the “real” reason to be in a trade.
- Set of rules and conditions that will get you in and out of the market.
- Conditions define your edge.
- Two sets of conditions: Idea generator, entry and exit scenarios (exits imply profit taking and or loss).
- Takes into consideration market/stock criteria.
- Takes into consideration potential risk reward in relation to objectives and resources.

entries

- Volatility breakout, consolidation or trend reversal.
- Time based, chart based, volatility based.
- Chart based patterns: flag, channel breakout, significant chart level, wedge pattern, 1-2-3, moving average crossover, test of support or resistance.
- *** must be very specific, not necessary to use all of them, know which ones you are comfortable trading (this includes considering initial risk).

Exits: trade management

- Initial stop loss: must be based on an acceptable dollar amount and volatility…
- ** How to determine dollar amount?
- Break even: when do you move initial stop to break even?
- Adding to trades: How do you know you should build a position and when would you do it?
- ** this will all be documented and monitored in your game plan.

Stops and idea validation

- Re entry will be significant for shorter term ideas
- Wider stops for bigger targets (think swing trading or choosing to trade stocks that have a larger range)
- How will you determine if a trade idea is still valid if you get stopped out for a loss? What would make you reenter the same position?

➢ Analysis tools to validate an idea:

❑ General market, market internals, sector, industry, your stock.

❑ Order flow, your traded trend, multiple time frame analysis.

- Are will you willing and ready to make the same trade multiple times taking small losses until it pays off?
- ** when you get to this stage you have confirmed a belief in the probabilities of your edge and your ability to follow your plan!

Profitable exit considerations

- Two types: (very different thought processes!

1. Exit into momentum scaling out and trading around a core position. (more active)
2. Trailing a winning position and exiting on a predetermined pull back (less active requires patients for both setups and giving the trade time to play out)
3. Trailing a winning position will create larger draw downs but bigger winners (must mentally be OK with this).
4. ** A “draw down” occurs when profits in an open trade diminishes.

Choosing time frames: deciding where you can win

- Generally speaking:

✓ Swing traders will monitor the monthly and weekly charts and time on the daily (and possibly the 60 min depending on goals).

✓ *Active Traders who plan to hold trades intra day to 2 days operate on the weekly and daily charts and time on the intra day.*

➢ *If the monthly is in sync with your idea this gives you more conviction.*

✓ Short-term intra day momentum or scalping type trading plans should use the daily, hourly and enter on lower time frames.

- It is imperative you choose the time frames that matter to you or you will hesitate and mix trade management goals.
- Moving from intra day position trader to intra day scalper back to position trader is extremely difficult to do.
- Choose your playing field and dominate it.

Choosing how you plan to identify opportunity

- Trend Lines:

✓ Easy to identify order flow & trends

✓ Keeps you grounded and engaged in price action

✓ Can be time consuming to use

- Moving Averages:

✓ Easy to use: 5ema, 20sma, 50sma

✓ Multiple applications for trends, strength of trend, entry and exit triggers, potential support and resistance

✓ Multiple types- exponential vs. simple

✓ Worthless in non-trending markets

✓ Tend to be lagging indicators

- Candlesticks:

✓ Simple set up

✓ Easy to recognize opportunity

✓ Always in tune with the most current price action

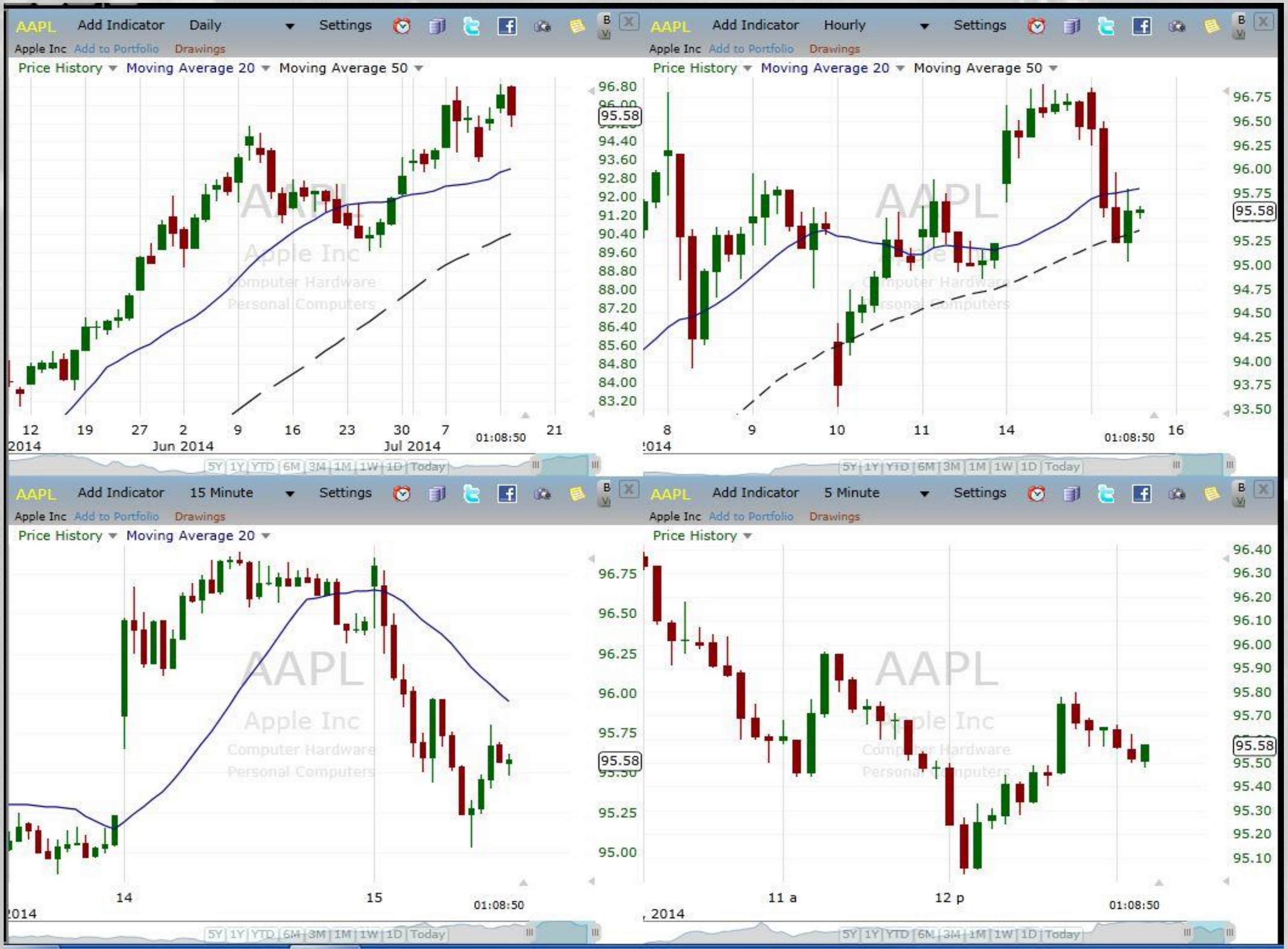
✓ Reduces monitor real estate

✓ Actual price points vs. subjective

Trend Lines in MTFA

20 SMA in MTFA

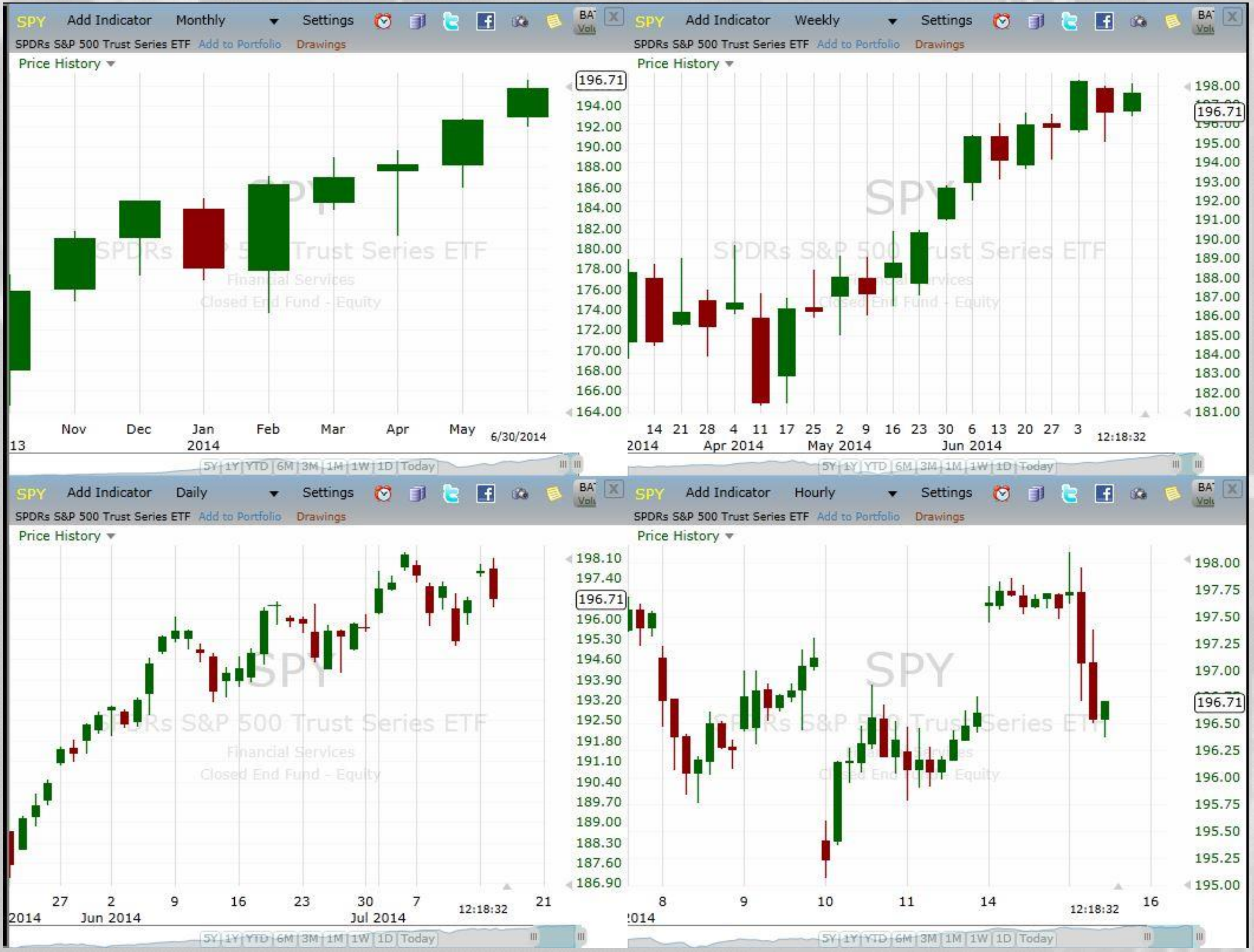
20 & 50 SMA in MTFA



Candles:

well-bid
well-offered
targets
inside candles
entries
exits

in multiple
time frames



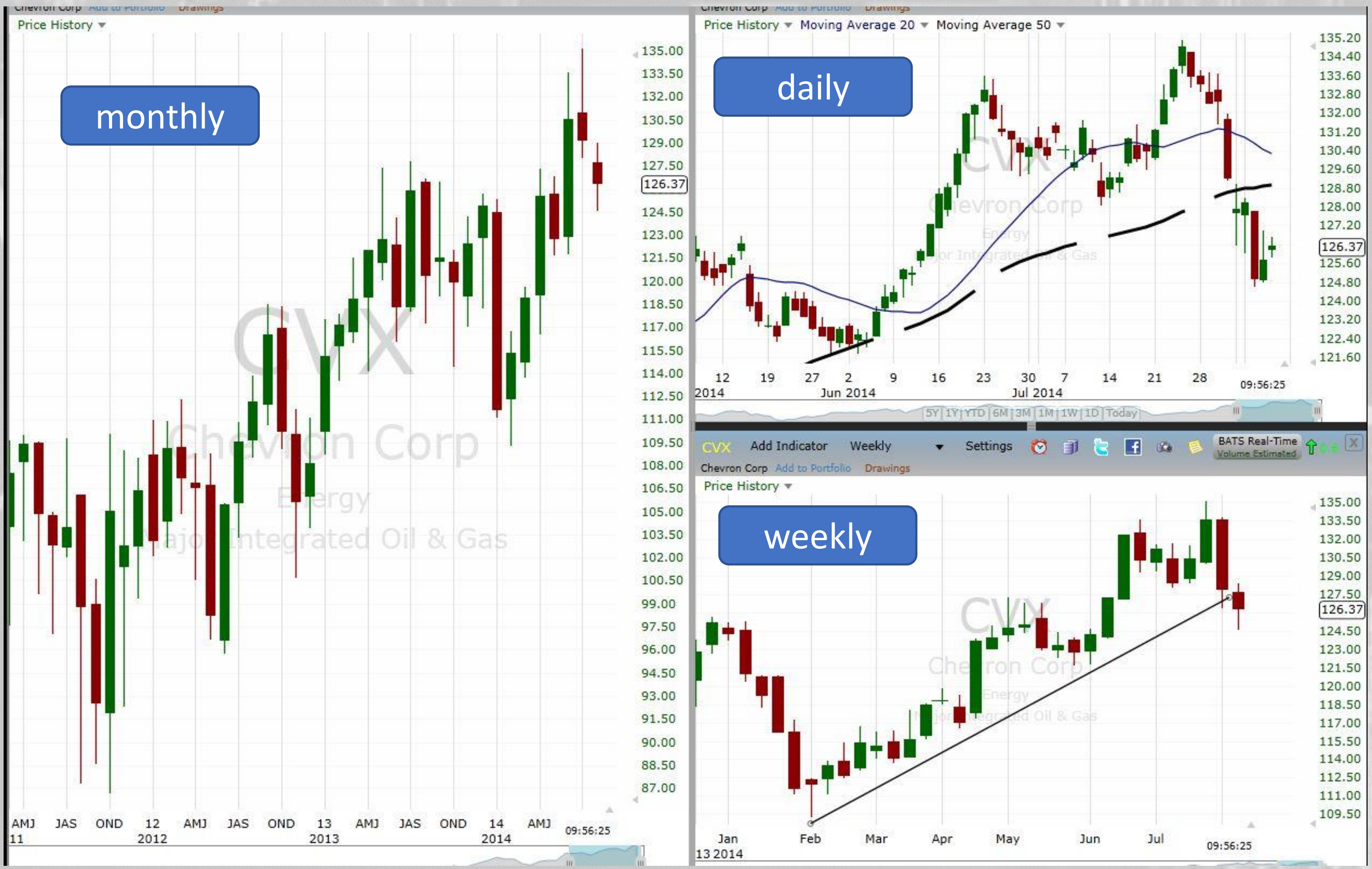
CVX

Using all three analysis tools

candles

moving averages

trend lines



Complete multiple time frame set up

What do you plan to do when your order flow and trend is *different?*

- Your "A+" ***trade set ups*** are when order flow and trends are in sync in multiple time frames
- Your ***best trades*** will be when your lower time frames offer an acceptable risk for potential profits in the direction of a clear order flow and trend on the higher time frames

✓Do you stay away until an entry triggers in your chosen time frames?

✓Do you drop to lower time frames for a new trend?

✓MENTOR ADVICE: It will be very tempting to switch to lower time frames, I would avoid doing it until you have mastered decision making skills and are consistently profitable on your A+ set ups

- How to be ***profitably patient***
- Plan to reset your trading edge every 60 minutes
- Do not look for entries on the 5 or 15 until the hourly candle resets to match order flow and trend

In case you are new to trading and do not have the experience to grasp the enormity of the previous page…

I promise you the strategy you just learned is million dollar advice…

Go back one page, replay the video and take good notes…

The Trading Plan

Giving Structure to Your Strategy and Risk Guidelines

Core Trading Plan Concepts

- The trading plan is a set of rules of when to exit and enter trades.
- Also includes how much capital will be at risk per trade and proper share size for the idea based on the entry and stop loss parameters.
- Most consider a trading plan to be the business plan for a trader.
- Keeps you focused on only those opportunities that match your strategy (as opposed to making random trades).
- Gives you a clear reason for each trade.
- Outlines your money management plan.
- **The reason most traders do not write a plan is they don’t want to commit to a strategy. They want to trade everything.

Two basic elements of the trading plan

Trading System: defines your edge

- Criteria for stock selection
- Scenarios that you believe to be high-probability based on your strategy
- Outlines entry and exit signals
- Stop-loss placement
- Profit targets

Money Management: defines risk

- Risk levels
- Position sizing
- Number of positions and how to allocate capital per position
- Trading style will dictate trade management (scalp, momentum, position trading)

How to Benefit From Your Trading Plan

- Build a plan that allows you to focus on your strengths
- Helps you ***avoid emotional and spur of the moment decisions***
- Allows for risk taking consistency with criteria that matches the market conditions with your current capital and risk profile
- Set exact guidelines for when to avoid being in the market
- Set exact scheduling for when you plan to coordinate your Game Plan and when you plan to review your trading performance
- Create a plan with the fictional intention of raising money from your oldest relatives who need the money to live.

Why most trading plans end up not being followed…

The majority of traders attempt to trade ***all*** strategies, scenarios and market conditions ***with limited resources and experience.***

There is no focus on an edge,
effectively rendering a plan worthless.

Outlining Your Trading Plan

- ❑How do you define your edge, what is your system?
- ❑How will you define profit and loss targets?
- ❑Which time frames matter to your edge?
- ❑Which entry signals will you look for? (difficult to expect to use all of them)
- ❑How do you identify your "A+" trades and how will you trade them differently?
- ❑How does your edge factor into trade management? (trade duration)
- ❑What are your money management parameters?
- ❑Will you trade both long and short?
- ❑What is your criteria for stock scanning?
- ❑What is your max loss per day or trade?
- ❑How many positions will you manage at once max?

Outlining Your Trading Plan 2

- ❑Do you plan to carry over-night positions?
- ❑How do you plan to manage winning trades? SMA cross-over, book profits after a certain dollar amount, hold to the close, hold to your profit target, hold until higher-time frame stochastic is at an extreme.
- ❑What time of day are you planning to review the day and journal?
- ❑What time of day do you plan to create your Game Plan and run your scans?
- ❑Do you plan to run new scans intra-day or do you plan to only trade the ideas you had coming into the day?
- ❑Do you plan to trade the news?
- ❑How will you route your orders for maximum efficiency; both for getting shares and for reducing costs by using ECN’s?

Start Here: gather your resources

- Time: training, planning, trading, review, continuing education and networking, projections for personal financial responsibilities and available cash
- Capital: risk capital in relation to funding your account and living expenses
- Current education: Books, courses, seminars, online course, chat rooms
- Future education: How will you improve? FIND a MENTOR.
- Current experience: real world (how much did you journal and learn from your own personal trading experience)

How to honestly assess your resources

1. Time: How much time can you devote to active trading?________________

2. Capital: Risk $_____ living expenses $_____

3. Do you have enough to live and trade?

4. Current skill level based on your training, experience and *results* up to this point: 1= newbie 10 = trading master #____

5. Trading Plan: is it detailed enough that you could hand it to someone and raise money?

When it will start to click for you…

- Finally learned trade management is more important than trade entry (can work entries in a good idea)
- Finally learned trading is NOT about being right on a trade by trade basis, *but over many good ideas and NOT putting too much emphasis on individual trade results*
- Finally understanding how to learn from my winners and build a <u>trade expectation</u>
- Finally understanding consistency comes from clearly defining my strategy, and flawless performance executing my strategy
- Results come from flawless performance which I can control, I can’t control or predict the next move (powerful concept to remember)
- It is profitable to sit out conditions that don’t match my edge

Self Analysis

1) How would you rate your market knowledge?

2) How would you rate your trading knowledge?

- How will you improve both of the above?

1) What are your psychological strengths and weaknesses in relation to developing your trading system? (specific to your Concept)

2) What strengths and weaknesses in terms of personal discipline that you will bring to your trading.

3) Do you have emotional or financial issues that may affect your ability to focus or trade effectively or follow your plan?

- If yes, how will you address this situation?

Understanding Key Trading Concepts And Markets

Clarifying your goals and objectives

before you begin writing your trading plan

Thinking strategically

- Define your passions:
- What part of trading do you love?
- What do you love to learn/find fascinating when trading?
- What style do you “think” you want to trade? (very often this is different from what you think after you do some planning)
- What skills are needed to succeed at this?
- How do you plan to improve the skills you already have?
- How do you plan to develop the skills you don’t have?

Defining your trading goals and objectives

- How much money do you have personally?
- How much can you afford to invest in your trading business? This includes capital to trade and living expenses.
- How much money do you need to earn each year? Do you need to earn all of that from trading?
- What if you don't make enough from trading to live off of?
- What are your contingency plans and when will you take action on this?
- How much do you expect to make as a percentage of your trading capital? (prop traders as well)
- What risk level are you willing to accept to achieve that?
- What is the largest drawdown you are willing to accept on a daily, weekly and monthly basis?
- How will you know your plan is working or not working? Who can you ask for advise or mentoring?

Money management

Defining your risk for each trade and managing leverage.

Discovering that preservation of capital is your first priority

Keys to the treasure chest

- Simply put:

1. Money management is how much capital you are going to put at risk for each trade.
2. Risk management is how you will put that capital to work regarding trade management and share size. (this is your trading plan)

- Good trading creates income, **good trading with proper money management creates wealth**

Definitions

- ***<u>Money Management:</u>*** Is the proper use of capital. How much of your account equity will be at risk on the next trade.
- Takes into consideration trade probability and the value of your entire account.
- ***<u>Risk Management:</u>*** Taking small losses and managing the rewards in relation to the potential risk.
- Entry point: setups that get you into the market based on your structure of price action.
- Exit point: Planned price objectives and price action scenarios that will dictate immediate action. These exits are stop loss areas and profit targets.
- Share size for initial trade entry will be determined by above before the trade

Money Management Formula

- Proper money management is the foundation for long term profitable trading.
- *It is one of the few components of a trading plan that the trader has complete control over.*
- A good money management formula will teach you to determine a dollar amount to risk.
- This dollar amount must be a number you are comfortable placing at risk for each trade.

Being prepared to accept risk.

- There is a very important reason for your need to accept this dollar amount before the trade.
- If the trade should happen to **not** be a winning trade and you need to execute a stop loss, you will execute it flawlessly because you have already accepted the risk. **The dollar amount.**
- In other words, “if this trade moves against me, I am okay with losing or risking $X because of the potential profit.”
- Most traders turn small losses into big losses because they are not prepared mentally to exit a trade that is not working. They are only ready to book a profit!

The 2 % Formula:
calculating risk amount and position size

- No more than 2% of your equity should be lost on any individual trade.
- Note this does **not** mean only 2% of your equity should be allocated to a trade. It means no more than 2% should be at risk on any one position.
- Note we are talking about your equity here (cash), not your buying power.
- The 2% Principle limits trader losses, preserves capital and gives the trader a definite dollar amount at risk, based on account size, before entering a trade.
- You can adjust this up or down depending on your personal risk tolerance.

The 2% calculation and determining share size

1. Multiply equity balance x 2%. This will give you maximum dollar risk per trade.
2. Determine the difference between your stop loss point from entry price.
3. Calculate position size:

- Maximum dollar risk per trade divided by the difference between the entry price and stop loss point.
- The beauty and simplicity of this method is that it completely neutralizes the volatility of expensive stocks that can move quickly.
- Whether you are trading a $15 stock or a $150 stock it doesn’t matter! You are risking the same dollar amount, the risk amount and stop loss will tell you how many shares.

share size calculation

Position size =

[2% of equity balance /(entry price – stop loss point)]

- For example:

1. Equity balance = $5,000. 2% x $5,000 = $100
2. Entry price =$20.20, stop loss = $20. This is a .20 difference.
3. $100 / .20 = 500 shares for this position.

Average dollar profit per trade

- As you **gain experience** and a track record you will have a better idea of how much profit you “usually” earn on winning trades on average.
- When you reach this level of experience you will risk a certain amount based on your average profit per trade.
- Most professional traders are willing to risk on a trade what they feel they can make relative to their history.
- After trading for several months, you should calculate your average cost to trade, including software, losses, subscriptions and such so you know to the dime what it costs to run your trading business. (quarterly is usually a good reference)

Successful Money Management

- Starts with knowing your probabilities inside and out. It's more than simply calculating a number to risk.
- You must accept the fact that some trades simply have higher odds of making money… and then earn more on those ideas.
- Professional traders know when the odds are in their favor and will allocate MORE when the odds get better.
- Identifying these conditions in your strategy is a must goal.
- If the odds are not good, you should not risk the same amount if you should risk anything at all.
- #1 Goal after strategy and edge: How to assess risk in relation to potential reward and make trades accordingly.

How Mindset Affects Money Management

- Professional traders don’t mind losing, they understand it’s a part of the process.
- For you to accept this concept you must always remember you are making one trade of many that allows your edge to play out over time.
- The proper mindset is “I want to trade my edge as often as possible.”
- Your edge has a better chance of producing for you over 100 trades than it does over 10. As long as your money and trade management is focused on probabilities and preserving capital.
- You should never mind one losing trade because if you stick to your rules you will make it back over a large sample of “good trades well managed.”

Money Management and Mindset Continued

- Making the right trade over time is more important than making money each trade.
- It is impossible to make money on every trade and it is also not necessary to earn consistent money.
- Taking accepted losses for a few trades in a row is good trading. You are preserving capital and allowing the odds of your edge to have a larger sample size to work.
- Holding losing trades, cutting profits short and not trading bigger when the odds are better are your primary obstacles to overcome.
- To conquer them it all boils down to believing in probabilities.

Obstacles to Successful Money Management

- The biggest obstacle unprofitable traders need to climb is placing too much emphasis on the results of each trade.

➢Most do this for two reasons:

✓You need money immediately. (money countdown clock is ticking)

✓You have gigantic ego and you expect to always be right.

➢Good traders:

1) Manage risk trade by trade but
2) Set up each trade based probabilities of profit
3) Focus on the probabilities of their edge over time

How a Belief in Probabilities Makes You Better

Start with the context of "A large sample of high-probability trades managed well= long-term success."

Large Sample:
This removes the pressure of each trade needing to make money.

High-Probability Trades:
You believe your edge works more often than not and you only take those trades.

Managed Well:
Proper risk and leverage managed well based on probability.

When you believe in your edge over time and in your ability to trade *only* those ideas and manage risk, profitable trading is a matter of sample size and not individual trade results.

This means you will realize, to make more you need to trade your edge as often as possible to allow the probabilities to do their work.

For active traders, learning to trade multiple positons is a must to make this happen.

How this Concept Will Affect Each Trade

- When you trade from a point of view, that each trade is simply one of many for this year, you will never hesitate entering the next trade nor will you hesitate taking a pre determined loss.
- This is because you are trading the probabilities, not this outcome.
- Why would you hesitate entering?
- Because you aren’t 100% sure this trade will “work.” You don’t want to lose money on this trade. Instead your mindset should be: “each trade with an edge must be executed flawlessly to allow my edge to work over time.”
- Why would you hesitate taking a loss?
- Because you never accepted the dollar amount risk as a cost of doing business and now are trading your opinion.

How do You Know You Believe in Your Edge?

- ***Secret answer that you must watch the video for!***

- "I believe in my edge completely when I _____________ to trade my ________without hesitation despite the ______________ of my most recent trades…"
- "It is more ______________ to know what I am______ to do _______, than it is to know ________ is ________ to ________ next…"

How do You Know You Believe in Your Edge?

- ***Secret answer that you must watch the video for!***

- “I believe in my edge completely when I continue to trade my strategy without hesitation despite the results of my most recent trades…”
- “It is more important to know what I am going to do next, than it is to know what is going to happen next…”

The Game Plan

Identifies which stocks and markets fit the criteria of your concept and determines how you will trade them

Game Plan thought process

- Goal is to be prepared, not reacting
- Look for ideas during NON market hours.
- **Have a DEFINITE idea if the best Game Plan is to be a buyer or seller today (do not switch back and forth).
- Market hours should be for executing well thought out ideas, exploiting your edge Scenarios from your Trading Plan.
- Plan your contingencies, trade review and risk management.

Big Picture Outline of Game Plan Workflow

Time Frames:
- ❑Monthly
- ❑Weekly
- ❑Daily

Market:
- ❑SPY
- ❑DJIA
- ❑NASDAQ

Sectors:
Basic materials, Conglomerates
Consumer goods, Financial
Healthcare, Industrial Goods
Services, Technology
Utilities

- ❑Industries
- ❑Sub groups within those industries

- ❑Leaders within those industries and sub groups
- ❑Volume and intraday "trade-ability"

- ❑Order Flow
- ❑Significant levels
- ❑Probability
- ❑Best idea

Game Plan Choices: Choosing Stocks to Trade

1) Top-down Analysis: Market, sectors, industries then choosing leading stocks from industries trading in sync with the market
2) Technical Scanning: Scan all stocks for technical patterns and criteria with no parameters to market correlation
3) Personal Universe-then technical scanning
4) News Plays: Earnings, upgrades, downgrades, FDA announcements, unexpected C-level news, interest rate changes, etc

- ** All trades should always have a pre-scan filter for volume and volatility to match your resources

Top Down Analysis Sequence

Market Review

- Scan the major indices (Dow Industrials, NASDAQ and S&P500) using MTFA
- Is the overall market in an uptrend, downtrend or no trend?
- Where are they in relation to the 50SMA and 200 SMA on the daily charts? This will clue us into a longer term bullish or bearish bias.
- Is there confirmation or divergence on the daily charts?
- How is today's volume? Does recent price action and volume indicate accumulation, distribution or continuation?

Sector Scanning

- Scan major sectors or industry for obvious MTFA set ups: Trend or Pause?
- Identify the liquid stocks in those sectors and make note if they are similar to the sector chart. These stocks will go in your list for tomorrow.
- Which sectors were the strongest or weakest today?
- Which sectors have been the strongest or weakest this week? This month? This Quarter?
- Are they setting up a trade for tomorrow? A test, a flag, consolidation, or candlestick entry signal?

A Note on Relative Strength Plays

- Relative strength refers to whether or not your stock is trading in sync with the market.
- In some cases it could mean the industry as well but generally it means the general market.
- It's a well-known fact that a rising tide lifts all boats and the same is with the market. You can *expect* to get better follow through.
- When you do your game plan or are trading make note of which stocks are in sync and plan to trade those with a higher expectation.
- Make note of stocks NOT rallying when the market goes higher and plan to short-sell those if and when the market reverses.
- These stocks *already* have a supply bias and should sell harder to the downside. It is not the best idea to short-sell strong stocks.

Game plan components

- Which stocks meet the criteria and offer profit potential based on your Trading Plan
- Ask: “is it a good idea? Is it a good idea now?”
- Define YOUR possible entry scenarios
- Define all possible trade management scenarios (higher open, lower open, flat open and what you will do)
- Define all significant levels to trade around
- Define loss targets and stop targets

Additional Game Planning considerations

- Is this a good idea right now? What would make it a great idea?
- Has volatility changed? How do I know this? How do I plan for that?
- What Macro news do I need to know?
- What sector related news do I need to know?
- How did the market trade over night?
- Where do I expect the market to open today?
- What do I Plan to do if it does or does not open as I planned?

Trade Scenarios: *examples* of ideas for your next trading day

- I will buy a test of the two day low in the morning. I expect this to be support.
- The stock has been up four consecutive days and is coming into resistance. I will sell short if the resistance holds on the open.
- Volume breakout from consolidation today, I will expect follow through tomorrow.
- A melted candle formed in this stock today after a three day pullback, I will trade it long above the opening range tomorrow.
- Relative strength play: I will look to short these stocks tomorrow if a weak market or buy these if a strong market tomorrow.

Potential Trade Scenarios to Game Plan

- Swing high: down trending day tomorrow
- Swing low: up trend day tomorrow
- Melted candle: indecision at the end of a 5 candle momentum move. Look for better opportunity.
- Bullish U-turn: up trend day tomorrow
- Bearish U-turn: down trend day tomorrow
- Inside Day: break out or break down of yesterdays trading range
- 20 day break out or break down. If it is a “real” break, you should see light volume pauses leading to a continuation of the breakout direction. If you do not see this by 9:45-10am, expect a U-Turn type of day and many traders caught on the wrong side of the break out or breakdown.

Key support and resistance levels to monitor

- Test of opening range high or low
- Test of today’s high or low
- Test of yesterday’s high or low
- Test of high or low for the week
- Test of 20 day high or low
- Test of any other significant support or resistance level on the daily charts.

Game Plan Management: Intraday

- The CORE CONCEPT here is to NOT look for trading ideas during the day. Do not trade against an obvious order flow or trend until you have a track record of earning money…
- How do you define and assess profit potential?
- What specifically does it look like to you.
- Match your risk to your ideas to patterns that will allow you to trade the stock without stress.
- Are you OK with doing nothing?
- How will you know to adjust risk up or down?
- Will you program exits or trade with discretion?

Assessing Probability and Managing Trades

- "Better" trade ideas warrant more attention and capital, learn to identify them.
- You must learn to translate your game plan into well-executed ideas.
- Developing this skill is crucial to position yourself for long-term success. Have great ideas before the market opens is not the same as making money with them.
- *In the following video we are going to translate a game plan into actual trade management drills so you can learn the steps to repeat your success.*

How to convert a game plan into actual trade management and thought process…

Game Plan Video