

Layer This!!

As a trader you wake up every morning pondering which direction is the market going to move today. The weather looks beautiful everyone on CNBC has a smile on their face so this must be a bullish day. And then the rain starts to fall something happened overseas and the market starts a decline. Nearing the end of the trading day there is a late rally and you find the market close exactly where it opened making it a flat for the day. Many traders do not have the emotional strength to handle Day Trading because of the wild swings and mood changes that the stock market faces on an hourly basis so they decide one of two choices. A. They will let somebody more seasoned than themselves with far more resources trade their money, or B. They will trade long term approaches because historically the market has always gone up over the long haul. While many people understand that the market has pullbacks or turns bearish for months or even years it historically always goes back up. The only problem is what if these pullbacks happen when you need to retire and start pulling out of the funds you took a lifetime to build. During 2001-2003 that is exactly what happened. A devastating market that was made worse by the attacks on Sept 11th left many would-be retirees working into their golden years to make back and capture some of the losses in this time frame. And yes the market did rebound and even make higher highs but that was only for those people who had the stomach to stay in the marketplace and capture those profits. There were a lot more stories of those individuals who rode the ship down and couldn't stomach the losses anymore and decided at the worst possible moment to go into bonds or cash and they missed the entire upswing of the market.

What if there was a 3rd option, one that would allow a trader to sleep at night, a method that regardless of what the market did the trader could smile and know they were protected and that they were indeed making money somewhere regardless of market direction.

A Seasoned trader will trade not only multiple strategies, but multiple directions at the same time. Since the market doesn't always go up a trader should always have on bearish positions, or stock positions that will capture a profit in a declining market, bullish positions or trades that will profit in an up trending market and a sideways position for those times when the market seems to be stuck in a sideways moving pattern like it was for most of the summer of 2007 and well into November.

By establishing strategies for all three directions a trader has ensured themselves that regardless of market sentiment they are profiting somewhere in their portfolio and can then turn their trading into trade management to maximize their profit and minimize their losses.

I know for many traders the thought of making money in a bearish market doesn't seem natural or it is just too confusing to attempt. In fact about 95% of traders only trade the bullish side of the market and miss the entire opportunity to trade in a declining marketplace. Let's walk through the mechanics of how to profit in a bearish market. Let's assume you were looking at Microsoft and your analysis told you that for an extended period of time you thought Microsoft was going to decline in value. If you only traded the

market in the bullish direction then you could simply sell your shares of Microsoft so you do not lose any profits however you are then on the sideline waiting for a bullish sentiment to re-enter. As an experienced trader you have more choices and could place what is called a short sell of the Microsoft stock. Let's assume that Microsoft is at \$30.00 in value and your analysis told you it was going down to \$23.00. A short order on Microsoft would allow you to borrow the stock from your brokerage firm with a promise to repay back the stock sometime in the future, you could then go out and sell the stock on the open market and take in a credit of \$30.00 a share. There is no time frame that you have to repay back the stock to your brokerage firm however they are charging you a monthly interest rate for allowing you to short sell the stock. Let's say that 3 months later Microsoft is now valued at the \$23.00 a share that your analysis said it had a high probability of reaching and you went back into the open market and purchased enough Microsoft to repay back your borrowed shares from your brokerage firm. The net difference is that you sold something for \$30.00 and received a credit, later in the future you bought back what you sold for a lower value of \$23.00 leaving you with a \$7.00 dollar profit. While this is a different way of thinking for most retail traders this is exactly what institutional traders are doing to profit in a declining marketplace.

Trading a sideways market is the third and final direction that the market can move. Profiting in a sideways market can be accomplished using option and stock strategies. A great strategy for traders to utilize is a strategy called covered calls. This is a strategy that uses the stock you may already know and you rent it out to others on a monthly basis to bring in a revenue stream in times when the market moves sideways.

If you were a speculator that invested in a stock that was trading at in a range from \$35-\$40 dollars a share that is currently trading at \$37.50. Since you own the stock you have the ability to rent out the option to someone else to purchase the stock at \$40.00. For every 100 shares of stock you own, you have the right to sell a call option to someone else to have the right to buy the stock at \$40 a share for a predetermined price. Using the previous example if you were to sell a call option to someone else for \$200 dollars for them to have the right to purchase your stock for \$40 dollars. If your stock increases above \$40 dollars a share your stock will be called away from you but only after you profit as your stock goes from \$37.50 to \$40.00 or a profit of \$250.00 plus the \$200 dollars you sold the call option for, leaving you with a \$450.00 profit.

If your stock moves sideways for a month and closes at \$37.50 you did not realize any profits on your stock but you did make \$200.00 dollars for renting your stock out for a month.

If your stock goes down to \$35.00 a share you will lose \$250.00 on your stock but the \$200.00 you brought in for renting out your stock minimized the loss leaving you with a net loss of \$50.00.

Since we cannot predetermine where a stock will be in 30 days often times selling a call option against the stock we own can minimize our losses and can allow us to profit regardless of where the stock moves.

Once you have the knowledge and the ability to profit from the marketplace regardless of which direction the market moves you can begin to build your trading plan which should

include a percentage of each of these trading directions so that regardless of which direction the market breaks out your making money somewhere and you are then managing the rest of your open positions. This will truly put your trading in a higher probability and will also protect you in the even that the market does something unforeseen.