Brainy's Articles on

Share Trading**

Trading Styles, Plans and Strategies

Introduction

Having decided to invest or trade in the share market, some people simply launch into it with only a little thought, planning and preparation (or perhaps not much at all). The old adage *"a failure to plan is a plan to fail"* is very appropriate here. A key part of the preferred planning process is to contemplate the particular investing (or trading) *style* to be adopted, and the content of an investing *plan*, as well as consideration of one or more *strategies*. [For simplicity in this Article, the terms *investor* and *investing* are often used interchangeably with *trader* and *trading*.]

This article in Brainy's series on Share Trading (number ST-2400) provides an introduction to the topic of share market *trading styles*, *trading plans* and *trading strategies*, with more details in the following Articles in this series:

- Article **ST-2410, *"Trading Styles (and the Styles Worksheet)";***
- Article **ST-2420, "*Trading Plans (and the Trading Plan Worksheet)";***
- Article **ST-2430, *"Trading Strategies (and Strategy Template)"***.

Why do I need this? Can't I just invest and be done with it?

Without giving some consideration to how much money to invest in particular shares, or how often to review the investments, or a possible exit strategy, it is possible to over-allocate funds to such an extent that a large amount of money is "at risk". It is the fear of exactly this that causes many people to not sleep well because they spend a lot of time worrying about their investments. If the market hits a rough patch, and the major market index falls, many people start to worry about whether they should take they money back — even for a loss. Many people will continue to hold losing investments in the mistaken belief that all stocks will eventually rise over the long term — even while a stock disappears into oblivion (and there were many of these during the GFC of 2008 and beyond).

Here is a simple example. Let's say that in 2007 you had $100,000 to invest in the share market, and you decided (for whatever reason) to invest a third of it equally in three big blue chip stocks like the following (and for simplicity we won't worry here about things like portfolio asset allocation):

- BHP Billiton (BHP) — a miner,
- Commonwealth Bank (CBA) — a big bank, and
- A property group like Centro Retail Group (CER).

This means that in early 2008 you had about $33,000 invested in each of these. At the time of writing, the share price performance of these three companies can be summarised in the following table:

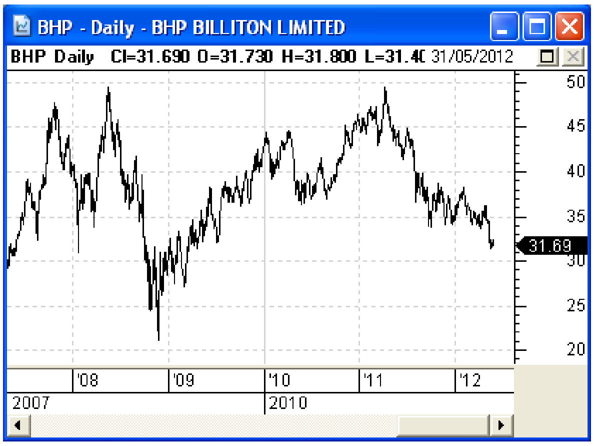
	At market peak 2007/2008			Lowest values 2008-2009		As at end May 2012	
	Share price	Qty for $30k	Value	Share price	Value	Share price	Value
BHP	$49.55	666	$33,000.30	$21.10	$14,052.60	$31.97	$21,292.02
CBA	$61.55	536	$32,990.80	$24.07	$12,901.52	$49.40	$26,478.40
CER	$2.03	16256	$32,999.68	$0.016	$260.10	$0.32	$5,201.92
TOTALS:			**$98,990.78**		**$27,214.22**		**$52,972.34**

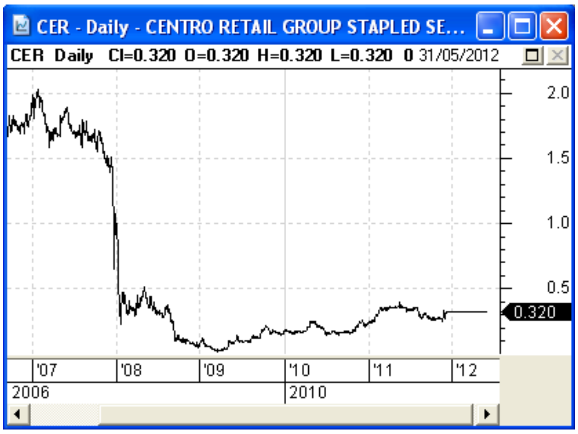
Now, you might argue that this example is not fair because the Global Financial Crisis (GFC) ruined the share price of many companies; but it is important to remember that a so-called financial crisis, and a bear market, come around once every 4 years or so, and the effects of a bear market usually last for many months. And a financial crisis as bad as this one does come around every 10 to 20 years. Some bear markets are very much worse than others — either in effect, or duration or both.

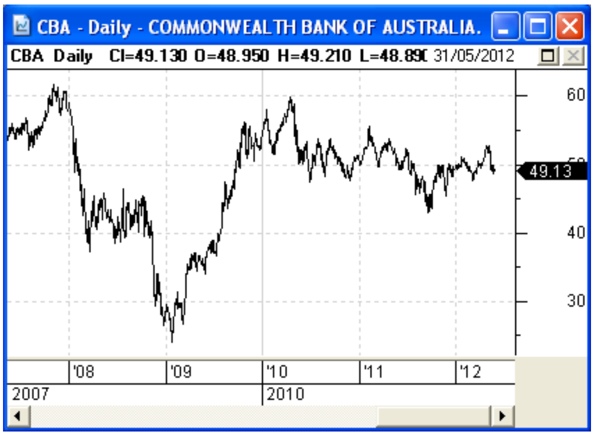
** - The two words *trading* and *investing* are often used somewhat interchangeably.

In the table above, note that the $100,000 of starting capital was only worth less than $53,000 more than 3 years later in May 2012. If you view the price charts of these three stocks over the time from 2007 to 2012 (at right), you can see that they suffered severe price hits, then clawed back some of their losses.

Except that CER's price (as in the chart below) crashed from above $1.50 to below 50 cents within a few weeks in the 2-month period December 2007 to January 2008. And then it never really recovered before being restructured more than 3 years later in December 2011.







In reality, a lot of retail investors get carried away with the emotion and hype of a raging bull market, and newcomers to the market buy in at the late stages when the astute professional investors are selling their over-priced stock to unsuspecting investors (in share market terminology this is called *distribution*). So this example is in fact a good one, and it is typical of what actually happens to retail investors who don't have some basic training or years of experience in the markets.

This example is representative of what happens to the investors who don't have strategies in place to manage and protect their investment capital. The sceptics amongst us will say that the professionals who tell us to stay invested for the long term are the same ones who will still profit from commissions even when the market goes backwards.

Risk and money management

With proper risk and money management strategies, it is possible to sleep at night, and it is possible to avoid the large losses that can affect retail investors. See more on this topic in other Articles in this series on Share Trading and Investing (in the Article number-range **ST-4xxx**).

Investing / trading styles

It is very helpful to understand the notion of investing/trading styles, and your own preferred and comfortable trading style. This includes considering the distinction between an *investor* and a *trader*. This is explained in detail in Article **ST-2410, *"Trading Styles and Styles Worksheet"***.

Do I really need a plan or strategy? — discretionary trading

Many of the experts in this field advocate that share market traders/investors should have a *trading strategy* — especially those who are just starting out. If an investor does not have a clear and concise strategy that is recorded on paper and back-tested for confidence, then the investor is probably trading in what we call a *discretionary manner*. If trading without a strategy, and without the experience to truly qualify as discretionary, then the trading manner might best be described as speculative, which is about as good as betting on the horses or the pokies.

For more information about discretionary trading, refer to the Article **ST-2410, *"Trading Styles and Styles Worksheet"***.

Trading / investing plan

When trading, it is very important to start out with a trading plan that is written down. It will describe things like:

- The investment objectives, and investment horizon.
- The funding arrangements (eg. cash, loan, margin loan, etc.).
- The preferred financial instrument, or multiple instruments (eg. equities, CFDs, warrants, options, futures, currencies, etc.).

The trading plan describes "what" you want to do and achieve at a high level. The *trading strategy* outlined below is more of the "how" you will go about it. For more information on *trading plans*, refer to Article **ST-2420, "*Trading Plans (and the Trading Plan Worksheet)".***

Trading / investing strategies

Definition: "a predetermined set of rules for making trading decisions".

Once your trading plan is defined, then it is important to record how you will go about implementing the plan. In its simplest form, a *trading strategy* comprises a set of rules or decisions that describe the circumstances that will trigger you to place a buy order, and the conditions for a sell order. Your total trading strategy might include just one set of buy/sell rules, or it might include several.

The key elements of a trading strategy include the following:

- Stock selection method / criteria — A description of how you will find stocks that are candidates for purchase.
- Entry criteria — A description of the criteria you will use to decide whether to make the purchase or not.
- Exit criteria — A description of the criteria you will use to decide when to sell the stock (eg. a target price increase, or a specific price point, or a percentage, etc.).
- Stop loss / profit levels — The point at which you will sell if the stock does not behave as expected.
- Money management strategy, position sizing and risk management — The various strategies you will use to determine how much money to commit to a particular stock purchase, and how to divide up your available capital across a number of stock positions. Also, the strategies to employ to safeguard your capital and minimise any losses.

For more information on *trading strategies*, refer to Article **ST-2430, *"Trading Strategies (and Strategy Template)".***

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Back testing for success

It is important to test out your trading strategy before putting it into practice. You can do this and gain confidence in your strategy with back testing. Back testing can be done in a number of ways, including:

- By manually viewing price charts for conditions meeting your trading criteria, and noting the hypothetical results that would have been achieved.
- By using charting software with "scanning" capability to scan a watchlist or group of stocks for those that meet your criteria within a specific time frame. Charting software like BullCharts can run your favourite scan across your selected group of stocks "as at" a specific date back in time. This process can be repeated for other specific dates.
- By using special back testing software to quickly work through hypothetical trading scenarios over a specific window in time (eg. TradeSim).

Paper trading

It is very important to practise before diving into the market for real. Even paper trading can be emotionally testing the first time you do it. It is important to experience this, and learn to manage the emotions, as well as to test out your trading strategy.

- Paper trading — This is where you go through the motions of stock selection using your trading strategy, and make a record of a hypothetical transaction as though you had bought a stock. Then sell the stock according to your strategy, and record the sale transaction. Over a period of time, after a number of transactions, your "paper records" will show whether your strategy is successful or not.
- ASX Sharemarket Game:
  - Register for MyASX at: www.asx.com.au
  - Play the ASX Game (usually runs twice each year for several weeks).

Summary

The importance of understanding one's preferred *trading style*, and of the need to prepare a *trading plan* and a *strategy* cannot be overstated. Readers are encouraged to study other Articles in this series on Share Trading, including:

- Articles **ST-64xx** on the topic of trading strategies;
- Article **ST-2410, *"Trading Styles (and the Styles Worksheet)";***
- Article **ST-2420, *"Trading Plans (and the Trading Plan Worksheet)";***
- Article **ST-2430, *"Trading Strategies (and Strategy Template)";***
- Article **ST-3100, *"Trading practise — Back Testing and Paper Trading".***

Your own notes and comments: ....

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