SECTION I

The World of the Day Trader

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Day trading is the practice of anticipating and exploiting temporary supply and demand imbalances in the trading of stocks. What does this mean? It means that long-term trends and market conditions are not the primary focus. Neither is reading the Wall Street Journal *cover to cover, nor combing through piles and piles of analyst research. These will not put food on your table. Why? Although these may be helpful to the long-term investor, they will not increase the odds of a profitable trade when your time horizon is only hours, minutes, or even seconds.*

This is the short term, and the only thing day traders should be concerned about is the immediate supply and demand picture in the stock. Every trade must be a precise, well-calculated move, where trading capital is put at risk only when the odds of a successful trade are substantially in your favor. Otherwise, you are throwing your money away, as it is far easier to lose money in this game than it is to make it. Welcome to the world of the day trader.

CHAPTER 1

Exploiting the Excesses of Capitalism

Did you ever wonder how the top trading firms on Wall Street are able to make so much money year after year? Whether or not the great financial institutions would like to admit it, and whether or not the general public is aware it is happening, the Wall Street brokerage firms do to the individual investor exactly what the Las Vegas casinos do to their gambling patrons. In the gaming world, the house edge is probability, a slight statistical edge that the casino has over the gambling public. The more you gamble, the less likely you are to win.

While the casinos deal in craps, roulette, and blackjack, Wall Street deals in stocks, bonds, and commodities. In the financial markets, the effects of the house edge are more mysterious and dangerous, because unlike the casino, where most gamblers understand that the odds are stacked against them, on Wall Street it can go unseen, unfelt, and undetected by the ordinary investor. This hidden force is known as the bid-ask spread. The spread is the mechanism that transfers wealth from the investing public into the hands of the Wall Street brokerage firms. The odds dictate that the more you trade, the less likely you are to win. And when Wall Street wins, the investing public usually loses. The key to profitable day trading is to recognize this fact, and, like the card counter in blackjack, to place your bets only when the odds swing overwhelmingly in your favor.

Taken at face value, conditions seem ideal for the day trader. Low commissions, a fair regulatory environment, and technology that allows someone in Alaska to have the same split-second financial information as a trader on the floor of the New York Stock Exchange are but a few of the reasons. Information travels so quickly and efficiently that the day trader can witness and react to tiny, second-to-second price fluctuations in stocks that in the old days would go unnoticed. It is possible to exploit market moves in less time than it takes to pick up the phone, allowing those with the quickest hands to capitalize on opportunities created by markets that can change drastically in just a few seconds.

We have come a long way. For decades, the world of stock trading was dominated by a select few on Wall Street. The best and most profitable traders all held seats on the New York Stock Exchange. In the past, this was a necessity. These insiders had a virtual monopoly on financial information. Markets moved too fast for those who did not have the same access to quick trades and timely information that the floor traders had. If you were not on the floor of the exchange, you were on the outside, plain and simple. To make matters worse, only a privileged few could afford the high price of owning a seat. Day trading required a tremendous amount of money and resources just to compete. And the playing field was not level. The individual investor did not stand a chance in this environment. That is why, back then, the idea of the individual day trader competing on the same field with the Wall Street giants was unheard of.

In those days, the high commissions alone prevented most individuals from aggressively trading their stock portfolio. There was no such thing as discount brokers: Full-service brokerage firms were the only means for the individual to invest. If you bought 1,000 shares of a stock, you might pay a few hundred dollars or more for the order. Imagine buying 1,000 shares of IBM and paying a $500 commission! The stock would have to move a half point just to break even. And that doesn't count the commission you'd pay on the way out. There was simply no way to trade actively under the burden of such high commissions. If you were in the market, you were in it for the long term. You had no other choice.

But times have changed. Thanks to online trading, the individual who is trading from home now has access to the same profits the Wall Street brokerage firms have been making for decades. Online orders can be executed in as fast as one second, and can cost as little as a few dollars. By monitoring a real-time quote screen, the active day trader, if successful, can literally make a living on the same small, high-percentage profits that have made the large trading firms millions upon millions of dollars per year.

But that does not tell the whole story. Although the online traders have access to the markets today in a way that they have never had before, they are still at a slight competitive disadvantage compared to the "insiders in the marketplace—namely, the market makers and the specialists on the floor of the New York Stock Exchange. The independent trader is on the outside looking in. The fact that the majority of day traders lose money further supports this fact. Successful day trading requires an acceptance of this reality. This will become clear as you get further into the book.

THE HOUSE EDGE

The basic premise of day trading is that you are attempting to make a living by profiting off tiny inefficiencies in the stock market. In layman's terms, this means buying stocks and reselling them to someone else at a higher price. The best trades are the ones where you resell the stock for a profit seconds after you buy it. So how is this possible? The markets do not give away money. Especially not to you and me. It's because the markets are inefficient and the system can be exploited for profit.

Day trading, like many other lucrative professions, is an extremely competitive business. The profits certainly don't come easy. Day trading is a zero-sum game. The profits you make come directly at the expense of someone else. Sometimes it's at the expense of the Wall Street trading firms, sometimes at the expense of the investing public. Nonetheless, if you know what to look for, the profits are there for the taking—and if you don't take them, someone else will.

Let's draw an analogy to the casinos. Tens of millions of people visit the casinos in Las Vegas, leaving behind billions of their hard-earned money. How does this happen? The casinos did not steal the money. It's because of something called the *house edge,* a slight and virtually invisible statistical advantage that the casino has over its gambling guests. Every single transaction the casino engages in is the end result of exhaustive mathematical research to determine if the risk the house is taking is justified. Not a single penny of the casino's capital will be risked unless the odds are in the house's favor.

The key to success is that the casino doesn't get greedy. Its owners are perfectly content with paying out a majority of their profits and only keeping a small percentage for themselves. They do not do this because they like to give their money away. They just know that if you stay at the blackjack table long enough, chances are, you will leave with less money than you came with. Over time, this house edge will destroy even the best recreational gambler.

But as strong as the house edge is, some people have devised ways to overcome it. Undoubtedly, you have seen the stories of card counters and other hustlers beating the casinos at their own game. They do this by raising their bets as the odds tip in their favor. In the past, by counting cards, a player was able to gain a slight statistical advantage over the dealer in predicting which cards would be dealt next. This edge became more exaggerated and more profitable the longer the gambler stayed at the table. There were numerous people who made a living by doing this. These were the true professional gamblers.

The only problem with this line of work is that the casinos prohibit card counting. The casino management is not stupid. They are not about to give their hard-earned money away to people they consider card cheats. In fact, Las Vegas spends millions of dollars per year to protect itself from these "parasites." Consistently profitable blackjack players will last only so long at the tables before the casinos pull the plug. Well-known professional card counters can't even set foot in the large casinos without being asked to leave. Many have to resort to disguises just to go unrecognized long enough the make their profits, but it only lasts for so long. The casinos are devoted to protecting their house edge.

Yet these are the same casinos that welcome you and me with open arms. Every single service the Las Vegas casinos provide is aimed at keeping you at the tables. From the free drinks to the 24-hour room service to the fresh air that is pumped into the gaming rooms, you are made to feel as comfortable as possible. The casino is open 24 hours a day, but you can't find a clock anywhere. That way you are unaware of the time you have spent on the tables. This all revolves around the premise that, over time, you cannot beat the house. Unless you have an edge, or are doing something illegal, the longer you gamble, the less likely you are to win. The Las Vegas skyline was built with the hard-earned money that people like you and me have left behind at its tables.

There is another industry where the edge is more subtle and less understood, but produces the same results—Wall Street. In many ways, the successful day trader carries the same persona on Wall Street as the blackjack hustler does in Las Vegas. Day traders' profits are made by exploiting the system. The system they exploit is controlled by forces much more powerful than the individual trading over the Internet. The Wall Street establishment that sets the odds does not take kindly to the intrusion of the day trader. As the casinos will do anything and everything possible to destroy the card counters, so will the Wall Street market makers do all in their power to prevent the day trader from being profitable, because the profits of the day trader come directly out of the market maker's pocket. Like the unpopular guest sitting at the poker table with a weak hand, you must recognize that, as a day trader, the odds are inherently against you, and the other players will do everything legally possible to prevent you from being profitable. However, this does not mean the system cannot be beat.

The great thing is that throughout the trading day, there are an infinite number of times when the odds are in your favor. In the short term, the markets are irrational and incredibly inefficient. The markets are moved by fear and greed. This creates a tremendous opportunity for quick profits, if you know what to look for. The secret to success is to take the clues the market gives you and use them to interpret the intentions of the other players. When the odds move in your favor, you can beat the players at their own game. To do this, you need to understand the components of Wall Street's version of the house edge, known as the bid-ask spread.

THE BID-ASK SPREAD

How do the large trading firms afford to pay the rent on those high-rise buildings in New York's financial district, which is some of the most expensive corporate real estate in the country? How do they afford to pay their top traders multimillion-dollar salaries? The money is earned at the expense of the investing public. As you know, the essence of the stock market is a difference of opinion. For every buyer, there is a seller. The large banks and brokerage firms make a sizable percentage of their profits by taking the other side of customer orders. When the customer buys, one of these financial institutions is usually on the other side of the trade. The key is that, like a used-car dealership buying and selling cars, the trading firms buy low and sell high, skimming a few cents per share on the trade. Contrary to popular belief, Wall Street does not make its money by hitting home runs on huge, one-time gains. Like the casinos, it makes its money on small, consistent profits. This is done through the market maker system and the mechanism known as the *bid-ask spread.*

The market maker system is the glue that holds the financial markets together. Basically, the market makers are the intermediaries in the buying and selling of stocks. On the New York Stock Exchange, market makers are known as *specialists.* Each individual stock has one specialist who is its sole market maker. On Nasdaq, the market makers are the numerous firms that trade in the stock. There are several market makers for each individual Nasdaq stock. The various exchanges have slightly different methods, rules, and systems for trading stocks, but the underlying principles are inherently the same. The role of the market makers is to maintain an orderly market.

When it is said that specialists on the New York Stock Exchange *make a market,* it simply means that at all times and under all circumstances they are both buyers and sellers of the stocks they trade. There is always a price at which specialists will buy stock from the public and sell stock to the public. They are always willing to risk their own money to take the other side of your trade. If you want to buy 1,000 shares, the specialist is willing to sell you 1,000 shares from his or her own account. If you want to sell, the specialist is willing to buy the stock from you, assuming there is no one else in the market. This is another way of saying that he or she is adding liquidity to the market by buying when there are no buyers and selling when there are no sellers. The specialist does this by keeping an inventory in the stock. This is essential to ensuring that stocks can trade freely and with fluidity throughout the trading day.

But there is a catch. Specialists do not provide this service for free. The price at which a specialist sells stock to you is always going to be higher than the price at which he or she is willing to buy it from you. Consider this a price markup for maintaining an inventory in the stock. This markup is what enables specialists to skim the nickels, dimes, and quarters from the order flow, from the normal course of buying and selling throughout the trading day. The more trading volume, the better the odds that they will make money. Much the same way that the more gamblers are at a casino, the better the odds that the casino will be profitable. So how is this legal? It is very simple. It is legal because the NYSE specialists are exposing themselves to a substantial amount of risk. The risk they take is what justifies the compensation they receive. Imagine being forced to buy stock during a time when large mutual funds are dumping the stock. This is like trying to catch a falling knife. Even worse, imagine having to sell stock to fill an influx of buy orders on a stock that is going through the roof. Either case could easily steamroll the market makers, leading to huge trading losses.

For this reason, acting as a market maker is a very risky and dangerous job. Yet, most of the time, the trading firms involved in this part of the business are able to make huge profits because the bid-ask spread is able to soften their risk. As we said, to maintain an orderly market, the market makers must always "make a market" in the stock they are assigned to, by setting a price at which they will both buy stock and sell stock simultaneously, *even if they don't want to do either.* Obviously, they want to buy at cheaper price levels than they sell, but it is not guaranteed. This is called *keeping a two-sided market.* The market makers are risking their trading capital to ensure that investors will always receive a fair execution, buy or sell. This guarantees that, so long as customers do not put limits on their prices, at some price their orders will be executed. The specialist system is the grease that keeps the stock market running smoothly. When the markets are quiet, this does not seem like such a big deal. It is when the markets are volatile that the market makers really earn their paychecks.

As we said, market makers do not provide this service for free. They must be compensated for the risk they take. For this reason, they are not expected to simultaneously buy stock from the public and resell stock to the public at the same price. It is simply too risky to expect this. Why would anyone risk his or her own capital not to make any money? Capitalism doesn't work that way. Thus, market makers are allowed to maintain a spread in the stock. This is no different than the used-car dealer who buys a vehicle for $5,000 on a trade-in and resells the same vehicle for $6,000. The $1,000 profit is the dealer's *cost of carry* for the risk of taking on inventory. There is no guarantee that the dealer will be able to resell the car, so the profit is justified. Instead of a car, the market maker will buy IBM at 105 and sell it at 105.10. The buying price is known as the *bid.* The selling price is the *ask.* And the difference between the two is the *spread.*

The spread is determined by how volatile the stock is. When it is said that the spread is wide, this means that the difference in price between where the market makers are buying and where they are selling stock to the public is large. *The more volatile the stock, the wider the* *bid-ask spread.* This is justified because the specialists are unsure of the future direction of the stock. The wide spread is the market makers' only way to protect themselves in the event the stock moves against them. Although bid-ask spreads are generally only a few pennies wide, the markup or spread between where the market makers buy and sell can be much wider in some volatile stocks, or in volatile market conditions.

Imagine an extremely volatile or illiquid stock with a bid-ask spread of a $1. This means that, even if the stock doesn't move, the market makers might be buying from the public at $99 and selling at $100. This means they're making $1,000 for every 1,000 shares bought and sold. But there is no telling in which direction the stock is going. It could be on its way to $110—or to $90. Even the specialists don't know. Remember, the market makers *must* provide liquidity in a stock at all times. This means that, even if they don't want to, they are forced to be the buyer of last resort if they can't match the public sell orders with buyers. In volatile markets, this usually means that market makers accumulate large positions when the stock is falling (the public is panic selling, and the market maker is forced to buy from them) and they lighten up (or get short) the stock when it is running (if the public is panic buying, the market maker is forced to sell into the rally). Even the best traders can sometimes lose large sums of money under this kind of extreme volatility and market stress.

There are times when the opposite is true. The most profitable time for market makers is generally when the stock is trading in an orderly manner. This allows them to make a few cents per share without much risk. For example, in a $25 stock, this would be done by buying from the public at 25 and selling to the public at, say, 25.10. The spread is 10 cents. If the stock doesn't move and the buying and selling is equally distributed, the market maker will have made 10 cents per share on each trade: $100 for every 1,000 shares that trade evenly. Imagine how much is made if the stock trades several hundred thousand shares without moving too much volatility. That could be tens of thousands of dollars of trading profits to the market maker. Over the course of a year, it is this house edge of a few cents per share that compensates them for the infrequent times they suffer huge losses. That is how a few cents per share, over and over again, can translate into millions of dollars in trading profits in the course of a year.

Another way to look at the bid-ask spread is as a form of *risk premium.* Imagine that the stock, instead of moving in one direction, is trading in a choppy manner. This is generally how volatile stocks trade. Under these conditions, the market makers must keep the bid-ask spread wide to protect themselves from the onslaught of day traders and speculators who will try to profit in the event the market makers are "off their market." Most of the time, the wide spread makes it very difficult to "pick off" the market maker. Because the profit the day trader makes usually comes at the expense of the market maker, market makers will not just give their profits away. Their only defense is to make it as difficult as possible for day traders to predict movement in the market makers' stocks.

If the bid-ask spread is the market makers' advantage over the investing public, where does this leave day traders? In the best of all possible positions. Even though the specialists and market makers have the advantage, and even though they set the odds, the playing field is more level today than at any time in history. This is because the regulatory agencies are protecting the interests of the individual investors. Luckily, in the eyes of these agencies, even the day trader is protected in the same way as the small investor.

Let's be honest. Wall Streeters would get away with everything they could if there were nothing to stop them. Capitalism would not have it any other way. But there is something to stop them. There are rules in place that force specialists to give priority to customer orders over their own. On the New York Stock Exchange, these rules essentially let day traders take the same side of the trade as specialists in filling customer buy and sell orders. This allows day traders to trade just like specialists and to gain some of the advantages of the house edge, by participating with the specialists in taking the other side of customer orders. This enables day traders, like specialists, to make those nickels and dimes from the investing public's order flow.

As you can see, day traders are in a very precarious situation. They rely on their own abilities, and their own capital, to beat Wall Street at its own game. Although day traders have the rules on their side, they are able to exist, survive, and prosper only as far as their trading ability takes them, because the odds are not *with* success, but against it. Day traders are going up against much bigger forces, possessing deeper pockets and more information. That should not faze you, however. The game is difficult, but it is not without rewards. Undoubtedly, you have seen the colossal amounts of money Wall Street firms are capable of making in a single year. A piece of that same pie is there for you as a day trader. It is just a matter of going out and staking a claim to it in a way that is prudent.

Farrell Says

Look to the bid-ask spread for clues. One skill that this book will teach you is the ability to tell the difference between a good supply-and-demand scenario to trade and a bad one. It has nothing to do with the long-term prospects in the stock. A good long-term investment can have a horrendous temporary supply-and-demand picture, and vice versa. A stock that is a terrible long-term investment may actually have a supply-and-demand equation that sets up for a profitable short-term trade. It all depends upon the bid-ask spread, where the buyers and sellers stack up at that given point in the trading day.

Notice in Table 1.1 that both stock A and stock B are trading at the exact same price (25). The bid and ask is also the exact same (24.95 to 25.00). In other words, both have buyers willing to buy at 24.95, and sellers willing to sell at 25.00. Although at first glance they appear identical, a closer look reveals that both offer vastly different profit potential for a short-term trade. Why? The answer has to do with the size of the shares willing to be sold at 25.00.

Stocks move in the path of least resistance. Notice the ask size. Stock B has only one seller of 100 shares at 25.00. Not a big deal. It doesn't indicate either way if this is a good or a bad trade. Stock A, however, has 999,000 shares for sale at 25.00! The conclusion: Stay away from stock A. Unless there is a buyer for all 999,000 shares of stock, or the seller at 25.00 decides to cancel, stock A is going *nowhere*. It is impossible for this stock to trade higher than 25.00 until those 999,000 shares are gone. More on this later.

Table 1.1 The Bid-Ask Spread Indicated a Large Seller

	Stock A	Stock B
Last trade	25	25
Bid price	24.95	24.95
Bid size	1,000 shares	1,000 shares
Ask price	25.00	25.00
Ask size	999,000 shares	100 shares
Conclusion	Unfavorable	Neutral