The 10 Laws of Daytrading

By Peter Reznicek
Shadowtrader Chief Equity Strategist

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1: Go “Top Down” for best results.

When looking for the best way to exploit intraday opportunities in the stock market, it’s always best to employ strategies that will allow you to have the wind at your back, so to speak. 85% of stocks follow the action in the broad market and as such you want to have the broad market moving in the same direction as your trades as often as possible. As timeframes get smaller from long term core holds to position trades to swing trades to daytrades, the direction of the broad market matters more and more on the outcome of your trade. Before entering any intraday position, discern the following:

Is the market having an “inside” or “outside” day? An inside day is one in which the broad market is currently trading inside of the prior day’s range. An outside day is the opposite where the market has managed to either make a new two day high or low and is trading outside of the prior day’s range. This matters a lot. Inside of the prior day’s range is usually a sign of a range bound market that is chopping around in fits and starts. This will generally frustrate the average daytrader because he/she will find excellent setups but they won’t seem to get moving. The trader will find that they will do better when the market has moved outside of the prior day’s range. Some daytraders have rules that they won’t trade at all if market is not having an “outside day”. The snapshots of the SPY below illustrate what inside and outside days look like. In the first picture note that all of the action on 7/8 is within the range of the highs and lows of 7/7. In the second, all of the action of 6/26 is outside of the highs and lows of 6/25, thus creating the ‘outside day’.

Where is the broad market in terms of its own support and resistance? This is a very key concept that many traders ignore because they are too focused on the pattern right in front of them of the individual stock they are trading. (More on this in Law # 5). If for example you are trading from the long side you would want to know that in the next 15-30 minutes or whatever your timeframe is, the S&P is not going to run into any resistance on its longer term daily or weekly charts. The S&P 500 is your best bet for measuring broad market strength or weakness as it's the benchmark index that all institutions measure the market by. If I know that there is a major resistance area at 1445 for instance in the SPX where the market has turned and dropped back before, then I am not going to be initiating any long daytrades if the S&P is for instance trading about 1442 or so and moving up. Remember that the index is just that, an index, meaning that it's a collection of stocks. It hits its own support and resistance because the stocks that make up the index also have hit resistance or sold off. Even if your stock is what we call "in the clear", i.e.: has no notable resistance above it, if the broad market starts to sell off it will more than likely act as a drag on your long and you'll end up swimming against the tide.

Is the broad market currently going up or down? This one may seem obvious but you'd be surprised at how many people completely ignore it or misjudge the direction.

Firstly, ignore what we call the Top Line figures. These are the amounts that the Dow, S&P, and Nasdaq are up or down on the day and are the figures that are most often quoted daily on CNBC, the radio, and in newspapers. The reason we say ignore them is because they are often very misleading.

The Dow could easily be quoted as being up 50 points and yet the trend is down all day. This is due to gaps. If the Dow gapped up that day and sold off directly from its open to fill the gap, then you will have a very hard time getting long daytrades to work that day at all because the intraday action of the broad market is actually down even though those top line figures are all green. In volatile times, these gaps can often be very large and spend the entire day filling by meandering towards the prior day's close. In such a situation it's imperative to be aware of the direction the market is actually moving rather than pay any attention to how much it's "up" or "down".

Secondly, be aware of where the broad market is in terms of the current day's range. An easy way to do this is to divide the day's action into three zones and label them 1, 2, 3 like in the picture below. Each zone is basically one third of the day's range. When the market is in zone 2, which is the middle third of the days' range, daytrades will often not work out very well because there is obviously equal pressure between bulls and bears. If the market is trading in zone 3, short trades will probably work better because sellers currently have the upper hand. In zone 1, long trades would be the way to go.

For the sake of illustration, this picture was taken at end of day. What you want to do is to start marking off the zones after approximately one hour of trade (10:30am EST) has gone by. Obviously they will move over the course of the day if highs and lows change. No problem, just move your high and low lines up and down accordingly and redraw. The midday doldrums (usually 11:30am to 1:30pm EST) are a good time to regroup and redraw your zones before going into the afternoon session. In closing, keep the wind at your back by trading in the direction of the broad market at all times.

2: Use market internals to gauge the markets real strength and direction

It's far beyond the scope of this practical rule set to do a complete discussion on the use of market internals. However, no set of rules on daytrading could ever be complete without a mention of them. They are the number one most important factor in predicting intraday market direction. I generally use Market Breadth (the amount of volume flowing in to up stocks minus the volume flowing into down stocks), the Advance Decline line (number of up ticking stocks minus the number of down ticking stocks), and the TRIN or Arms Index (essentially creating a fraction out of the breadth and advance decline lines and computing them into one figure), as my three main indicators of broad market bias. What I recommend for new traders to do is to put up charts of the three market internals right next to a chart of the SPY or $SPX. Make sure to have the internals set to the same timeframe as the broad market chart and just watch. How does the market constantly react or not react to changes in the three internals. Over time you will develop a feel for these movements and you will wonder how you ever traded without them.

3: Know your sectors

Whatever stock you are daytrading is part of some sector. If it's KLAC for instance, then it belongs to a group that is known collectively as the $SOX or Philadelphia Semiconductor Index. If it's ABX, then it's part of $GOX or Amex Gold Miners Index. Etc. etc. Every stock out there is a part of some subsector of the market. It's imperative to know this when daytrading because you can use the relative strength in these sectors to give added momentum to your daytrades. You can start by keeping a list of about 15-20 sectors in a sector minder on your screen at all times. Have them sorted by their % change from the open so that you can see exactly how much they are up or down on just that day. An example is below:

sector minder

Symbol	Comment	Last	Pct	High	Low
$BTK	biotechs	771.74	+1.58%	773.95	756.97
$GOX	gold	204.41	+1.09%	208.01	202.20
$DJUSSW	software	560.15	+0.82%	560.15	551.63
$DRG	drugs	301.45	+0.43%	303.64	299.94
$HCX	healthcare	359.60	+0.06%	361.92	359.02
$SOX	semiconductor	340.79	-0.57%	344.14	338.43
$UTY	utilities	527.58	-0.73%	533.61	526.73
$XOI	oils	1377.86	-1.82%	1403.35	1372.48
$OSX	oil services	326.62	-2.39%	334.91	324.74
$DJUSNS	internet	377.01	-2.87%	388.50	375.09
$IUX	insurance	235.21	-3.10%	242.73	231.19
$XBD	broker-dealer	124.05	-3.09%	128.00	120.97
$TRAN	transports	4574.82	-3.20%	4726.43	4571.32
$RLX	retail	315.56	-3.20%	325.99	313.63
$BKX	banking	48.02	-3.96%	50.00	46.52
$DJUSHB	homebuilders	225.42	-5.22%	238.00	221.11

Do research as to what stocks are in all of the different sectors. When looking for stocks to daytrade, simply looking at which sectors are extremely strong or weak (in comparison to the market) is a great place to start. If you are trading top down and you have discerned that the market is going up, then the sector that is holding the pole position in your sector list is probably going to have a lot of great opportunities for long day trades in it because it's obvious that money is flowing to that sector. Reverse this situation when looking for shorts. Conversely, be aware that sectors are strong or weak because of institutional rotation. This is the "money flow" that we discussed above. The bottom line is that you don't want to fight that, ever. There will always be stocks out there that are "outliers" which are not acting in sync with their respective sectors. So when you find that perfect bear flag pattern in BTU for instance, make sure that the $DJUSCL (coal sector that the stock is part of) is not one of the strongest sectors on the day.

Always note how just keeping the top down perspective when selecting sectors and stocks can keep you out of trouble. The number one reason that daytrades do not "follow through" is because at some step of the top down chain, something was out of sync. Either you bought in a weak market, or a weak sector or there was divergence in the internals that made you believe the market was stronger/weaker than it actually was. So to recap, knowing your sectors is just another way to stay top down and keep the wind at your back.

4: Relative Strength is the Key

Relative strength (or weakness for that matter) is simply a measure of how strong or weak a stock is against something else. Either measured against the broad market itself, or other stocks in its sector, or just other stocks in general. There are many ways to calculate this and there are lots of traders who make a great living trading only this style. I believe that in the spirit of the top down approach it can be of great help to you.

Usually you want to compare the performance of different issues and the broad market in terms of % change from open. This way you won't get caught in the trap of thinking that stocks that have gapped up are stronger than they actually are. In a nutshell, look for issues that are outperforming the broad market by a good margin for longs and ones that are lagging the market for shorts. If the S&P is up 0.75% from the open and a stock you are interested in daytrading long has opened flat and is now up 0.25% then it's probably not going to be much of a mover. Remember, stocks that are stronger than the market are exhibiting signs of institutional interest and thus they have greater momentum in the direction of their move and their counter-moves are usually shallower. A simple sector minder like the one above for the sectors can be set up if you trade a set universe of the same stocks every day. If not, then a simple scanner which can scan the whole market and find those issues that have the greatest % gains or losses on the day will point you in the right direction.

5: The Pattern is the Last Thing

By saying that the "pattern is the last thing", I mean to draw attention to law items 1, 2, 3 & 4 above and remind the you the trader that the above criteria need to be satisfied before searching for intraday patterns in individual stocks. You can find all the double bottoms, hammers, or bull flags in the world all day but if the market is not going to move in that direction, is range bound, the sector is weak, etc; the odds of your pattern following through are minimal. This is a key mistake that many daytraders make. They are unaware of what is happening in the bigger picture and simply believe that it's a game of pattern recognition. When it all comes down to it, it is the synergy of many different patterns all working in sync that will create the playable move.

6: Stay Away from the "Cheapies"

By the cheapies we mean the stocks that are under $10 per share. While we're at it, since this is an honest paper on daytrading, stay away from stocks under $20 per share too if you can. Cheap stocks are cheap for a reason... Cheap stocks only seem like they are going to give a lot of bang for the buck when newer traders start calculating future large profits in their heads due to the large share size that can be purchased due to the stock being of low price. This is a trap and I urge you not to fall into it. Firstly, these stocks are not good investments even for a longer term. The market is generally efficient so you can be sure that they are priced correctly. Secondly, they tend to not respect technicals. By this phrase, I mean that patterns tend to not follow through. In the same manner that there is a certain hierarchy to chart patterns in terms of timeframes where a pattern on each subsequent longer timeframe is more powerful than the preceding shorter timeframe, there is a built-in weakness in patterns on very cheap stocks. This is due to the increased amount of retail traders who are throwing money at these issues in a random fashion (often news driven) and the fact that these stocks are 100% unsupported by institutions. No fund would ever touch these stocks because they know that they could never get in with size without bulling the stock much higher just on their own buying nor get back out without crushing it back down to nothing. You are working against yourself if you take the time to do a top down analysis and then select a stock that is under $20 per share for daytrading. In my experience, I have found that somewhere between $30 and $100 per share is the sweet spot for intraday trading. Stocks generally move a certain amount per day which can be called "average true range" or "ATR". Generally, the larger the stock price the larger the ATR. For daytrading, you want to grab stocks that have at least $1.00 of ATR.

Meaning that on average the stock can move up or down at least 1 full dollar from highs to lows during an average day's trade. Stocks that are very expensive (i.e.: over $100 per share) should be played selectively and only by very experienced players. These issues tend to have wider spreads and have much bigger swings in price which may be unmanageable to a newer trader.

7. Always Include Volume in Every Analysis

This is a pretty simple one. Volume is the fuel that keeps moves going. When entering intraday and planning on getting out some minutes or hours later, it's absolutely imperative that you have what we are referring to as "follow through" in the stock you are trading. Stocks that are moving on large volume tend to keep going in the same direction that they started in. Stocks with small volume don't. There are two ways to look at this.

The first point is that you want to only daytrade stocks that are doing at least 500,000 shares per day. The more,the better. Large overall daily volume in the stock makes it easier for you to get in and get out in rapid fashion which is of the utmost importance when your timeframe for holding the trade is short. If the stock is not trading much, you do not want to be the one holding the bag when you cannot get out because there is just nobody supporting the bid.

The second factor when bringing volume into your analysis is that you would like to confine your entries to stocks that are trading much larger amounts of volume that particular day then they usually average. If a stock generally does 1 to 1.5 million shares a day, but has already traded that by 10:30am on the day you are looking at it, then you know "something is up". There is huge interest in either buying or selling this stock on that day and it should continue throughout the session. If you are using a scanner to find patterns, add a volume filter to it and look for stocks trading about 4-5 times their daily average volume.

In a nutshell, in the same way that you will stay away from the "cheapies", stay away from stocks that trade little volume. Remember, this is daytrading so you are looking to get out as quickly as minutes later. You absolutely cannot afford to not have a market for the merchandise you want to unload quickly when it reaches your target price.

8. "How Much Can I Lose?"

Ask yourself the above question before every single trade. This is extremely important and may involve a certain shift in mindset which is of the utmost importance before entering. What I mean specifically by this is that every single trade must be analyzed first in terms of what is the maximum loss both in cents/dollars per share and total dollars before entering. Most newer traders never think this through enough, only thinking about "How much can I make?" before entering the trade. What matters much more is where the stop loss is in relation to the entry and how much of a dollar loss will it incur at the selected share size if gets hit. Enter every trade with the attitude of what could possibly go wrong. Remember that in trading even the best laid plans generally fail about 40-50% of the time. Your job is to simply make a little more on the times that it goes according to plan while keeping the losses steady at the same amounts or less each time.

9. Use Hard Physical Stops

This one might also seem obvious but it gets ignored. When holding stocks overnight, as long as you are an active market participant it's usually not a good idea to put in hard physical stops due to gaps that can take you out of your position on the open and then reverse course taking you back into what would have been either break-even or a profit zone. This is due to the enormous flow of orders that are hitting the market both before the open and right at the open. The phrase "professionals rule the close, amateurs rule the open" is a fitting one. That being said, the longer your timeframe the more you can do with the stock as it approaches your stop. For example in a gap down situation where price opens under your stop we often advocate using a 5 or 15 minute rule strategy where stocks are allowed to trade for a set length of time and then stops are moved under lows of those candles. Or you may find support on the stock on any number of different timeframes to put your stop under. These could be hourly 20 period moving averages, lows of daily bars, lows of weekly bars, etc. Alerts can be set when stocks move close to these pivots and then the finger can be on the button without putting in a hard, physical stop that might get 'run' in an undercut of that particular pivot which is common. The point that I am getting to in a rather circular fashion is that in daytrading when your timeframe is very short, you do NOT have this luxury. You cannot under any circumstances give the stock very much leeway beyond your stop. Remember that because your timeframe is short there is very often just ONE prior reference point on the intraday chart that is going to act as your pivot. This could be literally something as small as the high or low of a prior five minute bar. Never forget that a thousand other intraday players are looking at the same picture and will also not let their trade run past that point.

In summary, the shorter the timeframe, the tighter the leash you must keep on your trades. The way to keep a tight leash is to use a hard, physical (actually entered as a working order) stop. This will also keep you from jumping the gun on killing the trade before it has a chance to work out. You know your stop is in and the stock can do all manner of things between the stop and your target. You'll rest easier knowing it's there. Moreover, if you've followed commandments 6 and 7 and are only daytrading "thick" issues that are at least $30 and trade volume, your slippage should be minimal.

10: Keep a Journal of Trades

It is only by looking in the rear-view mirror and analyzing your trades in detail that you can improve. You need to know everything about every single trade you take. The more information you can pack into the journal the better. It can be as simple as just putting in entry, exit and size or as comprehensive as you like. In my opinion, the more the better. Put in time of day, what was the market doing at the time of trade, how did I feel that day, what strategy was I employing on the trade, etc. Any way you can qualify a trade in some way that will allow you to analyze it better later is of use. Once you have a matrix in place of all of these different factors in your journal, you will see how quickly your mistakes jump out at you. You will be surprised to find out what you learn about your strategies and yourself. Do I tend to make money in the morning and lose in the afternoon? Do my pullback trades work out 80% of the time while my breakout trades work 20% of the time? Every time I trade BIDU I lose money. Hmmm…. There is an endless amount of analysis that you can do once you have all of this very important information in place. In this way you can eliminate trading errors and strategies which have proven to have low probability of success systematically. Below is a sample journal that you can easily duplicate in excel for yourself.

	Points	Shares	Gross	Fees	Net P/L
Totals:	1.55	5000	$835	$50	$785.00

date	side	shares	symbol	entry	exit	fees	Points	Net P/L	type	time	market trend	zone	comment / error?
07/10/08	short	500	AMZN	70.53	69.10	10.00	1.43	705.00	1st 5 minute low	9:36 AM	down	n/a	stop trail too tight
06/01/06	long	1000	UTHR	99.80	99.55	20.00	(0.25)	(270.00)	test of prior low	10:37 AM	down	3	counter-trend
06/02/06	short	1000	SPY	125.32	124.95	20.00	0.37	350.00	inverted hammer	2:01 PM	down	1	no scale out

The above is simply a sample to get you started in thinking about journaling your trades. In your own trading, feel free to add more columns and also keep a written journal that goes together with your trading blotter which can help you to sort out thoughts on trading. There are many books and resources on trading psychology out there but a simple trading journal might just be more powerful and useful to you then all of them put together. Writing down each individual trade in a log gives the trade "weight" and can make you think more before putting it on because you know that at the end of the day you'll have your trading journal to answer to and the numbers will never lie or paint any picture that is not 100% accurate.

While the above rules that I truly live by and those that I teach to my many clients are certainly not a full explanation of how intraday trading works, nor are they any discussion of specific strategies, they are a great place to start for newer traders who are looking to shorten the learning curve. I invite you to check out our site at www.shadowtrader.net. Once there, click on the many free trading tools available to help make your trading and education more successful. I wish you good trading…

Sincerely,
Peter Reznicek
Chief Equity Strategist