For day-trading techniques, simplicity and discipline are more important than having the latest and greatest black-box trading system. One such day-trading strategy that is effective in both equity and equity index markets is the breakout or momentum trade.

Taking momentum to the bank

BY THOMAS L. BUSBY

By definition, day trading is short-term. That is, the entire trading cycle is completed within the course of a single day or trading session. Given that constraint, prices must move quickly to profit. Another way to describe fast moving prices is to say they have momentum, and one of the best ways to make money quickly is to jump into the market before this momentum has run its course.

One of the more basic day-trading strategies is based around this concept. It's the breakout trade. This strategy may be used to trade a number of financial products. However, it can be most useful trading equities and equity index futures, such as those based on the S&P 500, Dow Jones Industrial Average, German Dax and Russell.

DETERMINING BIAS

The first step to this technique is determining the mood of the market. Are the bulls or the bears in charge? Or, is there a lack of consensus among traders? If you cannot decide whether to be long or short, sit on the sidelines. Do not attempt a momentum trade if there isn't a clear overall sentiment of the market. Key numbers, market indicators and simple charts help identify the general market bias.

Begin with key numbers or pivots. A key number is a price point that the market respects. That is, it is a place where the bulls successfully stopped a downward move, where the bears refused to allow the bulls to go higher, or a point where prices tend to shift. These key numbers also are called support, resistance and pivot points.

To get started with this analysis, consider such facts as where the market opened this month and where prices are in relation to that. What about the weekly number? Have bulls or bears won out so far? What are the weekly highs and lows? Then, perform the same analysis for the last couple of trading days.

Once you have considered the broader context, look at the current price. Where the market currently stands in relation to these various views of the bigger picture may not tell you to buy or sell, but it will give you a good idea of which way the wind is blowing.

In addition to key numbers, several important indicators also help in gauging market direction and momentum. An indicator used by many traders is the New York Stock Exchange (NYSE) Tick. The Tick numerically reflects the number of stocks listed on the NYSE that are moving up based on their most recent tick. The number is a net figure and is based on all the stocks on the exchange. As such, it shows how the market is collectively performing. If the Tick is registering 275, that means that 275 more stocks on the exchange moved higher on their last tick than those that moved down.

The Tick may change quickly. As a rule, readings of plus or minus 500 are not particularly significant. However, the stronger or weaker the Tick reading, the more opinionated the market is considered to be. Tick readings of 1,000 or greater express a pronounced sentiment. For example, if the NYSE Tick is 825, the longs are in control. Likewise, a negative 825 suggests the bears are in charge.

It's important to realize, though, that the Tick can get too high or too low. In such cases, the market may be overbought or oversold and a price adjustment away from the direction of perceived strength may follow.

Two other indicators to watch are the NYSE advance/decline line and the Nasdaq advance/decline line. These indicators reflect the number of stocks on the NYSE and the Nasdaq Composite that are trading up or down during the session. The data are based on the previous day's closing prices.

Again, 500 is a good baseline. If more than 500 stocks on the Nasdaq Composite are trading above yesterday's close, it may be time to buy. Likewise, if more than 500 are selling off, there may be a shorting opportunity. In an extremely bullish market, these indicators may run well above plus or minus 1,000. The Nasdaq and NYSE advance/decline indicators assist in determining the sentiment of the market and in gauging the depth of that sentiment.

In addition to these basic indicators, you should also review 30-minute charts. You'll want to ask a number of questions about recent price action. Are prices trending up or down? What was the last 30-minute high? The low? Are prices currently above or below those key points? Obviously, if minute-by-minute the market is moving down, the shorts are in control. In such a scenario, don't try to over-think the market; just don't buy it. As the adage goes, do not fight the trend.

TIME TO ACT

After you have identified the sentiment of the market and decided to be long or short, it's time to look for the right time and price to get into the trade. Momentum traders are a lot like surfers looking to ride a good wave. They want to spot a market move as it's building up speed and ride it to some short-term profits.

As any experienced trader knows, there tend to be times during the trading day when volume is greater and prices move quickly. That is the best time to put on a momentum trade. Identifying such times takes practice. Before executing this strategy, observe the market and learn if and when prices for the stock or futures contract experience the most price movement. Look for recurring key times when momentum is greatest.

For example, when the trading session opens, activity is usually high. Prices move up and down quickly. Therefore, the first hour and a half or so tend to be good for the momentum trader. The opposite end of the trading day is also good; activity often heats up at the end of a session. Traders are liquidating positions and that helps feed market moves. This often makes the final 30 to 45 minutes of a session fertile for quick and profitable breakout trades.

To see the internal strength of a move, you need to view volume during incremental time frames. Most trading platforms can report the shares or contracts being traded. It is important to monitor volume because it is the fuel for momentum, which, in turn, is the basis for a breakout trade.

TRADING TIMES: EXXON MOBILE

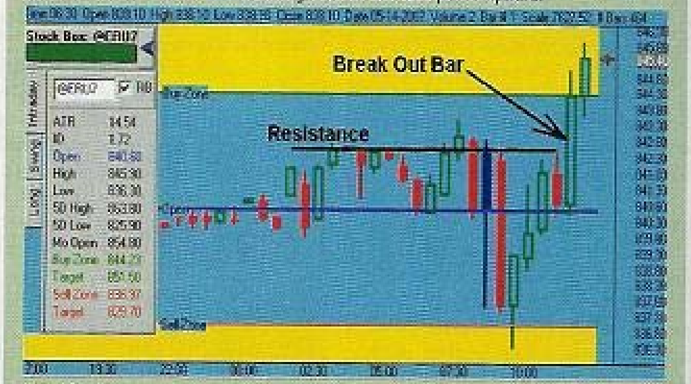
On June 11, 2007, Exxon Mobile (XOM) had a nice breakout move. The move came late in the session. Once resistance was broken, there was a nice opportunity for profits.

TRADING TIMES: DAX

The Dax is a German index traded on the Eurex Exchange. This chart shows a breakout on June 8, 2007. Note the nice follow-through once resistance is broken.

TRADING TIMES: RUSSELL

Another interesting equity index futures is the Russell. On May 14, 2007, the bulls broke resistance in the middle of the trading session and took prices upward.



To pinpoint a price at which to buy or sell, return to the 30-minute and daily charts and identify points of support and resistance near the current trading price. To the upside, where did the bulls hit resistance? At what high point did the bears step in and move prices down? To the short side, how far were the bears able to go? At what point did the bulls see a bargain and step in and start buying? It is critical to identify support (the price floor) and resistance (the price ceiling).

Using this strategy, you need to wait until support or resistance is broken before you act. Don't try to predict it. If you buy prematurely, by definition you don't yet have momentum on your side.

If the sentiment of the market is bullish, the time of day is right, indicators point to higher prices and resistance is broken, jump in and ride the wave.

The reverse would also be true for a short. If the sentiment of the market is gloomy, there is a great deal of volume and momentum, indicators point lower, and support is broken, go short. Then surf for some quick profits. (See "Trading times," page 55 and above, for examples of these basic momentum moves at work.)

Successful trades should pay off quickly. If it doesn't, momentum may have stalled out. Constantly evaluate the position. If it comes to the point where you can't confirm and validate the trade, exit the position and wait for a better opportunity.

The momentum or breakout strategy is probably the most common day-trading technique. However, to execute it successfully is a true art. The steps may seem simple: determine the sentiment of the market and then find a wave of buying or selling in tune with that sentiment. However, as anyone who has tried day-trading appreciates, correctly identifying the mood of Wall Street is not an easy task.

It takes hard work, patience and dedication to master any art. Day-trading is no different, no matter how simple the core strategy may seem. FM

Tom Busby is a 30-year professional trader and Founder of DTI, a trading school in Mobile, Ala. Busby is a member of the Chicago Mercantile Exchange and the Chicago Board of Trade and has been seen on Bloomberg, CNBC and BNN. For more on Busby go to www.dtitrader.com.