

ACTIVE Trader®

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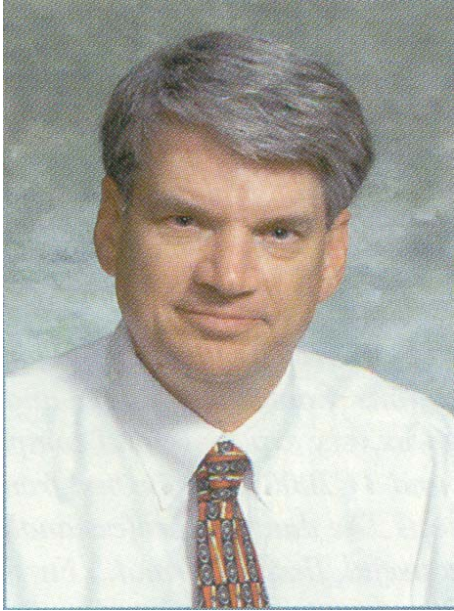
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Q&A: Thomas L. Busby

A road map to trading



BY LESLIE N. MASONSON

For Tom Busby, trading is a combination of practical market knowledge and disciplined methodology. Busby, the founder of the Day Trading Institute (www.dtitrader.com) in Mobile, Ala., is a 23-year market veteran. He maintains trading discipline through a systematic approach that integrates key principles of money management and technical analysis.

After several years in the Air Force, law school and stints at Merrill Lynch and Salomon Brothers, Busby's trading career changed in 1982 when the Chicago Mercantile Exchange (CME) launched the S&P 500 futures contract. The S&Ps offered liquidity, leverage, easy access and low transaction costs, and Busby began studying and trading the market.

The trading method he teaches today is a product of the crash of 1987, when Busby became a full-time day trader to avoid overnight market risk. His research led to a systematic approach comprised of three main elements: time of day, key numbers and the RoadMap to the Market, which tracks several important indicators (see "Mapping the market," opposite page).

After years of fine-tuning his trading methodology, Busby founded the Day Trading Institute in 1996 to teach others how to trade S&P futures, and later the Dow Jones and Nasdaq futures, using a mechanical approach.

"I found that by teaching others, I constantly forced myself to remember the art of balance - overcoming fear but avoiding greed," he says.

Busby trades every day, arriving at his office around 7 a.m. Busby's main trading vehicle is still stock index futures, although he occasionally will trade stocks.

Busby discussed his career, trading method and approach to the markets.

AT: How did you end up as a futures trader, advisor and educator after getting a law degree?

TB: I discovered the futures market in a *Wall Street Journal* article about the S&P futures contract, and I knew that if I was going to have any security in the business I needed to be able to approach the market from both the long side and the short side, which futures allow you to do.

Having been trained as a lawyer, I

always look at both sides of any decision. Success in trading requires such a mindset, no matter what approach you use.

AT: How long did it take you to develop your methodology, and how did you go about putting it together?

TB: I don't think anyone's education in the market is ever complete. My approach is a work in progress. I've been trading the S&P since its inception, and I created my trading foundation after 15 years in the school of reality. All the trading tactics I use are based on my actual experiences, not theory.

Over the years, I've learned to eliminate bozo mistakes - failing to doublecheck my orders or trading without stops - and change the relationship between analysis and execution. In my early years, I spent 98 percent of my time trading and 2 percent thinking. Now that's reversed. In a typical day, my method only allows about 120 to 150 minutes of trading time. This gives me more than ample time for analysis and reflection.

AT: Can you explain the first two elements of your trading model: key numbers and time of day?

TB: In the most basic sense, key numbers are the price levels that most commonly act as both points of support - where buyers step in - and resistance, which is where sellers step in. They're used to enter and exit trades and to set profit

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Mapping the market

The RoadMap is proprietary software Tom Busby designed around his trading method (see Figure 1, below). It allows him to determine whether to be long, short or out of the market. (Note: Some of the indicators discussed below are different than those used in the past and may be different than those used in the future.)

The indicators at the top of the spreadsheet are:

1) The S&P futures (SPU1), "The General," is not only Busby's primary trading vehicle, it's his primary indicator.

2) and 3) The Morgan Stanley High-Tech index (\$MSH.X) and the NASDAQ Composite index (\$COMPX) are Busby's leading technology indicators. He refers to them as "City Hall" (as in, "You can't fight city hall") because a trader should not trade against the direction of these indices.

4) The TICK indicator, which is the number of up-ticking stocks minus the number of down-ticking stocks. The TICK is used as a leading indicator (i.e., one that gives an early indication of market direction).

"A positive TICK reading tends to signal a rally," says Busby. "As [the rally continues], there is fall-off in the TICK. The primary question is whether that fall-off is

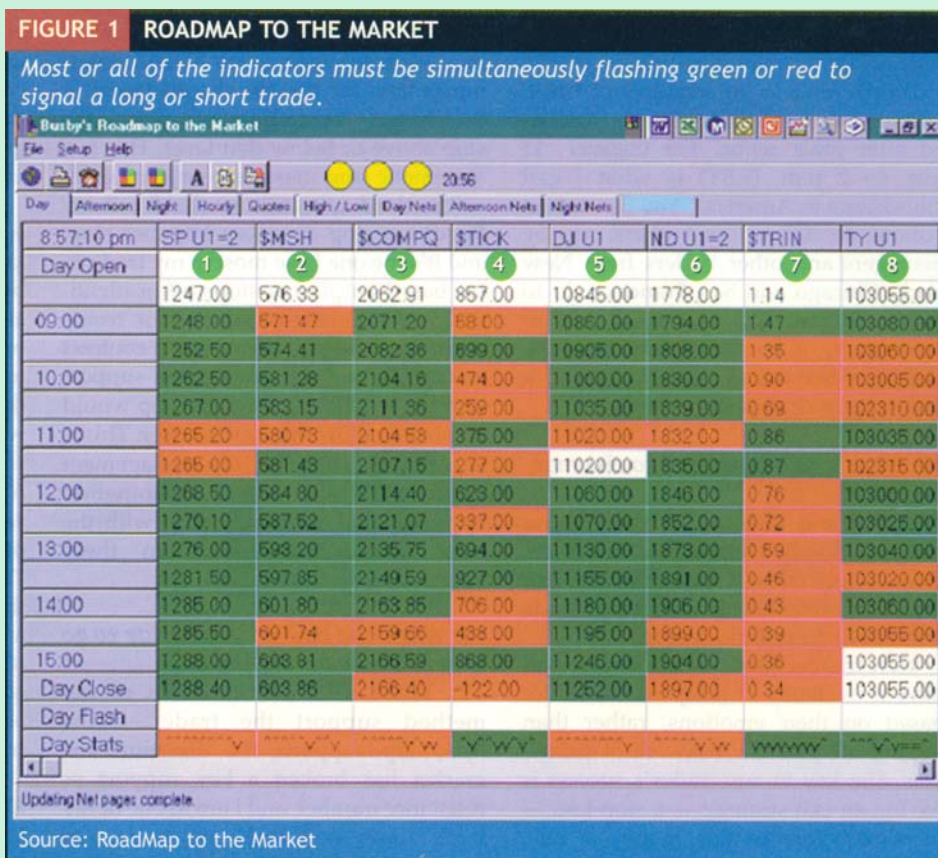
5) and 6) The Dow (DJ) and the Nasdaq (ND) futures are two important corollary indicators. Along with the S&P futures, these contracts confirm the overall mood of the market. If they are moving in the same direction, a trend may be emerging.

7) The NYSE TRIN [(advancing issues/declining issues)/ (advancing

volume/declining volume)] is an "inverse" indicator, in that the higher the TRIN (e.g., 2.00) the more bearish the market, and the lower the TRIN the more bullish the market.

8) The 10-year T-Note futures (TY) are another inverse indicator used to confirm direction.

Indicators (except the T-Notes and the TRIN) go from green to red when they fall from the previous value. Busby



trades only when all (or in some cases, a majority of) the indicators are pointing in the same direction. For example, if the Nasdaq Composite is green and the Dow Jones and S&P futures are red, there is no trade.

The "Day Stats" at the bottom of the screen shot show the 3D-minute direction for each indicator and allow Busby to quickly identify what the market has been doing in a day.

taking targets and stop levels. Also, my key numbers allow me to evaluate market strength or weakness.

They basically represent the levels all trades recognize and say to themselves, "If price could just make it through that level, I know it would keep going."

I began to catalog these numbers and was amazed to see the repetition. If you keep your own list, you will begin to notice the same numbers pop up again and again.

The time of day element is based on the idea that I trade only when market conditions are most favorable. To trade all day, every day, is futile. I've identified three "trade zones" that are most advantageous for me, and I simply don't trade outside these zones. Every trader must try to identify when [he or she is] most effective and stick to that time. Trading rewards quality, not quantity.

People tend to be creatures of habit, and the habits of traders can be correlated with price action. For instance, 11 a.m. to 2 p.m. (CST) is what I call "lunchtime in America." You can expect volume to dry up as brokers, money managers and other traders from New York, Chicago and San Francisco go to lunch. For me, this is a good time to enter trades if the conditions are right, such as when a trade sets up around a key support or resistance number.

AT: *What's your approach to risk management?*

TB: First and foremost, I worry about risk - I closely examine my downside. Prior to any trade, I determine the exit stop. My cardinal rule is to never trade without first declaring a stop.

New traders take profits too early and have a tendency to jump out of trades based on their emotions, rather than relying on prudent risk-control principles. The key to any trader's success is having an exit strategy - a stop-loss in place before putting money at risk. With a stop in place, a trader can reduce emotional turmoil. A trader who doesn't use stops has no chance of success.

AT: *How do you determine where to place a stop?*

TS: There are four approaches to stop placement. Basically, stop orders are placed below the entry point if going long, or above the entry point if going

short to protect the trader in case the market turns against him. But stops can be detrimental if not placed properly.

The "arbitrary stop" is the most basic approach. The trader establishes a fixed number of points for a stop - say, 4 points. If you buy an S&P contract at 1,169.50, then you would enter a stop order at 1,165.50. This is a mechanical stop-management approach. Beginner traders usually use this approach as they're learning. The learning curve, though, should be quick. We advocate this stop only in the sense that you must always have a stop of some sort in place. Arbitrary stops should be used as an emergency break of sorts, and should be utilized only when a trader has no real idea where a stop should be placed.

The second approach is a volatility stop. It calculates the range of a set of bars - in my case seven - and determines how far the bar should travel in that range. The trader then places the stop above or below that level. This is a systematic stop-management approach.

The third approach is what I call my RoadMap stop or a Key Number stop, and it's the one I use most in my trading. It's based on placing stops off of identified key numbers of support or resistance. For example, if you buy a contract at 1,169.50 and the nearest key support number is 1,167.60, then the stop would be placed below that key number. This is a technical analysis stop-management approach. I also use a combination approach that selects the stop with the least amount of risk from these approaches.

AT: *When and how do you decide to go long or short during the day?*

TB: When all three elements of my method support the trade - the RoadMap supports the direction, the market has broken a key support or resistance number, and I am in one of my trade zones - I make the trade. For example, if the S&P at 1 p.m. is at 1,182.80, which is lower than my 12:30 p.m. key number of 1,186.50, and the RoadMap indicators are all red and the S&P is breaking the 1,182 key support number, then I know to go short.

AT: *Can you specify the trade zones?*

TB: Trade zone No.1 is 9:30 a.m. to 10:15 a.m. (CST), zone No.2 is 12:30 p.m. to

1:15 p.m. (CST), and No.3 is between 2:15 p.m. and 2:45 p.m. (CST). The rationale behind the trade zones is quite simple. It forces me to determine the best time to put my money at risk. Through evaluation of my own trading I've learned these are the best times for me to trade.

There is no definitive reason why these times are what they are. Some are more fact-related, others are merely a feeling I get from the market. For example, I steer clear of the opening bell because, in my opinion, New York has yet to settle down and digest what the foreign markets have done the previous evening. During this herky-jerky period, it's better for me to analyze rather than trade. I also avoid trading from 10:30 a.m. to 12:30 p.m., because I like to gather data then. This decision is based primarily on the fact that I've had less success trading then compared to other times of the day. Why I haven't had the greatest level of success at that time is anyone's guess, but why challenge fate?

Trading is more of an art than a science. Over the years, I have started to know myself better and my trading has benefited from this knowledge. Patience and discipline keep me from overtrading or rushing into trades I'm not ready to make. On days when the outlook during the trade zones is unfavorable, I simply won't trade.

AT: *Are there times of the trading day when you won't enter a trade because of the risk involved?*

TB: Basically it's the first 30 minutes of the trading day, 8:30 a.m. to 9 a.m. (CST), and the last 30 minutes, 2:45 to 3:15 p.m. (CST). At these times there are so many competing rationales and flurries of activity that it's simply not prudent to trade.

AT: *Can you give an example of the kind of trading strategies you use?*

TS: First, I've learned to do what the market tells me. If the market is trending up, I will go long; if it's trending down, I will go short. Regardless of the approach you may use, unless you're correct about market direction, whatever else occurs is purely happenstance.

The "Negative Noon Balloon" trade is one I look for in the afternoon. The S&P

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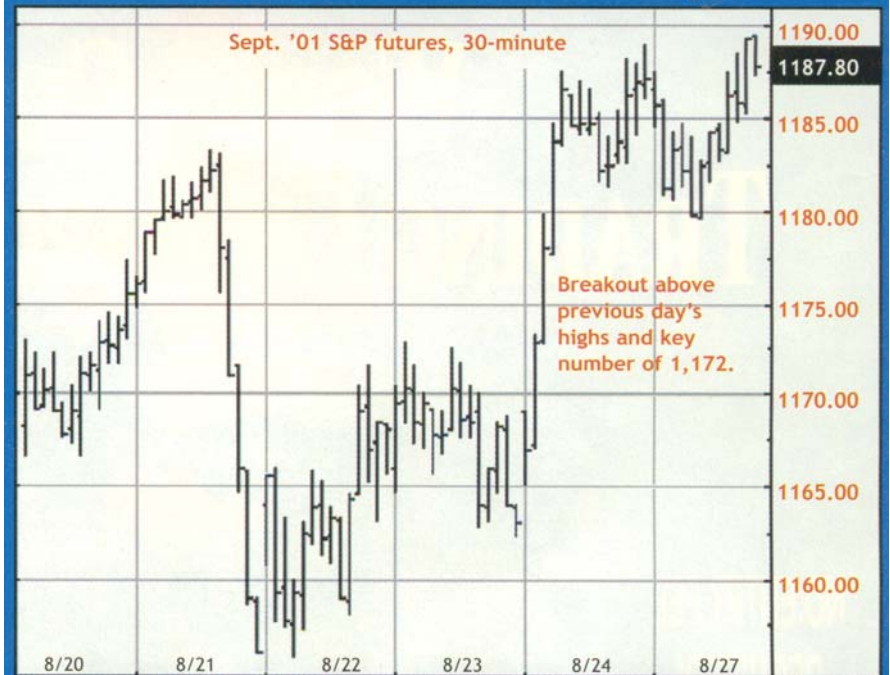
500 futures normally move higher between 12:30 and 1 p.m. (CST). But when the S&P moves down during this period, it sets a negative tone, and the market tends to sell off the rest of the afternoon.

When this occurs, I look for one of two things to happen: Either the S&P will continue to fall until it hits a 6-point target, or it will go up until it sets a new high for the day. One or the other will usually take place by 1:35 p.m., ending the trade. But if neither occurs, the setup will linger until the same time the following day, when a new 12:30 number is established. The chance of the S&P either not reaching its target or setting a new high by 12:30 p.m. the following day is extremely rare - it's happened only two times so far this year.

If neither of the two expected outcomes takes place by about 1:35 p.m., I would advise more novice traders to exit the trade. I am extremely wary about holding non-trending positions outside my trade zones.

FIGURE 2 KEY NUMBERS IN THE ZONE

A breakout above the previous day's high and the 1,172 key number during the favorable 9:30 to 10:15 a.m. CST time zone lead to a long trade.



Source: RoadMap to the Market

AT: *I know you keep a log of your trades. What information do you track, and how does it help you trade?*

TB: Anyone who trades should keep a log. It makes you a smarter trader. The primary rationale for my keeping a log is to improve by reviewing the actual trades I make - recognizing and correcting mistakes. I also use this record to verify that I've executed all my trades correctly. Regardless of your level of expertise, you can never be too sure you've handled your executions properly. A problem may happen only every so often, but it will happen sooner or later. Keeping a logbook also forces me to relive my trading day, which increases my resolve to stick to my method.

I track the actual trades that I have taken in each of my trade zones. I review the day's action, that day's strategy and the results of the strategy. I also examine the log to find relevant key numbers to determine future support and resistance points.

AT: *How do you use charts in your work?*

TB: I like to look at 30-minute bars. This

keeps me from getting caught up in the minutiae of the market, but it still allows me to see movement inside the day. If the markets continually test a certain number, you'll be able to see that easily on a chart.

For example, on Aug. 23, the two highs in the September S&P futures were 1,172.80 and 1,172.50. Over the years, 1,172 has been a common key number. On Aug. 24, the market tested the 1,172 key number, but was only able to rally to 1,173.00 prior to 9:30 a.m. At the breakout above the previous day's resistance, the market took off. (See Figure 2, above.)

AT: *What's your opinion about stepping away from trading when things are not going your way?*

TB: You have to accept there are going to be "off" days - days when you just don't have it, or you're distracted, or when the market is erratic and giving false signals. When you find yourself in that situation, get out. It's foolish to continually bang your head against the wall because you think there should be a door there. I can blame one bad trade a day on the market. But two? Whose fault is that?

AT: *How critical is it for a day trader to follow the SftP and Nasdaq futures during the day?*

TB: Without the knowledge of what the S&P and Nasdaq futures are doing, a trader is not fully prepared. The futures tell traders what the market is doing by leading the Nasdaq and Dow indices. While futures can be volatile and, at times, quite unpredictable, I have found them to be the most reliable indicator of market direction.

AT: *If you were to give advice to new day traders, or traders who can't seem to make a consistent profit, what would it be?*

TB: Before ever putting money at risk, you have to educate yourself about the market and establish a game plan with realistic goals. You must be comfortable with your decision-making process, match your personality with the markets you trade, and never force a trade. Always have an exit strategy in place before making a trade. The bottom line is that you must take responsibility for acquiring the education necessary to be successful in the market. 0