Stock Speculation

For XXX

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By XXXX

What is speculation? (Contdǔ)

ð Speculation is a guess or estimate in advance of outcomes which are uncertain.

ð Goods and services managed through any free market place involves speculation e.g. Equity, Commodity, Currency etc.

ð Why people speculate- not for money only, it can be excitement, ego and fear as well.

ð Is speculation different from trading- absolutely, trading is exchange of goods and services against money or in kind. Trading is to facilitate execution of a transaction which may or may not include speculation.

What is speculation? (Contdǔ)

ð Is Speculation different from technical analysis (TA)- TA is insignificantly small subset of speculation which does not influence even 5% of over all success.

ð Can speculation be only pure guess work? Yes, but when you speculate to make money consistently only guess work won't help.

ð Does speculation makes you wealthy overnight? Nothing makes us rich overnight, even it happens won't stay for long.

ð Is speculation anti Indian and crime? Not at all, speculation is part of life even when you are working in office.

ð Is speculation bad for fundamental investing? You may think yes or no, but it's part of any investing process. Difference is you speculate unknowingly.

Informed Speculator

ð Why it pays off to being informed speculator than ignorant speculator.

ð Information is major ingredient behind speculation- the more you have more is success rate.

ð Informed speculation is all about plan, philosophy, execution. Just like a day job.

ð Skewness of speculation is non linear both financially and non financially.

ð Practised discipline and patience is cornerstone of successful speculation.

ð The purpose centre- if you don't know why and what you are speculating the game is up for you.

Speculators-Money, Method and Madness

- ð Jesse Livermore- greatest speculator in world, 4 bankruptcies, billions in a week, 650% return a month. End-Suicide.

- ð William Durant- founder of General Motor, pumped billions from company, bankrupt finally. End- depression.

- ð Arthur Cutten- dirt farmer to billions, overnight icon for Canadians, luxury on island. End- mania and missing (perhaps suicide!)

- ð Wei Dong- car cleaner to owning the biggest fancy buildings in Beijing, even frightened mighty communist party once. End- Suicide

- ð Jumpers of 1929- scores of people jumped from Wall Street building to avoid financial catastrophe. This includes cobbler turning restaurant owner, caddie turned broker etc.

- ð Manu Manek- fearsome short seller of Mumbai for once got into nerves of even legendary Dhirubhai Ambani. End- Unknown, not seen in market for decades.

Fundamental Investing and Speculation

- Every stock price on BSE / NSE ticker includes a speculation element. E.g. if ITC price of 300 includes a fundamental value and speculation value.

- Speculation value some times way more than fundamental value and stays for ever.

- PE ratio is one of way to measure speculation!

- The wealth value chain- promoters do not run stock prices but business, it's the crowd who manage stock prices which can stay insane till you survive.

- Prices can go higher than we think and lower than we realise.

- Informed speculation minimise losses and maximise profits.

Speculation without Fundamental Investing

ð Popularly called trading in stock and commodity market.

ð Objective is to achieve certain known parameters (you can say money is one of them) through systematic study of crowd behaviour which influences the movement of price.

ð You loose 80% of times yet you have a chance to make billions!

ð Harder than you think, tougher than you see like object in rear view mirror.

ð Play on daily fluctuations or intermediary (day or swing), some play for long term price movement (positional).

ð Portfolio measurement is through expectancy not compounding!

Market Direction- Overarch

ð Index is average of individual stock price movements. If the overall wind is against, you are unlikely to win. In falling market buying a share that goes down.

ð Build a strategy for buy and sell basis market direction (up trend, down trend and range bound).

ð Understand divergence (it happens most of time) when section of crowd does exactly opposite to other section.

ð All components of speculation are intertwined with market direction.

ð Can you beat out macro economics, here is the place!

TEN Elements of Stock Speculation

- Speculation Objectives (purpose centre, a plan and it's target).
- Entry Method (how, when and where to take an entry)
- Exit Plan (when to fold)
- Holding Plan (Einstein said time is fourth pillar of physics, here as well!)
- Money Management
- Trading Systems
- Testing of Trading Systems
- Speculation work book
- KPI
- Behavioural Finance/Soft Science (this is 90% of speculation)

Element 1- Objectives

ð K now what exactly you want to achieve e.g. 100 Cr in 20 years. Break it down to smaller components. Say with 10 lac capital with 30% probability of winning how many stocks you require reach 1 Cr and how many years. E ffectively it will tell you whether you can reach 100 Cr.

ð Can you do it part time to achieve the number of stocks and trades above?

ð What type of resources required to achieve this? Books? Tutorials? Class room training? Mentoring? A day with ghost of Jesse Livermore?

ð Decide the type of market you want to deal with- real estate? Stocks? Forex? Commodity?

ð Money is the most insignificant part of framework, once you realise money flows.

ð Speculation or any thing that is attached to market is more social science than physical science.

Element 2-Entry Plan

ð Remember you are likely to loose between 60-65% of times or even more. The only way you can survive by cutting losses early and letting profits run (this line never changed from Livermore to Seykota). So don't fret over entry method too much, even stone throwing will hit target twice out of ten times.

ð Systematic entry method increases probability of winning through study of previous data (price, volume, time) visually (a chart!) or via table analysis (e.g. market profile) or even mode of fractal data.

ð Every method have given plenty of money in past. In reality entry plan is a very insignificant portion which is hyped in media like Fibonacci, Cup and Handle etc.

ð Market a free place to determine to demand and supply. Every price that goes up a section of crowd is ready to pay higher price; reverse is the case for price that goes down. Now decide your entry method, it can be as simple e.g. highest price among last 20 days.

ð Successful speculators write more than 20/30 trading set up every year depending on market situation.

Element 3,4-Exit and Holding Plan

ð Avoiding loss is key principle behind exit plan. Loss should be set a portfolio level, capital level and stock level.

ð Law of stop loss, hardest one to follow psychologically. Also difficult one to determine.

ð A good stop loss includes your risk appetite, market direction and volatility of individual stocks.

ð Stop loss methods (fixed percentage, variable percentage, mental stops). Sitting tight without a plan can make your chair broken on which you are sitting.

ð Time is main theme behind holding plan. Never hold for no reason.

ð Expectation of return drives holding plan. This can be opportunity cost or even loss minimisation.

Element 5-Money Management

- How much money, how many times and how long?
- Core component behind all other speculation elements.
- Scaling in or scaling out? Popularly called pyramid.
- Averaging down? Which market condition then?
- Position size and risk per trade
- When not to add?
- How can I be risk free?
- AMAZING FACT: the giant speculators always sit on negative risk. This means they won't lose anything after a period of time despite market moves against them. This is single most successful factor behind success.

Element 6,7-Trading Systems

ð Combination of plan 2-5 in a paper.

ð Key elements- market direction, filter, entry plan, exit and holding plant, position size, risk per trade, timing rules etc.

ð Back testing the system- sanitise using old data.

ð Paper testing- mock testing for few months (I am against, rather do small).

ð Trading system are individual specific, never copy them from others.

ð Fibonacci is a entry method not trading system!

Element 8,9- Speculation Workbook/ Metrics

ð Make it play book- a diary of trader

ð Entry and exit records

ð Lessons learnt

ð Each component of trading systems

ð Expectancy and R Factor (profitability is against risk not margins but due to).

ð Number and amount game (% winning against average winner/ looser)

ð Stop sign board tracking

ð High, low and median

Element 10- Behavioural Finance

ð Crowd is human behaviour. It's the human drives prices, even algo system are designed by human.

ð A human is ingrained with biases, prejudices and fallacies (god gift!)

ð Deliberate practice and habit formation overcomes biases.

ð Biases affect decision making in turn affect stock markets and it's prices.

ð 90% of success rate depends on how good you are in behavioural finance.

ð The dictum of hope, fear and greed.

Using Speculation framework in fundamental Investing Approach

- Value comes from business but price is determined by crowds in secondary market.

- Segregate research from execution. A stock on list does not mean buy or sell.

- Growth investing data are far more complex than historical data.

- Never go against crowd, always be part of crowd but know when to stop going with them.

- Over confidence- your analysis is wrong good number of times.

- Overwhelming- good number of times prices goes way beyond your analysis.

- Competitive advantage is played to make business stronger not public wealth.

- Investing is buying a piece of business, TRUE. Do not hallucinate you are buying a position in board.

R-Mode Thinking & Fractal Data

ð Limitation of L-Mode and idle core brain.

ð The super idle Right brain with infinite power.

ð Wiring through deliberate practice (Left side)

ð Wiring beyond deliberate practice or habit formation- fractal data (Right Side)

ð Fractal data- breaking bigger picture to smaller patterns

ð Interrelationship of fractal data

ð Assessing the underlying structure behind fractal data

DO/DO NOT

ð Read a book and do not publish in Twitter that you have red

ð Over indulgence in social forum (avoid two way communications unless you have a reason in written). Remember best guys of India/World do not have presence online, what you see may not be correct.

ð Do not parrot Charlie Munger (mental model is not investing). Read all type of books (do not think speculation is gambling, it's practice much older than value investing).

ð Do not quit the employment (investing is a job with or without employment) thinking you do not have to work further.

ð Do not count starting capital to start investing, everything starts from small and it's incredibly difficult.

ð Do not follow any one, good to inspire and admire but not bhakt.

DEMO- MARKET DIRECTION

Market up trend

1. Making higher high

2. 30DMA and 150 DMA are rising

3. Index> 30DMA> 150DMA

Nifty, BSE Midcap, BSE Smallcap

Range bound or sidways market

1. One index is making higher high where as other one failed.

2. 30 DMA and 150 DMA are rising for one index where as other one failed.

3. DMA 30 and 150 are criss cross for indexes.

Downtrend market

1. Making lower low

2. 30DMA and 150 DMA are falling

3. Index< 30DMA< 150DMA

Market strength and volatility

1. Rising or falling volatility ATR14

2. Rising RSI or Falling RSI

MMA Analysis

1. Traders behaviour- compression or expansion

2. Investors behaviour- compression or expansion

3. Trend change

4. Trend strength

DEMO- TRADING RULES

Rule 1: Position Size

1. Testing position (including direction testing)
Max Risk ǔ . with Max Pos Size ... K

2. Initial Position: Max ... Risk, Max Pos Size-....
Trade 1: Max ..... Risk, Max Pos Size- ....Lacs
Trade 2: Max .... Risk, Max Pos Size- ....
Trade 4 on wards: Max ǔ .Risk, Max Pos Size- ǔ .

3.Initial position is taken after testing position is confirmed. This is without using volatiity based ATR i.e. at 1R of testing position initial position is entered. All initial positions will be taken on Monday.
Pyramid is applied to initial position onwards. With 1R rise to initial position keep adding to base. Change the risk amount as described above. If the original position is closed next position becomes initial position. R is determined basis latest ATR/ volatility.

Rule 2: Amendment of Position Size

1. When Nifty, Midcap or Small Cap (any of them) corrects between 0 to 9%- position size remain same.
2. When Nifty, Midcap or Small Cap (any of them) corrects between 10% to 19%- position size reduced by 50%.
3. When Nifty, Midcap or Small Cap (any of them) corrects between 19% to 29%- position size reduced by 75%.
4. When Nifty, Midcap or Small Cap (any of them) corrects more than 30%- position size reduced by 87.5%.

DEMO- TRADING RULES

Rule 3: Money Management Matrix

1. Up trend stock and up trend market- a. buy if short listed b. hold if bought c. add to position when scaling in rules allow. d. add to position when relative strength of stock is out performing index or sector. (any one of condition from C or D).

2. Sideways stock and up trend market- a. buy if short listed b. hold if bought b. do not add position even if the scaling in rules allow

3. Down trend stock and up trend market- a. do not buy even if shortlisted b. hold if bought c. check bullish divergence d. do not add position even if allowed by scaling in rules

4. Up trend stock and sideways market- a. buy if short listed b. hold if bought c. add to positions when scaling in rules allow. D. add to position when relative strength of stock is outperforming index or sector (both conditions C & D required).

5. Sideways stock and sideways market- a. buy if short listed b. hold if bought c. do not add to position even if allowed by scaling in rules

6. Down trend stock and sideways market- a. if a price target is achieved sell 50% on continous 3 days negative ending (3% or more down) . B. Do not buy even if short listed c. Do not add to position even if allowed by scaling in rules allow

7. Up trend stock and down trend market- a. do not buy even if shortlisted b. hold if bought c. do not add position even if scaling in rules allow d. check bearish divergence

8. Sideways stock and down trend market- a. do not buy even if shortlisted b. hold if bought c. do not add position even if scaling in rules allow

9. Down trend stock and down trend market- a. do not buy even if shortlisted b. do not add position even if scaling in rules allow c. sell 50% when stock ends 3 days negative in a row (3% or more down)

DEMO- TRADING RULES

Rule 4: Stop Loss (SL) and Trailing Stop Loss (TSL)

1. For testing position ATR multiplied by 1 instead of normal 2, this is to test market direction.

2. Average true range multiplied by 2 times. Not Applicable for testing position.
If daily Volatility is less than 3% then then multiplication factor (MF) is 2.
If Volatility is between 3-4% then MF is 2.2
If Volatility is between 4-5% then MF is 2.4
If volatility is beyond 5% then MF is 2.5

3. Trailing stop loss is- a. when proft is more than 1R trail it to 1R.

Rule 5: Scaling in

1. Scaling in as per positionsize (see Rule 1)

2.With 1R rise to original position keep adding to base.

3. If the original position is closed next position becomes initial position. R is determined basis latest ATR/ volatility.

4. Scaling in is allowed subject to money management matrix (Rule 3).

DEMO- TRADING RULES

Rule 6: Scaling out

1. When profit target is achieved scaling out is allowed when stock ended three days negative in a row (3% or more down).

2. When market is in down trend and stock is in downtrend scaling out is allowed when stock ended three days negative in a row (3% or more down).

3. Scaling out rules work individually i.e. they superseed the money management rules (Rule 3).

Rule 6: Averaging down

1. Averaging down not allowed

Rule 7: Timing Rules (Entry and exit)

1. The 1% rule test (exit): every stock that hits SL/TSL comes under exit zone. Within exit zone stock is allowed to stay as long as it's making 1% per day till SL/TSL levels are achieved. The day it fails stock will be exited immediately, no second chance given.

2. Stock will be exited before 10.30 AM in morning.

3. Positive rule (entry)- after the stock is eligible for entry it can be bought only if market or stock is positive or not negative more than 1%. Positive rule is tested for the whole week, if the stock does not pass through stock is purged (for testing position and pyramid positions). However a confirmed position is allowed to roll over next week till expiry date of testing position.

4. Entry is allowed after 12.30 PM Only.

DEMO- TRADING RULES

Rule 8: Monitoring conditions (Weekend and middle of week-Tuesday/ Friday)

1. Monitoring is to be done a weekly basis. To be carried out only for confirmed positions.

2. Technical monitoring conditions: 3M to 1Y
- 2B Rule to check trend change
- the stock has gone to stage 3 but not hit the SL/TSL.
- 1/2/3 Victor Rule
- Support and resistance levels
- Broken trendline
- Broken DMA i.e. 30 DMA
A point would be noted, stock will be exited only when hit the SL/TSL.

Rule 9: Holding Rules

1. The cool off period is 1 Month.

2. Beginning 2nd Month the return expected is 1% per fortnight. Say by 3rd fortnight it should be 3%.

3. The holding plan is valid till stock hit SL/TSL.

DEMO- SPECULATION WORK BOOK

ð   Purchase date

ð   Time

ð   Feel good rating

ð   Name

ð   Type of position

ð   Status

ð   Source

ð   Avge Cost

ð   Profit target

ð   Remaining target

ð   Purchase value

ð   Inherent Risk

ð   Residual Risk

DEMO- SPECULATION WORK BOOK

- ð Original Stop Loss
- ð Trailing Stop Loss
- ð CMP
- ð No of shares
- ð Current Value
- ð Current Profit/Loss
- ð Locked in profit
- ð R Factor
- ð Current Date
- ð Current Margin
- ð Holding days
- ð Holding Expectation

DEMO- SPECULATION WORK BOOK

ð Sale date

ð Time

ð Sale Value

ð Actual profit/ loss

ð Actual Expectancy

ð Total Charges

ð Transaction cost %

DEMO- METRICS

- ð Gross Profit
- ð Gross Loss
- ð Net Profit/Loss
- ð Total Trades
- ð Winning/Loosing Trades and %
- ð Average Winner
- ð Average Looser
- ð AWL Ratio (Average winner/average looser)
- ð Largest Looser
- ð Largest Winner
- ð Maximum Drawdown
- ð Risk exposed and risk appetite
- ð Expectancy
- ð Max trades allowed and current trades

Resources

- Reminiscence of a Stock Operator- Edwin Lefevre
- Market Wizard Series- Jack Schwager
- How to make money in stocks- William O Neil
- Trading Psychology- Brett Steenbarger
- Trading in Zone- Mark Douglas
- Trading for a living- Alexander Elder
- Trend following- Michael Covel
- Papers and notes of Ed Seykota, Richard Dennis, Mark Minerveni, Curtis Faith, John Paulson, Paul Tudor Jones, Darryl Guppy, Martin Pring etc

Questions?

ð Send me a mail if you think I can respond:

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