David vs Goliath

How Small Traders Can Benefit from the Big Players

What does a trader need to complete his trades in a disciplined way? Confidence! And how can he get that? By knowing what he is doing and by completely understanding the situation in which he happens to be trading and by executing the very trades that match this understanding. Read here how a retail investor can mentally adjust to the "trading game", in which he is pitted as a David against the major investor Goliaths. What are the strengths and weaknesses of the Goliaths and what are those of trader David? What is his slingshot and how can he use it best?

» Amateurs and Professionals

The situation in the trading arena is as follows (and some traders – especially neophytes – are not quite aware of it): Alongside a small number of major investors (equity funds, pension funds, and so on) that can safely be called professionals, there is a large number of so-called retail investors. Of these, most have not progressed beyond the "amateur" status yet. And unlike in sports where professionals and amateurs compete against each other in separate leagues, amateur traders are, of necessity, pitted against the professionals from the very beginning.

Major investors have a number of advantages:

- Well-trained staff: Portfolio managers can be expected to have received the best possible training and to have plenty of work experience.
- Technology: The latest software, good analysts to use it properly, fast computers, high-speed lines.
- Sufficient capacity to conduct fundamental analyses. While good fundamental analyses comes at high cost, large investors can afford to meet them.
- Good contacts: The large investors' money managers have contacts in all directions of the financial sector, which gives them sources of information that retail investors can only dream of.
- Size: They can move the market.

Gernot Daum

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Opportunities for Retail Investors

On the face of it, things look hopeless for retail investors, don't they? To be sure, it's important to be aware of the situation. But this awareness allows ways to be found even for small investors to graduate from amateurs to professionals in order to finally make money on the markets.

Let's start with the last of the five items listed above: Is it really advantageous for investors to be capable of moving the market? Doesn't this also entail disadvantages for large investors? It certainly does. Here is a list of them:

- Inflow and outflow of capital. Customers of the funds are the ones responsible for timing. And these are often amateurs who purposely delegate their personal investment decisions. So the inflow and outflow of capital is likely to occur at more or less the wrong time for funds.
- Equity funds need to engage in marketing. This may lead to constraints on the selection of investments caused by the need to show for marketing purposes "that you are doing everything right."
- Successful equity funds continue to grow. But one particular fund may have been successful mainly because of good technical analysis. Starting from a certain size, however, this does not work anymore, making it necessary to switch to more fundamental approaches. But in this case that is no longer part of the special skills set of the fund managers.
- Is having many contacts always a good thing? The financial crisis of 2009 was primarily caused by the fact that everybody owning certain stocks (now often referred to as "toxic assets") was doing the same thing simply "because they all were" – and along the way everybody seems to have lost sight of the overall risk.
- And now to the item of size: Moving the market is not advantageous since that causes your own activities to be visible making it possible for other participants in the trading game to adjust to that. At bottom, the entire trend-following approach is based on this idea.

So, there is hope then. I will elaborate on the latter aspect of "visibility" in this article, resulting in trade setups for the retail investor. This is the basic idea of charting: Looking at what the big players are doing, following suit and "taking advantage" of their problems.

First off, an example: It's about a stock that in 2013 quite clearly resulted in constraints on large investors that retail investors were able to benefit from – by trend following, of course.

Day Trader David

In Figure 1 you can see a Software AG intraday chart of 29th Jan 2013 on a 5-minute basis. On this day, the company released figures showing that while its own targets had been achieved or even slightly exceeded, market expectations must have been much higher since the stock opened with a large downward gap .

The stock had gone up by more than 60 per cent from July 2012 to January 2013, doing significantly better than the overall market. There were certainly fundamental reasons for this. Large investors with good fundamental analyses recognised this in time and benefited from it. But what was the situation now? Apparently, there were quite a few large positions with a short time horizon in the market, otherwise there would not immediately have been the large gap, considering the numbers. How does a day trader behave in such a situation? He is going to wait and see how the situation will develop in the first one or two hours. After all, it will become apparent soon how serious the imbalances of the major investors really are. There will then be high pressure on them to reduce those positions, which may very soon lead to further sell-offs.

F1) Software AG Stock on 29th Jan 2013

Outline of a day trade after a down gap. Entry was made shortly before 10 am upon the breakout of prices below the 32 euro level. Shortly before the close, the position was smoothed below 29 euros near the daily lows.

Source: Author's own Statistikfuchs software

That's exactly what happened here. There was important support at 32 euros and the price was able to hold above it for an hour. A stop sell below 32 or below the daily low was now a reasonable trading plan. The trade was triggered shortly before 10 am. There was no reason to close the trade before the end of the trading session. This is the time for those who only do day trading to close their trades. Since it was possible for the stop to be placed on the daily high just above 32.50, the trade had a fantastic risk/reward ratio.

Swing Trader David

Change of time level: We are leaving the day trader and move on to a swing trader who holds his trades for days or even weeks. The Software AG stock will also have surfaced on his radar. He will be looking closely at the intraday chart and will figure out his chances. After such a day with virtually no resistance to the gap, this trader knows that many more sales can probably be expected from large investors. In actual fact, things were going slightly downhill for a few more days before the multi-week technical correction occurred which had been due. After that, though, there were swing trading opportunities on the short side. The chart in Figure 2 shows the development in the months after the downward gap shown in Figure 1.

A detailed discussion of trend-following tactics is not part of this article, which is why the potential trading plans will only be briefly outlined here: At point 1, a counter-cyclical entry into a short trade was possible since a 50 per cent Fibonacci correction mark was hit here. The following pro-cyclical entry opportunities for the security-oriented trend trader have been marked with point 2. At point 3a it was possible for the trade to be strengthened. However, this partial position would have been stopped out at point 3b in any normal trade management because of a false signal. Point 4 shows another (this time successful) opportunity to strengthen the trade pro-cyclically.

From the end of June it was possible to reduce the position significantly since a reversal pattern had formed above the "great" support at 22 euros (low of July 2012), and finally there was a clear trend counter-signal at point 5.

So there were many shorting opportunities for retail investors. And all that at the expense of large investors who had lost sight of the fundamental perspective and had used technical analysis (which was inappropriate for their position sizes) to push each other ever higher.

David and Two Goliaths

The following example is a more complicated chart pattern that shows several things:

- What particular signs are there for major investors in a market?
- What are the large investors' lines of thought and what traces do these leave in the chart?
- What are the consequences for the trading done by David, our retail investor?

While the chart pattern is for the "advanced" among traders, it shows well in which direction you can develop your thinking about the stock market if you're looking to understand the causes behind the patterns. This is all about the "megaphone" continuation of a rectangular pattern. The Bayer stock provided a fitting example of this in early 2013 – see Figure 3.

F2) Daily Chart of the Software AG Stock

The chart shows several swing trading plans. At point 1, the 50 per cent Fibonacci retracement was twice hit almost perfectly. Points 2, 3, and 4 show suitable spots to increase the short position. At point 3b, there would have been a false trade of the short position that was opened at point 3a. At point 5, there was finally a clear counter-signal for the downward trend.

Source: www.tradesignalonline.com

In December 2012 and January 2013, a rather narrow rectangle had formed within the limits of 71 to 73.50 euros. In such a case, the probability of the following scenario occurring is quite high: A strong buyer (Goliath 1) bought at 71, a strong seller (Goliath 2) sold at 73.50 and the rest of the market participants provided the fluctuation between these two price levels. "Strong" here means: There is an interest on the part of a single market participant (a major investor) in building up or reducing a large position in the stock.

Then, on 25th January, there was a large upward bar with a closing price above 76 euros (first marking). This was a strong buy signal since the seller who had sold at 73.50 euros had apparently sold his holdings while the strong buyer was still in the market. This is a suitable signal for our trader David to open a long position. But there are also false signals, and this was one of them. Within just a few days the price dropped again below 73.50 euros.

Just on the strength of the many new buyers being attracted by such a signal, this should actually not have happened. So the seller was still there after all and managed to get rid of some of his stocks at much higher prices. So far, so bad for the breakout trader. False signals are part and parcel of any trading system. That's why you need a stop management system that in case of loss stops out a position again after a short period of time (second marking). At this point, all you can do is just regret the loss. Or else try out an "advanced" way of looking at the situation. And this is exactly where it gets exciting!

Pulling out as a Tactic to Increase the Average Selling Price

The seller had pulled out. He had suspended his sales for a short time. Presumably, he had also been inspired by some good news on the stock that came out on 25th January. The buy signal caused many new buyers to enter the market and on the following days the seller started selling again, no doubt getting rid of some stocks at higher prices than before. This is precisely the task of a fund manager who needs to reduce a large position: driving the average selling price upwards. The pulling-out tactic helps him do that. Upon "coming back in", however, he promptly needs to put his cards on the table.

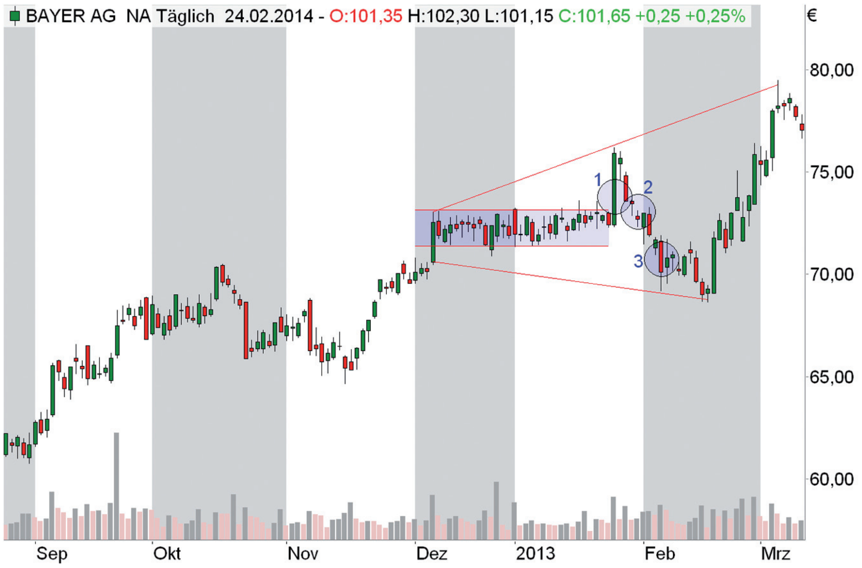
But what is going through David's mind now that he has just lost money? If he is an experienced trader, he is thinking one step further. And says to himself, "The buyer will now be pulling out too, which is only logical." And so it is now possible to turn the long position lost into a short-term short position and have a good risk/reward ratio.

Pulling out as a Tactic to Lower the Average Buying Price

Why is it logical for the buyer to also "pull out"? Because the latter knows, of course, that the apparent breakout – which proved to be a false signal – has caused many traders to be now in new long positions and that those traders do not all operate with a tight stop. And because, given the strength of selling pressure shown by the seller "coming back in", even many traders who have had their positions for some time will now be giving up. So the buyer will remove his bid at 71 euros, waiting for lower prices. The big red bar on 6th Feb 2013 (third marking in Figure 3) is an impressive showing of this mechanism. That was also the right day to close the short-term short position at 70 euros or just below. Gambling further on this position would have been risky since pulling out is a short term tactic.

The buyer needs to come back in very soon to collect his shares amid all the panic and triggering of stops. However, this time the price even fell quite a bit lower in the following days, eventually resulting in the chart

F3) Megaphone Pattern at Bayer in Early 2013



This pattern shows a "duel" between two major investors each of whom "pulled out" their sell orders upwards (point 1) and their buy orders downwards (point 3) respectively, as described in the text.

Source: www.tradesignalonline.com

revealing the line-plotted "megaphone" pattern caused by the expansion of the previously existing rectangle.

But back to our experienced trader David who made the breakout trade, accepted his loss and then implemented the short trade. That trade has probably not only compensated for his loss, but on balance has even made him a small profit. This is what flexibility in trading is. You can develop it by trying to understand the situation and motives of those involved in the market – and by taking advantage of your own "invisibility" as opposed to the visibility of large investors.

David's Trading Work

What will be the consequences now for the daily trading done by our retail investor David? Using the example of the Software AG stock, trades were shown in two time levels suggesting an important aspect in the organisation of trading: Since a retail investor's time is limited, a strict selection of stocks is necessary. And this means shares where something "extraordinary" is happening as was the case here with the Software AG stock. It's these shares that you will be looking at more closely, and you will then be working out different trading plans accordingly.

The formation of a very narrow rectangle is also something extraordinary. David can set up a scanner for such patterns and use these as the starting points of his trading plans. Breakout setups are his first choice in such a case. It's also important for him to be open to new ideas if things don't develop as planned. In the case of narrow rectangles, David should also check and see whether there is a takeover bid at that price. Prices especially of minor stocks may then not move at all and the stock may not be worth bothering with. However, major DAX stocks are rather unlikely to experience this and are easy to research in any case. In the Bayer stock, there was no such takeover bid at that point in time.

A Word of Caution Concerning Special Situations

Finally, here is a counter-example. In the Rhoen-Klinikum stock (Figure 4), a narrow rectangle had formed in May 2012 and there was a potential breakout trade (see marking). However, the chart situation was the consequence of a publicly known takeover bid by Fresenius for Rhoen-Klinikum in April. In Figure 4, the timing of this is highlighted by the massive upward gap. This then is not a "duel" between two large investors. In such a case the risks outweigh the opportunities. It is possible, for example, for the takeover not to go according to plan, which was the case here causing massive price losses.

Such situations should be ignored by David and limited to cases where the duel between two Goliaths is visible on the chart but is not accompanied by any news or at least none that is of any significance.

Conclusion

Competing against the large investor "Goliath", the retail investor "David" has a fighting chance if he chooses to base his trading style on Goliath's weaknesses. The latter's principal weakness is his visibility which is due to the size of his positions. This is where David's slingshot has an opportunity to strike. The Software AG stock was used as an example to explain how David may benefit from any false positioning on the part the Goliaths in two different time levels. The example of the Bayer stock shows how flexible trading evolves from an understanding of the way major market participants operate. The counter-example provided by the Rhoen-Klinikum stock demonstrates that it is absolutely necessary to research all the relevant news that is happening. «

F4) A Word of Caution Concerning Rectangular Patterns after Takeover Bids

The trading risk is too high for takeover scenarios, as is illustrated by the example of Rhoen-Klinikum. News that the deal is unlikely to be reached caused the stock to plummet at the end of June.

Source: www.tradesignalonline.com