Ten Essential Rules for Investing

Tyler Bollhorn

1. **When looking for market beating stocks, focus on abnormal trading activity.**

   Stocks that go up faster than the overall market do so because investors perceive that the company's fundamentals are improving. Positive information on the company's business have to flow from the company to the investor, a process that is not always fair. Some people get better information than others.

   When investors learn of a positive change in the fundamentals, they buy the stock, often aggressively. A large investor who takes a large position in a stock will create abnormal trading activity. An increase in volume and strong upward price movement are hallmarks of stocks trading on new information that is not yet widely known.

   When seeking stocks with good potential for market beating performance, start by looking for stocks moving up abnormally with strong volume. Make sure this happens after a lengthy period of no action in the stock. The stocks that go from ignored to exciting have the best potential.

Chart 1 - T.POU broke its downward trend with an abnormal price again and volume for the week. The stock doubled in price in the months ahead.

2. Strength comes before weakness, weakness before strength. Don't chase emotional markets.

Humans are not well suited to stock trading because we judge the future by what has happened in the past and we are emotional, especially with our money. That means we get greedy when we see a stock that is going up day after day and fearful when a stock is falling sharply. It is important to never chase after emotion with our trades. Buy stocks when the are starting to go up rather than chase them in to parabolic upward trends. Sell stocks when they start to go down through support levels rather than wait until a market panic to unload.

Chart 2 - consider stocks when they are starting new upward trends (green box) and be cautious when price runs away from the trend line (red boxes) as these are emotional times. Exit when the upward trend line (green line) is broken.

3. Know where the market proves you wrong.

There is too much uncertainty in trading to always be right. Being wrong and taking losses is a part of trading that you can not control. You can control how much you lose with good risk management. When taking any trade, establish the point where the market will prove you wrong. For this, I use a recent low point as support. Since this recent low represents a price where the buyers stepped in and started to move the stock up, it also represents a lower boundary for what investors think the company is worth. A break below that implies something negative is happening and is a good time to jump ship.

Chart 3 - AMD broke from a predictive pattern which gave it a high probability of moving up. However, it was not a certainty so having a stop loss plan at the last low was a good strategy.

4. Never add to a loser.

It is tempting to average down on a position; the idea that adding more shares to lower your cost base means the stock does not have to up as much to get back to even. However, consider what it means when a stock is going down. Investors have found a reason to accept lower prices – something is wrong at the company! Until the market starts to show optimism, get out of the way of a stock that the market thinks negatively about. If you really like the company, let it fall lower without you as an investor and be cash strong to get it at a bargain when it starts to turn around.

5. Let the winners win.

Our winners have to pay for our losers, trading is a numbers game. Selling strong stocks to lock in profits can leave you missing out on even more gains. As long as the stock is trending higher, hold on to it. Exit only when the trend is broken and the stock is more likely to go lower than higher.

I find that I get 1 or 2 trades out of 10 that are big winners and that is where the overall profits come from. If you sell stocks too early, you miss out on the big movers that improve your performance.

6. Don't take more risk than you can handle.

Traders get emotional and loser their discipline when they take on too much risk. How much risk is appropriate for you? While this could be a function of your age, portfolio size, trading experience or market conditions, the most important determinant of risk tolerance is your comfort level. At what level of risk do you stop sleeping well? Take less than this amount.

7. Stocks aren't risky, people are. Know who you are.

Stocks will always move up and down over time, volatility is how we make money from the market so it is a good thing. Traders can accept volatility with a plan to control risk. The stock market is a dangerous place for those who approach the market with the greed of a gambler or the fear of someone who can't tolerate the risk. Capital preservation and a disciplined approach to trading are essential.

8. People lie, markets don't. Trust the message of the market.

Many traders fight the trend, armed with the emotional attachment to their stock that comes from knowing the story too well. People who fall in love with a stock or trading idea will tend to focus on the information that confirms their bias and ignore anything to the contrary. What you know does not matter, all that matters is price direction. If the trade is not working, get out. If the market is doing something that does not seem to make sense, you are probably missing some information.

9. Beating the market requires an edge, find yours.

I know of no pursuit more challenging that trading. You are competing against millions of other traders in the chase for market beating performance. Those who win usually have an advantage. For some, the advantage is better information or industry knowledge. Others have the benefit of large amounts of capital that can open opportunities not available to most. My advantage is tools that I have developed, allowing me to find strong stocks sooner. Find your edge.

10. Keep it simple

Markets tend to focus on only one or two things at any time. The overall stock market may be focused on interest rate policy and comments from the President. Investors may focus solely on earnings or a new product cycle for a tech company. Biotech stock performance will tend to focus on the development process for new drugs. Know what the market's focus is an ignore the minutiae.

When developing a trading approach, use the same philosophy of keeping it simple. A myriad of confusing rules is more an indication of a lack of true understanding than it is sophistication. Own stocks that are going up with good risk management. Stay clear of stocks that are going down until their momentum changes.