Swing Traders Edge

The Systematic Swing Trading System

System Manual

Important

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Introduction

The STE trading system is a systematic rule based system for swing traders. The system looks to enter stocks (long only) which have pulled back over the last four days and have a high probability of rising over the next few days.

With clearly defined rules for stock selection there is no guesswork involved deciding which stocks we should trade and when to take a position. Predetermined entry and exit points take the stress out of managing a trade.

The Rules

The rules of the STE trading system should be applied to end of day data only. The system does not require monitoring during the day.

Indicators:

- 10 day ADX.
- 5 day simple moving average.
- 200 day simple moving average.
- 100 day historical volatility.
- 20 day simple money flow

Rules for entering a trade:

1. The closing price must have dropped consistently for the last 4 days.
2. The closing price must be below the opening price for that day.
3. The closing price must be less than the 5 day simple moving average.
4. The closing price must be greater than the 200 day simple moving average.
5. The 10 day ADX must be greater than 20.
6. The 100 day historical volatility must be greater than 20.
7. The 20 day simple money flow must be greater than $4,000,000.

If all 7 of the above rules have been met then a limit order is placed to purchase the stock the next day at 3% below the closing price. This order is valid for that day only.

Rules for exits:

8. The closing price is greater than or equal to the 5 day simple moving average.

If rule 8 is valid then place a market order to exit the entire position at the next market open.

The Rules Explained

Rule 1: The closing price must have dropped consistently for the last 4 days.
When swing trading stocks on the long side the priority is to find stocks that have pulled back and are becoming oversold. Selecting stocks which have consistently closed lower for at least 4 days are considered to be oversold and provide a good probability that the stock will increase in price in the near future.

Rule 2: The closing price must be below the opening price for that day.
While the first rule determines that only stocks that have had consistent selling pressure over the last 4 days are selected, the second rule reinforces that oversold condition by only allowing stocks that have closed that day below their open, thus continuing the overall selling pressure.

Rule 3: The closing price must be less than the 5 day simple moving average.
The 5 day simple moving average can be a simple indication of whether prices are oversold (below the moving average) or overbought (above the moving average) and so we require the closing price to be below the 5 day simple moving average. Also the exit point for any trade is when the closing price is greater than or equal to the 5 day simple moving average so it is important that any stock selected is below the exit point before we start.

Rule 4: The closing price must be greater than the 200 day simple moving average.
As we are only taking long trades we want to keep to stocks which are generally considered bullish, so we only consider stocks which are currently trading above their 200 day simple moving average.

Rule 5: The 10 day ADX must be greater than 20
and
Rule 6: The 100 day historical volatility must be greater than 20.
It is important when swing trading that we ignore stocks which are not experiencing a lot of volatility or movement as these types of stocks generally do not offer good returns as swings in price tend to be small. Rules 5 and 6 filter out such types of stocks by ensuring the 10 day ADX is greater than 20 (stocks below 20 are considered to be in a trendless state) and the 100 day historical volatility is above 20 (again, stocks below 20 are considered to have very low volatility).

Rule 7: The 20 day simple money flow must be greater than $4,000,000.
First an explanation of 'simple money flow' may be necessary. Simple money flow is the total value of the closing price multiplied by the number of shares traded that day, giving us a rough idea of how many dollars were traded in that stock on a given day. This is important as we only want to be trading in liquid stocks that we can get into and out of with relative ease and avoid

excessive slippage. A 20 day average of the simple money flow is used as we only want to consider stocks which are consistently liquid and avoid any low liquidity stocks that experience a sudden short term rise in volume and then die down again.

When rules 1-7 are met then place a limit order before the next market open.
If a stock meets all 7 rules then it is a candidate for trading. A limit order should then be placed before the market opens the next day at 3% below the last closing price. Yet again we are returning to the selling pressure theme. We have already determined that the stock has accumulated selling pressure over the last 4 days by closing lower each consecutive day, and on the last day we have continued that selling pressure by ensuring the stock closed below the opening price. By waiting to enter the trade only if the stock drops another 3% intraday reinforces that selling pressure and increases the odds in our favour that we will exit the trade with a profit.

Rule 8: The closing price is greater than or equal to the 5 day simple moving average.
As mentioned in rule 3, the 5 day simple moving average can be a simple indication of whether prices are oversold (below the moving average) or overbought (above the moving average). As this is a swing trade we want to exit the trade when the stock is no longer oversold and so we exit the trade as soon as the closing price is greater than or equal to the 5 day simple moving average by placing a market order to sell the stock at the next market open.

Too Many Stocks

The STE system is designed to be used on a large universe of stocks to produce a select number of possible trades, but even after these rules are applied there can still be a large number of viable stocks left to trade, too many for most accounts.

To solve the issue of which stocks should be traded when too many possible trades are available we use a filter to sort the available stocks into an order that can help us find the stocks with a higher probability of reversing.

The filter we use is to measure how much (as a percentage) the stock price has dropped over the last 4 days. The formula looks like this:

C = closing price today.
C[4] = closing price 4 days ago

$$\% \text{ price dropped} = (C[4] - C) / C[4] \times 100$$

This filter is then used to sort the available stocks into order starting with the highest ranking stock, the stock that has sold off the most over the last 4 days. As you can probably guess by now the reason for using this filter is selling pressure. Typically the more a stock has dropped in price over the 4 days the higher the selling pressure has been, and the more chance there is of that stock reversing over the next few days.

So, for example, if we started with a universe of 10,000 stocks and after applying our stock selection rules we were left with 100 possible stocks to trade, but we only wanted to trade 5 stocks. We would then apply our filter to sort these 100 stocks into an order with the highest value first.

Stock	% Price Dropped
Stock1	12.04%
Stock2	11.68%
Stock3	11.55%
Stock4	8.98%
Stock5	7.89%
Stock6	7.12%
Stock7	6.20%
…	…

From this sorted list of stocks we can then pick the top 5 stocks to trade.

My Portfolio

Now that we know which stocks we should trade we need to decide how to allocate the funds in our portfolio. We use a portfolio size factor of 10, meaning we divide our portfolio into 10 equal sizes to be traded.

Each night the number of buy orders placed is equal to the number of empty positions within our portfolio. So, if we were currently trading 4 stocks within the portfolio then we would have 6 available positions within our portfolio and we would place limit orders to buy a maximum of 6 stocks the following day.

Once a buy order is triggered that stock then fills a position within the portfolio until an exit is triggered and the stock is sold, allowing that position to be allocated to a new stock.

A single stock can only fill one portfolio position. Once that stock has been purchased and becomes part of the portfolio it cannot be purchased again until that particular trade has been completed and the stock has been removed from the portfolio.

However, we can continue to place orders for a stock on consecutive days if the limit order is never triggered. We only exclude a viable stock once it enters the portfolio.

A Typical Day

Here is an example of how a typical day might appear using this system.

Once the stock market has closed for the day we can start our analysis. The first job is to confirm any buy or sell orders for that day and update the portfolio. Any new buy orders that were filled need to be added to the portfolio.

Position	Stock
1	Stock U
2	Stock V
3	Stock W
4	Stock X
5	Stock Y
6	Stock Z
7	- empty -
8	- empty -
9	- empty -
10	- empty -

Next we examine the stocks within the portfolio to see if any have met the exit criteria. If so then market orders to sell these stocks need to be placed for the next day and these stocks should be removed from the portfolio. We will assume stocks Y and Z have triggered their exit.

Position	Stock
1	Stock U
2	Stock V
3	Stock W
4	Stock X
5	- empty -
6	- empty -
7	- empty -
8	- empty -
9	- empty -
10	- empty -

We now know that we have 6 available positions within our portfolio.

The next stage is to scan our universe of stocks to find those that meet our entry rules. If after scanning we find more than 6 stocks (the number of available positions within our portfolio) we will need to sort these stocks into order using our filter (the percentage drop in price over the last 4 days).

After sorting the stocks into order we then need to discard from the list any stocks that already exist in our portfolio as we only allow a stock to be purchased once for the portfolio.

Once we know which 6, or less, stocks we want to trade we place limit orders 3% below the close for the next trading day.

Results – Original System

Here are the simulated returns using the STE trading system from January 2000 to December 2006.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2000	52.20%	43.97%	49.63%	-2.16%	-6.56%	14.66%	14.28%	10.52%	0.90%	-2.17%	19.18%	4.52%	**433.73%**
2001	0.99%	-0.09%	1.41%	7.42%	11.43%	1.77%	6.17%	19.33%	-3.73%	0.00%	8.95%	13.81%	**88.54%**
2002	5.76%	2.33%	5.65%	9.25%	13.54%	-5.02%	-7.42%	1.89%	1.92%	-2.61%	4.69%	10.84%	**46.35%**
2003	9.66%	0.86%	7.74%	1.74%	6.95%	14.07%	22.31%	4.61%	9.05%	14.04%	8.63%	8.39%	**177.13%**
2004	13.32%	2.15%	4.21%	8.26%	4.47%	4.43%	-11.77%	0.27%	4.21%	3.56%	14.66%	9.17%	**70.26%**
2005	-4.49%	6.76%	-0.70%	15.46%	4.21%	5.88%	-1.03%	21.71%	6.39%	-0.21%	8.48%	1.15%	**81.01%**
2006	18.66%	15.26%	8.61%	16.03%	6.14%	-3.62%	4.20%	1.68%	-1.46%	4.90%	3.81%	3.93%	**108.32%**

Includes commission of 1 cent per share.

Stops

The original version of this system does a not use stop loss. This is because a stop loss will generally reduce the overall effectiveness of a system. However, not everyone is comfortable trading without a stop loss and if that is the case then a stop loss should be included.

The further away a stop loss if from the entry price the more room the stock has to complete the trade according to the original rules, and the closer the overall results will be to the original system. So it is important to find a balance between letting the system work for us and reducing any anxiety by knowing there is a stop loss in place if the trade goes against us.

I have included performance results on 3 different stop loses: 10%, 25% and 50%.

Results – 10% Stop Loss

Here are the simulated returns using the STE trading system with a 10% stop loss from January 2000 to December 2006.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2000	39.23%	24.41%	-5.68%	56.95%	-9.42%	11.37%	2.12%	15.82%	-0.91%	-1.26%	14.91%	1.18%	**248.08%**
2001	-8.40%	-7.41%	-6.05%	5.18%	6.55%	-1.85%	5.00%	13.02%	-8.55%	-1.86%	8.67%	10.97%	**12.57%**
2002	-3.57%	4.38%	2.58%	2.56%	9.02%	-1.43%	2.64%	1.89%	-1.82%	-1.38%	4.80%	4.55%	**26.26%**
2003	7.81%	0.03%	6.22%	-0.24%	4.03%	10.36%	17.69%	3.00%	-0.48%	8.31%	11.76%	1.55%	**94.55%**
2004	7.96%	-0.59%	9.80%	-5.69%	21.94%	-2.30%	-13.55%	-0.42%	-0.05%	1.51%	12.86%	10.14%	**43.74%**
2005	-5.38%	4.02%	5.39%	8.07%	5.59%	4.83%	0.47%	17.02%	6.33%	0.61%	5.08%	-1.16%	**62.07%**
2006	14.20%	13.01%	11.82%	9.47%	-1.33%	-5.90%	0.15%	0.72%	-1.04%	5.55%	3.03%	2.28%	**62.86%**

Includes commission of 1 cent per share.

Results – 25% Stop Loss

Here are the simulated returns using the STE trading system with a 25% stop loss from January 2000 to December 2006.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2000	53.29%	37.78%	26.96%	45.08%	-12.61%	13.67%	12.86%	10.95%	-4.87%	-0.52%	14.67%	1.26%	**431.71%**
2001	0.99%	1.52%	-3.48%	7.42%	8.91%	2.34%	4.86%	19.33%	-9.00%	-0.57%	8.31%	12.77%	**63.88%**
2002	6.13%	6.86%	5.65%	9.25%	13.54%	-4.60%	-1.97%	1.89%	1.92%	-2.73%	4.69%	5.89%	**55.65%**
2003	9.66%	0.00%	7.74%	-0.04%	6.95%	13.79%	20.27%	4.61%	9.05%	13.89%	11.54%	8.39%	**171.51%**
2004	6.97%	1.17%	2.69%	-3.50%	17.00%	4.43%	-15.32%	-3.24%	4.21%	0.67%	14.66%	9.17%	**40.97%**
2005	-6.43%	6.76%	1.01%	11.21%	5.79%	1.54%	2.96%	18.20%	9.12%	-0.78%	8.48%	-1.42%	**69.85%**
2006	14.51%	15.26%	10.32%	10.72%	8.66%	-1.32%	5.03%	1.68%	-1.48%	6.50%	3.81%	1.88%	**104.86%**

Includes commission of 1 cent per share.

Results – 50% Stop Loss

Here are the simulated returns using the STE trading system with a 50% stop loss from January 2000 to December 2006.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2000	52.20%	43.97%	48.80%	19.27%	-7.65%	14.66%	13.72%	10.52%	0.90%	-2.49%	19.18%	4.52%	**534.25%**
2001	0.99%	-0.09%	1.41%	7.42%	11.43%	1.77%	6.17%	19.33%	-3.73%	0.00%	8.95%	13.81%	**88.54%**
2002	5.76%	2.33%	5.65%	9.25%	13.54%	-10.59%	0.28%	1.89%	1.92%	-2.61%	4.69%	10.84%	**49.23%**
2003	9.66%	0.86%	7.74%	1.74%	6.95%	14.07%	22.31%	4.61%	9.05%	14.04%	9.25%	8.39%	**178.70%**
2004	6.97%	1.49%	4.21%	8.26%	1.54%	4.43%	-11.77%	0.27%	4.21%	3.56%	14.66%	9.17%	**55.20%**
2005	-4.49%	6.76%	-0.70%	15.46%	4.21%	5.88%	-1.03%	21.71%	6.39%	-0.21%	8.48%	1.15%	**81.01%**
2006	18.66%	15.26%	8.61%	16.03%	6.14%	-3.62%	4.20%	1.68%	-1.46%	4.90%	3.81%	-1.43%	**97.58%**

Includes commission of 1 cent per share.

The Aggressive STE

The aggressive version of the STE trading system is identical to the original version of the system, with one exception. Instead of only allowing a stock to be purchased once for our portfolio we will allow a stock to occupy up to two portfolio positions.

The second entry provides an opportunity to purchase the stock at a point where even greater selling pressure has been applied, and as a result providing a greater chance of the stock climbing higher over the next few days.

The disadvantage of this aggressive version is that we sacrifice the diversity of the portfolio, but historically this has proved an acceptable compromise.

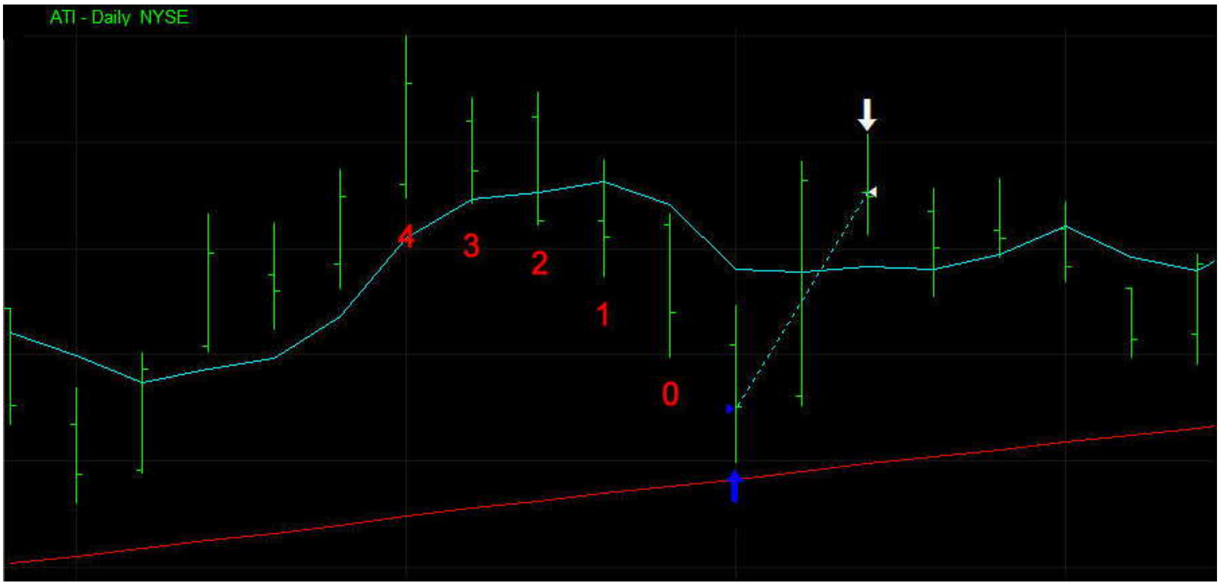
Results – Aggressive System

Here are the simulated returns using the aggressive version of the STE trading system from January 2000 to December 2006.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
2000	59.30%	56.42%	48.57%	-1.18%	-5.57%	20.63%	12.61%	9.97%	2.50%	-1.89%	18.44%	4.76%	**543.98%**
2001	2.63%	-1.32%	4.63%	8.85%	13.49%	6.38%	5.32%	21.66%	-2.81%	-0.02%	9.99%	15.51%	**120.22%**
2002	10.41%	2.20%	7.21%	8.67%	12.28%	-1.52%	1.19%	1.89%	2.29%	-5.24%	6.13%	12.06%	**72.78%**
2003	9.76%	-0.05%	8.39%	2.16%	8.20%	15.48%	25.49%	9.18%	6.82%	20.11%	9.92%	4.50%	**206.53%**
2004	13.65%	1.94%	3.31%	7.79%	9.85%	8.91%	-10.32%	-1.31%	5.95%	2.61%	19.21%	9.82%	**94.46%**
2005	-4.78%	9.08%	-4.61%	17.82%	6.52%	6.34%	0.14%	21.84%	10.11%	1.21%	7.36%	-1.34%	**90.47%**
2006	27.36%	17.76%	8.72%	15.88%	10.01%	-4.12%	9.01%	1.76%	0.75%	8.98%	5.91%	4.66%	**169.10%**

Includes commission of 1 cent per share.

Example 1



In the ATI example above we can see a trade take shape. The day the stock would appear on our scans (09/22/06) is indicated by the bar numbered ‘0’. As we work through the rules:

1. The closing price has dropped consistently for the last 4 days as shown by the numbered bars on the chart.
2. The close for today (09/22/06) is below the open.
3. The close is below the 5 day simple moving average (blue line).
4. The close is above the 200 day simple moving average (red line).
5. The 10 day ADX is 24.73.
6. The 100 day historical volatility is 54.35.
7. The 20 day simple money flow is $127,930,000.

And so on 09/22/06 ATI was a viable stock to trade using the STE trading system.

Assuming ATI was one of several stocks that were presented by the STE trading system that day then we may want to calculate the percentage drop in price from 4 days ago. To do this we take the closing price of 4 days ago (bar ‘4’) and subtract the current bars closing price (bar ‘0’), and divide the total by the close of bar ‘4’.

$$C = \text{closing price today} = 60.79$$
$$C[4] = \text{closing price 4 days ago} = 65.10$$

$$\%\ \text{price dropped} = (C[4] - C) / C[4]\ \times\ 100$$

$$\%\ \text{price dropped} = (65.10 - 60.79) / 65.10\ \times\ 100$$

$$\%\ \text{price dropped} = 6.62\%$$

The close on 09/22/06 was 60.79 so a limit order is placed to buy the stock the following day for 58.96.

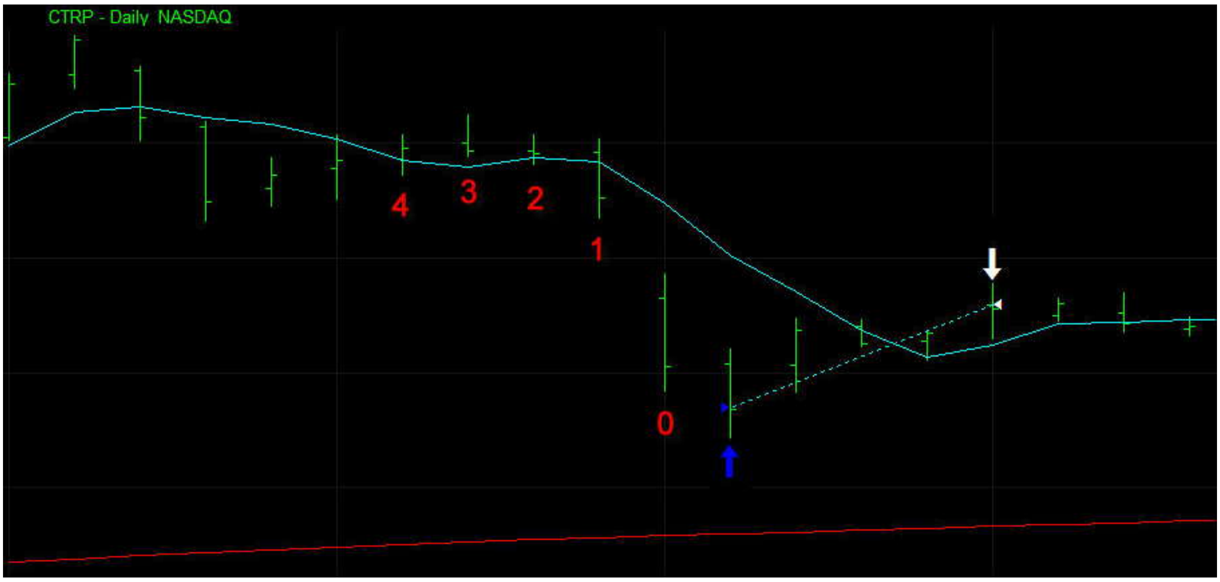
The next day the stock continues to sell off and drops below our entry point of 58.96.

On the 09/26/06, the stock closes at 63.28, above the 5 day simple moving average of 61.56 and a market order is entered to sell the position at the follow market open.

The following morning we exit the position at around 63.06, for a profit of approximately 6.9%.

Stock	**ATI**
Date Scanned	09/22/06
Close Down 4 Days	Yes
Close Below Open	Yes
Close Below 5sma	Yes
Close Above 200sma	Yes
10 Day ADX	24.73
20 Day HV	54.35
20 Day SMF	$127,930,000
% Price Dropped Filter	6.62%
Limit Order Price	58.96
Date Exit Triggered	09/26/06
Exit Price	63.28
Percentage Gain	6.9%

Example 2

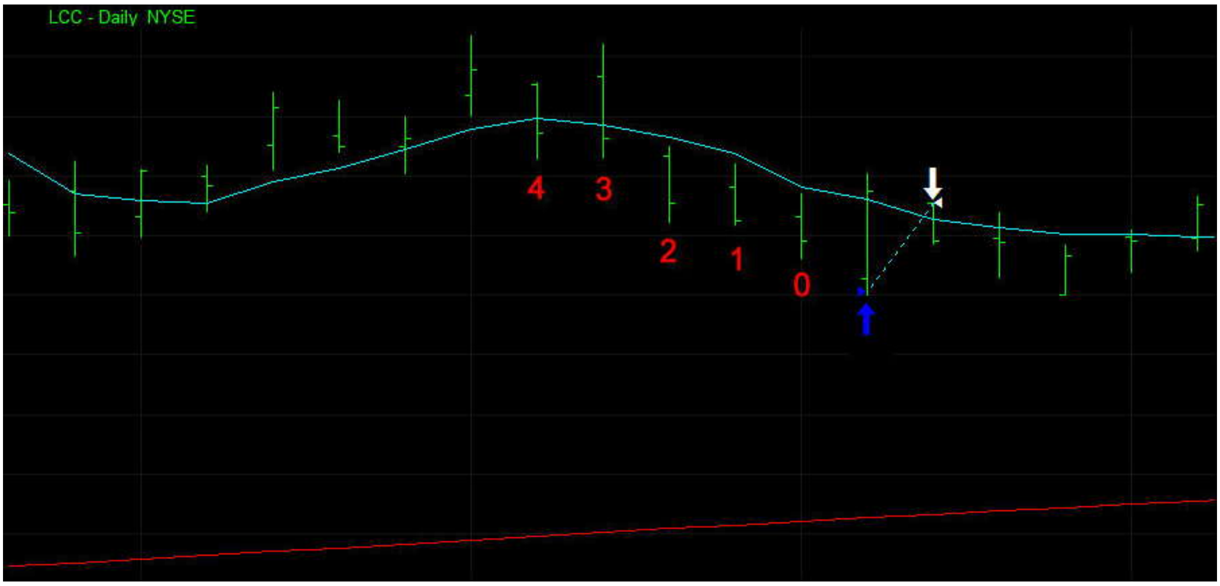


Stock	CTRP
Date Scanned	02/12/07
Close Down 4 Days	Yes
Close Below Open	Yes
Close Below 5sma	Yes
Close Above 200sma	Yes
10 Day ADX	27.14
20 Day HV	41.96
20 Day SMF	$38,420,000
% Price Dropped Filter	13.67%
Limit Order Price	58.44
Date Exit Triggered	02/16/07
Exit Price	62.94
Percentage Gain	7.7%

Example 3

Stock	**AAPL**
Date Scanned	12/26/06
Close Down 4 Days	Yes
Close Below Open	Yes
Close Below 5sma	Yes
Close Above 200sma	Yes
10 Day ADX	44.31
20 Day HV	28.00
20 Day SMF	$2,493,000,000
% Price Dropped Filter	5.56%
Limit Order Price	79.06
Date Exit Triggered	29/12/06
Exit Price	86.29
Percentage Gain	10.4%

Example 4



Stock	LCC
Date Scanned	12/18/06
Close Down 4 Days	Yes
Close Below Open	Yes
Close Below 5sma	Yes
Close Above 200sma	Yes
10 Day ADX	24.86
20 Day HV	55.53
20 Day SMF	$127,110,000
% Price Dropped Filter	6.16%
Limit Order Price	54.12
Date Exit Triggered	12/19/06
Exit Price	57.10
Percentage Gain	5.5%

Example 5

Stock	REGN
Date Scanned	02/26/07
Close Down 4 Days	Yes
Close Below Open	Yes
Close Below 5sma	Yes
Close Above 200sma	Yes
10 Day ADX	27.82
20 Day HV	41.44
20 Day SMF	$12,930,000
% Price Dropped Filter	6.44%
Limit Order Price	20.54
Date Exit Triggered	03/08/07
Exit Price	19.41
Percentage Loss	-5.5%