

# Setups for Stocks

*Entries and Triggers*

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Date



# Outline



## Theoretical

- What we are trying to accomplish with a “setup”?
- How does the market move?

## Practical

- Specific trading patterns
- Filtering to find best candidates

## Applied

- Understanding yourself
- How Waverly Advisors research might help.

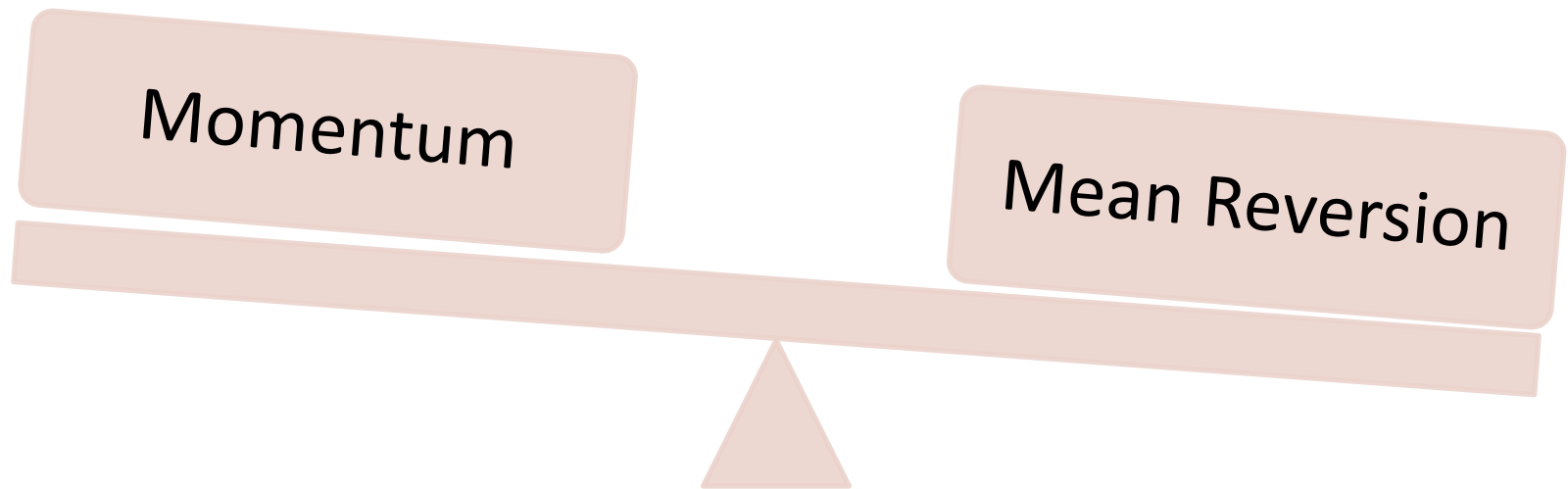
# Why Setups?

- We have a finite amount of time and attention.
- Where to best deploy resources?
  - Capital
  - Attention
  - Risk
- There are, very roughly, 7,000 stocks traded in the US.
- How to find the best *and* have reasonable confidence we are not missing opportunities?

# Market Lessons (from Statistics)

- Financial markets are highly competitive.
  - There is no free lunch
- Financial markets usually move in ways that are indistinguishable from random walks.
  - Why can we not simply say they move randomly?
- Behavioral and psychological factors play a part in market prices.

# Two Forces Model



# Lessons from the Two Forces

- Price movements are shaped by *mean reversion* (range contraction) and *momentum* (range expansion).
- Over a large sample of market action, these two forces balance each other out.
  - Random walks describe price movements well when the forces balance.
- Is it possible to identify conditions that will show when one force is likely to predominate?

# The Two Forces in Patterns

## Mean Reversion

- Fading large single bars
- Fading N-day runs
- Fading breakouts of N-day highs or lows
- Fading large excursions from moving averages

## Momentum

- Volatility compression
- Pullbacks

- 
- Different asset classes and timeframes have different tendencies for mean reversion!
  - These tendencies can be captured in some traditional chart patterns.

# Implications for Trading

- Usually we have no reason to be in a market (because of random walk).
- When we do identify spots that might offer opportunity, there is only a very small statistical edge.
  - This is why consistency, discipline, and risk management are so important.
- The patterns we use must reflect statistical reality and say something meaningful about the probabilities.



# Where Is the Trend?



# Or Like This?



# We Can Get Lost in Details

- ...but at least we can say this:
  - Markets go up sometimes
  - Sometimes they go down
  - Sometimes they go sideways
- Furthermore, at any point in time, the market can continue doing what is doing, or it can do something else.
- This seems obvious and not useful, but wait...

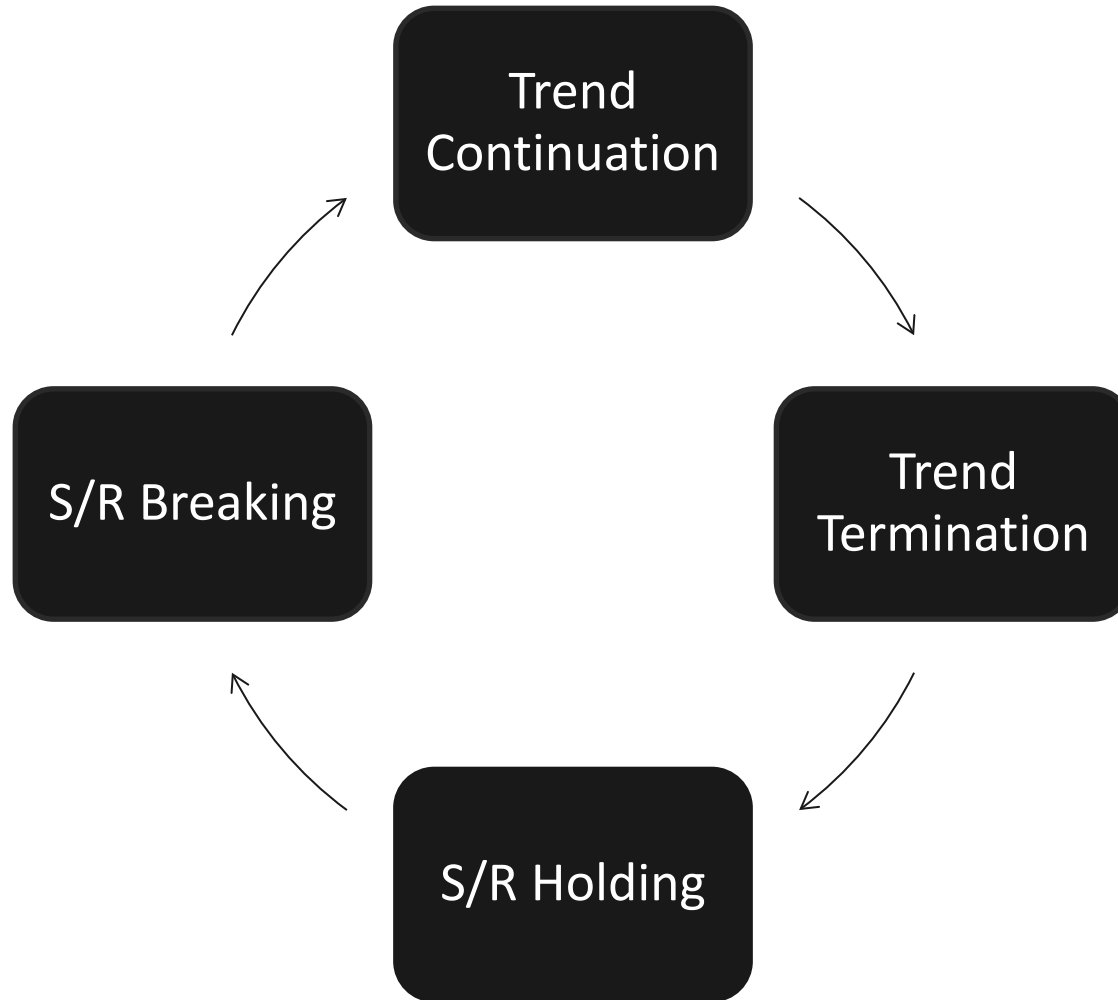
# Inflection points: Structuring the Market

- If trending, the trend **can continue**.
- If ranging, the range **can continue**.
- If trending, the trend **can end**
  - into a range.
  - into a reversal.
- If ranging, the range **can end** into a trend.
  - (That trend may continue or fail.)
- Trends or ranges can only continue or end.

# The Four Trades

- **Trend Continuation**
  - Identify a trend and look to position with the trend
- **Trend Termination**
  - Identify a trend that may be ending and look to take a position against the trend
- **Support/Resistance Breaking**
  - Identify a range and look to trade breaks of the confines of the range
- **Support/Resistance Holding**
  - Identify a range and look to trade tests of the confines of the range

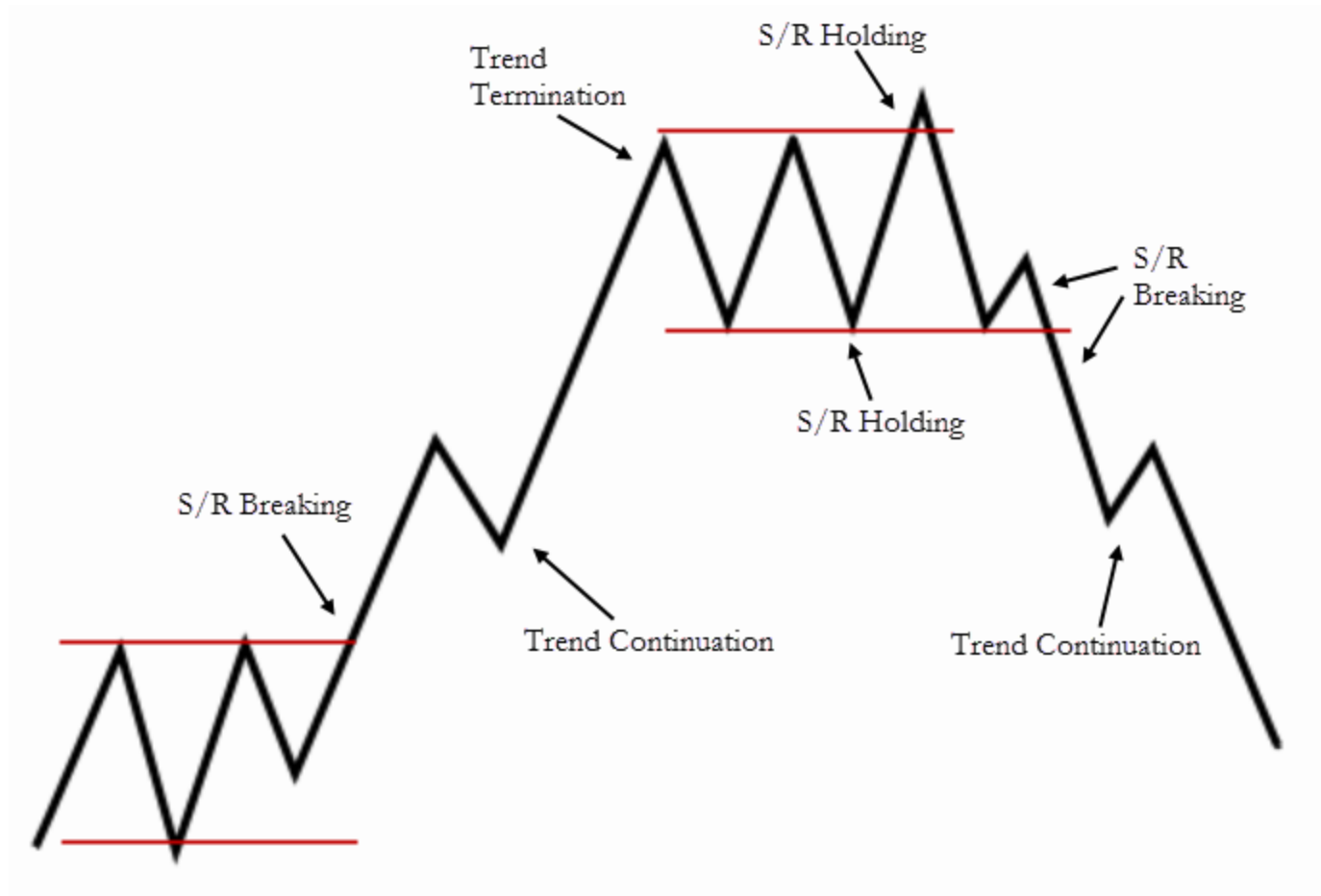
# Trading the Cycle



# Tools for the Trade

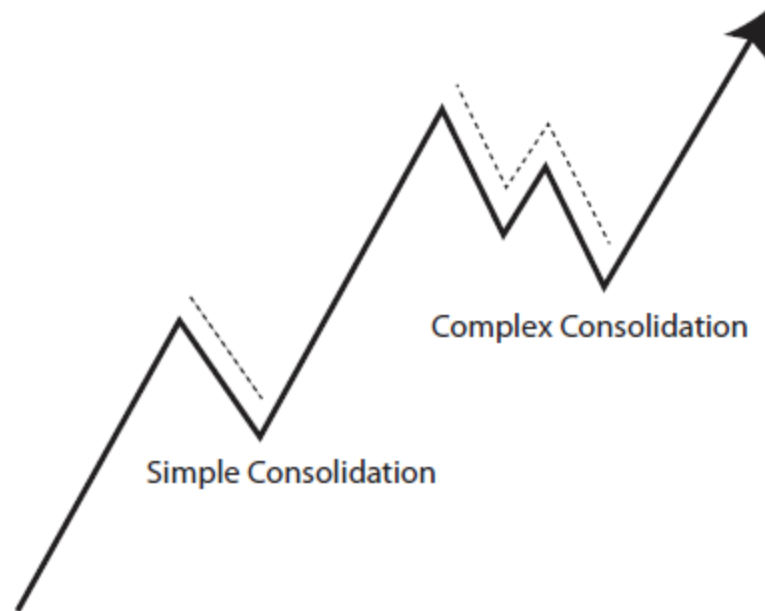
- Trend Continuation
  - Pullbacks
  - Breakouts
- Trend Termination
  - Failure tests
  - Anti Pattern
- Support/Resistance Breaking
  - Breakouts
- Support/Resistance Holding
  - Failure tests
  - Failed breakouts

# Trading the Cycle



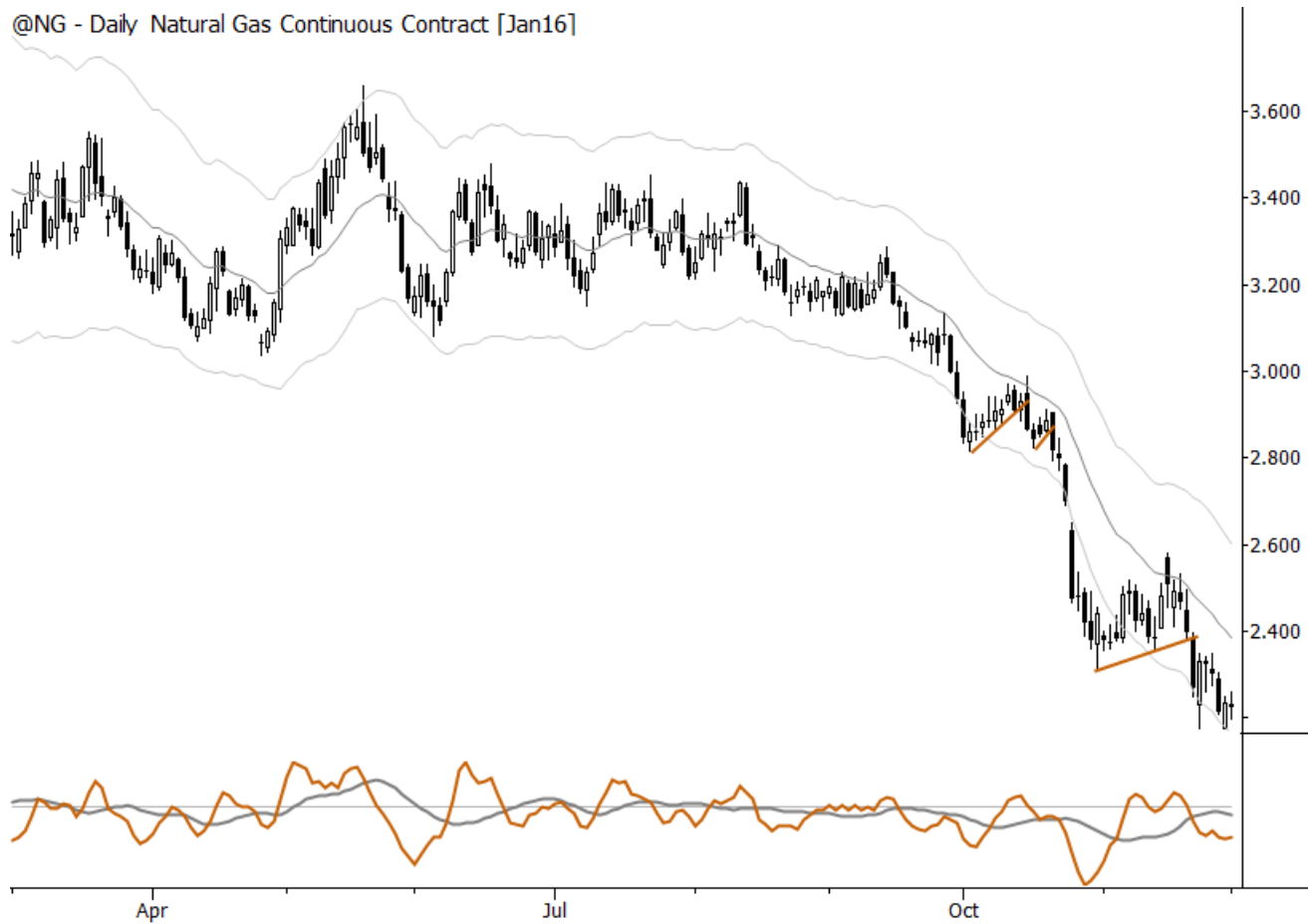


# Pullbacks



# Pullbacks

@NG - Daily Natural Gas Continuous Contract [Jan16]



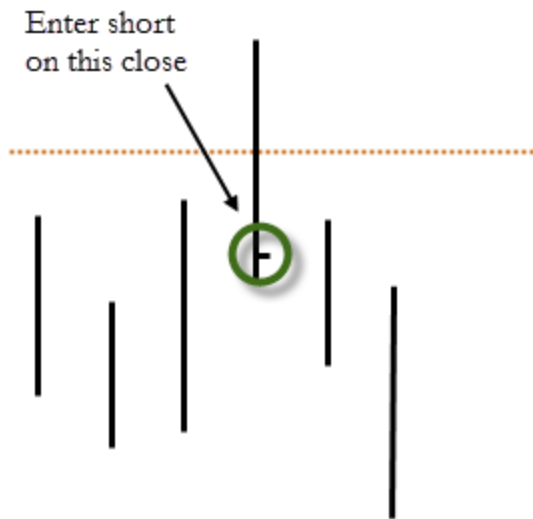
# Classic Breakout

DRYS - Daily DryShips Inc

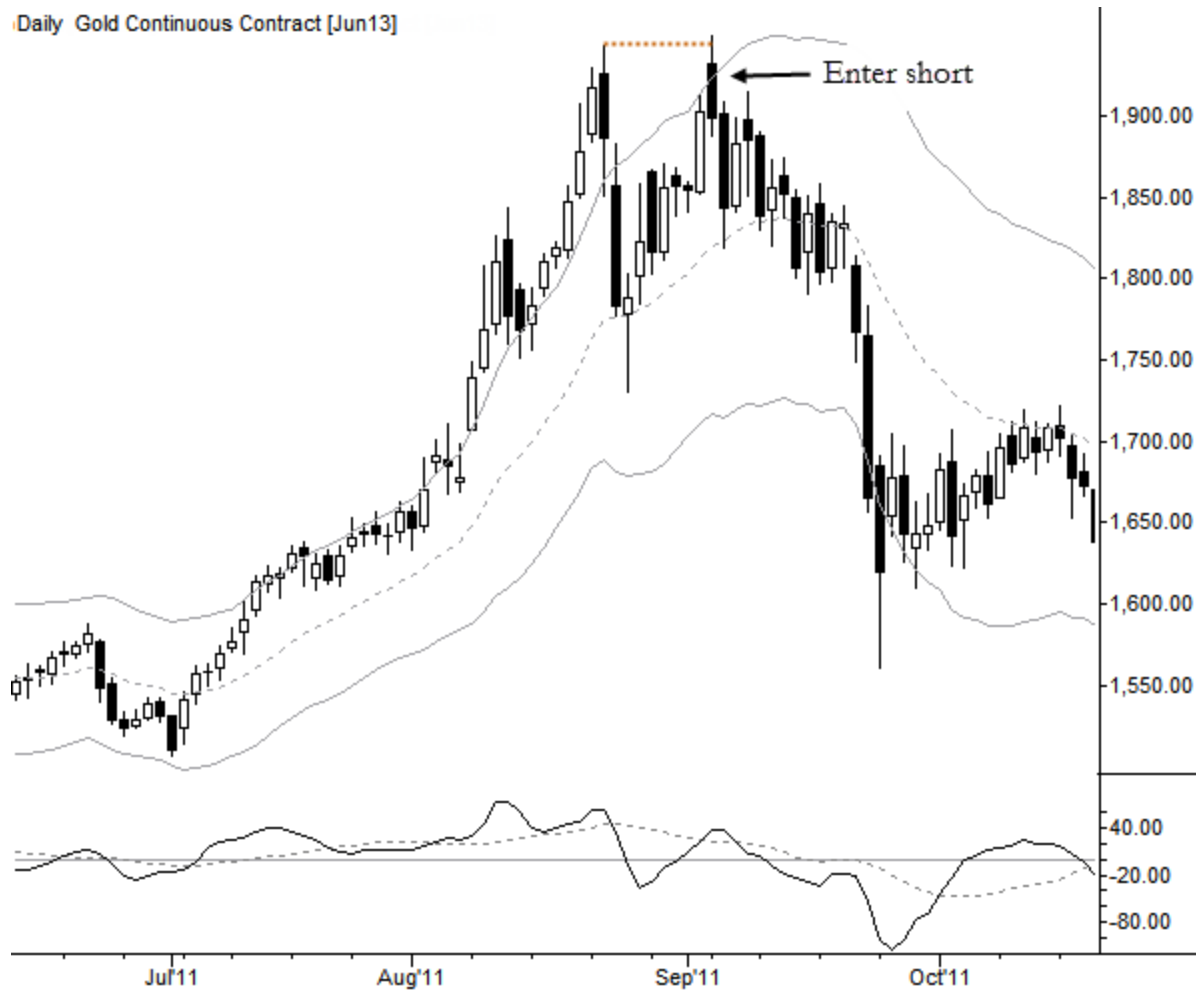


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# Failure Test



# Classic Failure Test



# Filtering or Scanning

- Why filter? Shouldn't we just look at all the stocks in the world?
- Well, there are too many, but even if we could, filtering can do a few things:
  - Can show us overall market bias, bottom up
  - Can remind us where probabilities lie
  - Can point out things we might miss in scanning charts
- Filters, scans, screens, setups are only tools.

# First Steps

- Sufficient Liquidity
  - Avg volume
  - Avg \$volume
- Sufficient movement
  - ATR
  - ATR%
- Relative Strength
- Stability

# Liquidity

- Why it matters:
  - We want to be able to get in and out when we want to, without too much slippage.
- But, there are some cases in which illiquidity may be a good thing.
  - Trends are essentially one-sided failures of liquidity
- At least, understand the risk of liquidity and consider how it might change under stress.



# Measuring Liquidity

- We use volume as a proxy for liquidity.
  - But is this always good?
  - What might be better?
    - Measuring average bid/ask spread?
  - Time of day influences?
- Active traders probably want 1MM shares / day.
- Swing traders might be ok, in some cases, under 500k shares / day.
- Know your risk.

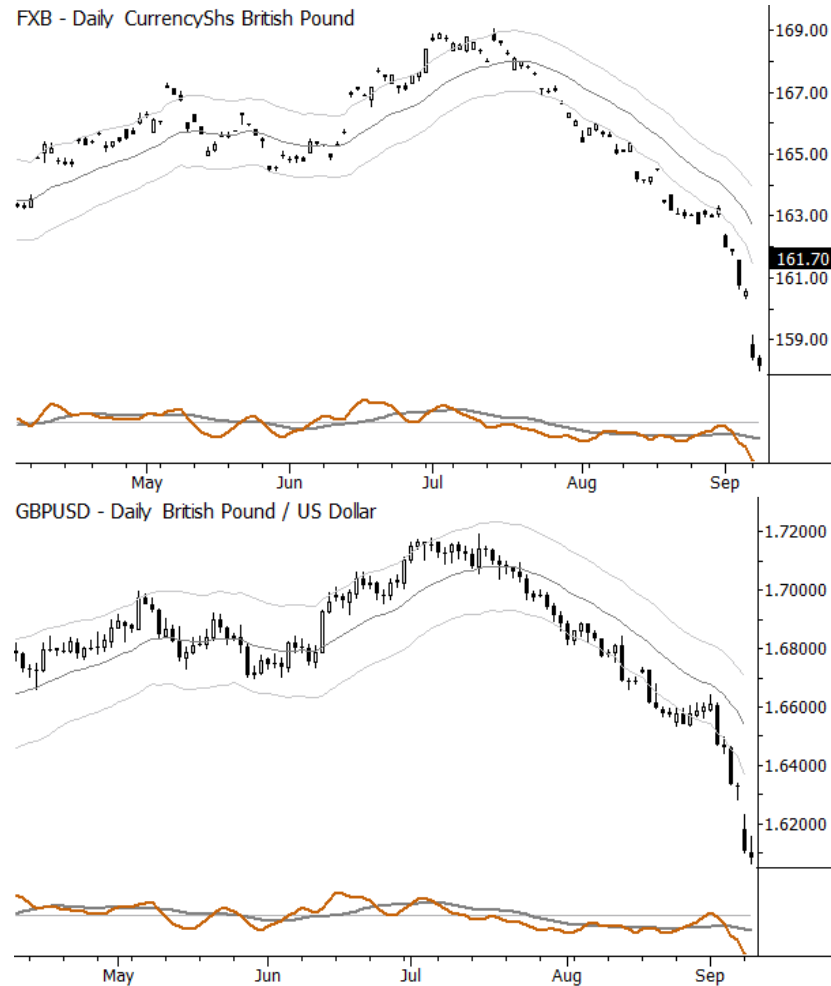
# Dollar Volume

- Average volume, expressed as a dollar amount rather than shares.
- Two calculations:
  - Average volume \* current price
  - Average volume \* average price (same period)
- Maybe more relevant for position traders, but does give better representation of how much capital could be deployed.

# Measuring Range

- Many traders will include an ATR screen to remove stocks that don't move.
- This can be good and bad
  - Even intraday traders, who generally need range, will find good range in “news stocks” which may have been excluded by any reasonable screen.
  - Markets can trend well, but with very small daily ranges.

# ETPs Bring Some Challenges



# Adjusting ATR for Price

- ATR depends on price
- %ATR expresses ATR as a % of the underlying price
- Two very different risk profiles:
  - **Stock A:**
    - \$100 with \$1.00 ATR
    - 1.0 %ATR
  - **Stock B:**
    - \$10 stock with \$1.00 ATR
    - 10.0 %ATR

# Rough Guidelines for Liquidity

- Active Traders:
  - 1MM shares / day
  - \$0.75 ATR
  
- Position Traders
  - 500k shares / day
  - No ATR screen

# Relative Strength

- There is validity to being long the strongest and short the weakest, over a large sample size...
- But there are also some potential issues:
  - Mean reversion can often set in at extremes
    - Naïve application of relative strength often runs into “snapback” from both strong and weak groups
  - Relative strength rankings will often show strong sector/industry concentrations
  - Many ways to measure relative strength

# Simple Return Measures

- In most software packages, one can use Rate of Change (ROC), which is a simple percent change over a specified time period.

$$ROC = Close_{today} / Close_{n \text{ periods ago}} - 1$$

- A basic relative strength measure can be created as a ranking of these returns.



# Multiple Period Comparison

	1 Month		3 Month		6 Month		1 Year
TLT	1.19	GLD	8.37	SP Futs	10.69	SP Futs	21.91
SP Cash	0.90	Gold Futs	8.21	SP Cash	9.92	SP Cash	20.03
SP Futs	0.80	TLT	6.41	SPY	9.85	SPY	19.99
Treas Futs	0.64	Treas Futs	4.7	TLT	2.67	USO	6.56
SPY	0.57	Crude Oil Futs	1.48	Treas Futs	2.26	Crude Oil Futs	5.43
DX cash	-0.07	SP Futs	1.42	GLD	1.55	DX cash	-2.95
UUP	-0.09	SPY	1.19	DX cash	0.01	Treas Futs	-3.73
Crude Oil Futs	-1.56	SP Cash	1.15	Gold Futs	-0.53	UUP	-5.00
GLD	-2.06	USO	1.12	UUP	-0.74	TLT	-7.33
USO	-2.05	DX cash	-0.09	USO	-1.69	Gold Futs	-17.84
Gold Futs	-2.15	UUP	-0.88	Crude Oil Futs	-2.06	GLD	-18.52

# One Possible Solution

- Rather than use a simple measurement of return, average several periods' returns.
  - A good discussion can be found in O'Neil (William O'Neil: *How to Make Money in Stocks*, 4<sup>th</sup> ed. 2009), but many other authors use similar tools.
- Many options:
  - Use as few as two or many more periods.
  - Weighted or unweighted.
  - Can implicitly weight by period selection:
    - E.g., 1 week, 2 week, 1 month, 1 year is front weighted
    - E.g., 1 month, 1 year, 1.5 year, 2 year is back weighted

# Waverly Advisors' Relative Strength

- We use a front-weighted multi-period relative strength measure.
- Periods and calculation are proprietary, but there is no secret sauce.
  - The measurement was crafted to be coherent with and to support our trading style, not because it is better than any other.
- We use this as an idea generation tool and as a filter for other trades.

# Ranked RS

- The actual RS value may not be especially meaningful.
  - This shouldn't be surprising: **relative** strength!
- Can simply compare a list of RS values to each other to get a RS ranking.
- It is also possible to compare stocks relative to a stock universe.
- We do this with a non-parametric ranking:
  - Create the raw RS measure for each stock in the S&P 500
  - Create the raw RS measure for the test stock.
  - Express the test stock's RS as a percentile of the S&P 500.
    - Can also be outside the range of the S&P 500

# Regions, Styles, and Industries

International	Now	Chg	VRat	US Sectors (SP1500)	Now	Chg	VRat	US Industries (Top)	Now	Chg	VRat	US Industries (Bottom)	Now	Chg	VRat
Japan	1	2	0.6	Consumer Discretionary	1	1	0.6	Internet & Catalog Ret	1	0	0.7	Media	35	-21	0.7
S Korea	2	6	0.5	Information Tech	2	-1	0.4	Internet Soft & Svcs	2	0	0.7	Comm Svcs & Supplies	36	5	0.3
S&P 500 Index	3	-2	0.2	Financials	3	0	0.3	Building Products	3	0	0.3	Capital Markets	37	-8	0.3
Finland	4	-2	0.9	Consumer Staples	4	1	0.6	Water Utilities	4	3	1.0	Chemicals	38	-10	0.4
Israel	5	0	0.5	Industrials	5	-1	0.3	Life Scis Tools & Svcs	5	5	0.4	Pharmaceuticals	39	-7	0.5
Nthrlands	6	3	0.8	Health Care	6	0	0.3	Industrial Conglomerates	6	0	0.5	BioTech	40	-10	0.1
Germany	7	-1	1.1	Utilities	7	2	0.5	Software	7	-2	0.3	Household Products	41	-8	0.5
France	8	2	1.0	Materials	8	-1	0.4	Construction Materials	8	-4	0.2	Marine	42	-3	0.4
Russia (NDQ OMX 15)	9	-5	1.0	Telcom Svcs	9	-1	0.5	Specialty Retail	9	27	0.9	Multi-Utilities	43	-1	0.6
UK	10	2	0.9	Energy	10	0	0.8	Tobacco	10	3	0.4	Electrical Equip	44	1	0.2
Mexico	11	-4	0.7	<b>US Industry Groups</b>	<b>Now</b>	<b>Chg</b>	<b>VRat</b>	Beverages	11	0	0.9	Div Financial Svcs	45	-10	0.2
Sweden	12	-1	1.0	Retailing	1	1	0.7	Distributors	12	12	0.3	Personal Products	46	11	0.3
Australia	13	2	0.2	Software & Svcs	2	-1	0.5	Insurance	13	4	0.3	HCare Prov & Svcs	47	6	0.6
Indonesia	14	5	0.5	Food Beverage & Tobacco	3	4	0.7	Real Estate Mgmt&Dev	14	4	0.3	Containers & Packaging	48	-1	0.3
Switzerland	15	-1	0.9	Insurance	4	2	0.3	Professional Svcs	15	8	0.3	Electric Utilities	49	-1	0.5
India (SP India 10)	16	5	0.4	Banks	5	-2	0.2	Textils, Apprl & Lux Gds	16	33	1.0	Food & Staples Ret	50	0	0.4
Taiwan	17	0	0.9	Real Estate	6	7	0.6	Household Durables	17	20	0.3	Health Care Tech	51	8	0.3
Hong Kong	18	-5	0.5	Semis & Semis Equip	7	-2	0.5	Commercial Banks	18	-6	0.2	Div Telcom Svcs	52	-6	0.5
Philippines	19	1	1.1	Cons Durables & Apparel	8	11	0.8	HtIs Rests & Leisure	19	3	0.5	Leisure Equip & Prds	53	-2	0.8
Thailand	20	-4	0.5	Capital Goods	9	-1	0.3	Aerospace & Defence	20	-4	0.3	Paper & Forest Products	54	6	0.3
S Africa	21	-3	0.5	Consumer Svcs	10	-1	0.5	HCare Equip & Supply	21	6	0.3	Comps & Peripherals	55	-11	0.6
Singapore	22	1	0.8	Commercial & Prof Svcs	11	1	0.2	IT Svcs	22	-2	0.3	Machinery	56	2	0.3
Canada	23	1	0.5	Automobiles & Compnts	12	-2	0.4	Wireless Telcom Svcs	23	-14	0.7	Oil, Gas&Consmlble Fuels	57	-2	0.8
Arabia Titans 50	24	-2	1.0	Media	13	-9	0.7	REITs	24	10	0.6	Div Consumer Svcs	58	-2	0.6
Brazil	25	0	0.9	Pharma, Biotech & Life Sci	14	-3	0.3	Gas Utilities	25	-4	0.3	Trading Cos & Dists	59	2	0.2
Greece	26	0	1.1	Health Care Equip & Svcs	15	2	0.4	Semis & Semi Equip	26	-11	0.5	Road & Rail	60	-8	0.6
<b>US Mkt Cap Indexes</b>	<b>Now</b>	<b>Chg</b>	<b>VRat</b>	Household & Prsnl Prod	16	-2	0.5	Auto Components	27	11	0.4	Consumer Finance	61	-7	0.3
S&P SmallCap 600 Index	1	5	0.2	Diversified Financials	17	-2	0.2	Thrfts & Mrtg Finace	28	12	0.2	Multiline Retail	62	2	0.6
US Growth	2	0	0.3	Transportation	18	-2	0.6	Construction & Eng	29	-3	0.5	Communications Equip	63	0	0.5
S&P 100 Index	3	-2	0.2	Utilities	19	2	0.5	Airlines	30	-22	0.8	Energy Equip & Svcs	64	-2	0.8
Russell 2000 Index	4	3	0.2	Food & Staples Retailing	20	3	0.4	Elec Equip & Cmpnnts	31	-12	0.2	Metals & Mining	65	0	0.8
Russell MicroCap Index	5	3	0.1	Materials	21	-3	0.4	Food Products	32	11	0.6	Ind Pwr Prod & Trdrs	66	0	0.9
S&P 500 Index	6	-3	0.2	Telcom Svcs	22	-2	0.5	Automobiles	33	-8	0.3				
US Value	7	-3	0.2	Tech Hardware & Equip	23	-1	0.5	Air Freight & Logistics	34	-3	0.4				
DJ Wilshire 5000 Comp	8	-3	0.2	Energy	24	0	0.8								

# Filtering for Specific Setups

- Two broad approaches:
  - Define specific patterns and look for those patterns
  - Find stocks which have general characteristics

# Setups and Triggers



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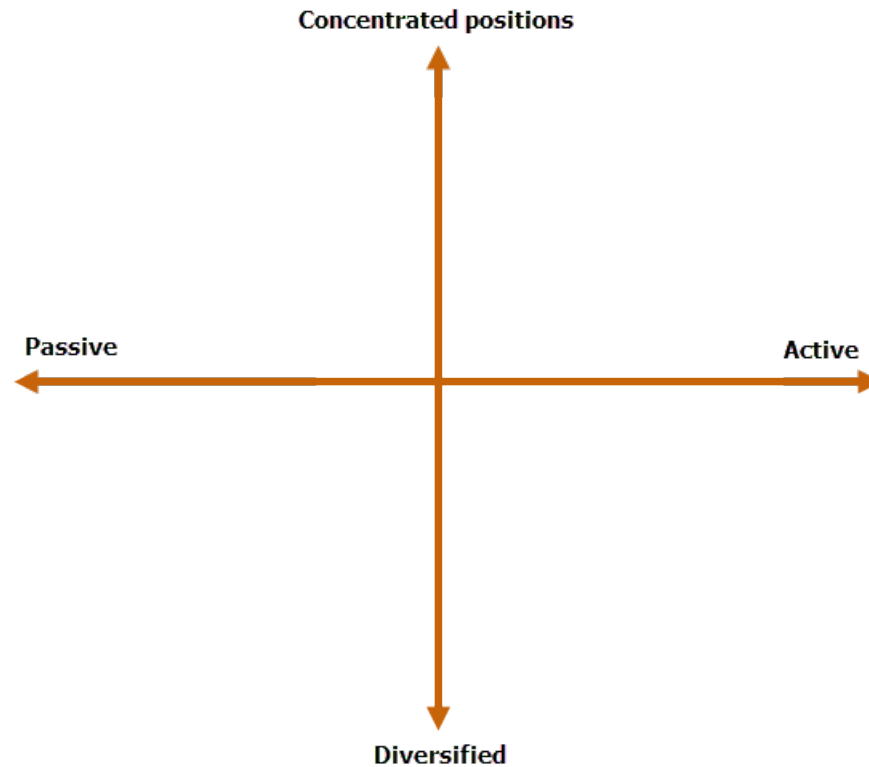
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# Know Yourself

- There is no one-size-fits-all solution.
- Who are you, as a trader/investor?
  - Timeframe
  - Risk tolerance
  - Activity levels
  - Sophistication
  - Specialized knowledge
  - Etc.
- All of these factors, and many more, are important to consider.



# Who are you?



# Two “Styles” of Trading

- **With-Trend**
  - Seeks to enter a position in alignment with the pre-existing trend, or at the beginning of a new trend.
  - Common structures are pullbacks and breakouts.
  - Ideal entries are often around “centers”.
- **Counter Trend**
  - Looks to take positions against the current dominant trend on the trading timeframe.
  - Is there any true counter-trend trading?
  - Hope is to be able to capitalize on a shorter trend against the main trend.
  - Trades often come around extremes.

# Comparison of the Two Styles

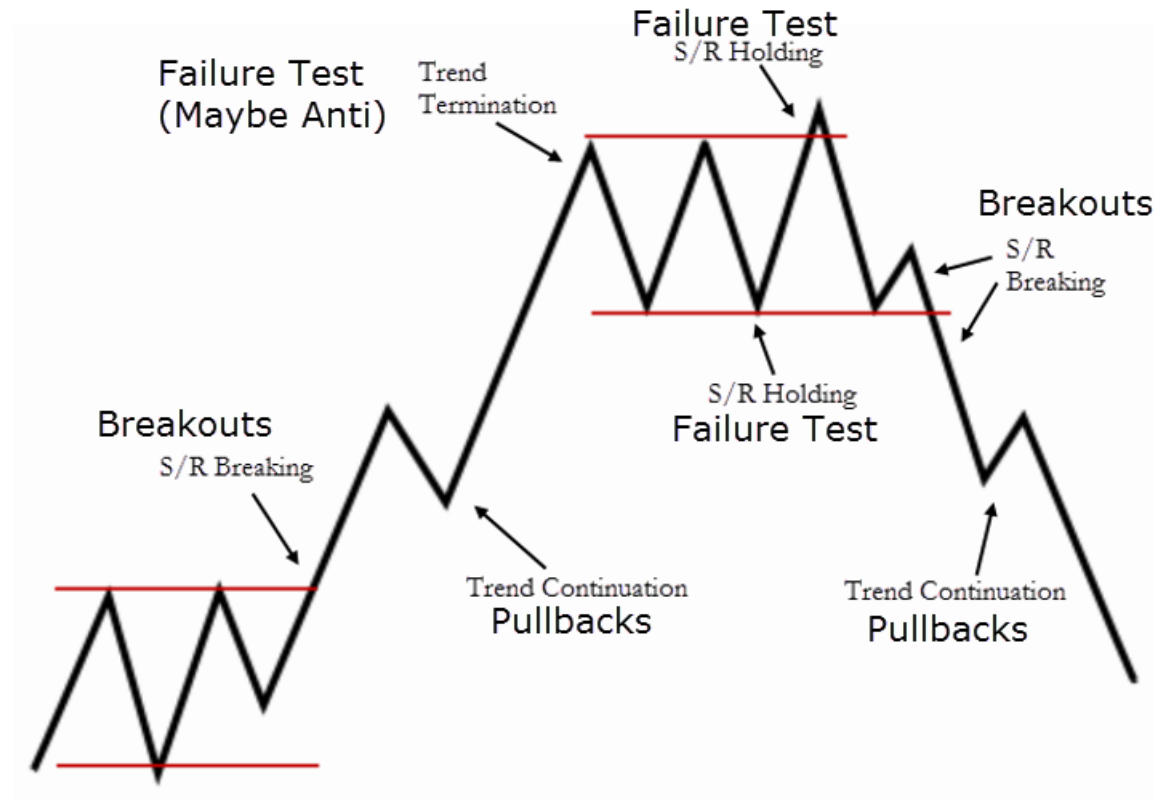
## With-trend

- Trades can often be held a long time.
  - “Ride your winners”.
- Winners tend to be larger than losers.
- May reward a more passive mindset.

## Counter-trend

- Trades tend to have limited expectation.
  - Important to take profits proactively.
- Losers are often bigger than winners.
- Often require aggressive (decisive) psychology.
  - Immediate gratification
- More trades

# Where Do You Want to Trade?



# Waverly Advisors: Tools for Stock Setups

- Can use top-down or bottom up
- Specific setups and entries
- Also broad context on the *types* of patterns that are likely to work
- Strong sector performance track record
- Many quantitative screens (the “good stuff”)

# Top Down Readers

- Start with broad context bullet points on all assets
- Look at pages on US stock indexes and global stock indexes
- Consider global and sector relative strength
- Consider sector weighting and performance
- Look at specific entries from the current week

# Bottom Up Readers

- Start with understanding the overall market environment
  - This may not seem “bottom up”, but it is reality
- Focus next on individual stock pages
  - Entries are our best cases from across the market
  - But, again, the types of patterns and market context may shape all your trading

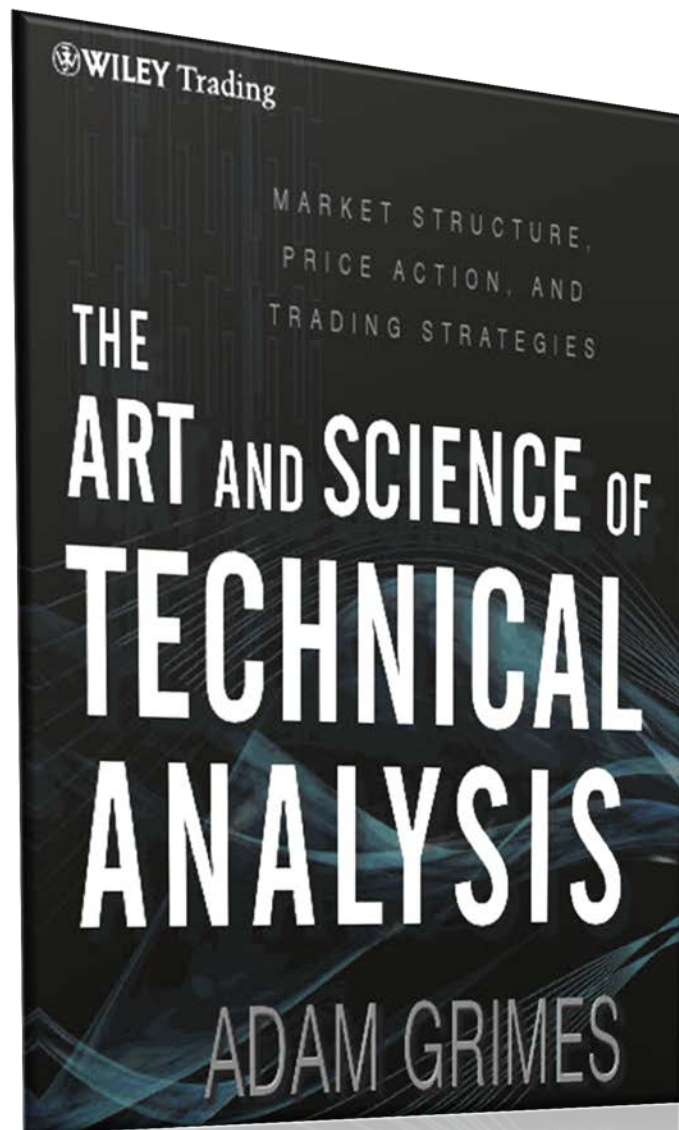
# Tactical Playbook

- High level summary of major markets
- Chartbook and analysis of all major asset classes
- Specific trading ideas
  - Entries
  - Exits
  - Stop levels
- Relative strength analysis
- Tactical equity screens
- Sign up for Tactical Playbook on TWS



# Using Our Research

- Idea Generation
- Risk Management
- Timing
- Blended systematic/discretionary trades
- Tactical inputs to existing processes
  - Educational background
  - Using inputs from relative strength, tactical equity tools, etc. as part of bigger decision making process
  - Incorporating relative strength
  - Inputs (return assumptions, etc.) to portfolio processes



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# My Blog

<http://adamhgrimes.com>

ADAM H GRIMES

*financial markets, risk, and life*

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## MarketLife Ep 28 – So you want to be a trader? Here's what you can do next.

Sep 8, 2015

This week's podcast picks up where we left off last week, and looks at how to apply the lessons and ideas to your own development as a trader. These two podcasts are targeted at developing traders, or perhaps longer-term investors who want to learn to trade more...

[read more](#)

## One, two, three steps to shorting stocks

Sep 2, 2015

I want to share a quick short setup in the S&P 500 index today. This is a repeatable pattern, and draws on many elements I have discussed here on my blog, and also in my book, The

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# Waverly Advisors, LLC:

## Research Products

### **Tactical Playbook** – Available on Interactive Brokers

- Written for the active trader on the daily/weekly timeframes
- Exact trade recommendations
  - Hybrid systematic-discretionary methodology
- In-depth technical “drill down” into a set of markets.
- Bigger-picture overview of all liquid asset classes.

### **Tactical Portfolio Outlook** – Contact Waverly Directly

- Written for the longer-term manager
  - Addresses both the allocator and the longer-term active trader.
- Emphasis on executing with ETFs in a long-only and long-short environment
- Focus on Equities, Equity Sectors, and other asset classes
- Macro perspective on risk factors and major economic events.

### **Options Market Outlook** – Contact Waverly Directly

- Proprietary, quantitative analysis of options market
- Incorporates both volatility and directional analysis
- Macro risk factors and cross-asset perspective
- Actionable trade ideas



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