



Wiley Trading

The Three Skills *of* Top Trading

Behavioral Systems Building,
Pattern Recognition, and
Mental State Management

HANK PRUDEN

Praise for *The Three Skills of Top Trading*

"Professor Pruden's new book, *The Three Skills of Top Trading*, is unquestionably the best book on a specific trading method and the necessary attributes for trading that I have read. His logic, understanding of human foibles, and use of the Wyckoff method of trading are broadly referenced, readable, understandable, and entertaining."

— Charles D. Kirkpatrick, II, CMT, coauthor of
*Technical Analysis: The Complete Resource for Financial Market
Technicians*, Editor of the *Journal of Technical Analysis*,
and board member of the Market Technicians Association

"At long last, someone has taken the time and effort to bring the work and insight of Wyckoff to wider public attention—and Hank Pruden has done so masterfully, with great clarity and eloquence. Hank has taken the best of Wyckoff's work, combining it with the essential aspects of trader discipline and psychology, to provide a highly readable and particularly useful guide to trading. MUST READING!"

— Jacob Bernstein, www.trade-futures.com

"Hank Pruden puts all of the elements needed for successful trading into one volume. This book not only belongs on every trader's shelf but should be close enough for continuous reference."

— Martin J. Pring, President, www.Pring.com

"Dr. Pruden has brought together his lifetime of work in developing a modern approach to analyzing and trading the markets built upon classic market analysis from the early part of the twentieth century and topped off with modern-day tenets of behavioral finance and mental state management."

— Thom Hartle, Director of Marketing for
CQG, Inc. (www.cqg.com)

"I usually consider a book to be well worth reading if it gives me one paradigm shift. I believe that this book will give the average investor a lot more than just one."

— Van K. Tharp, PhD, President, Van Tharp Institute



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Preface

This book gives the trader, the investor, and the analyst a true competitive advantage in the challenging markets of the twenty-first century. Today, there are powerful agitations in the United States and globally to shift responsibility for investing onto the shoulders of the individual. But, just as responsibility moves away from corporations and the government, the individual faces conflicting advice as to how to manage financial investments. The efficient market hypothesis is riddled with false assumptions that lead to wrong results. Equally mistaken are brokers who advise their clients to buy and hold. The real behavior of markets, what the data show in numerous markets over many time frames, is that "Market 'timing' matters greatly. Big gains and losses concentrate into small packages of time." (Benoit B. Mandelbrot)

Some of the most successful traders are the ones who got their market timing right. Take, for example, George Soros, who during two months in 1992 profited about \$2 billion by betting against the British pound sterling. Although few traders are in the same league as George Soros, most can profit from market moves concentrated in time.

This book aims to equip the trader with a balanced set of skills for capturing the "packages of time" that make for big gain opportunities in the market. It will also help the trader sidestep the timing pitfalls stemming from superficial data analysis and erroneous interpretations of market indicators.

To compete successfully the trader must become a Complete Trader. As you can see in the Three-in-One Trader Model (Figure P.1), three mutually reinforcing elements form the Complete Trader. This book will help you develop skill within each of the elements of systems building, pattern recognition, and mental state discipline, giving you solid footing well along the path to becoming a Complete Trader.

This book brings together the three skills of top trading: behavioral models for systems building, pattern recognition, and mental state discipline.

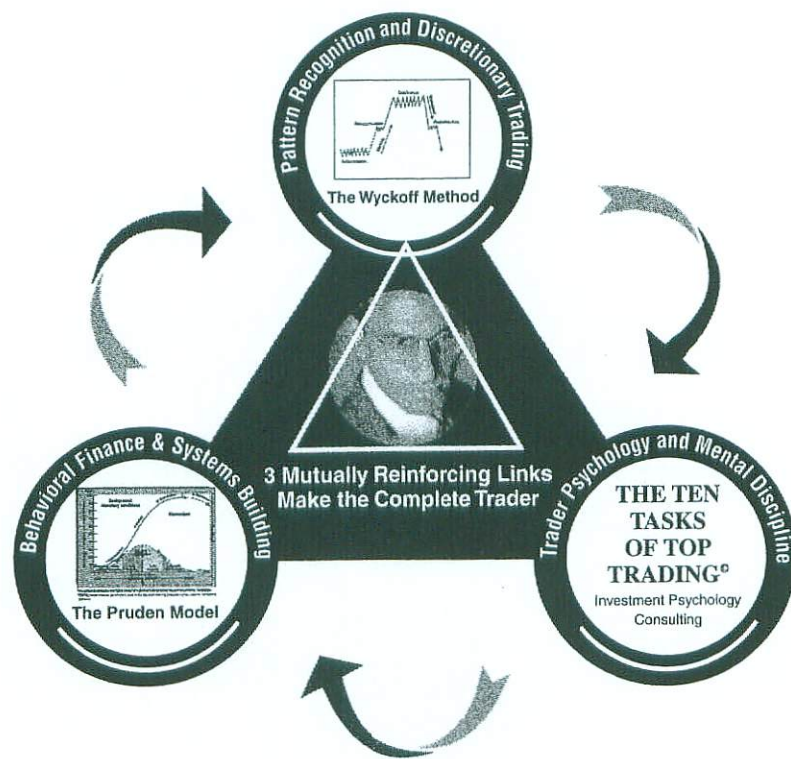


FIGURE P.1 Three Mutually Reinforcing Links Make the Complete Trader

These three key skill areas work together to move the art and science of technical analysis and trading to the level of sophistication required in the twenty-first century. This book integrates elements of trading that are often treated separately into a mutually reinforcing analytical package that makes intuitive sense.

Part One of *The Three Skills of Top Trading* addresses systems building and behavioral finance. There are three chapters devoted to this skill area.

Chapter 1, "Systems Building for the Three Skills of Top Trading," focuses on the building of decision-support systems. It introduces the right-brain/left-brain idea. Several schematics show the relationships of the Life Cycle Model of Crowd Behavior, the Wyckoff Method of Technical Analysis and Speculation, and the tools for mental state discipline found in the Ten Tasks of Top Trading.

Chapter 2, "Behavioral Finance," serves as a resource chapter for the trader. It defines the field of behavioral finance, gives a brief historical review, and explains how behavioral finance can be subdivided into individual behavior and mass psychology.

Chapter 3, "The Life Cycle Model of Crowd Behavior," explains how and why a trader can build a technical decision-support system. The Life Cycle Model defines the four key dimensions of price, volume, sentiment, and time. It also shows how indicators that measure these parameters are integrated into a mutually reinforcing decision framework. The S-shaped and bell-shaped curves of the Life Cycle Model's visual schematic are complemented by an analytical checklist for weighting indicators.

Part Two covers pattern recognition and discretionary trading, with a focus on the Wyckoff method of technical analysis and speculation. There are four chapters devoted to this skill area.

Chapter 4, "Wyckoff: The Man, the Method, the Mystique," shares tales of Richard D. Wyckoff, reveals the history behind Wyckoff's time-tested pattern recognition method, and proposes that his principles are increasingly relevant to the trader of today. In addition, it introduces the five steps of the Wyckoff method of technical analysis and speculation.

Chapter 5, "The Basic Elements of Charting for the Wyckoff Method," defines and illustrates the usage of the basic vertical line or bar chart and the construction and usage of the figure or point-and-figure chart. It also includes the proper procedures for drawing trend lines, trend channels and support and resistance lines within a trading range. In addition, charts show comparative strength and weakness, the role of price spread, volume, and divergences. Finally, you will learn how to coordinate bar and figure charts.

Chapter 6, "The Wyckoff Method of Technical Analysis and Speculation," defines and illustrates the application of Wyckoff laws, tests, and schematics. This chapter describes the three basic Wyckoff laws: supply and demand, effort versus result, and cause and effect. The nine Wyckoff tests are crucial for enabling the trader to identify and enter a trading position that has very favorable reward-to-risk odds. The analytical checklists of the three laws and tests are complemented by visual schematics of trading ranges for accumulation and distribution. Even though Wyckoff's method is a judgmental method and not a mechanical system, these laws, tests, and schematics are designed to give the trader a logical, systematic approach to chart analysis.

Chapter 7, "Anatomy of a Trade," offers concrete and complete examples of the diagnosis of a trading range and the identification of chart locations to take high-reward, low-risk trading positions. The second half of the chapter shows step by step how an expert Wyckoff-oriented trader entered, followed through, and exited trading positions using options on an energy company's stock. In addition, this chapter introduces nine new tests for reaccumulation as a supplement to the nine classic buying tests for accumulation.

Part Three covers trader psychology and mental state discipline. There are three chapters devoted to this skill area.

Chapter 8, "Trader Psychology and Mental Discipline," transitions us into Part Three by drawing on Wyckoff's observation that the mastery of a sound methodology is only half of the trader's battle; the other half is the mastery of one's emotions and mental state. At the center of this chapter is a model, the Ten Tasks of Top Trading, which provides the trader with a system for accessing the appropriate mental state for each key task of a trading campaign from diagnosis to action to exiting a trade.

Chapter 9, "The Composite Man," introduces the concept of the Composite Man, a powerful tool for mastering trading methodology, unique to the Wyckoff method. In addition, the concept of the Composite Man serves as a useful device in the quest for mental state control. This chapter explores in depth the nature and use of the Composite Man and introduces several other complementary techniques to capture the proper mental state for effective trading.

Chapter 10, "Putting It All Together: Ten Principles for a Trader to Live By," is at once an introduction to *The Three Skills of Top Trading* and a summary and conclusion to the book. The chapter concludes with an example of a three skills trader, Weylin Canada, foreign currency trader. The case study of Canada's trading reveals his growth as a trader, his adoption and application of the Three Skills of Top Trading, and examples of his technical analysis and trading actions using charts of currency pairs. Most important, it illuminates the three key skills: (1) He works with a *behavioral model*, a theory, an idea about how the world works that helps him gain profits. (2) He applies both *pattern recognition* and quantitative technical analysis tools. (3) He pays attention to his *mental state control*, which galvanizes him when he needs to take action and extract gold from the veins of ore that his system helps him spot on his price charts.

The Three Skills of Top Trading speaks to both the astute and the aspiring trader who wishes to sustain or gain an edge in trading to meet the challenging markets of the twenty-first century. The competitive edge is going to those traders who embrace skill sets reminiscent of the old-time traders and technicians who lived and worked on Wall Street in the early decades of the twentieth century. This book reveals how the new science of behavioral finance accelerates and enhances these skills and helps to make them accessible to traders of all levels.

In addition, this book addresses the needs of a wide variety of traders. Almost all traders can capitalize on at least one of the elements of the Three Skills model. For example, I believe that systems traders will find the message of Part One, "Systems Building and Behavioral Finance," to be quite rewarding; the Life Cycle Model of Crowd Behavior is especially versatile and rigorous. On another front, swing traders who use pattern recognition can benefit from the Wyckoff laws, tests, and schematics offered in Part Two. Finally, tape readers, and indeed all traders, can benefit from studying three sections located in Part Three: "The Ten Tasks of Top Trading," "Chart Reading in the R-Mode," and "A 'Sealed Room' and 'Only One Client.'" However, this book is truly greater than the sum of its parts, and the trader who integrates every facet of *The Three Skills of Top Trading* should have the decisive competitive edge in the twenty-first century.

The Three Skills of Top Trading is designed both to stand alone and to supplement and complement other books currently available on technical analysis and trading. I encourage you to read it carefully and to return to it often. Let it be your guide as you forge ahead along the path to better trading and expanded profits.

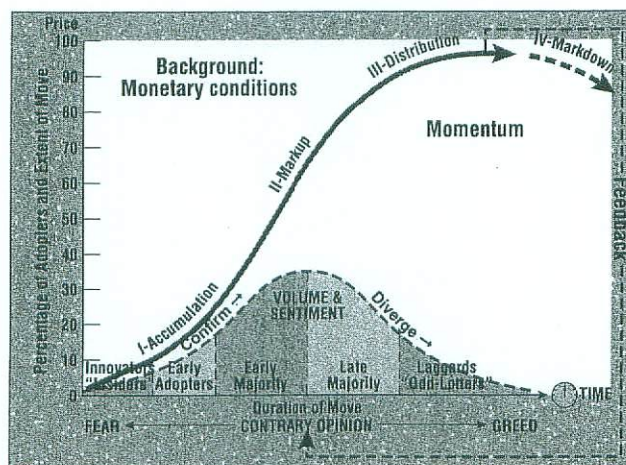
Curves, S-Shaped and Bell-Shaped

The cumulative nature of the herd instinct is reflected in the S-shaped curve of the life cycle model (Figure 3.1), while the counterpart bell-shaped curve shows how groups of market participants are positioned and interrelated, ranging from the early smart money to the "odd-lotters," those who enter the market last (Figure 3.2). Together, the two curves form a life cycle model that is a powerful integrator of indicators to gauge technical market conditions and to predict market behavior. In fact, the life cycle concept is so powerful that economic theorist Theodore Modis argues that such models can forecast the rise and fall of almost anything.¹

The foregoing adoption/diffusion life cycle model, which is widely used in social science and in marketing research, fits the stock market with ease. Using this model, Figure 3.3 shows how the four major parameters of technical analysis—price, volume, time, and sentiment—are interrelated.

Four Elements: Price, Volume, Sentiment, and Time

The four major technical parameters of the Life Cycle Model of Crowd Behavior are distinct aspects of the technical condition of the U.S. stock



The adoption/diffusion life cycle model is modified here to fit the stock market. Here, we see the four technical analysis parameters used in the decision-making process—price, volume, sentiment, and time.

FIGURE 3.3 The Pruden Model

Source: From "Life Cycle Model of Crowd Behavior," by Henry Pruden, *Technical Analysis of Stocks & Commodities* 17, no. 1 (January 1999), 77-80. Copyright © 1999, Technical Analysis, Inc. Used with permission.

market. Since the data for each parameter are independent from that of the others, the indicators representing them can be combined. This additive feature of price, time, volume, and sentiment is very important; together they provide a more complete and binding conclusion regarding a market's present position and probable future trend.

Indicators that represent each parameter can be arranged to provide a more in-depth and reliable understanding of each parameter, as suggested in Figure 3.4. Furthermore, this grid can be used as a worksheet to aid in model development and testing. As the figure shows, each element is broken down into three levels of analysis. The analyst enters data into the "Indicators" and "Weighting" columns according to the market being analyzed and time frame selected. (See the last section of this chapter,

Indicators

Three deep at every position

Four elements: Price, volume, time, and sentiment

Three levels of analysis, or three units of analysis for every element

Element	Unit	Indicators*	Weighting
			Bullish—Bearish +4 +2 +1 -1 -2 -4
Price	Momentum Extent Form		
Volume	Total Upside/downside On-balance		
Time	Cycle Duration Season		
Sentiment	News Opinion Speculation		

This form shows each element broken down into three levels or units of analysis. Entries under "Indicators" and "Weighting" depend on the market and time frame being analyzed.

*Indicators are chosen by the analyst. Depending on the time frame used and the market studied, each technician can systematically select an array of specific technical indicators to represent each element of the model.

FIGURE 3.4 Three-Deep at Every Position

Source: From "Life Cycle Model of Crowd Behavior," by Henry Pruden, *Technical Analysis of Stocks & Commodities* 17, no. 1 (January 1999), 77-80. Copyright © 1999, Technical Analysis, Inc. Used with permission.

accumulation has built a good potential as measured by the Wyckoff point-and-figure method.

Thus you have waited until this point to initiate or add to your position and by doing so you have enhanced the likelihood of success and maximized the use of your trading capital. In schematic 1, this opportunity comes at point 11 on the "pullback to support" after "jumping resistance" (in Wyckoff terms this is known as "backing up to the edge of the creek" after "jumping across the creek"). Another similar opportunity comes at point 13, a more important last point of support (LPS).

In phase D, the markup phase blossoms as professionals begin to move into the stock. It is here that our best opportunities to add to our position exist, just as the stock leaves the TR.

THE "JUMP ACROSS THE CREEK" ANALOGY

The term *jump* was first used by Robert C. Evans, who piloted the Wyckoff Associates educational enterprise for numerous years after the death of Richard D. Wyckoff. One of his more captivating analogies was the "jump across the creek" (JAC) story he used to explain how a market would break out of a trading range. In the story, the market is symbolized by a Boy Scout, and the trading range by a meandering creek, with its "upper resistance line" defined by the rally peaks within the range. After probing the edge of the creek and discovering that the flow of supply was starting to dry up, the Boy Scout would retreat in order to get a running start to "jump across the creek." The power of the movement by the Boy Scout would be measured by price spread and volume.

Defining the Jump

A jump is a relatively wider price-spread move made on comparatively higher volume that penetrates outer resistance. A backup is a test that immediately follows the jump—a relatively narrow price-spread reaction in comparatively lighter volume tests—and confirms the legitimacy of the preceding jump action.

The Wyckoff method instructs you to buy after a backup following an upward jump (a sign of strength) or to sell short after a backup following a downward jump (a sign of weakness). Also according to Wyckoff, you should not buy breakouts because that would leave you vulnerable to swift moves in the opposite direction if the breakout turns out to be false. Hence, at first glance, the Wyckoff method appears to be telling you to buy into weakness and sell into strength. Upon close examination, the rule is to buy the pullback test after a sign of strength.

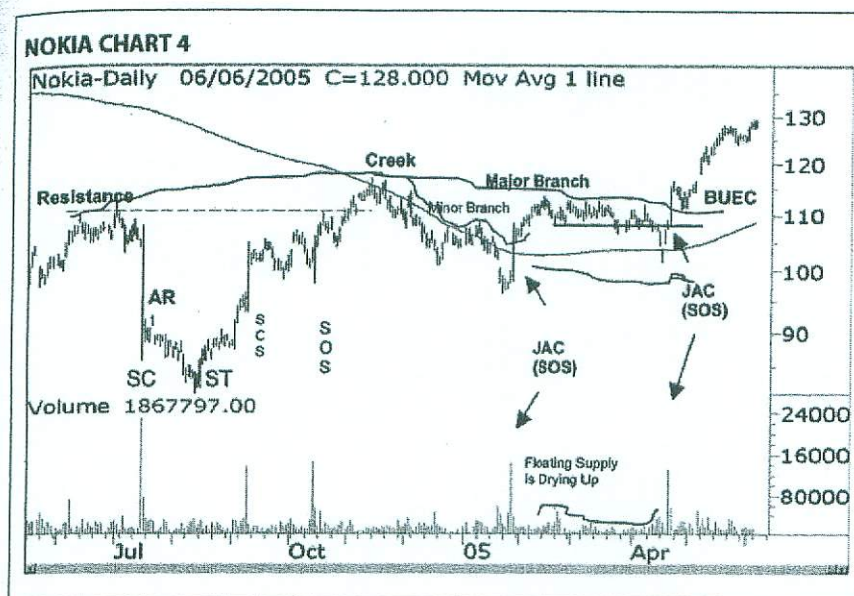


FIGURE 6.12 Nokia Chart 4—Daily, Late 2004 to Early 2005

Source: Michael Östlund & Company. © TradeStation Technologies 1991–2007.

ume day is where the “jump” occurred. Thus we also know this is where the edge of the meandering (minor) creek is. In other words, this successful JAC was also a sign of strength (SOS). A long position could have been initiated during the pullback test following the jump, at around 104, with a protective stop-loss order entered below the support level, around 95. In practice, such a long is not typically entered by a student of the Wyckoff method, because it is evident the major branch of the creek still lies ahead.

After jumping the lower and lesser branch of the creek, the Boy Scout continues upward to the vicinity around 115 where earlier he had found the flow of supply too fast and too deep to jump across. Here again, in early 2005, around the 115 price level, the creek creates a squiggly line of resistance, along the peak prices of the recovery rally, or slightly above the 110 price level of Nokia. However, this time things are different. The Boy Scout observes that the volume is shrinking and price level narrowing. He is witness to a drying up of the floating supply creating the edge of the major creek/major resistance level just above 110.

CHAPTER 8

Trader Psychology and Mental Disciplines

Richard D. Wyckoff observed many years ago that the mastery of a sound technical analysis methodology was only one half of the game of speculation in the securities and commodities markets. The other half of the game was the control of one's own emotions and the mastery of certain mental qualities or mental discipline. Wyckoff argued that "rigid self-control is half the battle. . . . You must operate with no emotions whatsoever . . . until you can learn to trade and invest without hope or fear you will not meet with all the success you should."

Wyckoff went on to cite the injunctions of a famed nineteenth-century cotton speculator, Dickson G. Watts, who said that "the qualities essential to the equipment of a speculator are judgment, self-reliance, courage, prudence and pliability. To these could be added another quality, patience." Wyckoff concluded: "If you do not possess courage, self-reliance, patience, prudence and pliability, cultivate those qualities. . . . You must train yourself . . . make a searching analysis of your own mental process."¹

Although this need for mental discipline in traders was recognized over 100 years ago, the serious study of trader psychology and concepts and techniques for understanding and enhancing the trader's mental discipline did not become popular until the late twentieth century. In his June 1994 article "Mind Games" in *Futures* magazine, David Nusbaum wrote: "Many traders are turning to psychological 'coaches,' eager to find an edge on the unknown they can control—their own behavior." He went on to report that:

This trend—of course—started in California. The study of the psychology of trading began in 1988 for the Zim's group, an informal

collection of money managers, retail and institutional brokers and independent traders named for a small hamburger chain in San Francisco where they first held meetings.

Psychology was the focus, says Zim's member Hank Pruden, also editor of the Market Technicians Association Journal, because following a mechanistic program is all right for beginners, "but not if you wish to be a world champion. . . . There are other elements involved, including the ability to trust your intuition to perceive things differently." In other words, using your head.²

Nusbaum's article profiled several popular "trader's coaches" and their techniques. Notable among them were Mark Douglas, author of *The Disciplined Trader: Developing Winning Attitudes* (Upper Saddle River, NJ: Prentice Hall Press, 1990); Charles Faulkner of Mental Edge Trading Associates, Chicago; and Dr. Van K. Tharp of the Van Tharp Institute in Raleigh, North Carolina, who at the time of publication had written five books on trading psychology.

Starting in 1988, I collaborated with Tharp on a study of trader psychology and mental discipline. Our collaboration culminated in the creation of "The Ten Tasks of Top Trading," which led to an article that was ultimately published in the *MTA (Market Technicians Association) Journal*, Winter 1992-1993.

I was inspired to create the "Seven Tasks of Top Trading" after reading John Sweeny's article entitled "Van K. Tharp, Ph.D.: Trader's Psychologist" in the April 1987 issue of *Technical Analysis of Stocks & Commodities (TASC)* magazine. In the article, Tharp was quoted as saying that, based on his training, experience, and six years of research and testing, he was convinced that "Everything is psychological in terms of investing. So it's really understanding those psychological variables that are most important for winning and losing. . . . For example, each system typically has a number of discrete trading steps that one must follow and each step is associated with some distinct psychological state. If you follow the steps but you don't have the right psychological state associated with it, you're going to be in trouble."³

That interview in *TASC* prompted me to start thinking about the possible task steps and corresponding mental states. I came up with a model composed of seven different tasks and the mental state appropriate for each task. Table 8.1 is the original model that I created to share with Tharp and the members of the Zim's group.

I called the model "Know How by Hobbes." *Know How: Guided Programs for Inventing Your Own Best Future* (San Rafael, CA: FuturePace, Inc., 1986), by Leslie Cameron-Bander, David Gordon, and Michael Lebeau, is a Neuro-linguistic Programming book, and Hobbes is the

CHAPTER 10

Putting It All Together: Ten Principles for a Trader to Live By

This chapter introduces or recapitulates the ten principles for a trader to live by. The discussion of the first nine principles is integrated and illustrated by the tenth principle using a case study of an ace foreign exchange trader, Weylin Canada, 2004 graduate of the Golden Gate University graduate certificate program in technical market analysis. The case study, Canada of Esoteric Investments, San Francisco, California,

The Ten Principles

1. Be your own boss: Create a "sealed room" for yourself and commit yourself to "only one client."
2. Leapfrog your competitors: Gain the winning edge by acquiring high-concept and high-touch talents for the twenty-first century.
3. Learn the Wyckoff method of technical analysis and master the Wyckoff art of speculation.
4. Become the complete trader: Play the role of the Composite Man.
5. Always be disciplined: Follow through your trades with the Ten Tasks of Top Trading.
6. Build your trading systems on the solid, scientific foundations of behavioral finance.
7. Use decision support systems to help set up your market timing.
8. Test your trading system and train yourself to use it via the action sequence method for active learning.
9. Adopt a planning and control process.
10. Integrate the Three Skills of Top Trading and make them an inseparable part of yourself.