

# TradeRiskManagement

## Futures and Stock Analysis

### TRM Trading Signals FAQ

#### What is Trade Risk Management?

Trade Risk Management is a technical methodology for identifying overbought and oversold markets and then using a contrarian trading strategy to trade those markets with reduced risk. With the introduction of Trading Signals, Trade Risk Management offers an approach to identifying overbought/oversold trading opportunities along with actual buy and sell signals!.

In addition to a buy or sell signal we can now also evaluate the quality of such signals. This, we believe to be something new. There are many services that provide traders with systems that give buy and sell signals. But, to our knowledge, no service actually provides their customers with a service that evaluates the quality of their signals based on probability bands. With other services it's buy here, sell here. Nothing more said.

At Trade Risk Management you'll find charts for stock markets around the world, international world currencies, spot prices (including the base metals of the London Metal Exchange) and commodity futures prices. If there is a special time series you would like to see displayed on a regular basis, or have any comments about improvements to the website, please email me. I look forward to hearing from you.

## What are Trading Signals?

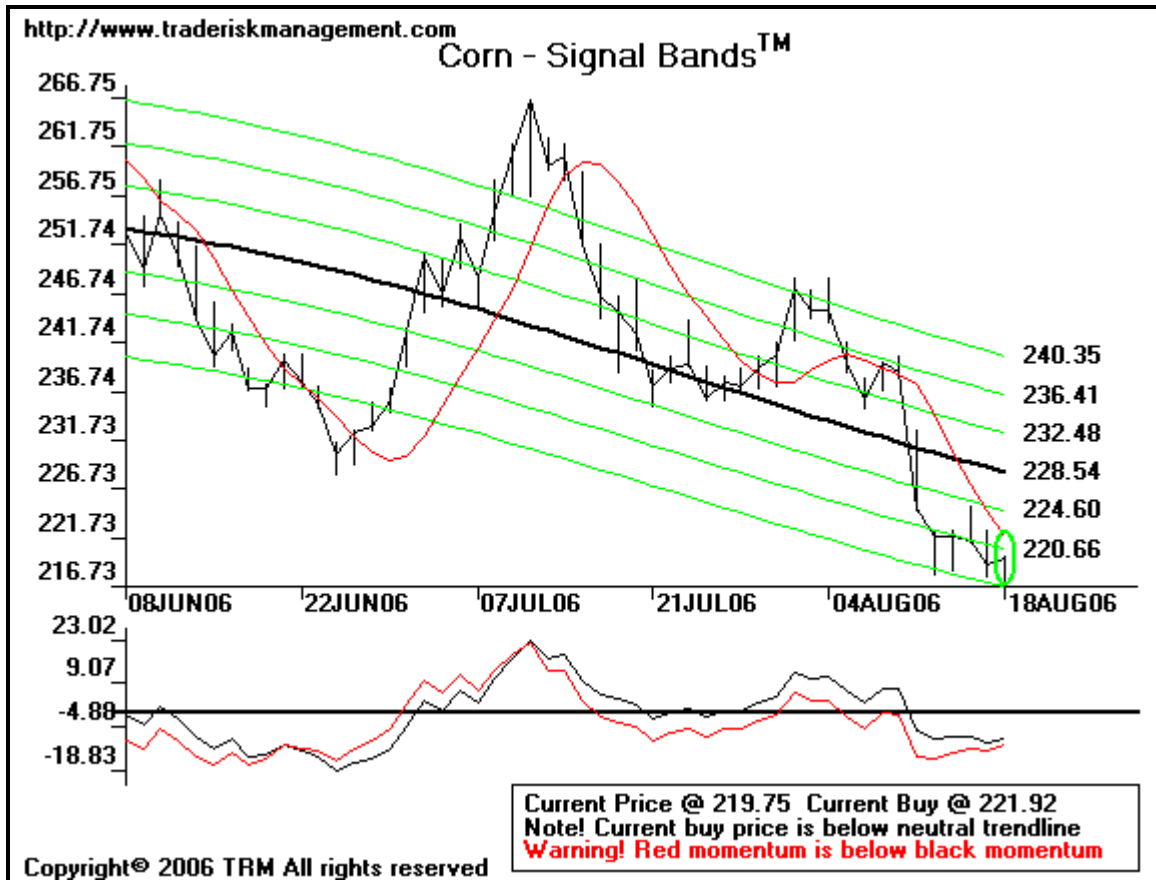


Chart 1

To get a better idea of what Trading Signals are, focus your attention on the image displayed in Chart 1 above.

Trading Signals are based on the idea that buy/sell signals are generated when the price crosses above and below a trendline. Usually, this trendline is a moving average or some exponential smoothing of the prices. But, in TRM's Trading Signals this trendline (always displayed in red!) is calculated according to a proprietary algorithm. Nevertheless, the use of the red trendline conforms to customary crossover usage. Thus, when the price moves above the red trendline we have a buy signal and when the price falls below the red trendline we have a sell signal.

Notice also that the current price is displayed in the box toward the bottom of the chart. Also, the latest buy or sell price is displayed. This buy/sell price is simply

the current value of the red trendline. As we will see later this value can also double as a stop loss point.

In addition to the prices and red trendline you will notice that we also display a set of the Sigma Bands. Note that these Sigma Bands are not the same Sigma Bands that appear on TRM's Sigma Band chart. These Sigma Bands are designed to respond faster to changes in both price and momentum. The Trading Signal chart shows the position of the current price in relation to the bands. Thus, in each case, we see if the price is overbought or oversold, as defined in terms of probability.

Finally, notice that the box also contains some comments and warning messages. These messages refer to the "quality" of the buy or sell signal. We'll discuss these messages in detail later on in the FAQ.

## What are the benefits of the new Trading Signals?

The new Trading Signals are designed to give frequent buy and sell signals. In addition, our new Trading Signals are designed to show where the buy/sell signal occurs within relation to the Sigma Bands and to show what is happening with momentum when the buy or sell signal occurs. This then gives us the ability to judge the quality of the buy and sell signals. Afterall, not every signal can be expected to result in a successful trade. However, with the ability to judge the quality of the signal the trader has a better chance of being on the winning end of a good trade and also a better chance of avoiding being on the losing end of a bad trade.

## What are the differences between Signal Bands and Trading Signals?

There are two main differences between Signal Bands and Trading Signals. First, the original Signal Bands were designed to give the trader an entry point into an overbought or oversold market based on the overbought/oversold conditions

indicated by the Sigma Bands chart. The new Trading Signals are more of a stand alone chart. In fact, the Sigma Bands that are displayed are not the same Sigma Bands shown on our Sigma Bands chart. They are designed to react faster to changes in the underlying prices. The trader may act on a buy or sell signal with the new chart without actually consulting the original Sigma Bands chart, although this is not advisable.

The other big difference between the two charts is the original Signal Bands attempts to give an entry point but no exit point. The new Trading Signals give both. The new Trading Signals track a buy or sell signal as it is unfolding. Once the buy or sell signal occurs the algorithm switches mode and tracks the next sell or buy signal. This process toggles back and forth indefinitely.

## What is the "Fundamental Rule"?

The "Fundamental Rule" simply says

"The further away the price is from the solid, neutral trendline the higher the profit potential."

The reason the Fundamental Rule is important is because it allows the trader to spot situations when a trade can be initiated in either an overbought or oversold region. Prices are naturally distributed around the solid, neutral trendline on the Sigma Band chart. The distributions of the price deviations from this solid neutral trendline are naturally bell shaped in appearance. Overbought and oversold regions are defined as the "tails" of this bell shaped curve. The probabilities associated with the tails are very low. Thus, when prices move into the tails, that is, the overbought or oversold regions, then prices will naturally migrate back to regions of higher probability, that is, toward the solid, neutral trendline.

## What messages are displayed on the chart?

There can be as many as three lines of messages included in the Trading Signals chart. The first line is always the same. It tells you what the current price is along with the latest buy or sell information. As stated before, when the price moves from below to above the red trendline we have a buy signal and the buy point is the value of the red trendline. Similarly, when prices move from above to below the red trendline we have a sell signal and the sell point is the value of the red trendline.

The second and third line can vary depending of the quality of the buy or sell signal. The messages are one of three types: "Notes", "Warnings", and "Danger". A "Note" is simply a notational message informing the trader that the signal is occurring under normal circumstances. A "Warning" message is a message informing the trader that a signal is occurring under less than optimal circumstances. Finally, a "Danger" message is informing the trader that the buy or sell signal is occurring under very undesirable circumstances. Chart 4 below illustrates all three types of messages.

### **What does the first message line say?**

The first line always gives information about the trade. First, it gives us the current close or settlement price for the market the chart pretains to. It then gives the buy or sell price that is currently in effect. This is the price at which the price crossed over the red trendline. The third value is the current value of the red trendline. It can be used as a stop loss point. More will be said about this later.

## What are "note" messages?

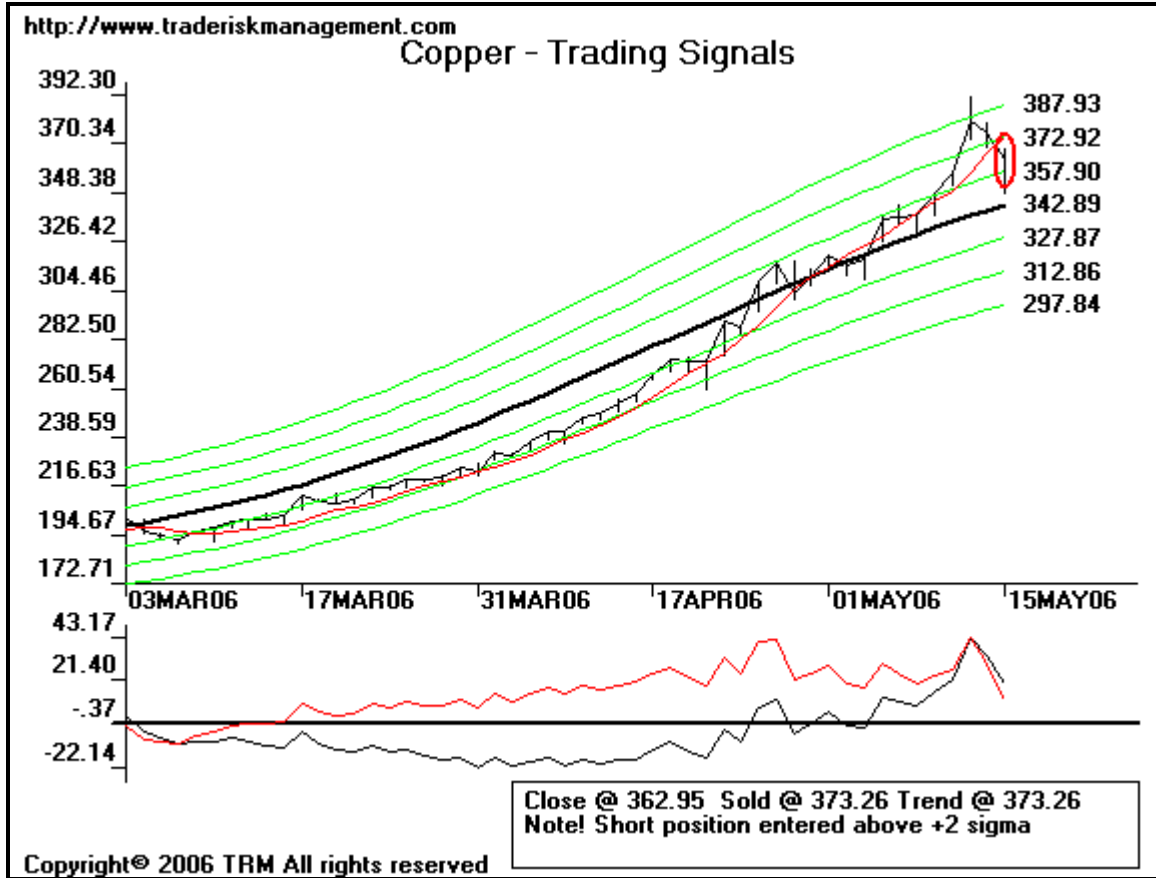


Chart 2

"Note" messages are designed to be information messages concerning the buy or sell signal. When a signal occurs it can occur under negative conditions or it can occur under conditions that the trader would expect to see happen. For example, ideally a sell signal occurs when the price is in an overbought region. One could then expect to see a confirmation message informing the trader that such a signal has occurred. This is a "note" message. Chart 2 above illustrates the "note" message for a successful sell signal in the Copper market.

## What are "warning" messages?



Chart 3

"Warning" messages are designed to be actual warnings that a buy or sell signal has occurred under less than optimal trading conditions. For example, suppose a buy signal is generated when prices are close to the solid, neutral trendline. Ideally, a buy signal should occur when prices are below the -2 Sigma level. If the buy signal occurs well above the -2 Sigma level, then a warning message notifying the trader of the less than ideal buying conditions, is generated.

Warning messages are generated to simply let the trader know that something may be wrong. The trader can still act on them. It's a judgement call. For example, suppose a sell signal occurs with prices coming down from above the +2 Sigma level? Since the sell signal occurs below the +2 Sigma level a warning message could appear. However, if the same signal had occurred just above the +2 Sigma level then a "note" message would have been generated. Under these conditions a trader may indeed want to take a sell position. Again, it's a judgement call.

Chart 3 illustrates this condition. Notice that the sell signal occurs at around +1.5 Sigma. This could be a good sell signal. But, because the sell signal occurred below +2 Sigma the trader gets a warning message. It's the trader's decision to act or not act on this signal.

What are "danger" messages?



Chart 4

"Danger" messages are designed to be extreme warnings that a buy or sell signal has occurred under very dangerous trading conditions and should be questioned by the trader. For example, suppose a buy signal is generated when prices are in the overbought region, that is, above +2 Sigma. Ideally, a buy signal should occur when prices are below the -2 Sigma level. If the buy signal occurs when prices are in the +2 Sigma level, then a "danger" message is generated. Essentially, a buy signal has occurred when the trader would expect a sell signal.

Chart 4 illustrates a bad sell signal. Notice the sell signal occurs below the -2 Sigma level, that is, in the oversold region. Why would one want to sell something that is oversold? Not surprisingly, a "Danger" message is displayed. And as it turns out the sell signal was a false sell signal. Sugar prices gave a buy signal within a couple of trading sessions and now Sugar prices are well above their -2 Sigma level.

Traders should always take "danger" messages very seriously. Danger messages are designed to keep the trader from making bad mistakes.

### What about momentum analysis!??

In our analysis of Sigma Bands we have always stressed the importance of momentum analysis. Nothing has changed here. Momentum analysis is designed to keep the trader out of bad trades and to help identify successful buy or sell signals.

In momentum analysis we monitor the relationship between the red and black momentum lines displayed at the bottom part of the chart. Consider, as an example, the red and black momentum lines at the bottom part of the chart labeled "Chart 1" above. Notice, that when the buy signal occurs, that is, at the time when the green ellipse occurs, the red momentum line has converged to the black momentum line. In this case the two momentum lines have simply converged, not actually crossed. Ideally, we would like to see the red momentum line move above the black momentum line.

Ideally, when a buy signal occurs we see the red momentum line over black momentum line. This confirms that momentum is strengthening. This is what the trader should look for. When a buy signal occurs look for strengthening momentum. When a sell signal (a red ellipse) occurs look for weakening momentum. In Chart 1, the two momentum lines are converging at a sufficient rate that one can conclude the red momentum will remain above the black momentum line during the buy signals lifetime.

Ideally we should always see the red momentum line cross the black momentum line as a buy or sell signal is occurring. However, in practice this does not always happen. So, if the red and black momentum lines have not actually crossed then look to see if they are at least getting closer and closer to each other. In other words, are the two momentum lines "converging?" Converging momentum lines can be a good sign that prices are preparing to reverse direction. But be careful here. Converging momentum lines are not as good an indicator as momentum lines that have actually crossed. Just how close should the lines be? That's a judgement call.

In Chart 1 above the red and black momentum lines are converging. So the trader needs to decide if this is a good buy signal. As it turns out it was an excellent buy signal and well worth the risk. But, again it is a judgement call.

Notice in Chart 2 that we have an excellent example of a good sell signal. When the sell signal occurs the red momentum line has dropped below the black momentum line. This helps confirm the validity of the sell signal, which turned out to be an extremely profitable trade.

The trader should always be concerned when a buy or sell signal occurs with the momentum lines getting further apart. Diverging momentum lines usually indicate that the prices may continue in the direction the momentum is already indicating.

### What about stop loss points?

There are those who hate stop loss orders, do not use them and recommend no one else use them. On the other hand there are those who swear by them and would not think of trading without them. We take the view that it's up to the individual trader to decide for themselves where stop loss orders fit into their trading strategies.

We don't actually use any kind of special algorithm to compute a stop loss point. However, we define buy and sell signals by the value of the red trendline. When prices cross the red trendline it is a buy or sell signal. Therefore, one could consider the current value of the red trendline as a stop loss point. For example, suppose one is in a buy position. Then the current value of the red trendline could easily be used as the current stop loss point. If the price were to drop below this point it would automatically trigger a clearing of the position. Does one then also want to turn around and use the same red trendline value to initiate a sell position? That, of course, is up to the trader. Again, it's a judgement call.

Notice on Chart 1 above that the first line ends with the words "trend @". This is the current value of the red trendline and could be used as a stop loss point, if one so chooses.

### What kind of signals should I look for when I want to buy?

If you're looking to buy the first thing to look for is the present price in relation to the Sigma Bands. Ideally, prices should be below the -2 Sigma level or at least close to the -2 Sigma level. Remember, the Fundamental Rule tells you that the profit potential increases the further below the solid trendline the current price is. So if the buy signal were to occur at the -3 Sigma level it would be better than a buy signal at the -2 Sigma level.

The next thing to look for is the actual buy signal itself. Has it occurred or is it so close to occurring that you're willing to assume the risk that it will occur? Never buy if it appears that a sell signal is eminent.

Finally, check to see if momentum is going your way. If you're going to buy you should feel comfortable that momentum is strengthening. Without momentum going in your direction the profit potential could be very disappointing. Chart 1 illustrates these ideas.

### What kind of signals should I look for when I want to sell?

If you're looking to sell the first thing to look for is the present price in relation to the Sigma Bands. Ideally, prices should be above the +2 Sigma level or at least close to the +2 Sigma level. Remember, the Fundamental Rule tells you that the profit potential increases the further above the solid trendline the current price is. So if the sell signal were to occur at the +3 Sigma level it would be better than a sell signal at the +2 Sigma level.

The next thing to look for is the actual sell signal itself. Has it occurred or is it so close to occurring that you're willing to assume the risk that it will occur? Never sell if it appears that a buy signal is eminent. Chart 2 illustrates these ideas.

Finally, check to see if momentum is going your way. If you're going to sell you should feel comfortable that momentum is weakening. Without momentum going in your direction the profit potential could be very disappointing.

### Don't be too precise in your selections!

TRM's Trading Signals will be giving you many buy and sell signals. It will be up to you to filter out which signals you choose to act on. But in our discussion on what criteria you should use to make decisions, things can get a bit "fuzzy", such as buying or selling outside the +/- 2 Sigma level. For example, suppose that prices are just at the 1.95 Sigma level? Should you act then? It's up to you but don't be too exact. Prices may not go any higher and you may be getting a good sell signal. So use some judgement here. Things are not that absolute that prices MUST satisfy the criteria. There will be many good buy and sell signals you may pass up if you become too literal. Use some judgement here!

### Important Disclaimer

In the world of Technical Analysis software developers speak of "buy" and "sell" signals. This is simply terminology that has been adopted to denote signals associated with price crossover points. These buy or sell signals are not actual recommendations to buy or sell. They are simply crossover points and it is up to the individual traders to decide for themselves whether to act of these signals. Use the signals at your own risk!