THE TEN COMMANDMENTS OF TRADING

by Chris Johnson

Straight-Up PROFITS

The 10 Commandments of Trading

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Commandment #1: The Trend Is Your Friend

My first commandment has become somewhat of a mantra for me: The trend is your friend.

A trend grabs the attention of the marketplace, and it makes traders feel good. Everybody likes to own stock that's trending higher, right? And everybody hates to own stock that's trending lower. It doesn't take an expert to figure that much out.

Historically, if you follow the trend of S&P 500 stocks, there's a 2:1 chance they're going to go up if the moving average is moving higher. The opposite is true too. If the trend is moving lower, then there's a 2:1 chance that the stock will fall.

That's why every day, I watch any trends that tie into my scorecard of stocks.

I don't like to hold a stock with a 50-day moving average that's trending lower. And if I'm holding any stock that *is* trending lower, it's because I've held it for 10 to 15 years – it's a staple of my portfolio, like Procter & Gamble. But there aren't many of those.

While investing in a trend is not necessary, especially for short-term trades, it almost always provides a tailwind to lead you to profits.

Commandment #1: The trend is your friend.

- ✓ **Rationale:** Trends grab attention and make traders feel good. The market loves a good, reliable trend more than anything.
- ✓ **History or Story**: Stocks follow trends, according to my historical studies on the S&P 500.
- ✓ **Application**: While investing in a trend is not necessary, especially for short-term trades, it almost always leads to profits.

Commandment #2: Avoid Running with the Crowd

My second commandment – avoid running with the crowd – can also be stated like this: Avoid a bandwagon stock. Unless, of course, you're the one driving. You always want to be in the driver's seat of the bandwagon. You don't want to be the person that's running behind, trying to catch the tail of it.

It pains me to admit that I have been that guy. The one who waited too long to buy a stock and then jumped on the bandwagon after it was too late. The stock hit a rock, and the wagon skidded off the road.

We've all done it, but my message here is *don't do it*. Not again.

Watch the bandwagon stocks. Instead of jumping on, position yourself to cash in on the "group think." When everyone else piles onto the bandwagon, it'll pull the stock up. So that's when you sell.

When everyone else is selling, it'll push the stock down. That's when you buy.

Buy low, sell high. It's the oldest rule in the book.

I understand that going against the grain isn't easy. That's why my second commandment of trading is one of the hardest to follow. I've broken it before – but it always just ends up reinforcing its truth.

Now, how do you tell if it's a bandwagon stock?

Let's say you like a stock, and when you turn on CNBC, everyone's talking about it. Sounds good, right?

Wrong. That should be a flashing yellow warning – proceed with caution. That's when the usual stock chatter gets louder and more crowded. When **85% or more** of analysts are rating a stock as a "Buy" or "Strong Buy," that's when you should formulate an exit strategy. This bandwagon will crash, and it'll be sooner rather than later.

Everybody likes to be a 3.5% return portfolio manager, wearing their dad's suit, feeling comfortable. That's where the group think comes from. But they're *deluded*. Everyone else around them is buying the same thing!

It's human nature – and you should never bet against human nature.

When you're dealing with the stock market, it's difficult to think independently. We're trained to watch all indices, the S&P 500, the "FAANG" stocks, and so on. But that's group think. And you can never outperform the group if you're part of it.

If you just buy the most common stocks and sit and watch your money move with the market, then you're always going to be stuck in the group. When the market goes down 10%, you also go down 10%. You can't time your entry or exit.

The bottom line? Just avoid running with the crowd.

Commandment #2: Avoid running with the crowd.

- ✓ **Rationale**: The best time to buy is when everyone is selling, and the best time to sell is when everyone is buying.
- ✓ **History or Story**: Wall Street analysts represent "group think." You can never outperform the group if you are part of it.
- ✓ **Application**: Research and find undiscovered opportunities in the market. If you beat the group, then it's their money that will multiply your profits.

Commandment #3: Don't Fight the Tape

I love this one: Don't fight the tape. In other words, never pick up pennies in front of a steamroller.

This is one I learned the hard way. I used to be in the business of picking up a lot of pennies...

Basically, this happens when you're trying to prove that the market is wrong and you're right. You're doing a ton of work and taking risks just to try and make a little bit of money.

When you're looking for pennies like this, you always end up getting your fingers stuck. They're either cut off from the rest of you, or all of you goes under the steamroller and you're flattened out, just like in the cartoons.

But you can avoid getting run over by a steamroller by steering clear of high-risk, low-profit situations when the market is moving against you.

Just like avoiding the crowd, this is another commandment that's hard to follow. You don't know how many times I've sat there and looked at a computer screen, yelling, "*What? They're not listening to me! This is not supposed to go up, this is supposed to go down!*"

It's completely self-delusional. As we've come to see, there's often no rational reason for a stock to be going up or down. Just think about the dot-com bubble. Stocks were soaring, and there was no real reason why.

Instead of yelling at the computer screen, that's when you need to look at what's happening and think, "*What is everybody else seeing that I'm not?*"

Here's your answer: *Nothing*. They're not seeing something you're not. They're simply being irrational. Sure, it's frustrating, but you always have to remember that *the market is irrational*. And trying to act rational in an irrational market is a fool's strategy. It's like picking up pennies in front of a steamroller!

I once attended a week-long seminar at the Massachusetts Institute of Technology on financial engineering and technical analysis. There was a guy there that talked about behavioral finance and the psychology of trading. His name is Terry Burnham, and he wrote a book called "Mean Markets and Lizard Brains."

The title isn't the only thing that caught my eye. His idea is based on research that studied traders in the Boston exchange. These traders had funny little helmets on that gauged brain activity. The researchers put them in different trading scenarios where they'd make buying and selling decisions.

They were trying to understand how long it took a trader to decide whether they were going to push the buy button or not – and the reason behind their decision. When it came down to it, these traders would only take a fraction of a second to make the decision to buy or sell, almost subconsciously.

What they found was that the part of the brain that lit up and made the decision was the so-called "Lizard Brain." This is the oldest part of the human brain, the brain stem, responsible for primitive survival instincts such as aggression and fear, like "fight or flight."

After their Lizard Brain had already made the decision, these traders would take an extra three to four minutes to rationalize their decision. They'd look at various charts, and explain why they had made their decision.

But in reality, their Lizard Brains had already decided for them. It didn't matter whether they were trading actual stock or marshmallows. Their brains would make a subconscious calculation of value, whether it was a "fight" or "flight" situation, and make a decision.

The part of our brain that tells us we're hungry or thirsty is the same part that makes that buy or sell decision. This is why I always tell people, *don't fight the tape*.

The tape represents an irrational market. Don't try to rationalize it – because as humans, we'll rationalize picking up shiny pennies right before a steamroller gets to it and crushes us in the process.

Commandment #3: Don't fight the tape.

- ✓ **Rationale**: Avoid high-risk, low-profit situations when the market is moving against you.
- ✓ **History or Story**: Sometimes, there is no reason for a stock to be going up or down. Trying to be rational in an irrational market is a fool's strategy.
- ✓ **Application**: If you have to ask yourself "why," you're already wrong, and you're fighting the tape. Yelling at your computer is not going to change anything. Get out!

Commandment #4: Prices Almost Never Reflect Value

The only price that you can ever count on for support is zero. It's not going to go lower than that. You can forget the dividend and valuation models from your Finance 101 textbooks. There is no way to accurately value a stock.

Just look at technology conglomerate Cisco Systems. Back in the early 2000s, the company fell apart. It announced earnings after the closing bell, and I didn't see the news until the next morning when I turned on CNBC.

The stock was down about 14%, and guess what? I had "out-of-the money" puts that were now sitting at a 400% gain.

Cisco couldn't catch a break. The fundamentals were falling apart. It was in a downtrend that seemed unbreakable. People on television were saying that it couldn't go lower than $20, but it did.

And it kept dropping.

I can't even remember where Cisco finally bottomed. It was somewhere around $6. I always say that overbought can always become more overbought, and oversold can always become more oversold – and that's exactly what happened to Cisco. Cheap can always become cheaper.

Remember this: Don't buy something just because it's cheap.

If someone tells you, "*Hey, look at the P/E ratio, it's a good deal at this price*," that's a warning sign. Nothing's cheap until it gets to zero.

A stock that's oversold can become more oversold. Cheap can become cheaper. Likewise, overbought can become more overbought. So watch out for those oversold and overbought situations, because price almost never reflects value.

Commandment #4: Prices (almost) never reflect value.

- ✓ **Rationale**: Outside of Finance 101 textbooks, there is no real way to value a stock. Overbought can always become more overbought; oversold can always become more oversold!
- ✓ **History or Story**: Cisco's $6 bottom in the early 2000s.
- ✓ **Application**: Beware when analysts and commentators are telling you that a stock is a good or bad deal "at this price." Cheap can always get cheaper, and expensive can get more expensive.

Commandment #5: The "Smart Money" Rarely Tells You What It's Doing

My fifth commandment is becoming even truer as time passes. The so-called "smart money" is those funds controlled by big institutional investors, and it's hard to find. That's because the people who are smart about their money don't want you to know how they make it.

You don't read about these people. You don't see them on TV, and you don't have a clue where they stand in the market.

But sometimes, word gets out. Once the smart money hits headlines, though, it's not "smart" anymore. It's usually too late. By jumping in then, you just end up caught in a crowd running toward the smart money. Everyone is using the same tactic, and you lose your edge. You're suddenly with a crowd – and, not to mention, you're breaking Commandment #2.

Now, that doesn't mean it's impossible to play the smart money. You just need to catch on early, before the news hits the mainstream. And that's where the options market comes in.

You see, the smart money leaves bread crumbs behind. And the best place to find those crumbs is the options market.

There's a ton of valuable data there. My database sees 380,000 records a day that are solely options data. It's a lot to go through, but it's worth doing. The smart money's data leaves clues behind that can lead you to big profits.

Take my first options trade as an example. Based on clues from the smart money's bread crumbs, I opened a put trade on Intel. And I woke up the next day to find the stock down 25%.

This trade changed my life. I hit the jackpot – and I have the options market to thank.

That's one of the reasons why I have over 20 models at my disposal. I'm always trying to evolve the models and stay a step ahead of the crowd – and picking up the clues left behind by the smart money is one of the best ways to do it.

Commandment #5: The smart money won't tell you what it's doing.

- ✓ **Rationale**: Remember Commandment #2 – avoid the crowd. The smart money *never* wants you to run with them.
- ✓ **History or Story**: My first options trade.
- ✓ **Application**: You need to figure out what the real market players are doing using the data bread crumbs that "smart money" leaves behind.

Commandment #6: Short Sellers Are Usually a Bull's Best Friend

Short selling is an investment or trading strategy that bets on a decline in a security's price. An investor or trader opens a position by borrowing shares of a stock and then selling them.

Before the short seller has to deliver to their buyer, they expect the shares to drop. That way, they can purchase them at a lower cost, keeping the difference and making a profit.

These brokers don't care if you want to borrow the stock and sell it to your Uncle Lou of all people. As long as you've got the margin, they'll give you the shares. They just care about getting the shares back and making some money of their own.

My point? Short sellers can turn into a bull's best friend. If you're using the counterintuitive approach, you're buying a stock that's fundamentally and technically sound.

Take biotech stocks, for example. They have a lot of short interest, mostly because they're the stocks that tend to be lottery tickets, one way or another. Say you're shorting a biotech company, and news hits that a drug failed. You'd likely make a ton of money.

But if you consider how the stock is doing technically and fundamentally, that may not always be the case. Many times, a stock will continue to edge higher, working its way into what we call a "short covering rally" or a "short squeeze."

It's really an evil type of twist. The stock that you bet against is moving higher, and you have to buy it to close out your short position. So you end up making it go even higher.

You can watch this data twice a month by looking at the short interest ratio on a stock. The magic number you want to look for is **six**. If the short interest ratio is above six and the technicals of the 50-day moving average are moving higher, then that means the fundamentals are good.

That should put the stock on your radar. Historically, the stock will more than double in the following four to six months!

Commandment #6: Short sellers are usually a bull's best friend.

- ✓ **Rationale**: More often than people think, short sellers are trying to pick up pennies in front of that steamroller. They have to pay their way out, which can generate profits for you. In other words, these sellers have to become buyers.
- ✓ **History or Story**: Watching a stock's short interest ratio.
- ✓ **Application**: Counterintuitive bets against a strong stock usually pay off handsomely.

Commandment #7: Sometimes, a Price Can Tell You Everything

It's so simple that it sounds stupid – but it's true. Sometimes, a price is going to tell you everything.

This goes for any type of index or stock. Round numbers are natural support and resistance levels. Some traders want to buy a stock when it's at $20.00, not $20.17, for example. The more zeros, the better – even though historically, the extra zeros are just psychological mile markers. But some traders believe a stock is fairly valued at a round number, and it hits a trigger.

They'll see an index or stock cross a certain line, and they start buying and selling. You see this time and time again, especially when something is heavily trumpeted in the media. And you know what? You should also watch those round numbers. Not because you feel it's a fair value (remember Commandment #4), but because behavior moves the market.

And when the stock hits that round number, it could lock in profits for you – keep it simple, stupid!

Commandment #7: Sometimes, the price will tell you everything.

- ✓ **Rationale**: Round numbers are natural support and resistance levels. The more zeros, the stronger the support.
- ✓ **History or Story**: Traders and investors tend to use psychological mile markers to "take inventory and act." Round numbers are easy to identify as mile markers.
- ✓ **Application**: Always eye round-numbered levels as potential entry and exit points based on the market's reaction to them. This is especially true when there is significant hype surrounding those zeros!

Commandment #8: Volatility Is a Trader's Best Friend

Volatility is necessary for your success.

This is especially true when you're trading options. There's nothing worse than buying a couple of months' worth of time premium and watching the stock go flat.

When I look for opportunities, I want volatility that's fast, aggressive, and in the right direction. Typically, depending upon what's going on in the market, fast and aggressive means big money.

Back in 2003, I was on CNBC. Somebody was calling me out, saying, "*Nobody wants volatility! We want zero volatility so that we don't have to worry.*"

But volatility is good for a couple of reasons. And one of the reasons is that it shakes the market loose. It kicks out the people who aren't really there to make money. You know the ones – they put a lid on everything and stand in the way of market movement.

Once they're gone, it opens up a lot more opportunity for us to make money. Because with my models, I can determine "directional volatility," which is key for making fast profits.

Commandment #8: Volatility is a trader's best friend – and a necessary component of your success.

- ✓ **Rationale**: The tortoise never wins the race when volatility is harnessed correctly. You need fast and aggressive moves to truly prosper in the markets.
- ✓ **History or Story**: My 2003 CNBC interview – "*Nobody wants volatility*."
- ✓ **Application**: Volatility can do a lot of good for your portfolio. You just need to know how to harness it. Determining "directional volatility" is key to fast profits and success.

Commandment #9: Stocks Are Driven Higher by Speculation, Not Fundamentals

This is one that I will argue with anybody and everybody on. It's actually pretty simple.

See, investing has changed dramatically over the last 20 years. Fundamentals, such as dividends, cash flow, and other "slow-moving" indicators are now trumped by speculation. People aren't looking at balance sheets, ratios, and the value line anymore. Now, everyone is trying to get an edge.

Think about the dot-coms. Everyone was dying to get in on the booming industry without any fundamental proof that the stocks were strong. The only reason the dot-coms exploded like they did is because of speculation.

Nobody is going to put a dollar into a stock, mutual fund, or bond if they don't think it'll give them at least $1.01 the next day. In other words, you don't buy a stock unless you think it's going to move. Every time you put money into the market, you're speculating.

That's why you *always* need to have a vigilant eye on the risk-on trade, so that you'll be there when it goes off.

How do you know when the risk-on trade goes off? When people in this room decide that you're *not* going to make at least one cent by putting one dollar in. That's when it's time to get out.

One simple way to watch for this is to compare the Russell 2000, a small-cap index of the stock market, against the S&P 500. You look at the relative strength of one against the other, and check to see that small-cap stocks are at least keeping up with the S&P 500.

If they're not, that's a problem. There's no better place to gauge speculation than the small caps. We don't buy small-cap stocks unless we think that there's going to be some health in the economy, because these are the companies that are going to be in the S&P 500 one day. They're coming up through the ranks, growing from index to index to index. So when people are buying, they're speculating that a big move is coming.

Commandment #9: Stocks are driven higher by speculation, not fundamentals.

- ✓ **Rationale**: Investing has changed dramatically over the last 20 years. Fundamentals such as dividends, cash flow, and other "slow-moving" indicators are now trumped by speculation.
- ✓ **History or Story**: How about the dot-coms?
- ✓ **Application**: Always maintain a vigil eye on the "risk-on" trade. This will tell you volumes on where the market is getting ready to go and where to profit.

Commandment #10: There Is an Exception to Every Rule

This is the "cover your butt" commandment. There's always an exception to every rule.

Never forget that the markets are irrational. As much as we'd like to think there are efficiencies that rule markets, things can and will happen for no reason. Expect the unexpected – and *accept* the unexpected.

You're going to have what people in my business call "Six Sigma Events." The precise meaning is that the probability of an event is about 2 * 10^-9. In other words, *twice in a billion*.

But these events still end up happening, because probability does not follow a normal distribution. You have to expect the unexpected is going to happen, because it will.

And you know what I do when the unexpected starts happening? I start closing stuff down and taking positions off. Because it's alright to sit on cash until you figure out what's happening, and wait until things turn into a rational market.

Look – I used to sail a lot when I was a kid at our summer home in Maine. I was sailing in a small 13-footer one day, and I got caught in a riptide.

My dad taught me that when you get stuck in a riptide, you drop the sail, pull the dagger out of the middle, and sit there, letting it take you wherever you're going to go. You don't try to fight it. Because if you fight it, you're going to flip over, and you could drown.

The same thing applies in the markets. Don't fight it. You don't have to figure out the next steps yet – just sit and watch it unfold.

I remember last decade when the Dow dropped almost 900 points in 10 minutes. I sat in my office, backed away from the computer, and just watched. The market had become completely irrational. And I knew that if I tried to control it, I'd lose a ton of money.

Commandment #10: There is an exception to every rule.

- ✓ **Rationale**: As much as we like to think there are efficiencies that rule the market and keep it "in check," there aren't. Never forget that the market is irrational. The unexpected should always be expected.
- ✓ **History or Story**: The Dow's 900-point drop in 10 minutes.
- ✓ **Application**: Realize that irrational markets are usually unbeatable. Avoid getting into situations where you think "it can't keep doing this," because it will, and you're only saying that because you are losing money.

Bonus – Commandment #11: Embrace Your Losses

These commandments are your guide to making money in the market. But keep in mind – losses will still occur. And to that, I have three words: Embrace your losses.

This might sound weird, but you can absolutely lose more often than you win and *still make money*, especially if you're trading options. In that case, it comes down to how big your wins and losses are.

I still wrestle with this, and it's led me to make a few changes to my trading techniques.

In January 2019, I got slammed in an expiration month for the first time ever. I still beat myself up for it. But instead of dwelling on it and losing more money, I started making changes to position management – and things are starting to turn around with more profits.

You have to think like Kenny Rogers on this one: "*Know when to hold 'em, know when to fold 'em*." The most important thing here is that the losses are the tuition we pay to become better, more effective, and more profitable investors and traders. If you just mark off a loss and walk away, you've lost money and that's that.

But think of it as tuition. I'm writing tuition checks for kids in college right now – and I want to cry when I write them, believe me. At the same time, I know that at some point, I'll get a return on those checks in different ways. Hopefully my kids are going to start taking care of me when I decide it's time for me to sit around, and they'll have the means to do it.

The moment you start to think of your losses as tuition, regardless of how big or small, is the moment you start to sharpen and hone that edge of yours.

I'm not asking you to get excited about your losses. That'll never happen. But at least you can look at them and say, "*Hey, I can take something out of this, and the next trade is going to be different. I'm going to do this differently on the next trade*."

It's almost like turning a barge around in the Ohio River. You've got to make the changes slowly, and eventually you start going back up the river again.

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