Complimentary Chapter

from

"The INVESTING OASIS: Contrarian Treasures in the Capital Markets Desert"

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Day Trading 2.0

(All the greed but less fear)

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"If you are not willing to own a stock for 10 years, do not even think about owning it for 10 minutes."

~ Warren Buffett.

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Objective:

A plan for short-term tactical trading.

Important:

This chapter is discretionary and only suitable for investors with higher risk tolerance. We discourage day trading. However, this chapter is focused on reducing the risks for those who wish to indulge in the high stakes, adrenaline sport of short-term trading. The methods shared are intended for more casual "day traders."

CAPITALISM 101

Who doesn't want to make fast money on quick trades? Do you have a superior methodology, access to unique information, or just a desire to take the occasional gamble?

According to Warren B, though, holding a stock for any period less than a decade essentially disrespects the sanctity of the underlying businesses. To him, the stock market's intended purpose is to help companies raise capital and allow them to deploy their strategic advantages in the real economy.

Short-Term Trading to Appease Our Alpha "God"

My principles still favor Warren's interpretation yet share price fluctuations and daily market vigilance can bring out our inner capitalist. While the bulk of your investments should still be maintained in a disciplined, core portfolio, there could be room to deploy tactical short-term trading as befits the opportunity.

In *The Art of War*, this would be akin to retaining the bulk of the forces at home base for long-term protection while periodically deploying warriors tactically in high-probability situations. With two very different purposes, one should be mindful not to interpose tactics between the two strategies as tempting as it may be. A wise leader should also never expect to win the war using only short-term battle tactics.

Day traders, by definition, believe they have superior information, tactics, or instincts (or all three) that can help them generate "Alpha"[1] using price trends over brief periods. Yet, here's sobering news:

- `Upwards of 80+% of day traders are unsuccessful and 75% quit within 2 years, according to a 2017 study on traders in Taiwan[2] by Professor Brad M. Barber and Terrance Odean at the University of California at UC Davis.
- According to an Oct 2021 article in the Economic Times[3], retail trading accounts are being opened at ~1 million per month, globally.
- Greater trading volumes attempting to exploit aberrant share price deviations leads to ever more efficient global markets.

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[1] Returns in excess of passive market returns.

[2] https://faculty.haas.berkeley.edu/odean/papers/Day%20Traders/Day%20Trading%20and%20Learning%20110217.pdf (Accessed 20 Feb 2022).

[3] https://economictimes.indiatimes.com/markets/stocks/news/is-this-the-era-of-the-retail-investor/articleshow/87236474.cms

- To generate "Alpha" in more efficient markets, investors will need to either increase their degree of risk, deploy greater leverage or seek less efficient markets (i.e. emerging markets, micro- and small-cap stocks).
- High volume traders face four daunting disadvantages:
  1. **Market makers** – Brokerage businesses often hire market-maker firms to improve deal flows on their site. This allows the market makers a minuscule advantage to intercede between the investor trades and the outside market.
  2. **Trading algorithms** – Algorithms are used substantively across the markets looking for unique pricing anomalies. Since they can transact within milliseconds to an opportunity, they feed on inefficient trades posted by inexperienced traders, particularly during periods of higher volatility.
  3. **Commissions** – If not trading on a "commission-free" platform, trading costs could comprise an unusually large percentage of each trade in smaller accounts. If a "commission-free" platform is being used, likely retail traders are being subjected to inefficient market prices due to the acceptance of market makers being deployed on the platform.
  4. **Taxation** – Short-term gains (<12 months) are taxed more heavily in the US than in Canada. Long-term gains (12+ months) are taxed more generously in both countries.

If any of these perspectives strike a nerve, why not rethink your game plan? Back in Chapter 5, "Firming our 'Backbone'," it was shared that, in ever-increasingly efficient markets, creating Alpha requires innovative thinking. So, rather than "swinging for the fences" for short term gains with a potentially lethal combination of greater risks and leverage, consider the following hybrid version of day trading, yet deployed with supporting guidelines.

Day Trading vs. Core Management

Long-term investment decisions are primarily cerebral and from the heart (the center of our principles). Short-term trading shifts decision-making into a direct relationship between the gut and the Amygdala ("fight or flight" center), where intuitive decisions are deployed instinctively along the Vagus nerve. And with euphoria triggering endorphin rushes, this is potential addiction territory.

With the markets being so efficient, the spoils of victory go to those willing to make bigger, riskier bets requiring volatility and leverage. Proof of this trend is the growing popularity of leveraged sector ETFs such as the SOXL (semiconductors), the TQQQ (Nasdaq), or the UVXY (Short-Term VIX exposure). As such, excess daily returns are being generated more from taking on more risk or leveraging bets than any superior plan of action.

Moving assets into positions, then cashing out at the end of each day, unfortunately offers no chance for Beta returns (passive market returns generated by the underlying corporate management teams).

Q: Why not pursue the best of both worlds?

1. Maintain a productive, low-maintenance, Beta-generating core portfolio where the focus is on giving the underlying management teams time to create real value.
2. Complement the core strategy with Alpha-generating tactical trading.

For practical purposes, the following table presents how decisions differ between Beta Investing and Alpha Trading. Recognizing the overt differences could enable an investor to draw a distinct line between the two methods if both are to be actively deployed.

	Alpha Trading	**Beta Investing**
Plan of Action	• Tactical, freewheeling.	• Strategic (IPS).
Risk Tolerance	• Low. Reactionary.	• Medium to high. Patient.
Type of Asset	• ETFs	• High-quality stocks.
Investment Holding Period	• Minutes to hours.	• Years.
Annual Expected Equity Returns	• 15+%.	• 8%+
Type of Decision-Making	• Gut instincts.	• Justified by research and deployed mindfully.
Trading Style	• Opportunistic.	• QARP (Quality at a Reasonable price). • Preset limit orders.
Level of Emotional Involvement	• Intense.	• Moderate.

Table 1. Differences between Alpha and Beta investing.

"Luck and risk are different sides of the same coin."

~ Morgan Housel, partner at The Collaborative Fund and author of The Psychology of Money

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DR. JEKYLL AND MR. HYDE

Table 19.1 highlights the direct conflicts between the core principles of Dr. Jekyll's cerebral investing philosophy versus the instinctual day trading spirit of Mr. Hyde.

For Dr. Jekyll, investing is a mindful process focused on buying and rebalancing quality stocks over an extended duration, and trades should only be deployed to enhance performance, diminish volatility (through better diversification), or to remove unnecessary risks. The core philosophy being, "Time in the markets, not market timing."

On the other hand, the day trading preference of Mr. Hyde is predicated on market timing. He is willing to sacrifice the higher probability of reasonable, long-term gains on quality assets in exchange for the potential for higher gains with short-term trading gambles on minor price movements. Without accountability to an IPS document, a regulator, a supervisor, or a mentor, the only limitations to short-term trading rely on an investor's gut instincts and courage.

With approximately 80% of day traders throwing in the towel within the first 2 years, what follows is a softer version of high frequency trading that can be used opportunistically to exploit short-term price weaknesses in the general markets. It prioritizes risk management to keep an investor from having to realize permanent losses on trades that go against them.

An Old Game, now using Guidelines

Here are guidelines that can help turn short-term gambles into more viable trades:

1. **Clarify your goals.** To win at short-term trading, an investor needs a concept, skill, or a tactic that can exploit a market weakness. To justify the time spent and the agonies, the rewards need to be far greater than what could be generated from a passive broad market ETF portfolio (i.e. 8%).
    a. **How much to risk?** As a soft rule of thumb, short-term trading capital should be <10% of your total wealth but start small to build confidence. If gains cannot be made with this capital, it will have proven wise to limit the amount of risk capital.
    b. **How much constitutes a win per trade?** Experienced traders target to generate 1–3% per trade. Start with smaller amounts to build discipline.
    c. **How much can be lost per trade? Per session?** Experienced day traders set the loss limit at 1% for any given trade. This means that an investor can bet just a little, or possibly everything, in one trade but that the Stop-Loss trade order should be set to ensure that an investor does not lose more than 1% of their total trading account. In a portfolio valued at $200,000 with 10% ($20,000) segregated for short-term trading, this limit would be $200 (=1% X $20,000). Note that this loss limit is per trade.

       Once a loss of 1% is accrued and the position is closed, an investor may consider opening a new trade. Good traders will win more than they lose, so there is no defined limit to the number of trades during any one session. Obviously, success is achieved when the number of good trades exceed the number of losing trades and the winning trade profits exceed the total losses.

       With Day Trading 2.0, we don't recommend setting any stop loss orders, let alone a tight loss trigger (1%). This will be explained further below in the section "Protecting your capital".
    d. How much can be lost before closing the trading account? This is an entirely personal decision but set a limit, just as we all should do before going to Vegas. Since the pain of losing is universally greater than winning an equivalent amount, start by setting lower limits.
2. **Open a separate margin account.**

   This will help segregate the "Vegas" capital from the core portfolio. Learn to "wear two hats" to separate Alpha and Beta decisions between the two portfolios.

3. **Quality is your "get-out-of-jail-free" ticket**

   The ideal security for short-term trading is a broad market ETF (i.e. SPY). By choosing to day trade only in broad market ETFs, permanent losses due to abandonment of a security should never happen. With greater faith in the resiliency of the stock market over individual corporations or sector bets, profitability becomes just a matter of time.

   Individual stocks and sectors could both be susceptible to specific risks that may periodically hinder their performance. As such, if an ETF trade goes negative on the day, an investor could continue to hold, and even deploy DCA (as outlined further below), until their ETF turns profitable (a day, a week, a month, etc.). This approach should already reduce a lot of the anxiety that coerces traders into daily liquidations expose them to losing trades for the sake of the safety of cash. This perspective assumes that an investor is comfortable not to cash-out each day and that periodically a trade position may exceed a 1% loss.

INVESTOR CAUTIONS

- Don't compound the riskiness of short-term trading with speculation or leverage. IPOs, penny stocks, small-cap stocks, and foreign stocks each introduce specific unnecessary additional risks. Risks are not additive; they compound.
- Use cash only. Deploying margin for a short-term trade can result in substantial equity erosion and equally adds time pressure with the interest clock ticking. As such, his could frustrate an investor's willingness to hold onto a negative position through to recovery over an extended time period (i.e. weeks/months).

4. **Implementation (see deployment of a DCA in Chapter 14)**

   - **Initial Tranche**. Divide the total at-risk capital into an initial purchase of 10–25% or an amount of your choosing. Plan to use the remaining capital as a DCA (i.e. \$20k – \$5k = \$15k/\$3k = 5 more tranches to be deployed).
     - **Alternatively,** initiate a position by selling a short-term (1-week or less) ATM Put contract on the targeted ETF. This has a ~50% chance to be exercised but often will generate a good premium. Only once a contract has been exercised are you then in the short-term trading game. Otherwise, by repeatedly selling short-term ATM Put contracts on an ETF, cash is generated from the premiums.

Note: Although the premiums generated from selling Put contracts provides an immediate advantage over DCA, a single contract is a commitment to buy a minimum of 100 shares of that security. This may be a larger commitment than a smaller account is willing to make.

If a single Put contract would be too large, initiate a position by setting a low-ball limit buy trade order on an ETF. Ideally wait until the markets have been trending negatively for consecutive days. The timing to initiate short term trading should be time agnostic. Strike when the situation becomes compelling.

INVESTOR CAUTION

- Avoid deploying short-term trading tactics when the targeted security and/or the markets are hitting 52-week highs. This leaves little room for error and big room for frustration.

- **Subsequent Tranches.** After making the initial purchase, set successively lower-priced DCA tranches at 2–5% price increments. Although this may violate the day trading rule to limit a loss at 1% per trade, the use of a DCA can help to accelerate the recovery to profitability for a quality security in three ways:
  - Each tranche lowers the ACB recovery point (breakeven price).
  - Each tranche buys more shares and accelerates the recovery rate.
  - Reinforces a trader's confidence not having to deploy all-in/-out trades.
- **Don't interfere with a winning trade.** Once a targeted security rises into profitability, stop implementing the DCA (even if additional capital remains undeployed). Further DCA tranches would raise the share's ACB. But do protect the gains.
- **Protect your gains.** When a position turns profitable, set a Trailing Stop-Loss (TSL) Limit order at a point of profitability just behind the current price (2–5%). The sell order would continue to rise along with a rising share/unit price until triggered by a sufficient pull-back in the share/unit price.
- **Protect your capital.** Ideally, if a Stop-Loss (SL) Order were to be deployed, it would be at a price point above an ETFs ACB to ensure profitability once a positioned has turned profitable.

  Yet if all the DCA tranches have been deployed, this would suggest that the ETF is likely still sitting on losses. By targeting a broad market index ETF, there should remain high expectations to eventually realize profitability.

  Only if an investor is willing to realize permanent losses should they consider setting a SL trade below the ACB. Although this SL order would protect against runaway losses, it also reflects a willingness to realize a permanent loss. If trading on a broad market ETF invokes anxiety, this degree of risk aversion could be pause for thought about short-term trading.
- **Generate CC income while you wait.** If you are willing to hold a stock or ETF at a loss for an extended period (i.e. days, weeks, or months) consider selling short-term OTM CCs regularly to generate additional income until the position recovers. To ensure profitability, always set the CC Strike Prices above the ACB.

INVESTOR CAUTION

- Stay away from the seven deadly sins. When deploying short-term tactical trading, engaging any of the following could defeat a short-term trader's best intentions:

1. Overweighted bets on stocks, industries, or sectors.
2. Trading on margin and multiple-leveraged ETFs.

3. IPOs, Speculative, Micro-caps, Small-caps, Commodities and Emerging Markets.
4. Trading both day and night markets to make up for lost value.
5. Short selling securities.
6. Hot stock chat rooms and market gurus.
7. Speed.

In Vegas, the speed of money/transactions only benefits the house because it raises the emotions and encourages thoughtless actions. This is also true with trading stocks. Trading platforms generate greater profits with higher trading volumes. Trading algorithms feed on speed. Their trading protocols have been mapped-out through thousands of hours or programming. They patiently wait for humans to execute undisciplined trades.

5. Know Thyself

The intensity of short-term trading can be overwhelming. When expectations are broken, disappointment can quickly escalate into frustration, anger, and capitulation. Deteriorating emotions will beget even worse decisions. Those around you may not enjoy this state of being. Take a breather. Keep it simple and stick with quality. The markets will recover.

INVESTOR CAUTIONS

Cell Phones vs. Laptops

Despite the convenience of cell phones, they can exacerbate the Behavior Gap:

- Trading on a cell phone usually means making decisions on the fly. Likely an investor is on the move and multitasking.
- Trading without doing dutiful research and establishing a purpose is essentially gambling.
- Using "Trade Alerts" is reactive and introduces time pressures.
- Deploying trades from in a consistent location allows for better focus and enable more mindful decisions.

"If you personalize losses, you shouldn't be day trading."

~ Bruce Kovner, hedge fund manager and CEO, CAM Capital

Summary Thoughts

Despite the allure of trading our way to riches, short-term trading is just a few clicks away from an expensive education. Short-term trading is so much more intense and requires constant vigilance. It also deploys a different set of skills and instincts than does traditional portfolio management. An investor must be mindful to turn off their tactical trading instincts when managing their core portfolio.

On the other hand, trading for Alpha requires being ruthless, not with the markets, but with oneself. Good and bad trades can result in emotional spillover effects. Winning trades can lead to overconfidence and upping the ante, while repeated losses can lead to PTSD for some, and even revenge trades for others.[4] While such reactions are only observable in hindsight, once realized, if you have an addictive personality or that losing money bothers you, consider steering your energy into the other mindful, constructive concepts embedded in Tiers 2, 3, and 4.

The exhilaration of short-term trading can allow an investor to put their tactical trading skills to the test but by deploying a few guidelines and a little patience, the markets will backstop you to greater success.

At the Oasis

- Tactical trading = market timing = gambling. Only wager what you can afford to lose.
- Never day trade on margin or with leverage.
- Keep it simple. Use a DCA on a broad market ETF. Positions can be carried until a market recovery. While losses linger, sell ETF CCs.
- Use an account separate and distinct from the core portfolio. Learn to wear two "hats".
- Trade purposefully. Building wealth should not require a sacrifice of health or relationships.

[4] https://www.investopedia.com/articles/investing/071713/downward-spiral-trading-addiction.asp