Risk and reward
12/28/2008

Since our major sell signal was confirmed on 1/31 this year, we adopted a cautious stance and that has helped us sidestepping a devastating global equity collapse which likely has affected 90% of all investors this year.
Our conservativeness during major sell signals in all three sectors this year have helped steer us away from financial disasters, but there is also a price to pay by missing some potential gains during sharp bear market rallies, and/or when the markets finally bottom.
The sharp recovery rally in gold stocks of the past few weeks is an excellent example of that, and by sitting in cash, we are paying the price of being conservative, because some gold stocks have doubled since the Oct bottom.
Sure, I can sit here all day and congratulate myself for keeping our members out of harm's way, because despite the sharp 100% gain off the Oct bottom, $HUI is still sitting at a yearly loss of 30%. But the fact remains that we are not participating in a mighty bounce, and as a member puts it, who the hell cares if the rally is a bear market bounce or a bull market rally, as long as there are profits?
Absolutely.
In fact, a similar mighty bounce as in gold stocks will likely occur also in the energy sector soon, as energy ETFs are extremely oversold like gold stocks were a few weeks ago. I myself will likely miss these potential gains also because unless risks are manageable in these counter trend trades, I will continue to sit in cash.
But you don't have to, and I can help.
Thus the purpose of this tutorial. It will help you to decide when to jump in based on risk and reward.

Lets talk about risk first.
Remember the tutorial about buy & hold in which my broker friend pointed out that we could lose more money trying to time the market bottom than staying fully invested?
http://www.simplyprofits.org/editorials/tutorials/08-1204_Buy_&_hold_beats_market_timing.pdf

He is absolutely right.
Looking at OIH again, all five buy signals since the top this summer have failed because each buy signal has failed to establish a new trend. A trader can go broke trying to pick the bottom of a bear market. A trader can also go broke trying to trade the counter trends as all five trades so far have been stopped out with heavy losses.
But sooner or later, there will be a very mighty bear market rally as we are currently seeing in gold stocks, therefore, how can we tell when the markets are likely to begin a such powerful rally?
Which of these buy signals and set ups should we consider to jump in?
Our trading models have no predictive value, so, I cannot answer the first question.
But I am very good at calculating risk and reward, and this tutorial will help you on the second question: Which of these buy signals and set ups should we consider to jump in?

Our trading models evolve around the 50 and 200ema, which is from years of observation on price action, and I find that these EMAs act consistently as support during a bullish config, and equally as resistance during a bearish config. And in order to reverse the current config, prices must first exceed the 200ema.

Therefore, the further away prices are from the 200ema, the better potential reward on a trade, whether that trade is intended as only a counter trend trade, or if the intention is to pick THE bottom.

- From the chart above, the first buy signal after the bearish config in Sep had a potential reward of 10% assuming prices would rally to the 200ema. Obviously not a good bet regardless of what risk was.
- The buy signals in Oct and Nov both had potential rewards of 80%, therefore, if risks were acceptable, both could have been bought. Of course, both would have been losers.
- The buy signal in Dec had a potential reward of 75% but if I recall correctly, risk was over 10%. That set up failed also.
- Then on Friday, we have a set up on OIH with risk of 5%, while potential reward is now at 100%. This is by far the best set up we've had since the sell off began. Therefore, the current set up is the most favorable so far, and if a trader has the intention of trading a bear market rally or trying to pick THE bottom, now is a better time than all previous instances. The only fly in the ointment is that this set up occurred during low holiday volume, and both Wed & Fri have very small ranges thus the 5% relatively low risk set up. Nevertheless, it is a set up and potential reward is attractive. I personally prefer to wait for TL support to establish but by doing so, I could miss a potentially explosive rally like the gold sector. That is my decision and I will live with it.

Looking back on GDX, the buy signal in Aug had a potential reward of 20% and the one in Sep was at 25%, not good regardless of what the risks were.

The buy signal in late Oct had a potential reward of 80%, and risks were over 20% as there was no set up. Subsequent set ups in late Nov and early Dec had equally high risks and rewards were even less.

The Oct buy signal obviously had the best potential reward but risks were also high, therefore, as suggested before, only those with a high risk tolerance should consider taking a position, and in hindsight, that aggressiveness has paid off to those who dared. However, a trader using the same aggressive approach in the energy sector would have taken large losses so far, and the potential profits from the gold sector may not be enough to offset the losses in the energy sector. Of course, in perfect hindsight we would put all bets on the gold sector and none in the energy sector…….

Looking at the growth sector with SPY, potential rewards from both buy signals were not good regardless of risks.

Next.

We will now look at the inverse ETFs, because risk/reward should be much more favorable than trading the counter trends.

QID – with a buy signal, we should expect a new bull leg up to a new high, or at the minimum, a test of the current high at 87. From current price of near 60, that is a potential reward of 40% or more. Therefore, if we have a set up with a risk of 10% or better, it will be an attractive trade.

DXD – potential reward is 52%+…..

SDS – potential reward is 51%+……

Summary

Bear market rallies are often sharp and powerful, and the more oversold an ETF is, meaning the further away price is from the 200ema resistance, the better potential reward it is. Therefore, aggressive traders wanting to either trade a counter trend rally, or trying to pick THE bottom, should keep their powder dry until risk/reward becomes favorable. Each trader has a different risk tolerance, therefore, you must decide for yourself what is manageable and what isn't. With the examples shown in above charts, it is easy to calculate your own risk/reward profile for each buy signal or set up. I myself am a conservative fellow: I can be bold during a bull, and often scared during a bear. Therefore, I continue to favor the inverse ETFs, and patiently wait for set ups. I will only consider trading the counter trends if risks are manageable to me, accepting the fact that I could miss some potential profits, or buying at much higher levels after the configs become bullish.

Staying disciplined to our trading models and managing risk has worked beautifully for us in the worst global equity collapse of our generation so far, but if you are tired of sitting in cash, or concerned that what is happening in the gold sector may happen in the energy or growth sector, then by all means, jump on those signals and set ups which have high potential rewards, as long as risks are acceptable and manageable to you.

My job and my service to you is to provide signals and set ups as I see them, and you folks can look over my shoulder to see if, when, and how much money I am throwing at the market at any given time.

If you are relatively new to trading, you may want to stay conservative and follow me closely.

But if you are an experienced trader and willing to take some chances, then compare risk and reward on each signal and set up and make your own trading decisions.

If you are a long term investor, you should be in cash or fully hedged until a major buy signal, or at least when the configs are bullish once again.

I hope this tutorial helps you to see how I approach trading from a risk/reward perspective in these highly volatile market conditions, because to me, that is much more important than betting on market directions.

End of tutorial