

Studies in Stock Speculation

Volume II

Ten Cardinal Principals of Trading and
Supplemental Discussions of General
Interest to Traders and Investors

Designed for the Special Benefit of Students
of Stock Speculation



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First Published in 1926 by
Ticker Publishing Company, New York

Fraser Publishing Company Edition, 1967
Box 494
Burlington Vermont 05402

Second Printing, 1978
Third Printing, 1985
Fourth Printing, 1998

Library of Congress Catalog Card Number 65-29150
ISBN: 0-87034-018-2

Printed in the U.S.A.

INTRODUCTION

Volume I of "Studies in Stock Speculation" was so well received, and continues in such constant demand by students of the stock market, that we believe this second volume will be appreciated by those who desire to expand their knowledge of trading and investing principles. Volume II appeals particularly to those who desire to profit by the experiences of others, and who are willing to investigate the science of speculation in an orderly and systematic manner.

Wolf begins with a presentation of the most important factors that govern successful trading in stocks. Ten cardinal rules are given and each one of them is discussed in some detail. The rules and examples are expanded by observations with the use of illustrations and charts. The average speculator obtains a clearer idea of what he is trying to do while receiving many suggestions as to how he may make the most efficient use of his own experiences.

Though dealing with the stock market of the 1920's, the rules and examples are helpful today. These words of wisdom cannot be applied arbitrarily or mechanistically but they can be adapted to the present day market environment since people still make the same mistakes.

James L. Fraser
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Ten Cardinal Principles of Trading

A Concentration of the Most Important Precepts
Contained in previous Lessons of the School
for Traders and Investors Heretofore
Presented in the Magazine
of Wall Street.

FOLLOWING the presentation of numerous lessons for traders and investors, it is appropriate to review the entire course and present in highly concentrated form the most important and essential elements of successful trading. If the average trader will adopt these principles, and follow them consistently and with determination, he cannot go far wrong, and the mathematical probabilities will be in favor of profitable operations.

After several tests of their practical value, he will find that his unfortunate trades may be charged almost entirely to the violation of one or more of these principles. To follow them strictly, is not so easy as a casual reading of them might suggest, because most powerful psychological influences will conspire to make the trader break his good resolutions. He should ever bear in mind that his worst enemy, "*sucker psychology*," is lying in wait to embarrass him the moment he is off his guard.

For the experienced trader, these ten cardinal

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principles of trading, as presented herewith, require no further explanation, for the brief statements contain their own suggestions with regard to detail. However, we appreciate that what is obvious to the experienced may not be entirely clear to one who is serving his apprenticeship, so we offer the following:

The first principle is the most important of all. It is absolutely essential to success. Its violation is the direct or indirect cause of more losses than any other indiscretion in market operations. It should be clear that in order to maintain the margins specified, it is necessary to have additional funds available in bank. Therefore, do not place yourself in a vulnerable position by buying more than you can carry comfortably. If you do so, your judgment will be impaired by anxiety, and at the first sign of real danger, you will have the impulse to avoid disaster by closing out the trades that show the least loss, in order to protect those that show the greatest loss, on the theory that by so doing you are wisely "taking small losses," whereas you may be actually developing one or two that are very large, for in all probability you are closing out your strongest stocks to protect the weakest, whereas it should be just the other way around.

If you are obeying the second principle, the question of maintaining margin is not so important, for in case of real weakness in one or more commitments, you will be stopped out at the technical danger point, and your margin will not become sufficiently impaired

Ten Cardinal Principles of Trading

to be of concern to your broker. This principle is beyond doubt the second in importance, but it is useless if you violate the third principle, for there is manifestly nothing to be gained by devoting your operations to limiting losses, and you will do little else if you habitually buck the trend.

If any of our students have had favorable or unfavorable experiences, that cannot be explained on the ground that some of these principles were either followed or ignored, we shall be glad to hear from them, so that we may improve upon our list. We believe our outline contains the essentials of success, but we do not claim that it is final, for the science of "marketology" is so complex, and involves such extensive and diversified knowledge, that we doubt whether an unabridged treatise thereof will ever be written, to say nothing of reducing it to the size of a label that you can paste in your hat.

Ten Cardinal Principles of Trading

- 1. Do Not Overtrade.**
Maintain a margin of not less than 10 points on stocks quoted under \$50 a share, not less than 20 points on stocks quoted from \$50 to \$100 a share, and 20% on stocks selling above \$100 a share.
- 2. Limit Losses.**
Place stops at technical danger points on all trades, and if the location of the danger point is uncertain use a 2-point or 3-point stop, or await a better opportunity.
- 3. Follow the Trend.**
Do not buck the trend, and do not hedge. Be either long or short, but not both at the same time.
- 4. Favor Active Issues.**

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Do not tie up funds in obscure or inactive stocks, and avoid thin-market issues except in long-pull operations.

5. **Buy During Weakness.**
Buy only after reactions confirming higher support.
6. **Sell During Strength.**
Close out on unusual advances at first sign of hesitation; and sell short only after evidence of distribution with lower support followed by lower top.
7. **Distribute Risk.**
Do not concentrate in one issue, but trade in equal lots of several different issues, all of which are definitely attractive. Avoid spreading over too many different issues.
8. **Protect Profits.**
Never let a 3-point profit run into a loss, and never accept a reaction of over 5 points unless the favorable trend of the stock has been definitely established.
9. **Avoid Uncertainty.**
When the trend is in doubt, stay out. Avoid a trader's market when the ultimate trend is uncertain unless the trade can be protected by a small stop and justifies the risk.
10. **Discount Fundamental Outlook.**
Never ignore fundamental conditions, and always favor the trade wherein fundamental and technical conditions co-operate. Avoid a trade wherein fundamental and technical conditions are opposed, except in cases of imminent liquidation, or over-extended short interest.

How to Commit Financial Suicide

A Concrete Example of the Dire Effects of "Overtrading"

IN our last lesson we presented a list of ten cardinal principles of trading. The first and most important admonition was, "Do not overtrade." It was pointed out that the violation of this principle was the direct or indirect cause of more losses than any other indiscretion in market operations.

Overtrading is dealing in more shares of stock than the available capital justifies. It is the effect of following that insidious impulse to "get rich quick." It is a form of credit overextension that makes the trader's position vulnerable to even a moderate reaction, and places his capital in jeopardy.

One who buys more stock than his capital will margin properly according to the customary regulation of a first-class broker, is acting on the assumption that the market's next move *cannot* be against him, but *must* be in his favor. This assumption is unwarranted according to any mathematical theory of chance. Not only is it contrary to sound trading practice, but it is not even a fair gamble. Such extension usually takes place in conjunction with the violation of the principle "Buy during weakness,"

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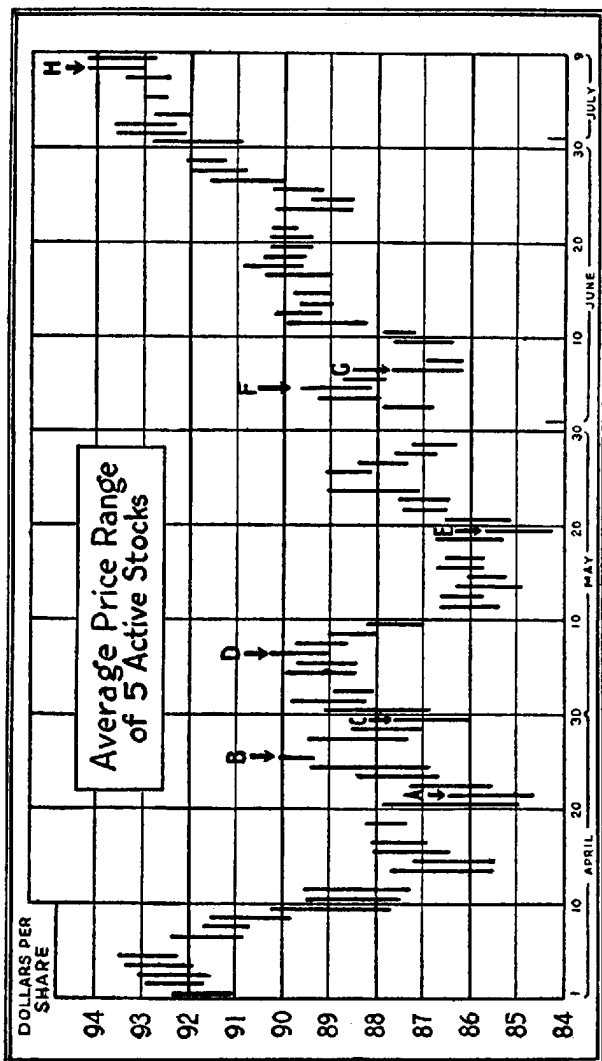
thus reducing the chances of a favorable new position, and at the same time it increases the probability of serious impairment of capital by simply doubling up the possible loss in case of adverse price movement. It is the reverse of common sense.

An Illustration of Overtrading

To illustrate the effect of overtrading, we present the following practical example: Our graph shows the range of the average price of five stocks from the beginning of April to early July. Suppose our "get rich quick" trader buys 100 shares of each of the five issues at the ideal level of 85 on April 22 (point "A" on graph) and agrees to maintain a margin of 20 points. The original capital required to carry this line is \$10,000. Odd-lot traders would require proportionate capital and would be under the additional handicap of odd-lot broker's commissions.

At "B," the average price has advanced to 90, thus adding 5 points, or \$2,500 to our trader's equity which now stands at \$12,500. He becomes enthusiastic. The idea of standing pat or realizing a part of his profits on strength to provide additional buying power in a reaction does not occur to him. He figures that he can margin another 100 shares at least, so he makes the additional purchase. He now holds 600 shares, requiring \$12,000 margin.

The natural normal reaction takes place, going more than halfway back, as fate usually arranges matters under such circumstances, and the average



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price of the 600 shares declines 4 points to 86 at "C." This wipes out \$2,400 of equity, reducing the margin to \$10,100, or \$1,900 short of 20 points. In order to maintain his position, our trader must either put up \$1,900 or cut his line down to 500 shares by closing out 100 shares at a loss of \$400.

Next day the market recovers, but our trader has no additional buying power, therefore, he must wait, while gnashing his teeth over the fact that his violation of one important principle has forced him automatically to violate another, namely, "do not sell in weakness." Also, he was left unable to follow a third principle, "Buy during weakness."

As the market advances, our trader observes evidence of increased strength and notes that prices were supported at a higher level at "C" and at "A," which is usually a bullish sign, at least temporarily. He sees stocks make a higher top at "D" and feels sure they are about to continue the advance that was arrested at "B." His average price has increased 4 points to 90 and his equity has increased \$2,000 and now stands at \$12,100. The market is very active. Our trader becomes excited. He mistakes "sucker psychology" for "market intuition" (if any such thing exists) and he forgets that common sense and sound principles are always good friends in times of stress. He itches to recoup his recent loss, throws caution to the winds and makes the colossal blunder of doubling up, on his hunch that this time he will make a killing. He takes the chance, and buys another 500 shares, thus

How to Commit Financial Suicide

increasing his line to 1,000 shares, and reducing his marginal protection to about 12 points, kidding himself with the hope that a substantial advance is under way, and with the promise that "hereafter" he will settle back into more conservative methods.

How the "Suicide Bug" Works

Now let us see how the financial suicide bug gets in its nefarious work. Following a flurry of activity at "D" the market begins to ease off and then slumps to 85 or under, at "E"—a decline of over 5 full points.

After the smoke clears away our trader learns that his equity has been pared down \$5,000, leaving \$7,100, or enough to margin 300 or 400 shares, making it necessary to unload 600 or 700 shares of excess baggage at a crushing loss.

The irony of this situation lies in the fact that our trader is without sufficient buying power to participate in the subsequent orderly advance to above 94, at "H," which would have left his original commitment showing a profit of 9 full points, equivalent to \$4,500, and his equity at \$14,500.

If our trader with his remaining \$7,100 persists in plunging, and continues to pyramid on every advance, without adequate protection, it will not be long until a moderate reaction wipes out his equity entirely. This constitutes financial suicide.

What's the answer?—*Don't overtrade.*

Limitation of Losses Essential to Successful Trading

The Insurance Value of the "Stop Loss" Order

NOW and then one hears a *temporary* trader remark, "I never take a loss. If a trade goes against me I wait patiently for it to swing the other way, for sooner or later it will offer me an opportunity to get out at a profit." Many examples might be cited to show that this type of optimist would require a long purse and infinite patience in order to make good his assertion.

Imagine how this theory would work with one who bought U. S. Rubber at 143 in 1920, or Marine Preferred at 87 in 1922, or Atlantic Gulf & West Indies at 176 in 1920, or Virginia Carolina at 92 in 1919. Also imagine the position of one who sold short such stocks as Woolworth, General Electric, Associated Drygoods, and U. S. Cast Iron Pipe on certain past occasions when these issues "looked topky," and you will have a rough idea of what happens to the trader who "never takes a loss."

The outlook for the trader who will not take a loss is hopeless, for he operates on the theory that his position cannot be absolutely wrong. Next in order

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comes the trader who will not limit his loss because he *hopes* that the market will take a turn for the better before he is badly crippled or completely wiped out. There is some hope left for this type of trader if he will mend his ways, and accept the second cardinal principle enunciated in our thirty-fifth lesson, i. e., *limit losses; place stops at technical danger points on all trades, and if the location of the danger point is uncertain use a 2-point or a 3-point stop, or await a better opportunity.*

Like all good rules, this one must be properly interpreted, and a little common sense must be used in its application. For example, it would be useless to apply this rule mechanically, and at the same time violate one of the other cardinal principles of trading, such as "Buy during weakness." It should be apparent that the purchase of a stock that has just advanced 10 points cannot be protected consistently with a 2-point stop, for it is a common occurrence for such an issue to react from 4 to 6 points before it proceeds with its advance.

The accompanying illustrations will introduce our idea of the proper use of stop-loss orders. Suppose the solid line represents the price movement of a certain stock that has declined from higher levels during a period of liquidation, has encountered resistance to selling pressure at the 25-level, and is apparently reaccumulated between 25 and 30. If this issue is purchased at the favorable point "A," as it advances from its rising support level, the trade

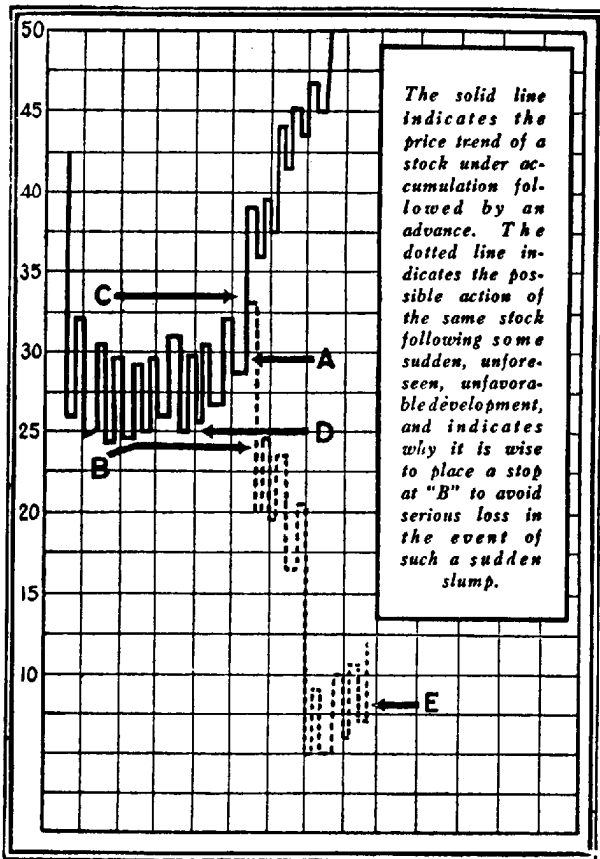
Limitation of Losses Essential to Successful Trading

may be properly protected by a stop at level "B," a little below the bottom of its zone of apparent accumulation. In this case a stop of about 5 points is required.

Suppose the trader prefers to postpone his purchase until the stock shows sufficient strength to rise up completely above its zone of apparent accumulation, and buys at level "C." As the price may either continue to rise, or experience one or more dips below the purchase price before it finally proceeds with its advance, it is logical also to protect this trade at level "B," requiring a stop about 8 or 9 points away from the purchase price. Only in the case where the purchase is made during one of the dips to around level "D," is it logical to operate with as small a stop as 2 points, because the proper place for the stop is at a level that will represent a probable complete change in the character of the movement and indicate new weakness not theretofore apparent.

The trader who purchased at "D," "A" or "C" believes that the stock is about to advance. A reaction from about the level "C" need not concern him unless it goes far enough to indicate that the former buying support is entirely withdrawn, and some *new weakness* has developed. This is sometimes difficult to determine from purely technical considerations until the price has broken through the level "B." However, if some sudden fundamental development of an unfavorable nature becomes apparent to the trader at the time the stock reacts from "C," then he will not wait

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for his stop at "B" to be caught, but will promptly close out at the market, and perhaps get out with a loss of only a point or two.

The insurance value of the stop at "B" is apparent in the light of the possibility that the stock may enter a sudden decline that will not be arrested until the new zone of accumulation "E" has been reached. If the trader is not watching his commitment at the time the "bad news" comes out that causes the decline, he is automatically out of the market at "B," and free to reconsider the issue again at "E" if he chooses to do so.

There are many other uses and arrangements of stops, which have been explained in previous discussions, and to which we may have occasion to refer in the future.