



# TRADING WITH AN EXPIRATION DATE: ETF STRATEGY FOR DAY TRADING

BY ED CARLSON



“EVEN TWINKIES HAVE AN EXPIRATION DATE.”  
—TALLAHASSEE IN “ZOMBIELAND”

The 1990s saw an explosion in the popularity of day trading. No doubt that was a manifestation in the markets of our “I want it now” culture, a cultural idiosyncrasy that has since imploded via the credit markets.

During that period, however, certain business interests did an excellent job of indoctrinating another group of investors into the mindset known as buy and hold. These investors took great satisfaction in their “knowledge” that in the long run stocks always move ever higher.

Both groups thought the other foolish, and in the end, both blew up.

### **STUDIES SHOW ...**

Personally, I never had any interest in day trading, but my research of market history convinced me that the buy-and-hold approach would eventually hit its expiration date just as it always had in the past.

This realization led to my study of technical analysis. Although day trading has never held any interest for me, refusing to follow a particular model of trading because it does not synchronize

with the current investment zeitgeist is analogous to refusing to bend over to pick up money spotted on the walkway.

### **THE UPSIDE OF ETFs**

For some time now (since the onslaught of complaints), the sponsors of leveraged exchange-traded funds have been warning that their products are good only on a day-to-day basis. But you can take advantage of the leverage available in ETFs without the risk of tracking error that comes from

## CHART SETUP

I use the typical 20-day moving average in my A/D line Bollinger bands, but I have adjusted the bandwidth to 1.5 standard deviations, rather than the typical two standard deviations. For the A/D ratio I set the bands at 60 days and two standard deviations.

In addition to the A/D ratio (top window of Figure 1), price and the A/D

line, I watch the 21-day moving average of the A/D line (bottom window of Figure 1).

I have overlaid Bollinger bands on it as well. The parameters for this indicator are set at 60-day moving average and two standard deviations. The horizontal line in the ratio chart is set at 0.5.

holding the funds for more than a day.

The strategy I outline here can be used for trading regular ETFs, leveraged ETFs or options on these funds. I personally trade this approach using the SPDR S&P 500 ETF.

## THE MODEL

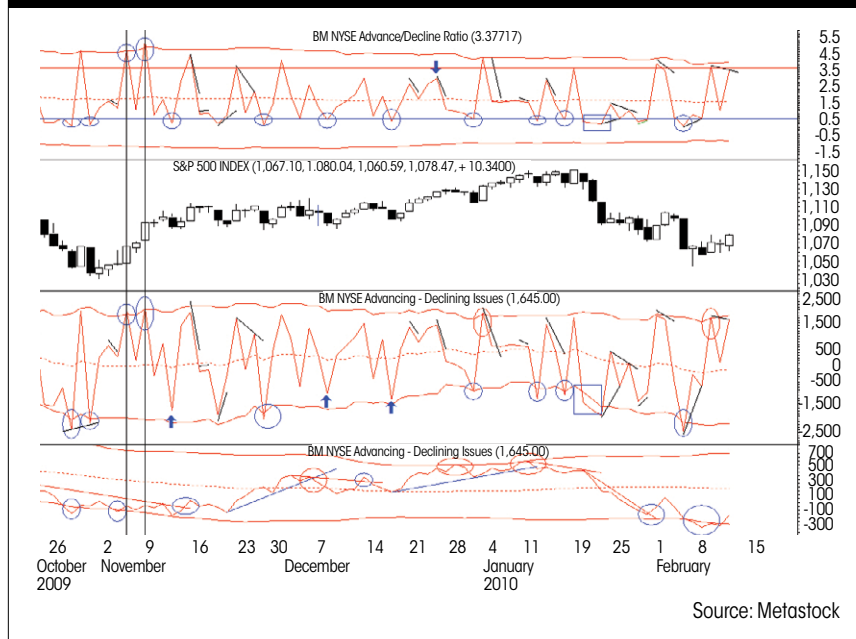
The model uses both the [advance-decline ratio](#) and advance-decline line.

But it is important that you understand to which A/D line I refer, as most technicians think of the cumulative A/D line.

The cumulative A/D line is calculated as a running total of daily net advancing minus declining stock issues on the New York Stock Exchange. It is a useful indicator I'm told, but that is not the indicator I use in this model.

The A/D line I use is much simpler. It is just the number of NYSE advancing issues minus the number of declining issues as calculated at the end of each day. No running totals are involved.

**FIGURE 1**  
Advance-decline Model with the S&P 500 Index



And the advance-decline ratio is a breadth-momentum oscillator, calculated by dividing the number of advancing issues by the number of declining issues each day. Again, very simple.

Both indicators are available on an intraday basis in most quote systems.

## BUY SIGNALS

Double bottoms are simple buy signals. A bottom in the ratio is defined as a close below the absolute level of 0.5. A bottom for the line is a close below its lower Bollinger band.

A double bottom is simply when both indicators simultaneously register bottom signals. Examples in Figure 1 are noted with blue ovals. These signals indicate that the decline has been overdone or stretched too far.

The study period for this article spans from the market high on Oct. 9, 2007, through Jan. 29, 2010. During the time-frame, double bottoms gave 33 profitable signals and 10 losers.

Using a bottom in either indicator without confirmation by the

other failed to show a tradable edge, although a bottom in the ratio accompanied by a failure (explained later) in the line often produced good signals.

### **SELL SIGNALS**

A simple sell signal is defined as the A/D line exceeding its upper Bollinger band. No corresponding signal in the A/D ratio is known. Out of 14 signals given during the study, four were bad.

### **DIVERGENCES**

A positive divergence is registered when price makes a new low but the indicator makes a higher low than previously. In this case, it indicates that fewer stocks participated in the current decline than the prior observed decline.

A negative divergence is the opposite scenario. Price makes a new high but the indicator, while advancing, fails to make a new high.

Divergences work best when the time involved does not exceed four days, including both the original and final dates. Divergences are marked on the accompanying chart with short black lines.

I count a total of 15 bad signals and 23 good ones using divergences. I differentiate smooth divergences from what we normally think of as a divergence, not because they are technically different, but because they are harder to see on a chart and the analyst may not notice them if he or she is not looking for them.

A smooth divergence is simply a divergence that takes place between two consecutive days and no intervening date exists between the two points of interest.

I count 48 good signals from smooth divergences and only five bad ones. My totals include only instances that saw divergences in both indicators.

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## FAILURES

I am not speaking of a failure of the model but a failure of the ratio to travel its normal distance, which is a signal itself. A failure is characterized by a three-wave move by the ratio without exceeding either the absolute level of 3.5 on the upside or 0.5 on the downside.

For example, if the ratio is below 0.5, think of that as the beginning of the count. I call that point No. 0. The end of the first wave up (the first inflection point) is point No. 1. Then there is a move down (wave 2) and you get a second inflection point, point No. 2. Each wave may encompass more than one-day.

Finally, you get the third wave to a new high or low. Remember, wave 3 must exceed the extreme of wave 1. It is quite rare not to see the third wave up exceed 3.5 (or the third wave down exceed 0.5). The inability of the ratio to exceed these levels is a sign of

weakness or strength and is noted on the chart with arrows.

When this happens, I call it a failure, and it constitutes a signal. Failures to the upside are sell signals, and failures to the downside are buy signals.

If the ratio indicator drops back to 0.5 prior to exceeding 3.5, then your count starts over. I think of the indicator as reloading when this happens.

During sustained declines the indicator may stay under 0.5 for several days. The count does not start until the indicator moves above 0.5. A count (point 0) must start below 0.5 or above 3.5.

During the study period, failure signals gave four bad signals and 12 good signals.

## BREADTH THRUST

A breadth thrust is a unique and relatively rare signal of which you should be aware. It does not work well as a day-to-day signal, but it is a

signal that a new advance is starting. If you are not aware of its presence, you may be confused with a sell signal.

Thrusts often come in pairs separated by just a few days, approximately a week apart. They are characterized by the A/D line exceeding its upper Bollinger band as the A/D ratio simultaneously exceeds its own upper Bollinger band.

## 21-DAY MOVING AVERAGE

Using a moving average as a filter is a common approach to weed out bad signals. I set up a 21-day moving average of the A/D line and overlaid it with Bollinger bands using a 60-day moving average and two standard deviations. I had the benefit of hindsight when drawing trendlines to do this study.

Using Bollinger bands I was able to look for extremes in trend. For example, the trend may still be positive but if the moving average is over the up-

per Bollinger band, then I determine that the moving average has switched, giving a negative trend signal until the time it drops back below the upper band (and vice-versa for buy signals).

From Oct. 9, 2007, to Jan. 29, 2010, I count 75 bad signals using the methods outlined in this article out of a total of 251 signals. Of those 75 bad signals, 57 could have been avoided by using the 21-day moving average as a filter.



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OF THOSE 75 BAD SIGNALS,  
57 COULD HAVE BEEN AVOIDED  
BY USING THE 21-DAY MOVING  
AVERAGE AS A FILTER.

However by using this filter, you would have lost 91 good signals during that period out of a total of 176 good ones, or 52 percent lost trades. Without the filter, the win-loss ratio is 1.93 and with the filter 4.7—an improvement but at quite a cost. Remember, I had 20/20 hindsight on determining the trend of the moving average.

## **REMEMBER THE EXPIRATION DATE**

Signals sometimes come every day but can normally be expected twice a week. I check each day prior to the market close. Option traders have an extra 15 minutes to initiate or close positions after the equity markets close. Do not get scared out of a position by intraday moves in A/D indicators.

Remember, this is a one-day indicator; it expires at the end of the day. Do not try to initiate long-term positions based on this alone. Many of the “good” signals are only marginally profitable. But as Dad always said, “You can’t catch fish if you don’t have your line in the water.”

Ed Carlson, the creator of the Carlson confirmation model, is an independent trader and consultant based in Seattle. He spent 20 years as a stock broker. He is a Chartered Market Technician and hosts the [Market Technicians Association](#) Podcast Series (a weekly audiocast featuring interviews with recognized industry professionals). Carlson manages [SeattleTechnicalAdvisors.com](#), a technical analysis website directed at financial professionals. Reach him at [Ed@SeattleTechnicalAdvisors.com](mailto:Ed@SeattleTechnicalAdvisors.com).