



Arthur Hill On Goals, Style and Strategy

Before investing or trading, it is important to develop a strategy or game plan that is consistent with your goals and style. The ultimate goal is to make money (win), but there are many different methods to go about it.

As with many aspects of trading, many sports offer a good analogy. A football team with goals geared towards ball control and low-scoring games might adapt a conservative style that focuses on the run. Teams that want to score often and score quickly are more likely to pursue an aggressive style geared towards passing. Teams are usually aware of their goal and style before they develop a game plan. Investors and traders can also benefit by keeping in mind their goals and style when developing a strategy.

Goals

First and foremost are goals. The first set of questions regarding goals should center on risk and return. One cannot consider return without weighing risk. It is akin to counting your chickens before they are hatched. Risk and return are highly correlated. The higher the potential return, the higher the potential risk. At one end of the spectrum are US Treasury bonds, which offer the lowest risk (so-called risk free rate) and a guaranteed return. For stocks, the highest potential returns (and risk) center around growth industries with stock prices that exhibit high volatility and high price multiples (PE, Price/Sales, Price/Hope). The lowest potential returns (and risk) come from stocks in mature industries with stock prices that exhibit relatively low volatility and low price multiples.

Style

After your goals have been established, it is time to develop or choose a style that is consistent with achieving those goals. The expected return and desired risk will affect your trading or investing style. If your goal is income and safety, buying or selling at extreme levels (overbought/oversold) is an unlikely style. If your goals center on quick profits, high returns and high risk, then bottom picking strategies and gap trading may be your style.

Styles range from aggressive day traders looking to scalp 1/4-1/2 point gains to investors looking to capitalize on long-term macro economic trends. In between, there are a whole host of possible combinations including swing traders, position traders, aggressive growth investors, value investors and contrarians. Swing traders might look for 1-5 day trades, position traders for 1-8 week trades and value investors for 1-2 year trades.

Not only will your style depend on your goals, but also on your level of commitment. Day traders are likely to pursue an aggressive style with high activity levels. The goals would be focused on quick trades, small profits and very tight stop-loss levels. Intraday charts would be used to provide timely entry and exit points. A high level of commitment, focus and energy would be required.

On the other hand, position traders are likely to use daily end-of-day charts and pursue 1-8 week price movements. The goal would be focused on short to intermediate price movements and the level of commitment, while still substantial, would be less than a day trader. Make sure your level of commitment jibes with your trading style. The more trading involved, the higher the level of commitment.

Strategy

Once the goals have been set and preferred style adopted, it is time to develop a strategy. This strategy would be based on your return/risk preferences, trading/investing style and commitment level. Because there are many potential trading and investing strategies, I am going to focus on one hypothetical strategy as an example.

GOAL: First, the goal would be a 20-30% annual return. This is quite high and would involve a

correspondingly high level of risk. Because of the associated risk, I would only allot a small percentage (5-10%) of my portfolio to this strategy. The remaining portion would go towards a more conservative approach.

STYLE: Although I like to follow the market throughout the day, I cannot make the commitment to day trading and use of intraday charts. I would pursue a position trading style and look for 1-8 week price movements based on end-of-day charts. Indicators will be limited to three with price action (candlesticks) and chart patterns will carry the most influence.

Part of this style would involve a strict money management scheme that would limit losses by imposing a stop-loss immediately after a trade is initiated. An exit strategy must be in place before the trade is initiated. Should the trade become a winner, the exit strategy would be revised to lock in gains. The maximum allowed per trade would be 5% of my total trading capital. If my total portfolio were 300,000, then I might allocate 21,000 (7%) to the trading portfolio. Of this 21,000, the maximum allowed per trade would be 1050 ($21,000 * 5\%$).

STRATEGY: The trading strategy is to go long stocks that are near [support](#) levels and short stocks near [resistance](#) levels. To maintain prudence, I would only seek long positions in stocks with weekly (long-term) bull trends and short positions in stocks with weekly (long-term) bear trends. In addition, I would look for stocks that are starting to show positive (or negative) [divergences](#) in key momentum indicators as well as signs of accumulation (or distribution). My indicator arsenal would consist of two momentum indicators ([PPO](#) and Slow [Stochastic Oscillator](#)) and one volume indicator ([Accumulation/Distribution Line](#)). Even though the PPO and the Slow Stochastic Oscillator are momentum oscillators, one is geared towards the direction of momentum (PPO) and the other towards identifying overbought and oversold levels (Slow Stochastic Oscillator). As triggers, I would use key [candlestick](#) patterns, price reversals and [gaps](#) to enter a trade.

This is just one hypothetical strategy that combines goals with style and commitment. Some people have different portfolios that represent different goals, styles and strategies. While this can become confusing and quite time consuming, separate portfolios ensure that investment activities pursue a different strategy than trading activities. For instance, you may pursue an aggressive (high-risk) strategy for trading with a small portion of your portfolio and a relatively conservative (capital preservation) strategy for investing with the bulk of your portfolio. If a small percentage (~5-10%) is earmarked for trading and the bulk (~90-95%) for investing, the equity swings should be lower and the emotional strains less. However, if too much of a portfolio (~50-60%) is at risk through aggressive trading, the equity swings and the emotional strain could be large.

Written by Arthur Hill

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