The Secret Code of
JAPANESE
CANDLESTICKS

Felipe Tudela

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Felipe Tudela

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Introduction

Would you like to acquire a powerful trading tool that is efficient and precise? Such a tool exists. It is the foundation to 'Japanese candlesticks.' This book is about them. You are about to discover the truth about Japanese candlesticks. It is a truth that no one has ever explained before!

Japanese candlesticks are fashionable. Their exotic nature attracts the public to them and they are surrounded by an aura of arcane science and seem inaccessible to the uninitiated. They have a magic of their own – the magic of an ancient civilization – and also have strange-sounding names – Dojo, Marubozu, etc.

However, they do not work efficiently, except for a very small number of traders. The reason for this is that few people today are willing to study a trading method until they master it. Candlesticks are also difficult to handle, given the diversity of their patterns. Most important is the fact that Japanese candlesticks have a unique master key that must be understood in order to make them work.

We are going to explain this key and illustrate it with practical examples. It will change your way of looking at candlesticks and at markets.

1
The Truth about Japanese Candlesticks

The truth about Japanese candlesticks is very simple. 'Japanese candlesticks' refers to the method that has guided the success of Japanese traders for centuries. Originally, Japanese traders made no use of Japanese candlesticks. They used another method.

From time to time, a contemporary author mentions it briefly, without making it part of his trading or giving it the prominence that it deserves. This method, which was used prior to candlesticks, is not explained in any book. What method was employed by the Japanese traders, who had no use for Japanese candlesticks?

We will come to that soon, but first let us trace its history.

THE ORIGIN OF JAPANESE CANDLESTICKS OR HOW KNOWLEDGE OF THEIR HISTORY COULD TURN YOU INTO A SUCCESSFUL TRADER

Kosaku Sato was born in 1716 during the Tokugawa period in the city of Sakata in the Yamagata prefecture. It was the eighth shogunate. Kosaku Sato was adopted by the Honma family and became known as Sokyu Honma.

Sakata was then one of the main ports and centres for rice distribution. This is where Sokyu Honma built a fortune founded on his study of fluctuations in the price of rice. He developed tactics and strategies that made him an awe-inspiring man in Osaka, Kyoto, and Edo. His personality was charismatic. He was thought of as a 'man of knowledge' and a 'market magician.' His reputation was such that the Emperor bestowed the title of 'bushi' or 'samurai' on him. Sokyu Honma was a strategist and a market warrior[1] whose exploits were celebrated by a popular song of the time:

> *When it shines in Sakata, its cloudy in Dojima*
> *and in Edo it rains.*
> *Nobody could ever be a Honma,*
> *But everyone would like to be at least a lord.*[2]

Sokyu lived to be 87 years old and died in Edo. His trading had been based on a secret method that he had created. This method, passed down from generation to generation, is the subject that we will explore in this book.

SOKYU HONMA'S METHOD

Honma's method has two parts. Neither mentions candlesticks. These two parts are:

(a) the *Samni No Den of the Market*;
(b) the *Sakata strategies*.

These will be explained, but a question remains: 'At what time do Japanese candlesticks make their appearance, since the master makes no mention of them?'

Japanese candlesticks made a late appearance – near the end of the nineteenth century.[3] They were developed at the beginning of the Meiji era in Japan, although their exact origin is unknown. However, there are many hypotheses. One hypothesis suggests that candlesticks were a kind of bar chart that was used by some American traders and was subsequently taken over and developed by the Japanese.

What really matters is that Japanese traders using candlesticks, whatever their origin or power, must use Sokyu Honma's method, above all. Japanese candlesticks exist for one reason – *to refine and give added precision to Sokyu Honma's method*. However, the true method belongs to Sokyu Honma. This method is so simple, so logical, and so powerful in its simplicity that it can perform without Japanese candlesticks. As William of Occam, a Western fourteenth century master logician, said, '*entia non multiplicanda*,' or 'let's keep it simple.'

In the following pages, we will explain this method.

2
The Spirit of Sokyu Honma's Method: The Master and the Disciple

As we learned in the previous chapter, Sokyu Honma developed his method in two parts:

(a) the Samni No Den of the market (the *subjective* part of the method);
(b) the Sakata strategies (the *objective* part of the method).

All great traders possess the same spirit and the same reflexes. Both parts of Sokyu Honma's method prove that he understood the immutable principles of a savvy speculator.

The Samni No Den of the market concerns the subjective point of view – the trader's attitude. The Sakata strategies relate to an objective point of view – the market's basic structures. Both perspectives constitute an indivisible whole, because to operate in the markets implies *a knowledge of the market* and *a knowledge of oneself*. What role does theory play in all of this?

It is here that we must make a distinction between Western and Eastern attitudes. For a Japanese trading master, the acquisition of knowledge is practical and not theoretical. Theory only plays a preliminary role. The passage to practice is immediate. It is practice that will answer the pupil's questions.

A bad habit that is often prevalent among Western students bothers Eastern masters. This habit is asking questions without any real purpose. This is the Western critical attitude. To ask questions is normal when acquiring knowledge, but often questions reveal unattractive aspects of the student – impatience and lack of maturity.

For the Eastern master, true knowledge appears when mental agitation ends. In order to learn, one must concentrate on only one thing and let reality bring its own

answers. The practice of any discipline will bring the answers to most questions. These answers will arrive when they should arrive – at the right time. When the student is ready, he will receive the answer.

The market has its own language. Only intensive practice will enable us to know it. We must become familiar with hundreds of cases, until the market becomes part of us – second nature to us.

If the student adopts the opposite approach, he is bound to fail. No wishful thinking is permitted here. Intensive and conscientious practice is the only possible path to success. We say this because Sokyu Honma's two methods must be studied, but, above all, practicing them will give us true knowledge.

Let us now move to the next chapter and study the first part of his method.

3
The Samni No Den of the Market: The Subjective Part of the Method

HOW TO MASTER YOUR TRADING: YOUR FIRST STEP TO SUCCESS

The first part of Sokyu Honma's method, the *Samni No Den of the market*, seeks to develop adequate reflexes and the right attitude of a trader in us. Here is the method and its five rules:

1. Without being greedy, look at past market movements and think about the time/price ratio.
2. Try to buy a *bottom* and sell a *top*.
3. Increase your position after a rise of 100 bags from the bottom or a decline of 100 bags from the top.
4. If your forecast is incorrect, try to recognize your mistake as soon as possible. Then, close your position and stay out of the market for 40 to 50 days.
5. Close 70 to 80 % of your positions, if they are profitable, closing what is left after a top or a bottom is reached.

EXAMINING THIS SIMPLE AND POWERFUL METHOD

Rule 1

This rule tells us to measure and study the time/price relationships. Note that this approach was at the heart of Gann's method, for which an equilibrium between time and price is crucial.[4]

This rule enables us to categorize the movements of the market in terms of time and price. Here is an example: the market has risen x points in y weeks from a historic bottom to a historic top. During this rise, there have been upward movements for each swing of p points and w weeks. Within this same movement, corrections and consolidations are each within a range of d points for a duration of e weeks. We follow the same procedure for the movement from the historic top to the historic bottom. This measuring technique may be applied to any time frame.

The rule tells us that we must not be greedy. It is important that we do not try to obtain the maximum possible gain, as indicated by past movements. We must try to win without becoming greedy. In this way we will avoid the risk of overstaying in the market and seeing our gains disappear.

Unfortunately, this is exactly what happens to most traders. Therefore, choose an exit point that will limit your avarice and that, at the same time, is indicated by the market itself. Here, only practice will bring you knowledge.

By studying the time/price ratios, you will discover things – the market itself will speak to you. Remember that the only master is the market. Remember also that it is necessary to have a practical attitude – a way to knowledge by doing.

I can guarantee that this rule alone will enable you to succeed in the market. The rule has another benefit. It will make you *invulnerable*. No one else will have knowledge of your tactic. It will be your secret.

Rule 2

This rule does not tell us to buy bottoms and sell tops, but to attempt to do it. This is something completely different. Act at the right time. Avoid a temptation to buy when it is already too late. Anxiety and impatience push us toward this kind of behavior. Learn to wait for only the best opportunities.

Rule 3

Increase your position following a rise of 100 bags from a bottom or a decline of 100 bags from a top. This rule indicates a price/volume ratio. For any given price change, there is a corresponding change in volume. Here, the market is inverted because the price was fixed and the volume was variable at the time. A rise of 100 bags means a drop in price. A decline of 100 bags means a rise in price.

This rule tells us to increase our position in the direction of the market (i.e. increase our position only if the market continues to rise; we should not increase our position if the market is down, unless it progressively declines). It also tells us to increase progressively only until our positions have been completed. For example, if we buy 900 shares, we must break up our buying into several purchases. We buy

first, say, 300 shares at one price and the next 300 only if the market goes our way. We buy the last 300 shares only if the market continues to go our way.

Do not buy everything at the same time! Exercising patience is a much worthier goal than winning in the market. Thanks to our exercise of patience, we will end up by having a much greater number of winning trades.

Someone may argue, 'But, when there is an opportunity, why not place all our positions in the beginning?' Greed has just made its appearance. A fatal mistake!

Rule 4

In case we are wrong, we must close our positions and stay away from the market for a period of 40 to 50 days. This advice is a nugget of wisdom. It conceals a secret and is a mystery in itself. Even though the meaning of the rule is to refrain from market activity so that we can have a clear mind, the following literal sense of this rule is excellent. Not only will your mind relax and rest, but also your unconscious will have time to integrate and perfect your strategy and tactic, enabling you to see 'clearly.' You will receive insight that only comes as a result of patience and waiting. The secrets of trading will be made clear.[5] Once again, we hear a call for patience and a warning to control greed. Understand whoever can!

Rule 5

Close 70 to 80 % of your positions as soon as you have the minimum expected gain. Wait until the end of the movement to close the others. Here, once again, it is studying the market that will tell us when to close each position. Again, this rule is a call for our patience and a warning to keep greed under control. Many traders want to close their positions as soon as they have a small gain. This leads, as a consequence, to achieving big losses and small gains. We must learn to wait and have the courage to see our position develop according to the precise plan that was prepared in the beginning. One must recognize that a plan that was prepared previously will tell us exactly when to close the first 70 or 80 % of our position and when to close the rest – taking into account the risk/reward ratio known and tested in advance. This rule contains a hidden and powerful secret. It is up to you to discover it!

Up to this point, we have examined the five rules of the subjective part of the method. Their logic is consistent. Further, the five have a common denominator – a *call for patience and to control greed*. This is a mastery of self that has, as a result, the *mastery of time*, because we learn to wait for the right moment, and the *mastery of price*, since we learn to buy at the right price.

There is a rigorous linking of the five rules. The first rule indicates the fundamental principle of the market and its fluctuations in time and price. It tells us to

measure them, to measure objectively the natural market movement – its oscillations or swings. Once the extent of this movement is known, the second rule tells us when to take action within these movements. We must wait for the right time. Once we know when to buy and when to sell, we must still learn how much to buy or sell. Rule 3 tells us this. Finally, once we are engaged in a trade, we must know when to exit and close our position with a gain or a loss. Rules 4 and 5 tell us this.

In this way, the Samni No Den, the part of Sokyu Honma's method which consists of the subjective five rules, will have taught us:

1. How to manage time and price.
2. How to manage buying and selling points.
3. How to decide what size of position to take.
4. How to manage losses.
5. How to manage wins.

However, in order to be able to apply the rules of this first part of the method, we need knowledge of market phases and the entire cycle. This comes in the second part of the method, the *five Sakata methods*. It also has five rules.[6]

In the next chapter, we will examine the 'five Sakata methods.'

4
The Five Sakata Methods: The Objective Part of the Method

SAKATA'S FIVE METHODS AND THEIR CORRESPONDING MARKET PHASES

The 'five Sakata methods' belong to the objective part of Sokyu Honma's method and focus on the structures or phases of the market. There are five structures or basic configurations:

1. *San Zan* means *three mountains* and is the *triple top*.
2. *San Sen* means *three rivers* and is the *triple bottom*.
3. *San Ku* means a *triple gap* and refers to the empty intervals between prices.
4. *San Pei* means *three lines* and refers to a continuously ascending trend that is composed of three time/price units.
5. *San Poh* means *three rests* and refers to a corrective movement within a trend that is made up of three time/price units.

Each of these strategies or methods is related to a specific market phase or configuration. These phases are:

(a) 1 and 2: turning points, tops or bottoms;
(b) 3: gaps;
(c) 4: trends;
(d) 5: consolidations, or times when markets rest before continuing their trend.

A market can be in only one of these five phases or structures at a time.

For Sokyu Honma, each one of these five market phases has a ternary structure (i.e. one that has three variables). This ternary structure, the foundation of which

has a precise meaning in Japanese sacred numerology, is the minimum requirement to define a phase that is valid for trading; i.e. for a trend to be exhausted, we require a minimum of three gaps. For a trend to exist, there must be at least three movements in the same direction. For a consolidation to appear, we require at least three corrective units (i.e. days, weeks, or other periods of specific duration).

Three is an important number. It has a somewhat mystical connotation for traders. Many things involve 'threes.' For example, a trend has a beginning, a middle, and an end. Markets can have more or less than three movements in the same direction, but any trading action taken must account for this triple recurrence. This will prevent mistakes and bad trades. Once again, Sokyu Honma appeals to our patience and to the imperative to control our greed.

Let us comment on each of these five Sakata structures. We know that Sokyu Honma had no knowledge of Japanese candlesticks. Candlesticks are an add-on after the fact to help interpret the five market phases. Alone and by themselves, these five configurations give us the *key to read the market*:

1. *San Zan*, meaning 'three mountains,' is a triple top as well as a head and shoulders that can be considered to be a variety of triple top.
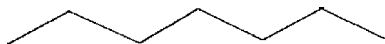
2. *San Sen*, meaning 'three rivers,' is a triple bottom or an inverted head and shoulders.

3. *San Ku* means 'three gaps.' Gaps occur within a trend. The first gap is evidence of new buying or selling power and the third gap often announces the exhaustion or end of the actual trend.
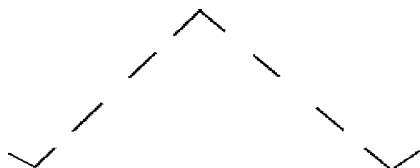
4. *San Pei* means 'three lines' or time/price units in the same direction. They signal the beginning of a trend. The three lines can be in different time frames and, for example, can very well be three daily consecutive bar charts within a trend, three

intraday consecutive bar charts within a trend, three weekly bar charts within a trend, or even three consecutive ascending swings within a trend. This is an important point to highlight, since a trend will consist of at least three impulse waves, each considered as a time/price unit by itself.
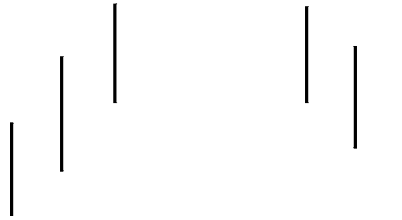
5. *San Poh* means 'three rests.' The market will correct three time/price units before continuing in the direction of the trend.
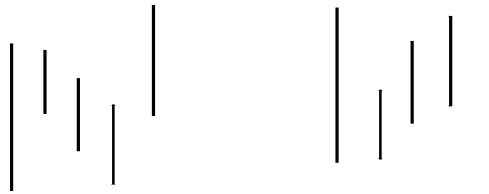
THE FIVE METHODS CONTAIN THE ENTIRE MARKET STRUCTURE

These five figures encompass the entire market structure and enable us to identify where the market stands at every moment. The market answers to the law of cycles. Its phases will repeat indefinitely: from a bottom to a gap, from a gap to a trend, from a trend to a corrective rest, and from a corrective rest to the continuation of the trend, until a top is reached. Then, the movement ends and the cycle will reverse itself. This perspective becomes evident when we try to explain the five phases in their essence and not as only specific and isolated candlestick patterns, as has been done until now.

We are the first to have discovered within the five Sakata methods the five phases that constitute the *complete market cycle* or *great market cycle*. Sokyu Honma has revealed to us his secret – the *absolute logic of the market*.[7]

This logic reveals an ideal model of market behavior based upon the number three. Market behavior will make evident the finite number of its possibilities or phases. This model gives us an efficient trading or investing tool. A specific methodology will correspond to each of these five market phases.

For this model to accomplish its function, the second part of Sokyu Honma's method must act in conjunction with the rules of the first part of the method, the Samni No Den. It then becomes a complete tool.

A SIMPLE PERMUTATION UNCOVERS SOKYU HONMA'S GREAT MARKET CYCLE

We have created a diagram, the first in existence to show the great market cycle, according to Sokyu Honma's five market phases.[8] This diagram shows how the five phases form the elements of a whole that is nothing more or less than the absolute cycle of the market. It is absolute because no market can escape this cycle, which will repeat indefinitely. The diagram begins with the Sakata five market phases:

1. *San Zan*: triple tops
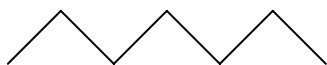
2. *San Sen*; triple bottoms

3. *San Ku*: gaps
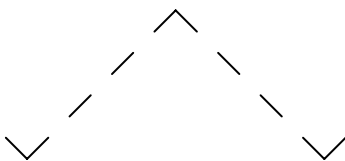
4. *San Pei*: trends

5. *San Poh*: corrections
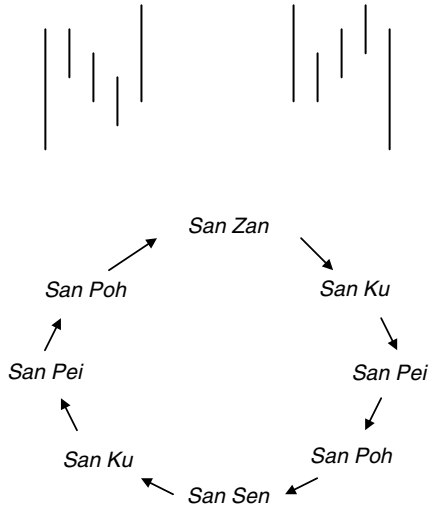
Figure 4.1. Permutation of the five phases.
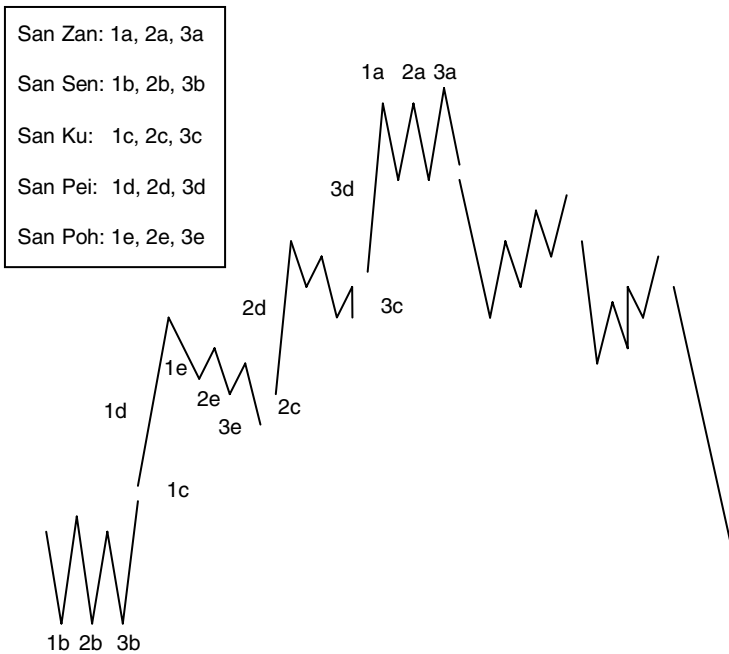
Figure 4.2. The great cycle of the trader samurai, Sokyu Honma.

Then we create a permutation of the five phases. Figure 4.1 is the graph of the permutation, which reveals the existence of an ordered sequence constituting a cyclic formula, the Sokyu Honma great cycle (see Figure 4.2).

We must now explain how to use the five phases of the Sokyu Honma great cycle to actually trade the markets.

5
Trading with Sokyu Honma's Method

We have seen that, in his 'five Sakata methods,' Sokyu Honma helps us to discover the five fundamental market phases. Each of these market phases is a part of a great cycle, and each corresponds to a specific market methodology. This is why the name of 'five Sakata methods' is fully justified.

We are now going to use the definitions of the five Sakata methods to trade the markets.

FROM THE FIVE MARKET PHASES TO THE FIVE OPERATIONAL METHODS

Sokyu Honma gives us five methods that correspond to the five market phases. These are the methods:

1. Method for selling triple tops (San Zan)
2. Method for buying triple bottoms (San Sen)
3. Method for buying and selling gaps (San Ku)
4. Method for buying and selling trends (San Pei)
5. Method for buying and selling reactions or consolidations (San Poh)

RULES FOR BUYING AND SELLING ACCORDING TO EACH OF THE FIVE METHODS

Method for Selling Triple Tops (San Zan)

The rule here is to wait for a triple top and sell as soon as the market has a sudden movement that takes it downward and away from the triple top. This applies to every time window.

Method for Buying Triple Bottoms (San Sen)

The rule is to wait for a strong upward impulsive movement with a long range (i.e. wide price fluctuations) after the triple bottom is fully in place. As soon as this happens, we will buy.

Method for Buying or Selling Gaps (San Ku)

For the buying method, we wait for a third gap to appear in a downward market. Then, we wait as long as it takes for a market turnaround, so that it goes upward and closes the previous downward gap. Then, we buy. We will exit the position at the third gap.

For the selling method, we wait for at least a third gap in an upward trend, which means that the trend is near its end. Then, we wait for a turnaround of the market and the beginning of a downward trend. Once the market has turned around and closed the former uptrend gap, we sell. We will exit at the third gap in the downward trend.

Method for Buying or Selling Trends (San Pei)

Buy or sell within a trend that already has three time/price units (bars) in the same direction.

Method for Buying or Selling Corrections within a Trend (San Poh)

Wait for a correction of three time units (bar charts) in the last time unit (bar chart) of the actual trend. This correction can slightly exceed the bar chart of the time unit that contains it. After this happens, we wait for the market to turn around and continue the trend. Then, we buy or sell as soon as the market breaks out of the bar chart or time price unit that contained its three-bar inner corrections.

These are the five rules for buying or selling in the Sokyu Honma method. These rules must always be applied in conjunction with the five Samni No Den rules.

Now we have an integral methodology that gives us what we need to know about the market phase that we are in, the precise moment to buy or sell, and the trader's behavior to manage his risk in order to minimize losses and maximize gains.

Sokyu Honma gives us all of the elements, both objective and subjective, necessary to succeed. In his methodology, the trader and the market constitute a harmonious whole.

Note that we do not need to use candlesticks here. These will come later at the appropriate moment in the next chapter.

We will now study some concrete examples that illustrate how to use the five Sakata methods to buy or sell the markets, without using candlesticks. In the next chapter, we will explain how candlesticks fit within the five methods.

EXAMPLES

Method 1 (San Zan): Selling Short a Triple Top (Figure 5.1)

We wait for a triple top to form and, as soon as the triple top is fully in place, we sell upon the first sudden movement that takes place just after the third top. Usually, we will be selling on a very long-range downward bar chart.

Method 2 (San Sen): Buy a Triple Bottom (Figure 5.2)

After the triple bottom is fully in place, we wait for a very long-range bar chart. We buy at the close of this very long-range bar chart. We close our position immediately after the third upward gap that appears soon after the triple bottom. We protect ourselves with a stop.

It is also possible to follow this trade with a trailing stop. In this case, we will exit the market as soon as we are stopped out.

Method 3 (San Ku): Buying a Gap (Figure 5.3)

We wait for the third gap in the downward trend (the first two gaps are not visible in the chart). After this third gap, we wait for a triple bottom to appear. After the triple bottom is in place, we wait for an upward move that will close this third downward gap. As soon as the gap is closed, we will buy. We will exit our position as soon as a third gap appears in the upward trend.

Method 3 (San Ku): Short Selling a Gap (Figure 5.4)

Within the upward trend we have three gaps, one after the other. Following these gaps, a triple top takes place. When, after this triple top, a downward move begins and closes the last gap of the preceding upward trend, we sell. We can exit the position as soon as three gaps take place during the new, downward trend.

Figure 5.1. Coffee continuous chart (daily) (Metastock Chart Courtesy of Equis International).

Figure 5.2. Coffee continuous chart (daily) (Metastock Chart Courtesy of Equis International).
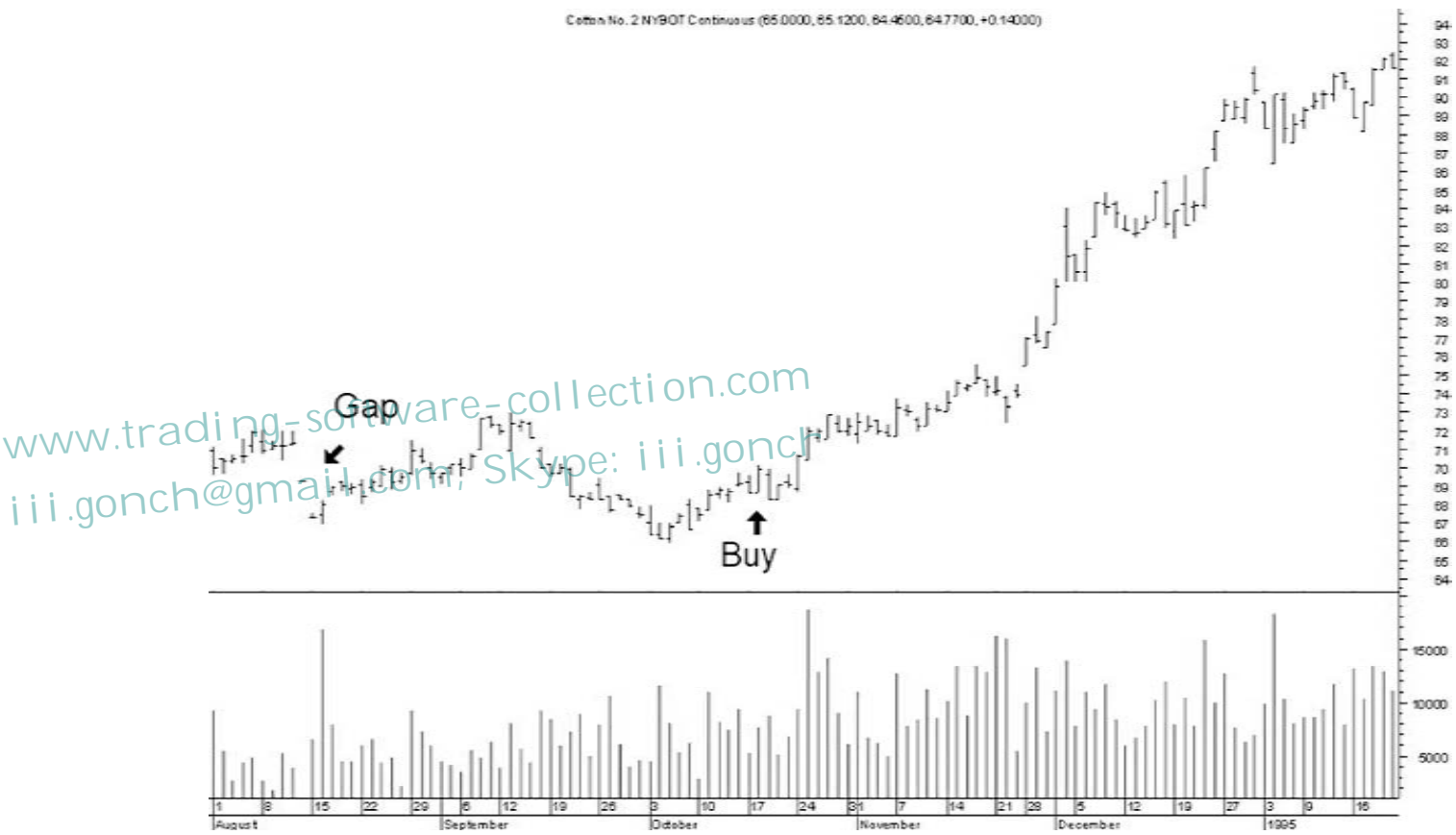
Figure 5.3. Cotton 2 continuous chart (daily) (Metastock Chart Courtesy of Equis International).

Figure 5.4. Natural gas continuous chart (daily) (Metastock Chart Courtesy of Equis International).

Figure 5.5. DJ Indu average continuous chart (daily) (Metastock Chart Courtesy of Equis International).

Figure 5.6. Wheat continuous chart (daily) (Metastock Chart Courtesy of Equis International).

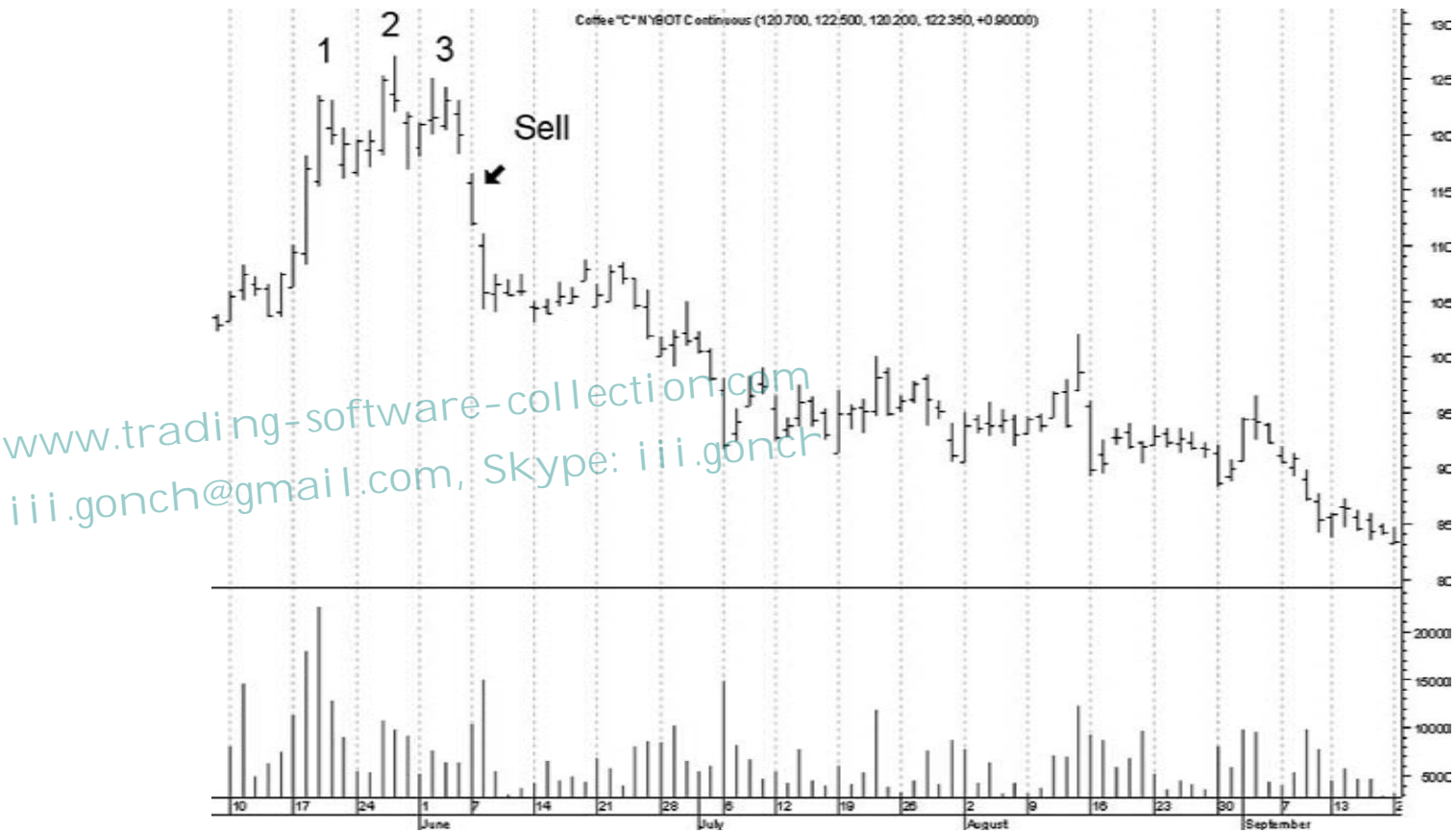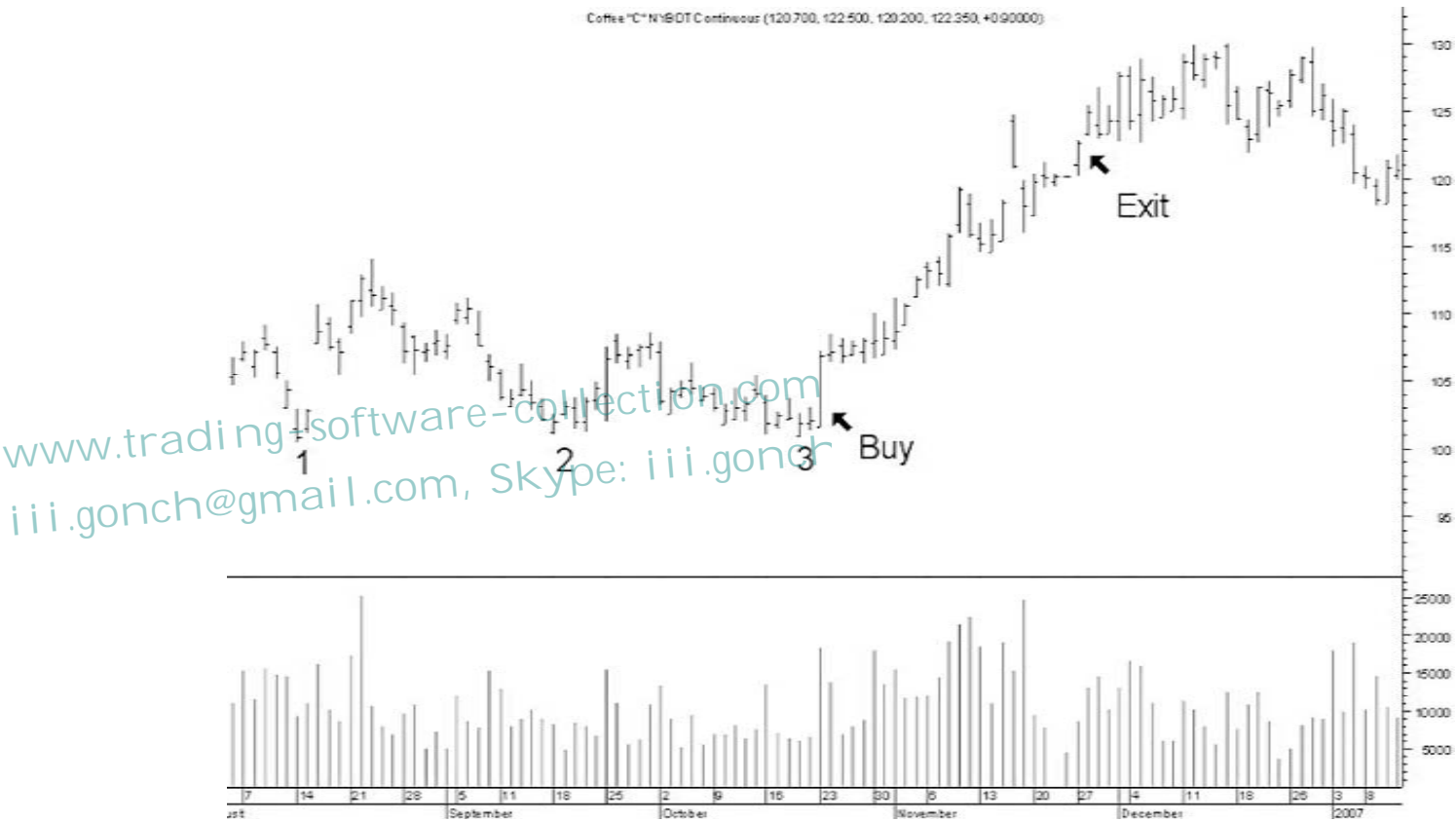Crude Oil Light Sweet Continuous (93.6700, 93.6800, 89.5300, 90.3800, -3.15000)
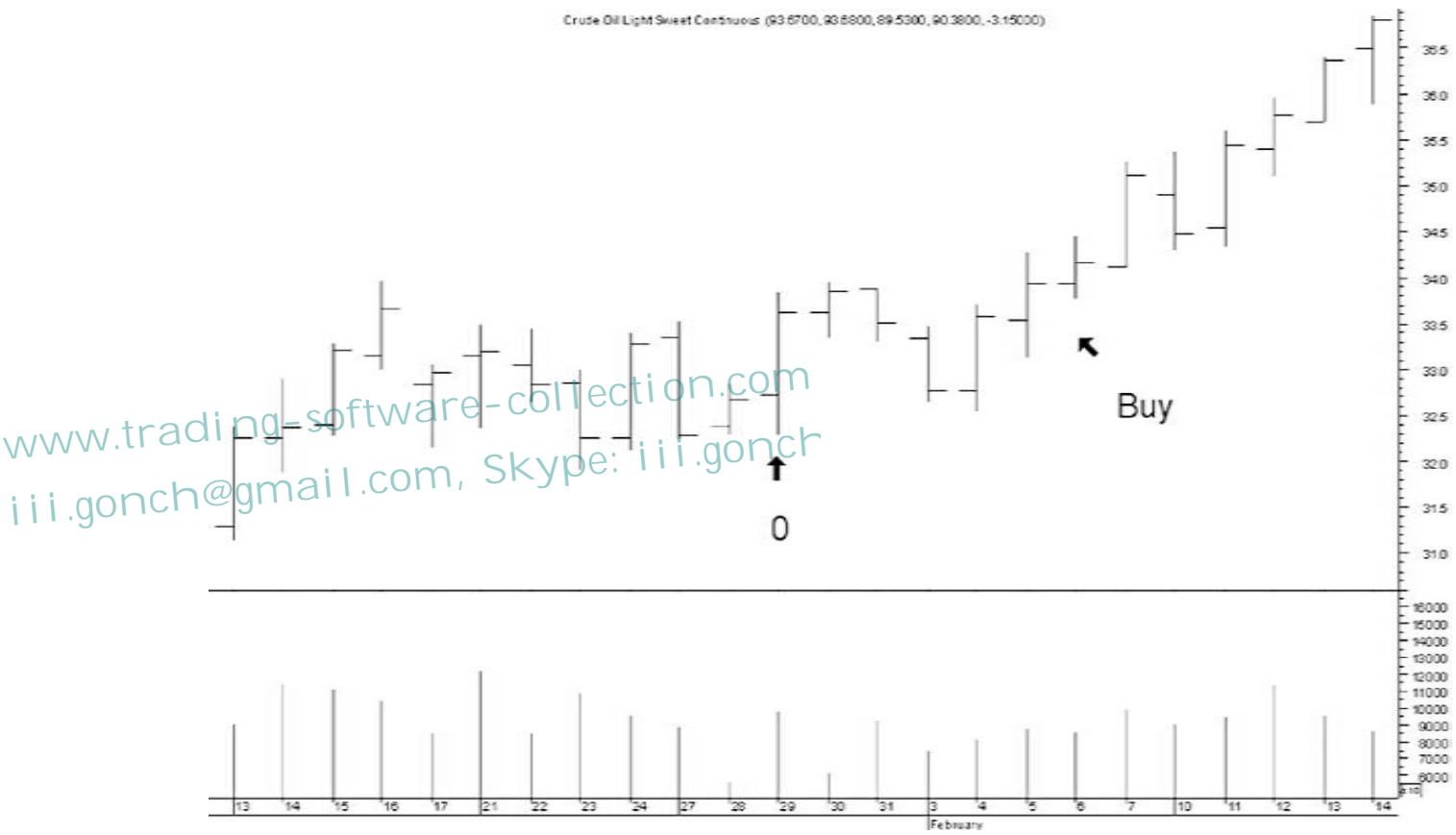
Figure 5.7. Light crude continuous chart (daily) (Metastock Chart Courtesy of Equis International).
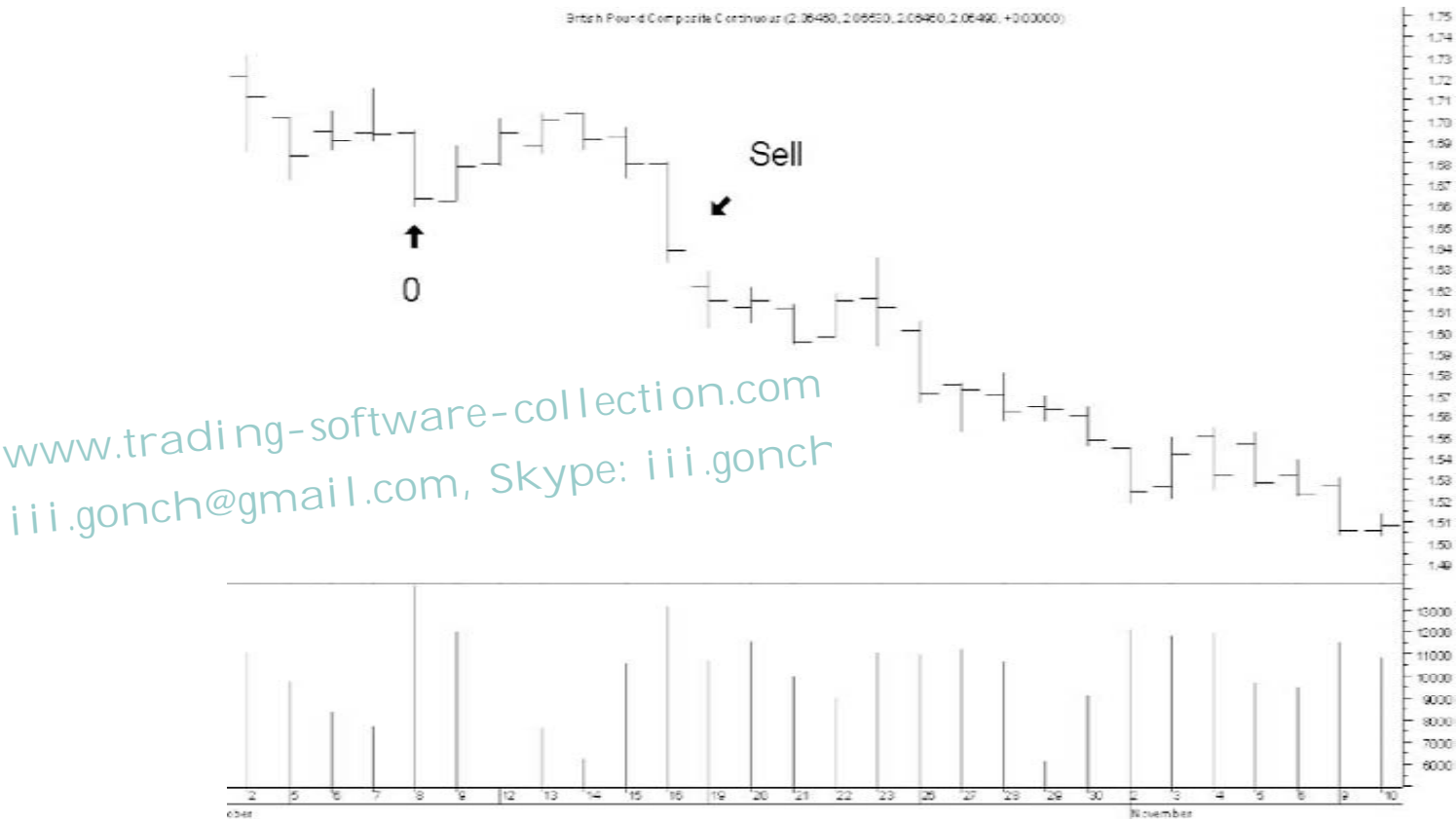
Figure 5.8. British pound continuous chart (daily) (Metastock Chart Courtesy of Equis International).
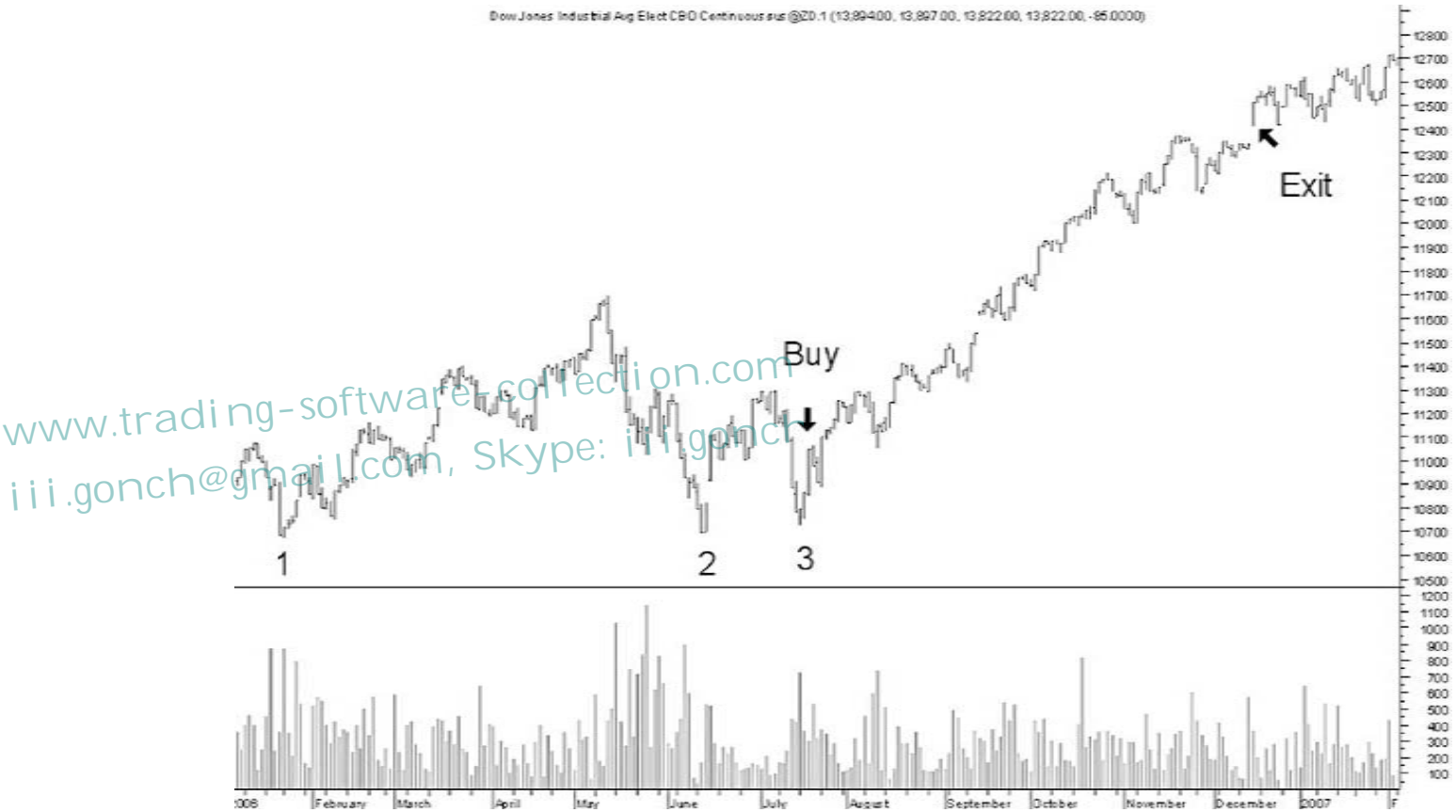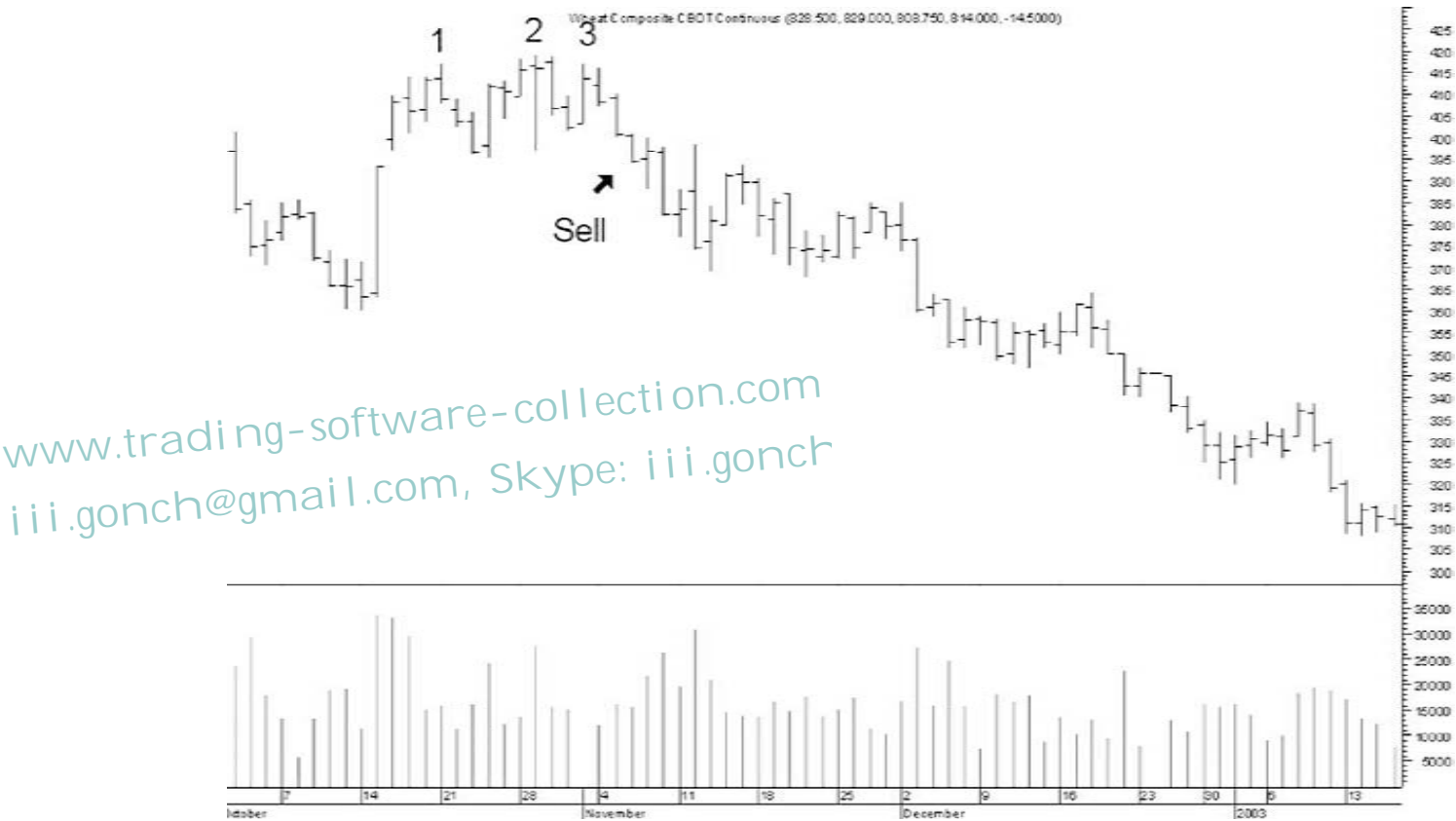
Method 4 (San Pei): Buying an Upward Trend (Figure 5.5)

We buy, preferably after a triple bottom takes place and as soon as a 'three white soldiers' advancing in the same direction pattern appears. We exit our position as soon as a third gap appears. However, we could keep a trailing stop and exit the trade when the stop is triggered.

Method 4 (San Pei): Short Selling a Trend (Figure 5.6)

We short sell as soon as the market turns around from a triple top. To sell, we need two conditions. Firstly, for three consecutive days, the close of each day must be below its opening. Secondly, each of the three consecutive down days must have a lower high and a lower low than the day preceding it. We will exit the position with a trailing stop.

Method 5 (San Poh): Buying a Correction (Figure 5.7)

We buy a correction of at least three days in an ascending trend. This correction must take place within the range of a preceding bar chart. The bar charts that make this correction are descending and contained within a bar chart that was the beginning for the correction (bar chart 0). The correction may slightly exceed the original bar chart in which the correction takes place.

   Before buying, we need to wait for the correction to end and for the market to reverse itself in the direction of the main ascending trend. We buy as soon as the market breaks out the high of the bar chart in which our corrective moves began.

Method 5 (San Poh): Short Selling a Correction (Figure 5.8)

We sell short as soon as the market breaks the low of the bar chart that is at the beginning of the correction. This is exactly the opposite of our previous example (Figure 5.7). We can observe how the range of the bar chart that is corrected and contains the corrective bar charts (bar chart 0) is slightly exceeded by the correction that has taken place.

6
Japanese Candlesticks: A Precision Tool within the Market's Great Cycle

As we have already seen, Sokyu Honma does not use Japanese candlesticks in his method. Japanese candlesticks made their appearance very late, towards the end of the nineteenth century.[9] The ten rules of Sokyu Honma's method have the advantage of being simple, precise, and powerful. They are sufficient in themselves.

The question then becomes, 'Why do we need candlesticks at all?' In fact, in a certain sense, we do not. This is why it is important to provide an answer to this question.

In general, candlesticks are not used as they should be. This is because it was not intended that they be used in isolation. When we use them in this way, they give us a series of patterns that are more or less valid, depending upon their context. This is why they are used today in conjunction with all kinds of indicators. This use is better than nothing, but is not how the first Japanese master traders intended them to be used.

Originally, it was intended that candlesticks be used in conjunction with Sokyu Honma's method. In any case, this is our perspective on this issue and, as far as we know, we are the first to have advanced such a hypothesis. The reason for our hypothesis is that it bestows on candlesticks all of their meaning and power.

Candlesticks give us patterns, the meaning and validity of which depend on the market phase in which they position themselves – the market phase that tells us exactly where the market is within its great cycle. In fact, Japanese candlesticks will give added precision and strength to our market analysis conducted with the use of Sokyu Honma's five methods. This is the reason why books about Japanese candlesticks refer to Sokyu Honma as the father of candlesticks, even though we have no evidence that he knew about them.

The problem with all these books that deal with Japanese candlesticks is that they never tell us how to integrate candlesticks within the market great cycle or even mention it. All they do is present us with the five Sakata methods and with candlesticks as a series of isolated patterns without the necessary synthetic links between patterns and methods.

We know better now. We know that candlesticks are only elements that must be used within the global market structure, which has five phases in strict conformity with the five Sakata methods. At last, we have the key to their use.

We are going to use candlesticks to provide additional confirmation for each of the entry and exit market rules that correspond to each of the five Sakata methods. Each of the methods is linked to one of the specific five market phases that constitute the great market cycle. It is within this framework that each candlestick pattern will find the reason for its existence within a very precise context, the function of which is to help to validate taking a position in the market. This will enable us to make high precision trades.

Which candlestick patterns will we use? We are going to use five basic patterns, as well as two turning point patterns and two continuation patterns. We have made our selection from a multitude of patterns, in order to choose the most useful ones. However, each trader is free to use any of the other patterns as well.

It should be emphasized again that we use candlesticks only to add precision to trades that we are going to make by using the five rules of the Sakata method.

Let us now examine our main candlestick pattern selection.

THE BASIC CANDLESTICK PATTERNS

1. Long Day

This is a candlestick that has a body with a very long range and a very small shadow.
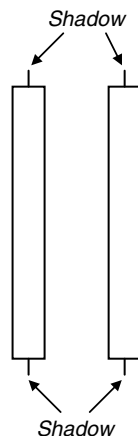
Shadow

Shadow

2. Short Day

This is a small candlestick that has a body that is square or almost square. The shadows are small.
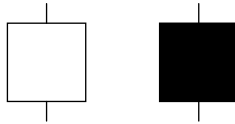
3. Marubozu

This is a candlestick that has one or both body extremes without a shadow. They are reversal or continuation patterns. They are more significant when both of their extremes have no shadows.

Flat extremes
(*without shadow*)

Shadow

Flat extremes
(*without shadow*)
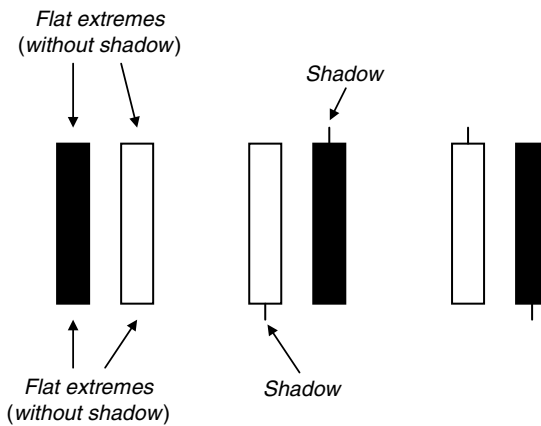
Shadow

4. Doji

This is a candlestick that has its open and close at the same level. This means indecision. The market is thinking about its next move.
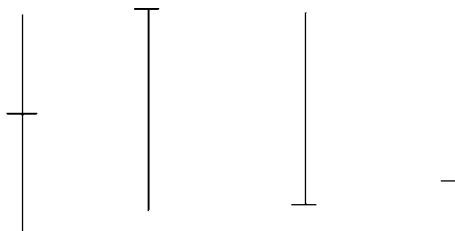
5. Turning Top (Koma)

This is a small body that has two shadows larger than the body. It means indecision.
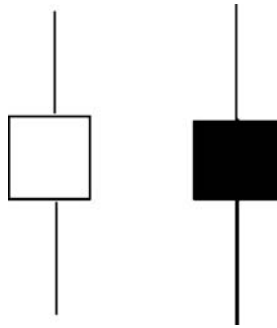
6. Rising Star

This is a small body with a gap above or below a long day: a turning point pattern. It shows indecision.
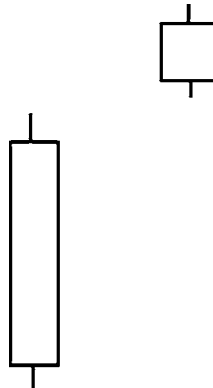
7. Parasol

This is a reversal pattern: the hammer and the hanged man. Both belong to this same pattern.
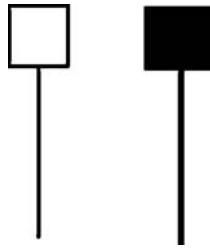
TURNING POINT PATTERNS

1. The Black Cloud That Covers (Kabuse)

Bearish. The second day (in black) closes below the mid-range of the preceding day.
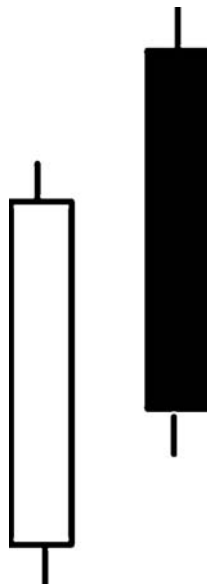
2. The Morning Star and Evening Star

There is a gap in each between the central figure and the ones at the sides.
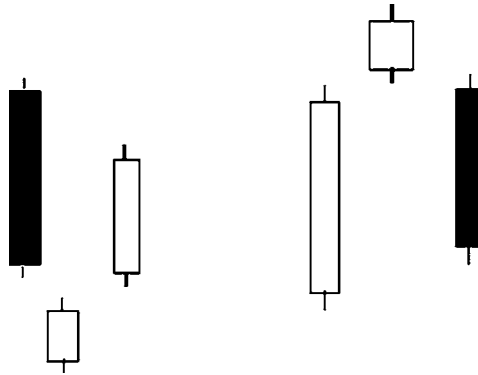
3. The Doji Morning and Evening Stars

There must be a gap between the Doji and its adjacent candlesticks.
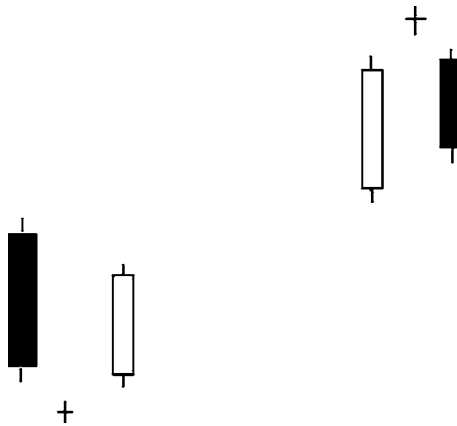
4. The Three White Soldiers

Very bullish. It means the downtrend is over.
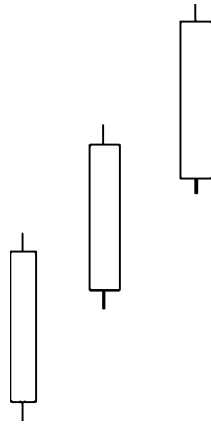
5. The Three Black Crows (Sanba Garasu) and The Three Identical Black Crows (Doji Sanba Garasu)

Bearish. In the second example, the opening is around the close of the preceding day for the two last candlesticks of this pattern.

6. The Kicker (Keri Ashi)

Two Marubozus with a gap between them:

(a) bullish: black followed by an ascending white;
(b) bearish: white followed by a descending black.
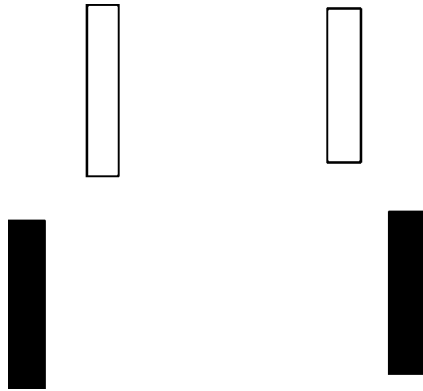
CONTINUATION PATTERNS

1. Three Descending Methods

These correspond to the three rests of Sakata in Sokyu Honma's method. The corrective candlesticks can be any color, but in the direction of the trend, the candlestick before the correction and the one after the correction must have the color of the main trend – in this case white, since it is a bullish pattern. The 'three descending methods' is the first pattern below a downward correction within an upward trend. See diagram (a) below.

(a)

(b)
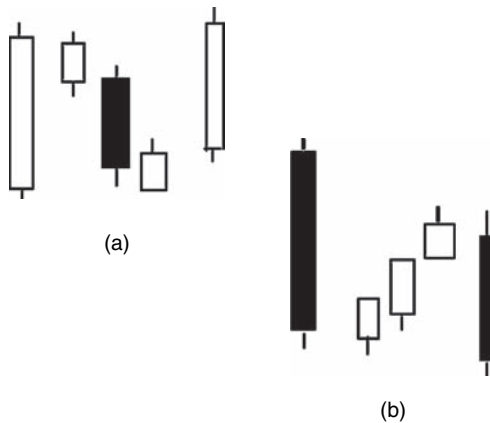
2. Three Ascending Methods

This corresponds to the second pattern shown above. We have an upward correction within a downward trend. It is the opposite of the 'three descending methods.' The candlestick before the correction takes place, and the one that reverses and continues the downward trend are black and in the direction of the main trend.

   We now have the main elements of our trading method: the ten rules of Sokyu Honma and our key candlestick patterns. See diagram (b) above.

RECAPITULATION TABLE FOR SOKYU HONMA'S TEN RULES

The Samni No Den of the Market

This includes measuring the market, position allocation, risk management, and trader psychology:

1. Without being greedy, look at past market movements and study the time/price ratio.
2. Try to buy a *bottom* and sell a *top*.
3. Increase your position after a rise of 100 bags from the bottom or a decline of 100 bags from the top.
4. If your forecast is wrong, try to recognize your mistake as soon as possible, close your position and stay out of the market for 40 to 50 days.
5. Close 70 to 80 % of your positions if they are profitable, closing what remains after a top or a bottom has been reached.

The Five Sakata Methods

These define the five phases of market structure, the great cycle of Sokyu Honma, as well as the specific trading strategy that belongs to each of these phases:

1. San Zan (three mountains)
2. San Sen (three rivers)
3. San Ku (three gaps)
4. San Pei (three lines)
5. San Poh (three rests)

   We now have all of the elements together that we need for our trading algorithm to work. We will examine it in the next chapter.

7
Algorithm in Tabular Format for the Five Sakata Methods within Sokyu Honma's 'Great Cycle'

This algorithm has been created to trade Japanese candlesticks within the framework of Sokyu Honma's great market cycle. The algorithm establishes a connection between each of the market phases and the conditions for each phase of the market that validate taking a position. Remember that each market phase corresponds to a moment within the cyclical structure that binds together the phases of the whole market – the *great cycle of Sokyu Honma*.

Following Table 7.1, we are going to study each of the five formulas that constitute our algorithm in more depth. Let me explain that an algorithm is simply a formula that enables us to repeat indefinitely a procedure in such a way that we obtain the same results each time. For example, any formula in algebra is an algorithm, simply because whenever we apply the formula, we obtain a similar result. The contents of the formula may change, but the formula will always remain the same.

In a similar way, each formula that we propose in order to trade each market phase will always be the same, even though markets never repeat themselves exactly. Each market phase has its own formula. This enables each formula to give the most precise approach possible.

We must emphasize that these formulas must be applied within an integral trading methodology that takes into account the Samni No Den of the market. As we have seen, that is the first method to apply if one really wants to succeed in the market.

This is such an important matter that, later in this book, we will devote further thought to it. At the moment, it is sufficient to say that this trading algorithm should never be used alone.

Table 7.1. The five phases of market structure

Phase of market	Method	Rule	Conditions required	Candlesticks
San Zan	Selling a triple top	Selling a very long range at the close	Triple top + at least 3 ascending gaps, consecutive and non-intersected from the previous ascending trend	Very long black Marubozu or three black crows
San Sen	Buying a triple bottom	Buying a very long range at the close	Triple bottom and at least 3 descending gaps, consecutive and non-intersected, from the previous downtrend	Very long white Marubozu blanc or three white soldiers
San Ku	Buy/sell a gap	Buy/sell the close of the last gap	Three (or more) consecutive, non-intersected gaps from the previous trend	Marubozu or three white soldiers or three black crows
San Pei	Buy/sell a trend	Buy/sell the close of the third consecutive time/price unit	Trend defined following a triple top/bottom and 3 consecutive and non-intersected gaps from the previous trend	Three white soldiers or three black crows
San Poh	Buy/sell a correction	Buy/sell the breakout from the range of the time/price beginning in the direction of the main trend	Three time/price units correction contained within the original price/time unit	Three ascending methods and three descending methods

THE BUILDING BLOCKS OF OUR ALGORITHM

We can see that our tabular algorithm has five methods, the five Sakata methods, but with additional elements that help to confirm their validity. Each of these five methods is, in itself, an algorithm than can be used independently. What this means is that you can, for instance, specialize in trading with only one of the methods. It is up to us to use one or more of the five formulas contained here. It

is important always to keep in mind what they really are: the trading tactics of the five fundamental market phases.

The phase of the market is our essential building block. It will define everything else. As you can see, Table 7.1 begins with the market phase. The reason is that all else will develop from this.

We must, above all, learn to think in terms of phases. Many traders expect a magical entry signal, leaving aside all else. This is not the correct approach. When studying a market to trade, we should first ask what phase the market is in now. From the answer to this question, all else will flow in an easy and natural way.

This is why Sokyu Honma began his trading methodology by postulating the five market fundamental phases first, and why they are called 'methods' in his system. Sokyu Honma knew instinctively that market phases provide the golden door to market knowledge. We should heed his teaching.

Once the market phase is established, our tabular algorithm will tell us which trading method corresponds to that phase. Following this will come a tactical entry or exit rule, plus the conditions that reinforce the rule and the key candlestick pattern to actually trade it.

This is why we have included five steps to trade each of the five Sakata methods: market phase, method, original rule, conditions, and candlestick pattern.

We must mention here that the original Sakata rule gave us only the specific phase the market was in. We have added the confirmation rules, as well as the candlestick pattern, that makes trading each one of the methods more precise. This is not an arbitrary decision. All of the rules that seem to have been added to each of the Sakata methods have been strictly deduced from the five Sakata methods as a whole.

All confirmatory rules are contained within the method. We have simply used the intersection points of the five methods where they naturally reinforce each other.

As an example, San Ku, the gap phase, tells us to buy or sell the last gap that the market has experienced as soon as this gap closes in the opposite direction, but only if three former gaps have taken place.

We have integrated this in San Sen and San Zan, the buying of a triple bottom or a triple top. The reason for this is that San Ku gives us information about the end of a move, and we want our triple bottom or triple top, the San Sen and San Zan phases, to be as fully confirmed as possible.

Therefore, without any need to go beyond the five Sakata methods, we find all of the necessary confirmatory rules. Each of the five methods is used to confirm the others. The five methods are interrelated. We make the most efficient use of them. This is also the case when we come to the candlestick patterns. We choose the strongest ones from them.

Let us now examine our entry rules in detail. The key entry rules are:

1. Buying or selling a very long range at the close
2. Buying or selling the closing of the last gap

3. Buying or selling the close of a third consecutive bar chart in the same direction and
4. Buying or selling a breakout of San Poh

All these rules are implicit in the five methods. Let us now look at the conditions needed to confirm our trades. The confirmation add-ons are all elements from the other four methods that we can use when we trade one specific method. In each instance, we will be on the lookout for the following conditions: triple tops or triple bottoms, at least three gaps in the direction opposite to our trade, and a trend in place.

After our main rule and conditions to confirm that the phase is in place, we will place our trade at a precise candlestick pattern. Here we have some preferred key candlestick patterns two of which we use. The first is *three white soldiers* or its opposite, *three black crows*. We note that they coincide with San Pei. We shall study them later.

We also use the Marubozu pattern. In fact, it has the same effect as our first pattern in taking a position. It has a very large range, but in only one time unit (i.e. only one day or one week or one month, etc.).

These two key candlesticks patterns are all that we need. We have included some other patterns in our previous chapter on candlesticks simply for added help in analyzing market behavior.

What we mainly use, in fact, are simply these two key patterns. They really do work! Here is their explanation.

THE KEY CANDLESTICK PATTERNS: THEY COULD BE ALL YOU EVER NEED

The Marubozu is king because it has a very long range. Western traders call it a 'thrust.' It is one of the most powerful entry signals that you can ever have.

This very long range tells us that the market has suddenly received tremendous strength. This is a rare occurrence. When it occurs, it is telling us that the market is ready to begin a new trend.

The long day is a pattern that we mentioned in our candlestick patterns because it is similar to the Marubozu, although never as strong, if considered by itself. We mention it here because it is important to evaluate it, along with the Marubozu. We want our Marubozu to share the very long range of the long day. In fact, the Marubozu is a species of the long day.

Thrusts will always be long days. It is this thrust quality that makes these patterns so important. We need a special kind of energy that comes to a market suddenly in order to push it along.

This is especially true when markets are turning around. Only real strength coming from the opposite direction can turn a market around. This turnaround always comes as a surprise.

Markets turn around when nobody expects them to do so. This invisible strength that was silently hiding and waiting for its opportunity is what a thrust gives us. This is why the Marubozu is so powerful. Always keep this in mind.

The triple sequence of the three black crows or the three white soldiers, another of our key candlestick patterns, corresponds to the San Pei pattern, which we shall explain later. For now, it is sufficient to know that the strength of this pattern comes from its three sequential time units that, when combined, make a very long-range equivalent to the thrust. Therefore, in all, two patterns are enough – the Marubozu, which is the strongest and has a very long range in one unit, and the sequence in three steps or bar charts (three black crows or three white soldiers).

Let us now examine each of the five algorithms given in Table 7.1.

THE SAN ZAN ALGORITHM

This is a triple top. It is formed when the market consolidates horizontally, oscillating in three upward waves within a range. Tops are made when markets change from a trend to a consolidation.

In itself, a top does not represent a turning point or a reversal of the entire trend. Generally, a top is exceeded and the former trend continues. This is the case for most single tops that are simply swing peaks before normal reactions within a trend.

A simple or double top is not enough to reverse a trend, although they sometimes do. A double top, or its variation, the head and shoulders, appears when the market changes from trending to nontrending and begins to test itself. When a simple or double top appears, the preceding trend can continue following a breakout of the simple or double top. It could also reverse itself and initiate a new downtrend.

In fact, we need additional elements to detect a turning point by which the entire preceding trend will reverse itself. This is why we wait for a triple top. Nothing is stronger than a triple top. Also, a fourth testing of the triple top may imply a breakout on the upside and a resumption of the trend. Therefore, if we are expecting the best conditions for a market reversal, we will find them in the triple top.

The triple top implies that the market has not had sufficient strength to continue the trend. It is a strong consolidation. Even if it does not necessarily mean a reversal, it is evidence of very strong resistance. This is accentuated if the top is within a historical range of tops. The universal trading lore confirms this. The triple top is not only found in Sokyu Honma's five Sakata methods phase of San Zen.

For many Western traders, the third top is key. They agree that the triple top is one of the strongest points from which a short sell is advised. They found that the triple top is stronger than a double top or a simple top. In *How to Make Profits in Commodities*, as well as in other books, Gann tells us to wait for a triple top.[10] For Gann, the triple top was one of the best possible places from which to start a short sale.

When trading tops, this is also true for Sokyu Honma, but for Honma, triple tops are also something else. By waiting for at least three tops to form, we will have a model market phase. The market phase that a triple top represents is the lateral nontrending consolidation at the end of an upward trend. Waiting for at least three tops will confirm that this market phase has been reached.

The number three is a very important number. We find this also to be confirmed by universal trading lore. For Gann, for example, the number three was a key number. For Sokyu Honma, number three was a filter that confirms a phase.

However, even our triple top in itself is not enough to initiate a trade. Sometimes even triple tops are broken on the upside. We need additional confirmation that the market has really reversed. In fact, we want to trade the past, not the future. We want to trade a triple top that has happened and not a triple top that is to be.

This is why in San Zan (the word *San* means 'three') we add the need for a very long range that we can sell at the close. Why do we add a long range? The answer is that a long range is very powerful. Its power comes from the fact that it shows a hidden strength that was waiting for its appropriate moment to appear. This hidden strength always comes as a surprise, and so it must if it is to work. Once this massive selling occurs, the entire market will follow.

Usually a very long range will mean the approach of real offering and selling power. This is why long ranges are unusual. They do not come every day.

Long-range entries are also confirmed by Western trading tradition. In the West, the very long range is called a thrust, as previously indicated. The thrust, if on the short side, is a very strong selling activity that suddenly occurs in the market. The thrust shows itself in a bar chart of very long range.

We find examples of thrust in Western trading by such masters as William Dunnigan, George Bayer or Richard Wyckoff.[11] Thrusts are one of the best and more powerful entries that we can consider when trading. This is why our selling short rule for San Zan is to wait for a long range or thrust to occur after our triple top. This confirms that the triple top that we are trading belongs to the past and that the market has already changed direction.

Remember that, in Japanese traditional trading, we always trade the past – never the future. Our future is the past. In order to trade San Zan, we also need some preliminary conditions in the past behavior of the market.

We are not asking only for a triple top, San Zan, to be present, confirming that the market has abandoned its trending stage for a range stage, but are also asking for gaps as an additional condition. Gaps will add credibility to the end of the previous trend. These gaps were in the previous uptrend, of course. Once more, number three is a very important number. We want to see at least three gaps in the former upward trend. We also want our gaps to be consecutive and not intersected. This means that we want our three gaps to occur during the upswings of the previous uptrend. We do not want a gap during a normal reactive downswing that occurs during an uptrend.

After three gaps have occurred, it is probable that the trend is near its end. If, in addition, the market makes three tops and reverses with a long range, we will have all of the elements necessary to form a reasonable judgment about the actual market behavior. In fact, we are not forecasting, but simply describing as fully as possible what has already occurred. We are not anticipating the downturn. We are already in it.

Finally, to take concrete action in the market and sell short, we wait for the strongest thrust patterns in candlestick trading – a black Marubozu or a three black crows pattern. Once we have completed our trade, we must wait and see its development. If everything goes well, we will exit our trade after three nonintersecting gaps occur in the new downward trend that we are in. We can also use a trailing stop.

Let us study our next algorithm.

THE SAN SEN ALGORITHM

This algorithm is a triple bottom. It is formed when the market consolidates, oscillating in three downward waves contained within a horizontal range. Bottoms are made when markets change from a downward trend to a lateral consolidation.

Like tops, bottoms do not necessarily represent turning points or reversals of the entire trend by themselves. Very often, bottoms are broken and the former downtrend continues. This is the case for most single bottoms, which are simply upswing starting points within a downward trend.

As we said with tops, a simple or double bottom is generally not enough to reverse a trend, although it sometimes does. A double bottom appears when the market changes from trending to nontrending and begins to test its support levels. When a simple or double bottom appears, the preceding trend can continue after a breakout of the simple or double bottom. It could also reverse itself and initiate a new uptrend.

In fact, we need additional elements to detect a turning point where the entire preceding trend will reverse itself. This is why we wait for a triple bottom. Nothing is stronger than a triple bottom. Also, a fourth testing of the triple bottom may imply a breakout on the downside and a resumption of the trend.

If we are expecting the best conditions for a bullish reversal, we will therefore find them in the triple bottom. The triple bottom implies that the market did not have enough strength to continue the trend. It is a strong consolidation. Although this does not necessarily mean a reversal, it has created very strong support.

This is particularly true if the bottom is within a historical range of bottoms. Universal trading lore confirms this. We do not find the triple bottom only in Sokyu Honma's five Sakata methods phase of San Sen.

For many Western traders, the third bottom is the most important condition. The triple bottom is one of the strongest points from which a long buy is recommended. They found that the triple bottom is stronger than the double or simple bottoms. In

How to Make Profits in Commodities, Gann found that the triple bottom is the best condition. For Gann, the triple bottom was one of the best possible buying points.[12]

For Sokyu Honma, as well, a triple bottom was needed. Triple bottoms also meant something else for Honma. By waiting for at least three bottoms to form, we have a model of one of the fundamental market phases.

The market phase that a triple bottom represents is the lateral nontrending consolidation at the end of an upward trend. Waiting for at least three tops will help to confirm this market phase as such.

The number three is a very important number. We find this also confirmed by Western trading lore. For Gann, as we previously indicated, this is also a key number. Number three is a filter that will confirm a phase.

However, even our triple bottom, by itself, is not sufficient reason to initiate a trade. Sometimes, even triple bottoms are broken on the downside. We need additional confirmation that the market has really reversed. In fact, once more, as with San Zan previously, we want to trade the past, not the future. We want to trade a triple bottom that has happened and not a triple bottom that is to be.

To appreciate the truth of what we are saying, and as an exercise, try to find a point after a double bottom that would have made a triple bottom buying point. You will see how many of those that appeared to be triple bottoms were not. In fact, the market continued its downward trend.

It is very easy to see market patterns after they have occurred. When you are looking at triple bottoms in a chart, you are in fact looking at successful triple bottoms that held. Many triple bottoms do not hold.

You need more elements to assess market behavior correctly. This is why in San Sen we add the need for a very long range that we can sell at the close. Remember that this was the same for San Zan. Why do we add a long range? The answer is that long ranges are very powerful. A long range has a hidden strength that waits for the appropriate moment to appear. This hidden strength always comes as a surprise, and so it must if it is to work. Once this massive buying power appears, the entire market will follow.

Usually a very long range will mean the approach of real demand and buying power. This is why long ranges are unusual. They do not come every day.

Long-range entries are also confirmed by Western trading tradition. In the West, the very long range is called a thrust, as stated earlier. A thrust is a very strong buying activity that suddenly occurs in the market. The thrust shows itself in a bar chart of a very long range.

As indicated previously, examples of thrusts have been used in Western trading by masters like William Dunnigan, George Bayer, or Richard Wyckoff. Thrusts are one of the best and more powerful entries that we can consider when trading the long or the short side of markets. This is why our buying rule for San Sen is to wait for a long range or thrust to occur after our triple bottom. This confirms that the triple bottom that we are trading belongs to the past and that the market has truly changed direction.

Remember that, in Japanese traditional trading, we always trade the past – never the future. Our future is the past. For this reason, in order to trade San Sen, we also need some preliminary conditions for the past behavior of the market.

We are not only asking for a triple bottom, San Sen, to be present, confirming that the market has abandoned its trending stage for a ranging stage, but are also asking for gaps. Gaps add credibility to the end of the previous trend. These gaps were, of course, in the previous downtrend. Once more, number three is a very important number. We want to see at least three gaps in the former downward trend. We also want our gaps to be consecutive and not intersected. This means that we want our three gaps during the downswings of the downtrend. We do not want a gap during a normal upswing that occurs in a downtrend.

After three gaps have occurred, it is probable that the downtrend is near its end. If the market additionally makes three bottoms and reverses with a long range, we will have all of the elements necessary to form a reasonable judgment about market behavior as it is now. In fact, we are not forecasting, but simply describing as fully as possible what has already occurred. We are not anticipating the upturn. We are already in it.

Finally, to take concrete action in the market and buy, we wait for the strongest thrust patterns in candlestick trading – a white Marubozu or a three white soldiers pattern. Once we have completed our trade, we must wait and see its development. If everything goes well, we will exit our trade after three nonintersecting gaps occur in the new upward trend that we are in. We can also use a trailing stop.

Let us study our next algorithm.

THE SAN KU ALGORITHM

This market phase is all about gaps. Gaps are the third Sakata market phase. This is a phase that has several unusual aspects. Let us examine them.

When key market gaps occur during a trend, the market is telling us something very important. For a gap to occur in the market, the deep hidden structure has changed.

A gap is a sudden, qualitative change in market behavior. It is a catastrophic event. The market suddenly jumps. The invisible strength suddenly becomes visible.

This only occurs at certain places and within a certain measure. There is a deep change in the vibratory rate of the market and the market explodes. Its continuity is broken.

Gaps occur sparingly, and only at key points. A gap is the manifestation of an invisible market phase. A market gap has an identity in, and of, itself.

The market is measured by gaps. Gaps tell us where, on its course, the trend is. We will learn from gaps if the market is exploding and beginning a new trend or if it is in the middle of a trend or at the end of it.

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We do not find gaps only in Sokyu Honma. The use of gaps in trading is confirmed by Western tradition also. In Schabacker and in Edwards and Magee, we find an exposition of gaps. They explain how a gap implies a measured move.[13]

Gaps are used to measure the market. We can also measure its heat or volatility at a maximum. This is why these authors also talk about the exhaustion gap, the gap that signals the end of a trend. In reality, all gaps are measures. The main ones imply huge forces that exhaust previous phases and begin new ones. The new phase can be the continuation of another trend segment or its final collapse. A great deal of energy is released in gaps.

Sokyu Honma went farther with gaps than anyone else has ever gone. Honma was the first to see the fundamental market phase hidden in gaps. Here is the secret lore of Honma concerning gaps: gaps measure the market as a whole and in a complete way. Market gaps form a complete set of market events. We can isolate this set. Better still, we can trade it. How? It is simple. Here is Honma's unique vision: trading them in the past, not in the future. Yes, because for Sokyu Honma the future was the past. It is not something similar to the past. What we actually trade is the past.

If a gap that appeared in the past is closed later, we will take action. When that gap is closed, we have a market entry. For example, if the price on a particular day gapped from 30 to 35, without any price in between, and later the market reverses and the price fills the past gap between 30 and 35, coming back to 29 and closing the gap, we would sell short. The past gap was closed today (the present), so we sold short.

When the former trend has had at least three gaps, and the third gap is closed at the reversal, we buy or sell this gap. We buy if it closes a third gap of a downtrend or we sell if the closed third gap appeared within an uptrend.

We act when a past event, the third gap, is closed in the present. What we are doing is trading the past behavior of the market at very precise spots. We sell or buy the close of the gap at the close of the bar where this occurs. This is our selling rule. However, we also ask for additional conditions.

We do not want our gaps in the preceding trend to intersect. This means having three gaps at different levels in upswings and where no gaps intersect.

Although it is not in the table, we can add, as a condition, a previous triple top or triple bottom before the gap is closed. This will add strength to the trade. When this condition is satisfied, we will enter the market on a very specific candlestick pattern, the three white soldiers if we are long or the three black crows if we are short. The same entry is valid if a Marubozu occurs.

Remember that the three soldiers is a San Pei figure that corresponds to a phase of the market. We will come to this later.

Again, it is important to notice that, in both cases, we are adding a long range, which is the case for each of these two patterns.

We exit the trade when a third gap appears, or with a trailing stop.

THE SAN PEI ALGORITHM

The San Pei market phase is the trending phase of markets. The San Pei algorithm is a procedure to trade trends in a very precise way. In the San Pei market phase, we have mini-trends. These always occur after a consolidation of some kind. In this case, we will see trends appearing after a triple bottom or triple top has occurred. For a trader, it is very important to be able to identify a real trend. This may not be as easy as it seems.

A market can trend upwards or downwards. Basically, an uptrend appears when a market makes a series of higher tops and higher bottoms. A downtrend appears when the market makes lower tops and lower bottoms. There are many consolidations occurring within an upward market. Here the trend stops. However, consolidations are often confused with trends, as they seem to form part of the whole upward move.

Whether a movement is upward or downward, a trend is only a part of it. Ranges or consolidations form a large part of it. This is why, for Sokyu Honma, San Poh was the model of a consolidation within a trend. However, we can also have triple bottoms or tops within these upward or downward movements. In fact, market phases have many ways in which they can combine.

In this effort to identify a trend, Sokyu Honma has given us an invaluable key. This key is San Pei, or the trending market phase of the market. Sokyu Honma devised a way to identify trends that is unique. He reduced trends to their core prototype or model – the minitrend! Sokyu Honma created a model of the smallest possible trend. In modern chaos mathematics, we could say that he found the ultimate trend fractal.

How did Sokyu Honma manage to do this? Very simple! Sokyu Honma created a trend that consists of three basic elements – a beginning, a middle, and an end. In a way, he found the archetypal trend.

Every trend has, necessarily, a beginning or first part, a middle phase, and an ending phase. It is sufficient, then, to express this in its minimal form – three time/price units or bar charts. This gives us San Pei. It consists of three consecutive bar charts with higher tops and higher bottoms, respectively.

This is the smallest trend and it can be identified. When this minimal trend occurs, the market is already trending. We can be sure that a trend is underway.

This is the marvelous simplicity of San Pei, Sokyu Honma's minimal trend. This phase and pattern are so powerful that they can almost be traded by themselves alone. However, we think that it is appropriate to add conditions to strengthen the message that a trend is already underway and should continue. This is why we ask for a previous triple top or triple bottom to be present, and also for the three gaps of the previous trend to have occurred. These gaps, as we already know, must not intersect.

Our entry pattern is a long-range candlestick pattern, but now this pattern is the same as San Pei itself. When San Pei is formed from three descending time/price

units, we have the three black crows. This is our signal to go short. When San Pei consists of three consecutive ascending time/price units, we have the three white soldiers. This is our signal to go long. In both cases, we enter the market at the close of the last bar chart or at the open of the next day.

It can be seen that we have added a very long range. Both San Pei patterns, taken as a whole, imply a long range and show us that there is a very special market strength.

We insist on the quality of long ranges. They constitute one of the most essential trading tactical elements. Long ranges should be present when possible. Long ranges will always uncover the market's hidden intentions, which is why they do not always occur. They require patience on our side. We must learn to wait for these patterns to occur. However, our results will fully justify our waiting.

In San Pei we find the quintessential trend trading technique, a key to trade trends in an almost perfect way. In giving us the essential trend unit, San Pei also gives us a major tool with which to trade the markets. In fact, trading, for the most part, is trading trends. You probably will be more successful in trend trading than in any other form of trading.

Coming back to our algorithm, once all conditions exist and we have sold or bought the market within San Pei, our exit will be made either at the third gap from the beginning of the initial trend or by the use of a trailing stop.

Let us study our next algorithm.

THE SAN POH ALGORITHM

The San Poh algorithm concerns a market corrective phase and how to trade it. This market phase corresponds to a correction within a trend. It always occurs within a trend. The correction of a trend is a market phase in itself. This corrective phase is a key and fundamental to understanding market cyclical development. We must look attentively for its occurrence.

Even within the strongest of trends, a market needs to breathe and to reassess itself. It will give us information about the strength or weakness of the trend. At times, the market will pause for a while and test its previous level within the trend itself. This correction within a trend is also called a normal reaction, which is not only found in Sokyu Honma's San Poh pattern that exemplifies a specific market phase but is also part of Western trading knowledge. For instance, a normal reaction for Livermore was that the correction in a trend was a key point at which to buy.[14] This is also true of Gann, as well as other traders.[15]

With Sokyu Honma, the normal reaction was defined in such a way that a model pattern was created. This model is the San Poh pattern.

Once again we find that number in the word, San, which means three. San Poh is a three-price/unit correction. Its origin is a bar chart that will contain three corrective inner bar charts. These three corrective bar charts, each of which is preferably lower

than the one preceding, may exceed from time to time the original bar chart within which the correction occurred.

This corrective phase can be an interesting trading opportunity for us. Our main rule is to buy as soon as the correction ends and the market resumes its trend and a breakout of the high of the original bar occurs. To this rule, we add conditions to ensure that our trade has the best possible chance to succeed. In this case, the breakout is itself condition enough, since a full trend must be underway for the correction to happen and a full trend is San Pei, which is present. All we do is simply jump on to it and follow its development.

As usual, we exit either after the third gap from the beginning of the trend or by use of a trailing stop. Although we do not ask for additional conditions here, we could ask for a previous triple bottom if we are in an uptrend or for a previous triple top if we are in a downtrend. We could also ask for three nonintersecting gaps to be present in the previous trend. Any of these would reinforce our confidence in the trade. However, the normal reaction itself and the breakout of its high within a trend are usually enough.

WHY ALL THIS WORKS

A question we must ask ourselves, after having explained our trading algorithm and its five methods, is why it works. The answer to this may initially seem to be easy, but, as we shall see, things are not always what they appear to be.

Parameters that work in harmony are key for a sound trading methodology. When we trade, we may use a method that has many parameters or very few parameters. One interesting observation is that, in a linear regression model, the use of more than three parameters blocks the model.[16] The same happens with trading systems of the kind that use mathematical indicators.

In these kinds of systems, the use of more than one or two parameters reduces the efficiency of the system. The different parameters are, so to speak, on different wavelengths and block each other, undermining the system. This is why the best systems that use mathematical indicators employ very few parameters, which is the only way to get them working in harmony.

With Sokyu Honma's five Sakata methods, something different happens. The system works, even though it incorporates many parameters. In fact, the system works better if we incorporate into its workings all possible harmonious parameters. Why? The reason is that in Sokyu Honma's system, parameters belong to the market core behavior itself. They are not merely statistical entities, but real entities that belong to a living organism that we call the market. The result is that this multiplicity of parameters do not block each other. Instead, as wheels within wheels, they ensure a smooth working of the entire market machinery.

One key aspect of our Sakata algorithm and its five procedures is that each individual phase of the five Sakata methods confirms the others. For instance,

San Zan will be confirmed by the presence of San Ku, San Poh, San Pei, and San Zen. The same is true for each of the other four methods.

In our tabular form we have included only the most important conditions required for each method to have trading validity. However, in each Sakata method, all of the other four are always present. Each method works in harmony with the others. This makes it different from methods that use only mathematical quantitative indicators. Later, we will delve into this problem and explain why mathematical indicators cannot reach the deepest levels of the hidden market core.

Another issue should be discussed if we are to succeed in trading with Sokyu Honma's methodology. This methodology must never be used without a plan. By a plan, we do not mean the algorithm and observing its rules in a disciplined way. This is important, but is very far from being what is most needed. By a plan, we actually mean the complete trading strategy that takes into account all of the elements, including the trader himself, and that will make a business of his trading.

Trading is not simply a matter of having a system of signals to tell us what and when to buy or sell and when to exit our position. We can say that this aspect of trading is the least important and will never guarantee our success. It is only a first step. Yes, it is only one aspect around which all else must be built. What we must do first of all is create a sound plan within which the algorithm will take place.

This plan is contained within Sokyu Honma's Samni No Den. In order to ensure success in his trading, a trader must have market knowledge, as well as being able to control his risk through asset allocation, position allocation, stop placement, money management, etc. Let us try, therefore, to minimize the importance of signals and of Sokyu Honma's five Sakata methods. The Samni No Den is much more important at this stage.

The reason is that the five Sakata methods must be applied within the Samni No Den. We will return to the Samni No Den, but before we do so, we will take a look at 37 examples in the next chapter on trading with the five Sakata methods.

8
Thirty-seven Applications Involving Indexes, Stocks, and Futures

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In the following pages, 37 examples are presented that use the five Sakata methods, the trading strategies that correspond to the five phases of Sokyu Honma's great market cycle. The examples include long and short trades.

Often, the different phases intersect; i.e. they are present at the same time and combine to validate a trade. This is logical since each market phase is validated by the other four. This means that when you wish to make a trade during a given phase of the markets the other phases will be there to validate the trade.

Each example differs, and the same phases will not always be there to validate a trade. Each trade is confirmed by the phases that happen to be there at the time. For example, in many instances, we will find San Sen or San Zan when trading San Ku or San Pei. However, San Poh will often be traded alone. The same can be said of San Pei, which can be used to jump on to an ongoing trend. We should not be surprised to find all of these phases together when a single trade within a single phase is in play. The market is a whole in which each and every phase depends on the others.

Most of our examples here are in a daily time frame. However, the method is valid for any time frame. It can be used for intraday trading, as well as for end of day, weekly, monthly, or longer time frames.

Do not rely on the examples shown here for your trading. Before trading any of the methods shown here, you must first test them, and see them working on a valid and large sample. Then, they should be built into a system to be traded within a plan, as we will explain in a later chapter.

EXAMPLES USING THE FIVE SAKATA METHODS

Method 1 (San Zan): Selling of a Triple Top (Figure 8.1)

In this example, once the triple top is in place, we sell short as soon as the 'three black crows' appear. We will sell at the close of the third candlestick of this pattern.

Method 2 (San Sen): Buying a Triple Bottom (Figure 8.2)

In this example, once the triple bottom is in place, we will buy the Marubozu that follows it. The market shoots upward. Our stop will be placed below the triple bottom. We can exit at the third gap or follow the trade with a trailing stop.

Method 3 (San Ku): Buying a Gap (Figure 8.3)

As soon as the last gap of the previous trend that had at least three gaps in it is closed during the new upward trend, we will buy. We will buy only if a pattern appears that will validate the upward trend. In this case, the validating pattern is a Marubozu, but it could have been another pattern developing after the closing of the gap. It would also have been better to have a triple bottom before or after the closing of the third gap to provide added confirmation that a long trend is probably developing. Such is not the case here.

Method 3 (San Ku) and Method 1 (San Zan): Selling a Gap (Figure 8.4)

Before selling short, we need the previous ascending trend to have at least three gaps. The arrow in the chart shows the last gap. After the last gap, a triple top is formed (San Zan). We wait for the gap to be closed (San Ku) and then we wait for a validating pattern to confirm the new downtrend. This validating pattern is the 'three black crows,' which belongs to San Pei. This shows how three different market phases (San Ku, San Zan, and San Pei, in this instance) are focused on the execution of a single trade. We exit at the third descending gap or with a trailing stop.

Method 4 (San Pei): Buying a Trend (Figure 8.5)

Here we buy an ongoing trend. The 'three white soldiers,' the bullish candlestick pattern that belongs to San Pei, confirms the ongoing trend and validates our buying. We buy at the close of the last San Pei candlestick. The market continues its uptrend.

Figure 8.1. US T bonds continuous chart (daily) (Metastock Chart Courtesy of Equis International).
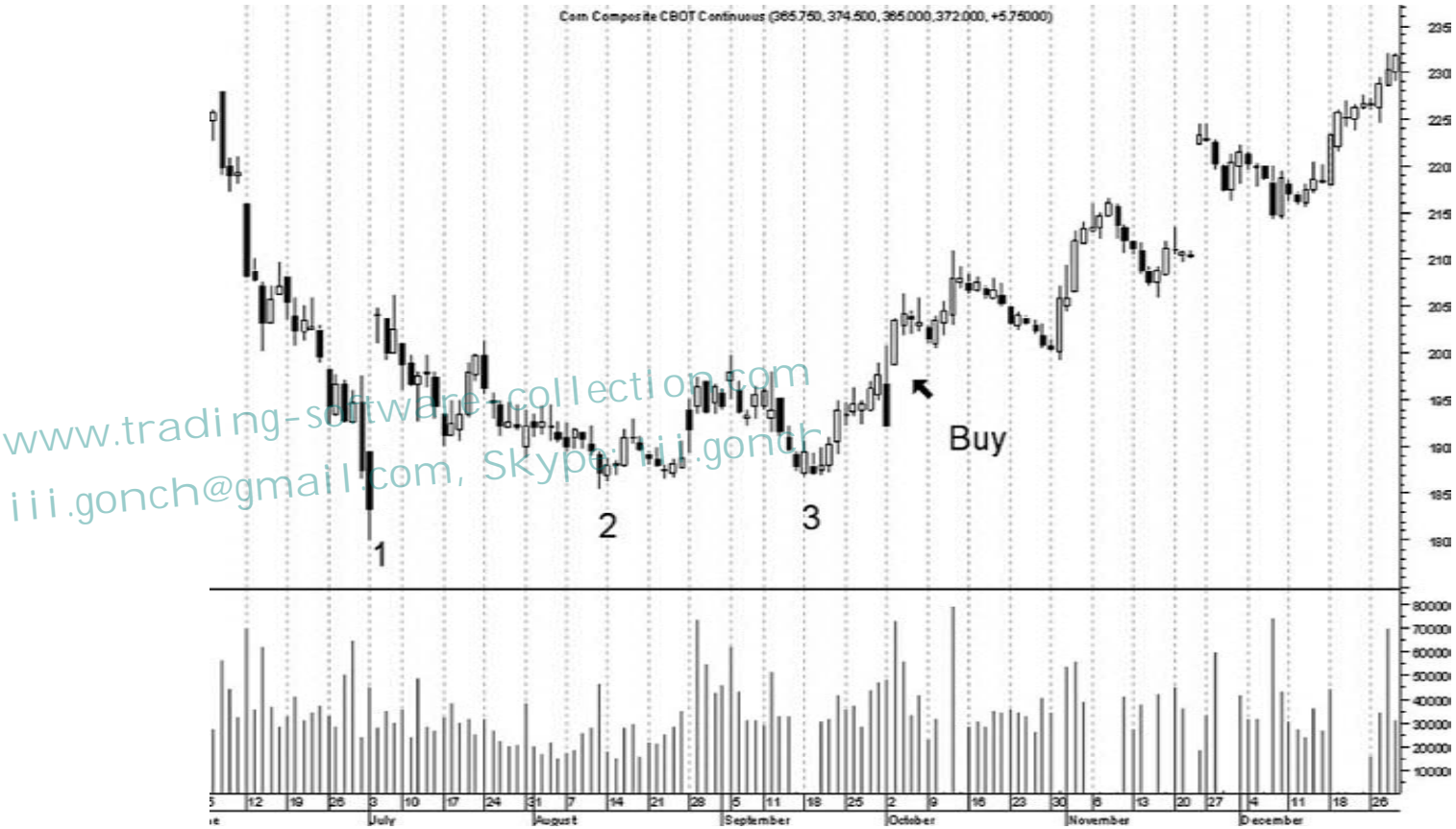
Figure 8.2. Corn continuous chart (daily) (Metastock Chart Courtesy of Equis International).
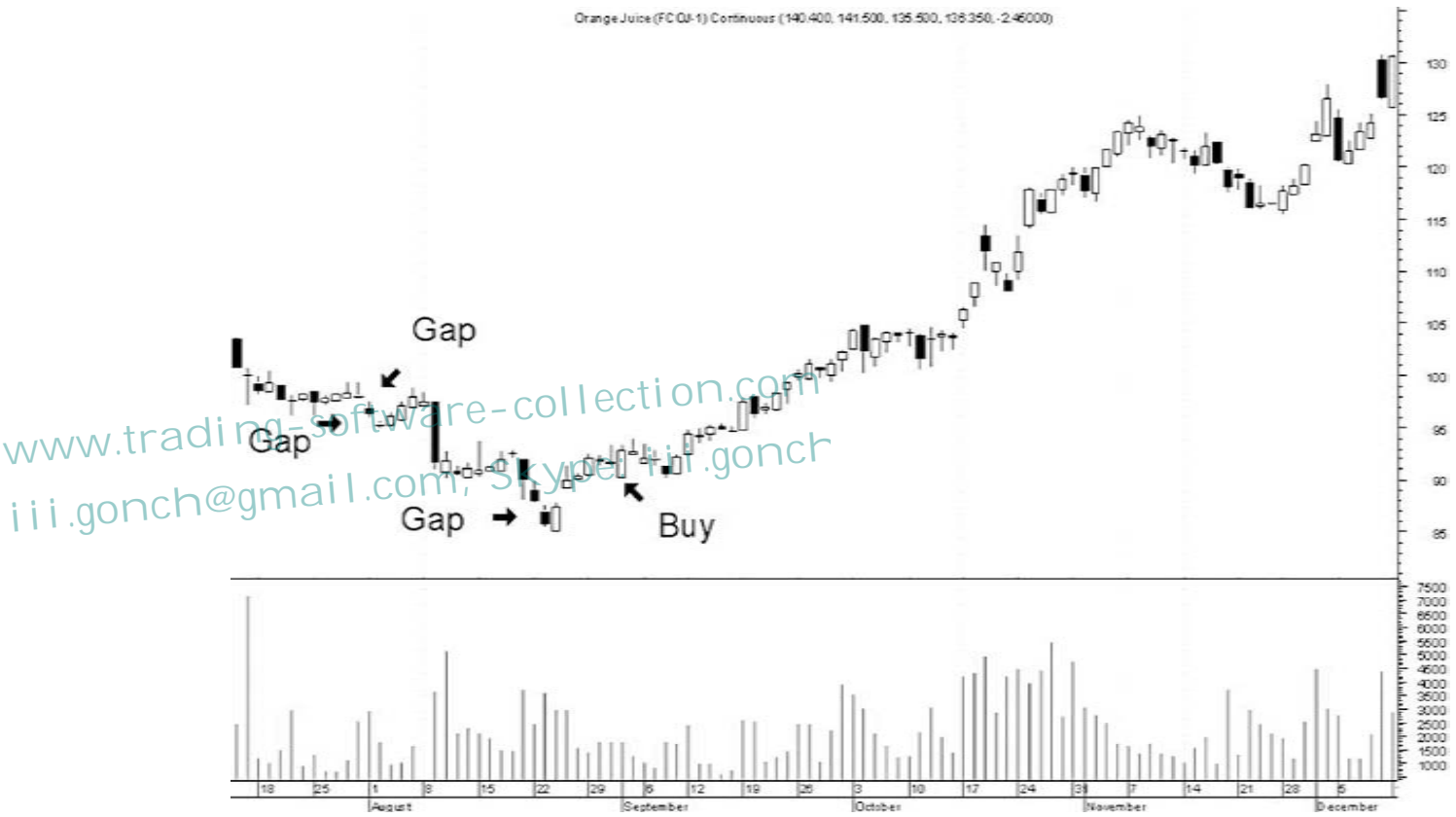
Figure 8.3. Orange juice continuous chart (daily) (Metastock Chart Courtesy of Equis International).

Figure 8.4. Natural gas continuous chart (daily) (Metastock Chart Courtesy of Equis International).
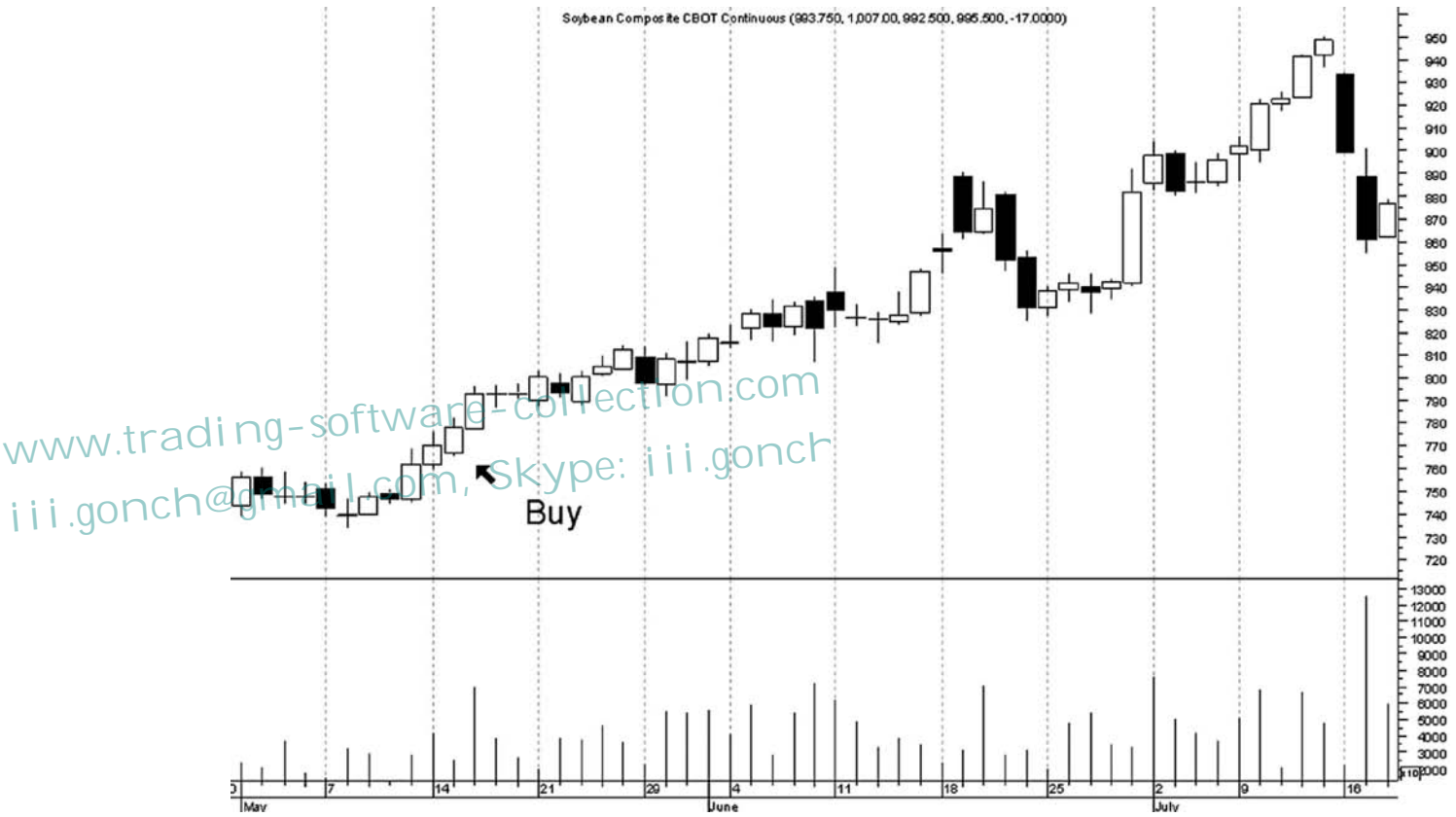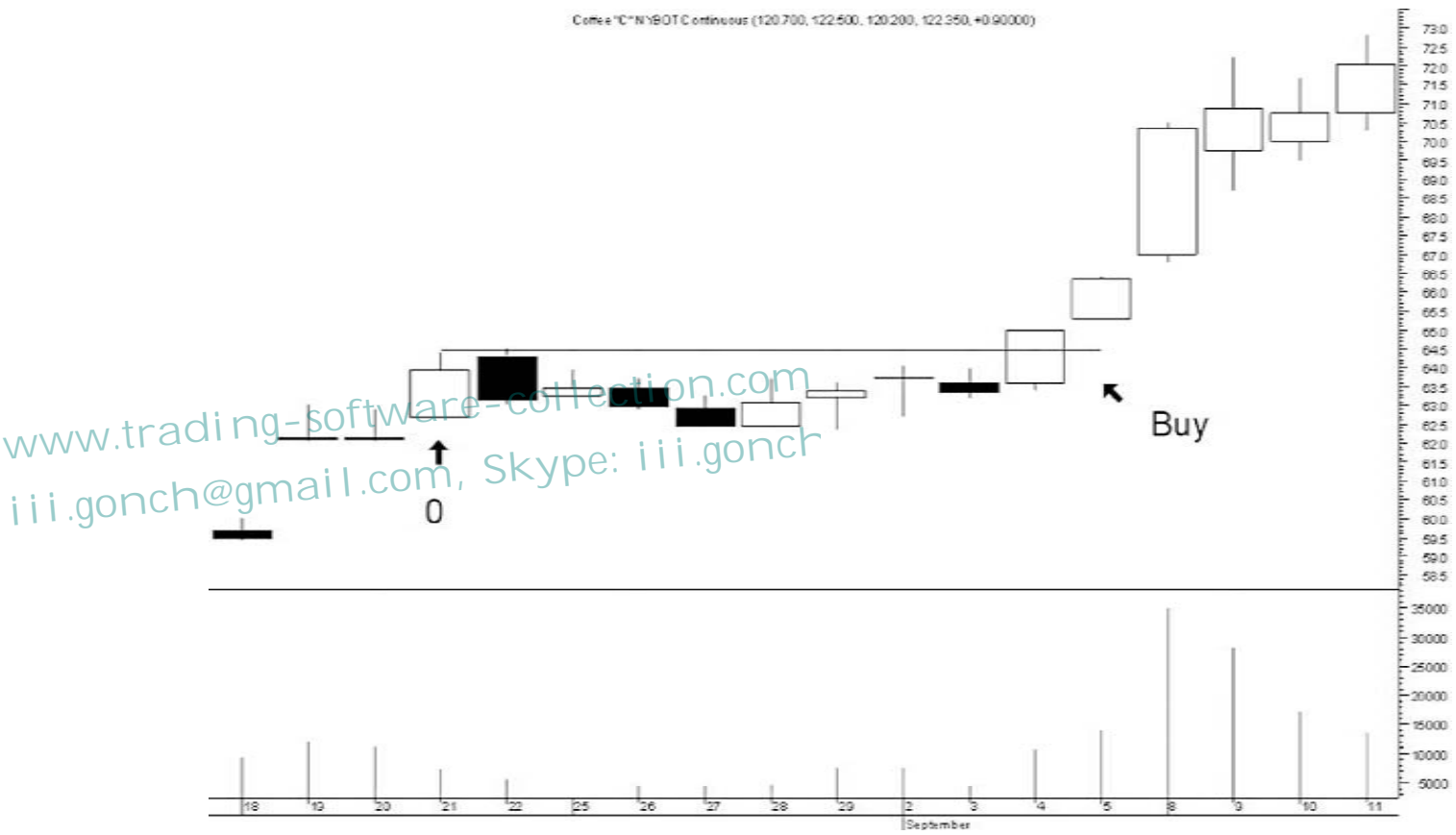
Figure 8.5. Soybeans composite continuous chart (daily) (Metastock Chart Courtesy of Equis International).

Method 4 (San Pei): Selling Short on a Downward Trend (Figure 8.6)

We sell short as soon as the 'three black crows,' the bearish candlestick pattern that corresponds to San Pei, confirms the ongoing downward trend. We will sell short at the close of the third and last candlestick of the bearish pattern. Following our short sale, the market continues its downfall. San Pei enables us to jump on to ongoing trends.

Method 5 (San Poh): Buying a Correction (Figure 8.7)

We buy at the close of the candlestick that breaks out at the high of the Marubozu (0) origin of three corrective inside candlesticks. After the breakout, the market continues its upward trend. We place our stop below the candlestick (0) origin of San Poh. We can follow the trade with a trailing stop.

Method 5 (San Poh): Selling Short on a Corrective Move within a Downtrend (Figure 8.8)

The market corrects upwards for three days, following a black candlestick (0). This is the candlestick that contains the correction. After this correction, the market continues its downward move until a breakout at the low of candlestick origin of the correction (0) occurs. This is our signal to go short. We will therefore sell at the close of the breakout day. Having a long day candlestick at the breakout of the low of San Poh gives added strength to the trade. The market continues its downfall for a long time.

Method 3 (San Ku) and Method 2 (San Sen): Buying a Gap Following a Triple Bottom (Figure 8.9)

Here the trade consists in buying at the close of the last gap validated by the triple bottom. We wait for the closing of the last gap of the previous trend. The previous trend satisfies our condition of having at least three descending consecutive nonintersected gaps (horizontal arrows). As soon as the last gap is closed, after the higher triple bottom (1, 2, 3), we buy a Marubozu that closes the gap. The market immediately gaps upward and continues its bullish trend.

Gas Natural NYMEX Continuous (7.17600, 7.22700, 7.07300, 7.21300, +0.03000)

Sell
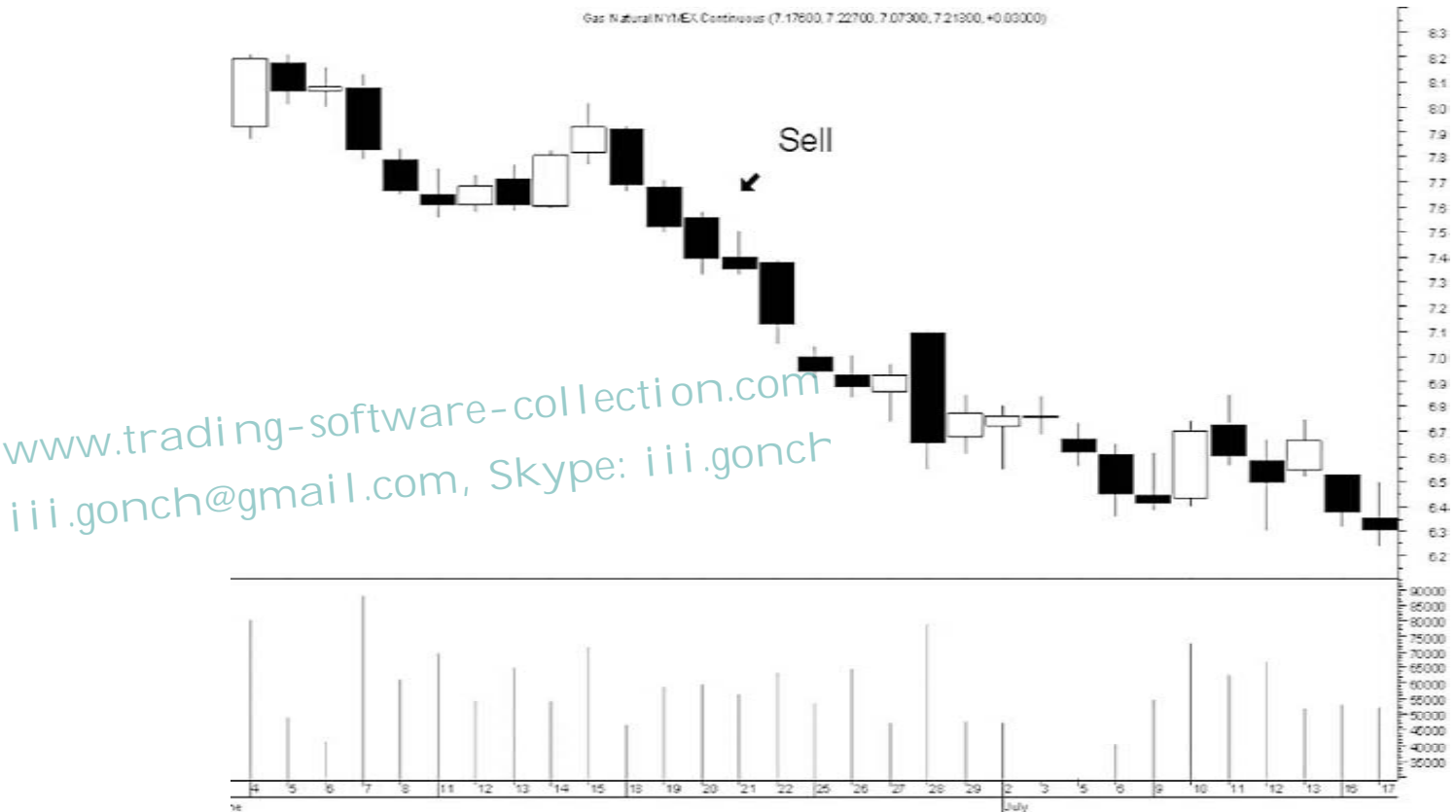
Figure 8.6. Natural gas composite continuous chart (daily) (Metastock Chart Courtesy of Equis International).

Coffee "C" NYBOT Continuous (120.700, 122.500, 120.200, 122.350, +0.90000)

Figure 8.7. Coffee C continuous chart (daily) (Metastock Chart Courtesy of Equis International).
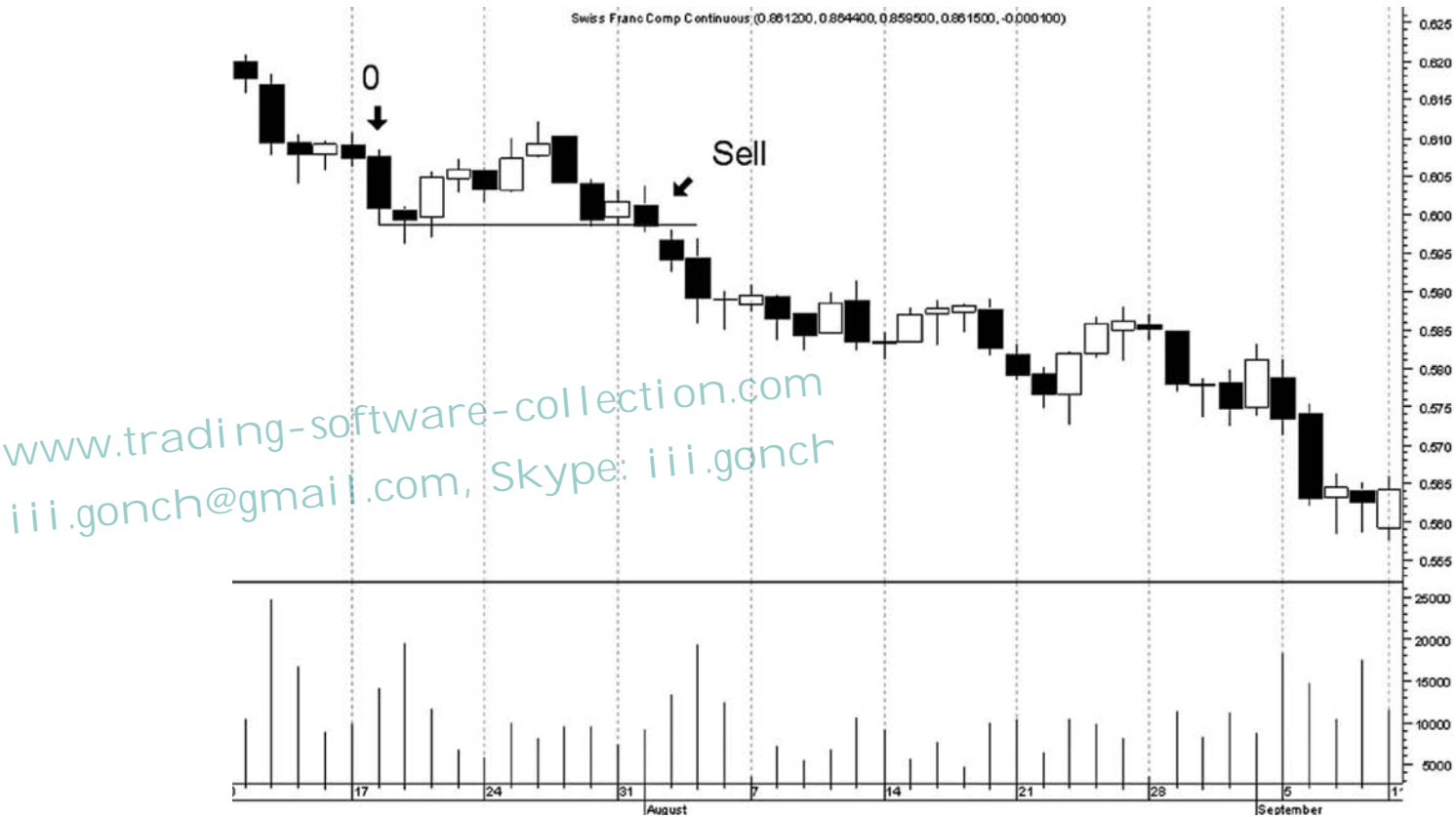
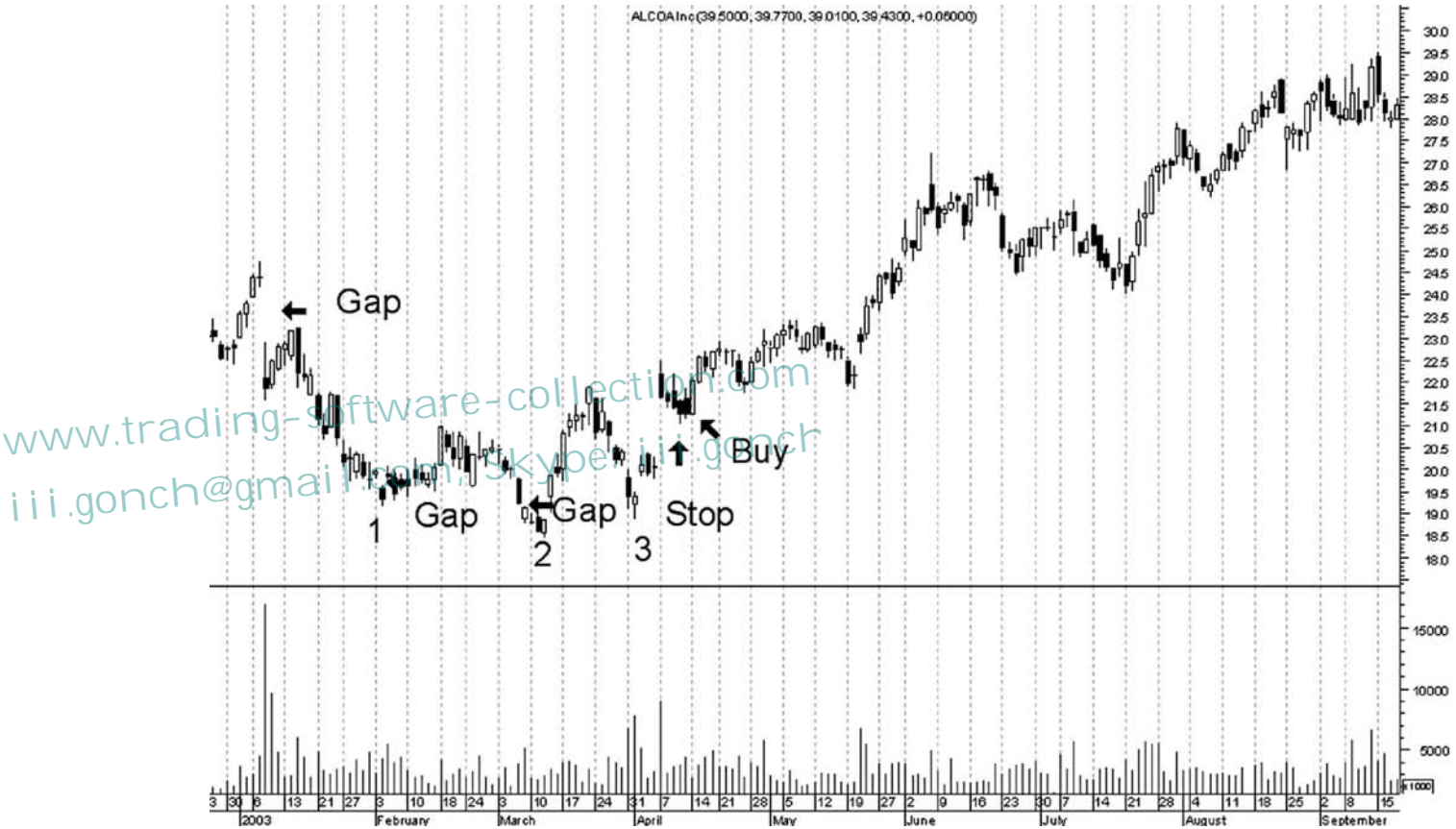**Figure 8.8.** Swiss franc composite continuous chart (daily) (Metastock Chart Courtesy of Equis International).
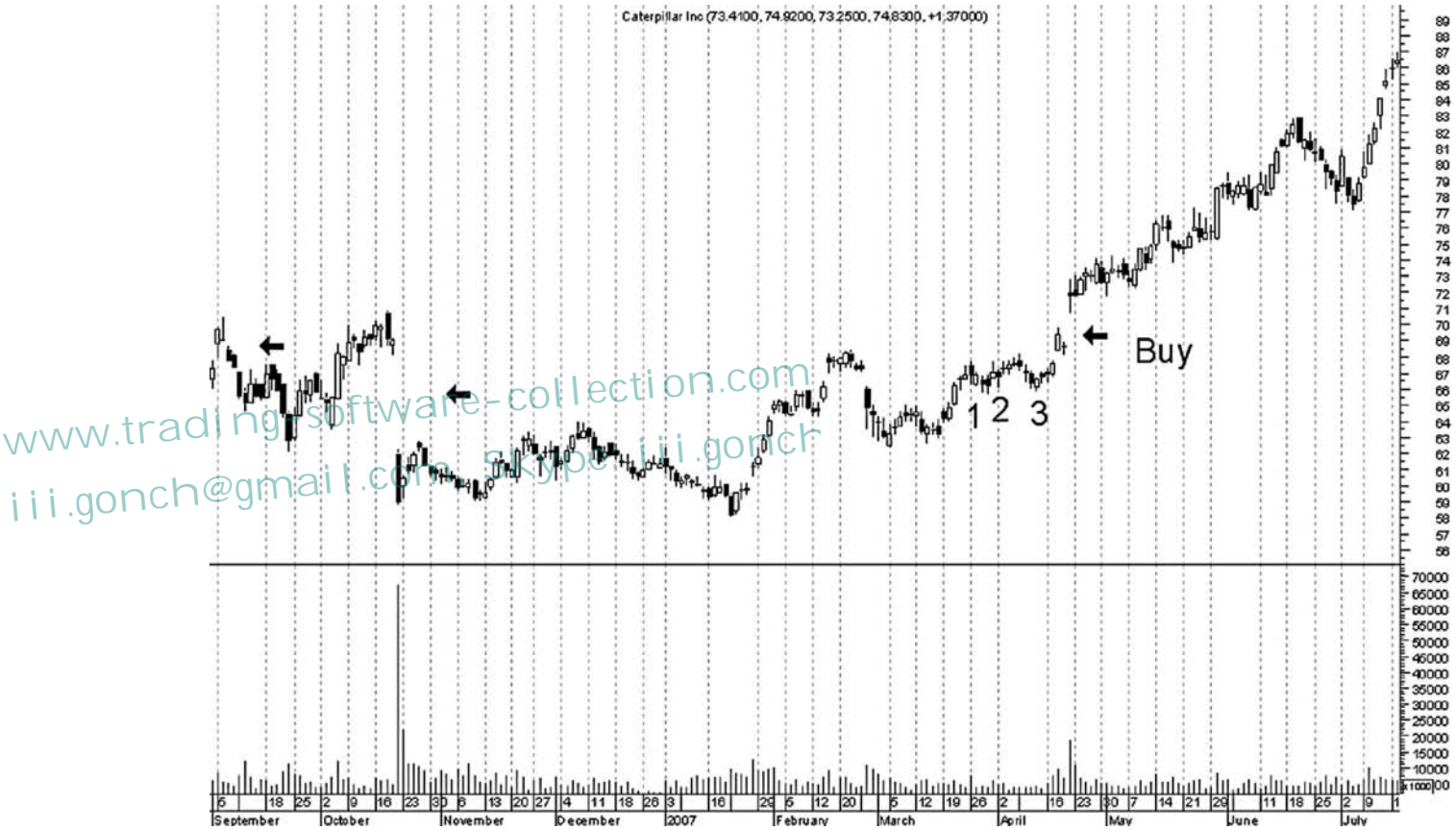
Figure 8.9. Caterpillar (daily) (Metastock Chart Courtesy of Equis International).

Method 3 (San Ku) and Method 2 (San Sen): Buying a Gap and a Triple Bottom (Figure 8.10)

When the previous downward trend has the necessary three descending gaps and a triple bottom is in place, we wait for the close of the gap. When the gap is closed and a Marubozu appears, we have our signal to buy. The trend continues its upward move.

Method 3 (San Ku) and Method 1 (San Zan): Selling a Triple Top after the Close of the Last Gap of the Previous Trend (Figure 8.11)

Here we had at least three gaps in the previous trend and a triple top (San Zan) is now in place. We need a validating pattern to sell. It arrives in the form of San Pei, which corresponds to the bearish 'three black crows' candlestick pattern. We will sell short at the close of the third candlestick of this bearish pattern. Our stop is placed at the swing high or at the initial candlestick of the pattern.

Method 5 (San Poh): Buying on a Corrective Move (Figure 8.12)

We wait for a corrective move of three inner candlesticks to take place within the candlestick origin of the correction (0). We then wait for the market to revert to its upward trend and break the high of the candlestick origin of the pattern (0). In both trades in this chart, as soon as the breakout occurs, the market continues its upward trend. In the second San Poh correction, the market explodes upwards as soon as the breakout of the high of the candlestick of origin (0) occurs. San Poh is an opportunity to jump on to a trend that has already been established.

Method 2 (San Sen): Buying a Triple Bottom (Figure 8.13)

To buy this triple bottom, we confirm that the previous trend has at least three nonintersected gaps. Once the triple bottom is in place, we wait for additional confirmation. This confirmation arrives in the form of San Pei, with a bullish 'three white soldiers' candlestick pattern. This means that the upward trend from our triple bottom is ready. We buy at the close of the third candlestick that completes our bullish pattern. The upward trend continues with full strength. Notice that there is no need to wait for the last gap of the previous trend to close. See San Sen in our algorithm in tabular form in Table 7.1 in Chapter 7.

Figure 8.10. Alcoa (daily) (Metastock Chart Courtesy of Equis International).

Figure 8.11. Citigroup (daily) (Metastock Chart Courtesy of Equis International).
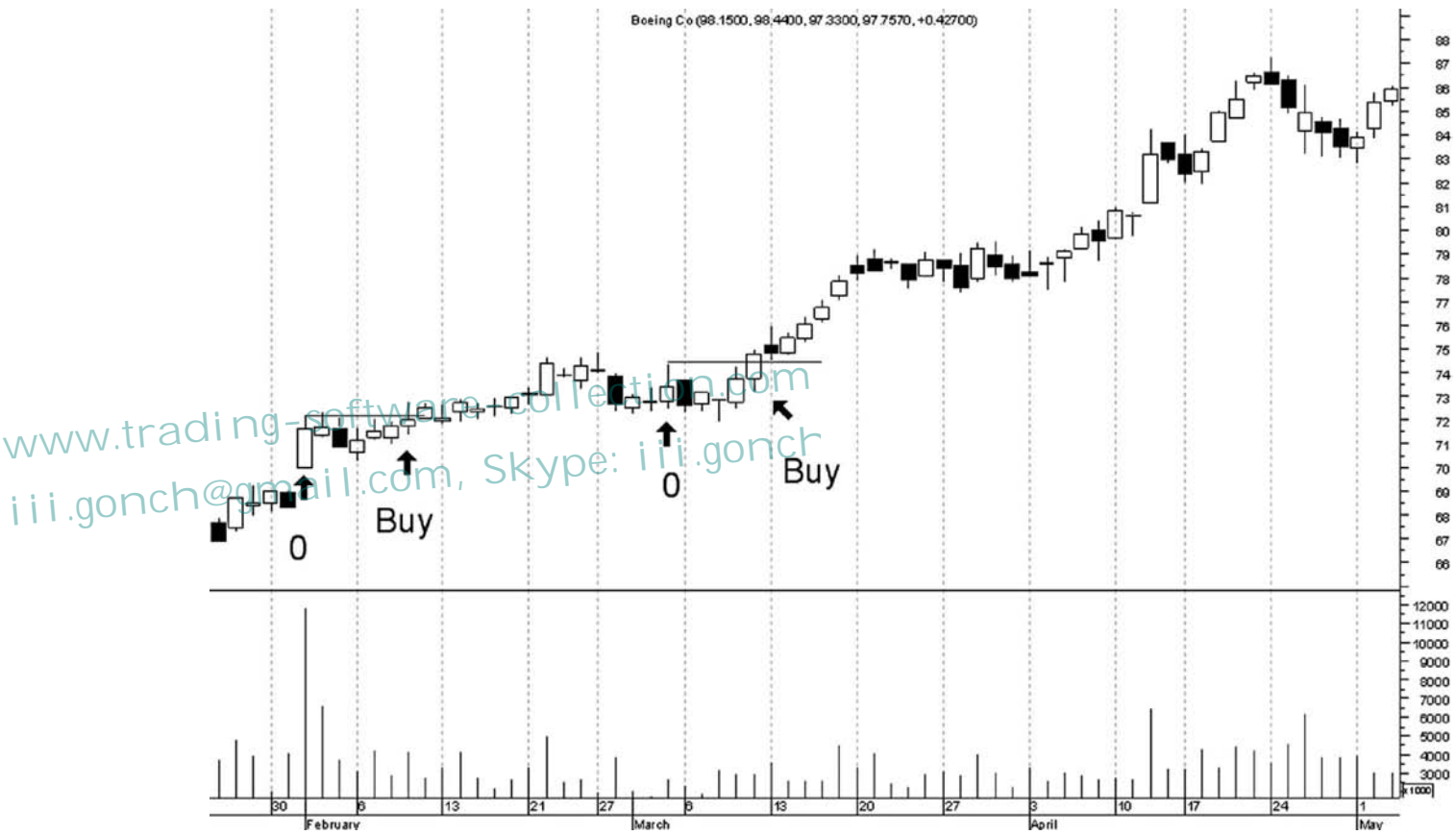
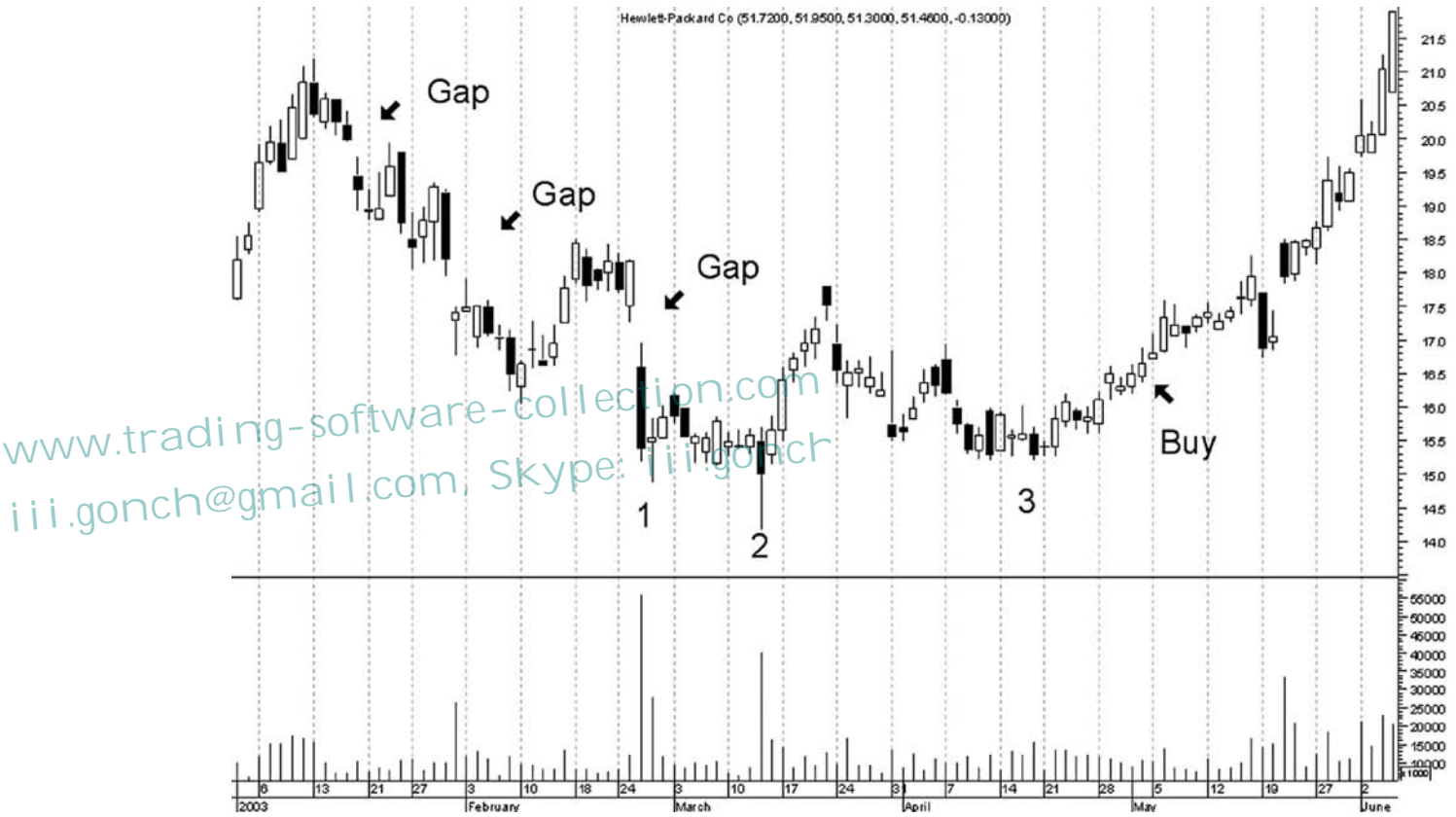**Figure 8.12.** Boeing (daily) (Metastock Chart Courtesy of Equis International).

Figure 8.13. Hewlett Packard (daily) (Metastock Chart Courtesy of Equis International).

Method 2 (San Sen) and Method 4 (San Pei) (Figure 8.14)

Once the inverted head and shoulders, a variation of the triple bottom, is in place, we wait for a sign that an upward trend has begun. This signal arrives in the form of San Pei (in this instance as the bullish 'three white soldiers' in candlestick language). We buy at the close of the last candlestick of the pattern. The market explodes into an upward trend.

Method 2 (San Sen): Buying a Triple Bottom (Figure 8.15)

Here the previous downtrend already has had three gaps, the last of which closed long ago. The market has reversed. Then, a higher triple bottom (1, 2, 3) was in place in February. All we need now is a signal that tells us to jump on to the trend that develops from the higher triple bottom. A long-range Marubozo appears. This means that we have enough thrust for a trend to begin. We will buy the Marubozo at the close and thus ride the trend.

Method 2 (San Sen): Buying a Higher Triple Bottom (Figure 8.16)

The market has reversed and closed the last gap of the previous downward trend. Then, a consolidation takes place and within it a triple bottom (San Sen) was completed in February (1, 2, 3). All that we need now is a signal to buy the triple bottom as soon as a trend begins from it. Our signal is a Marubozo. We buy at it and are in for the resumption of the trend, after the higher consolidation. Notice that we did not simply buy at the triple bottom. We wanted to have the highest probability that a new upward trend was beginning from it. The Marubozo gave us the thrust that we needed.

Method 3 (San Ku): Buying at the Close of a Gap (Figure 8.17)

We see that the market has reversed and is on the verge of closing the last gap of the previous downtrend. Our intention here is, specifically, to trade the gap. While we wait for the gap to close, a triple bottom takes place, and the gap is closed within its completion period. This triple bottom (San Sen) gives added assurance for our expected trade. Now that the gap is closed, we need a signal to jump on to the trend, which should begin from the triple bottom. San Pei, a 'three white soldiers' pattern, appears. We buy at the close of the last candlestick of that pattern and ride the new trend.
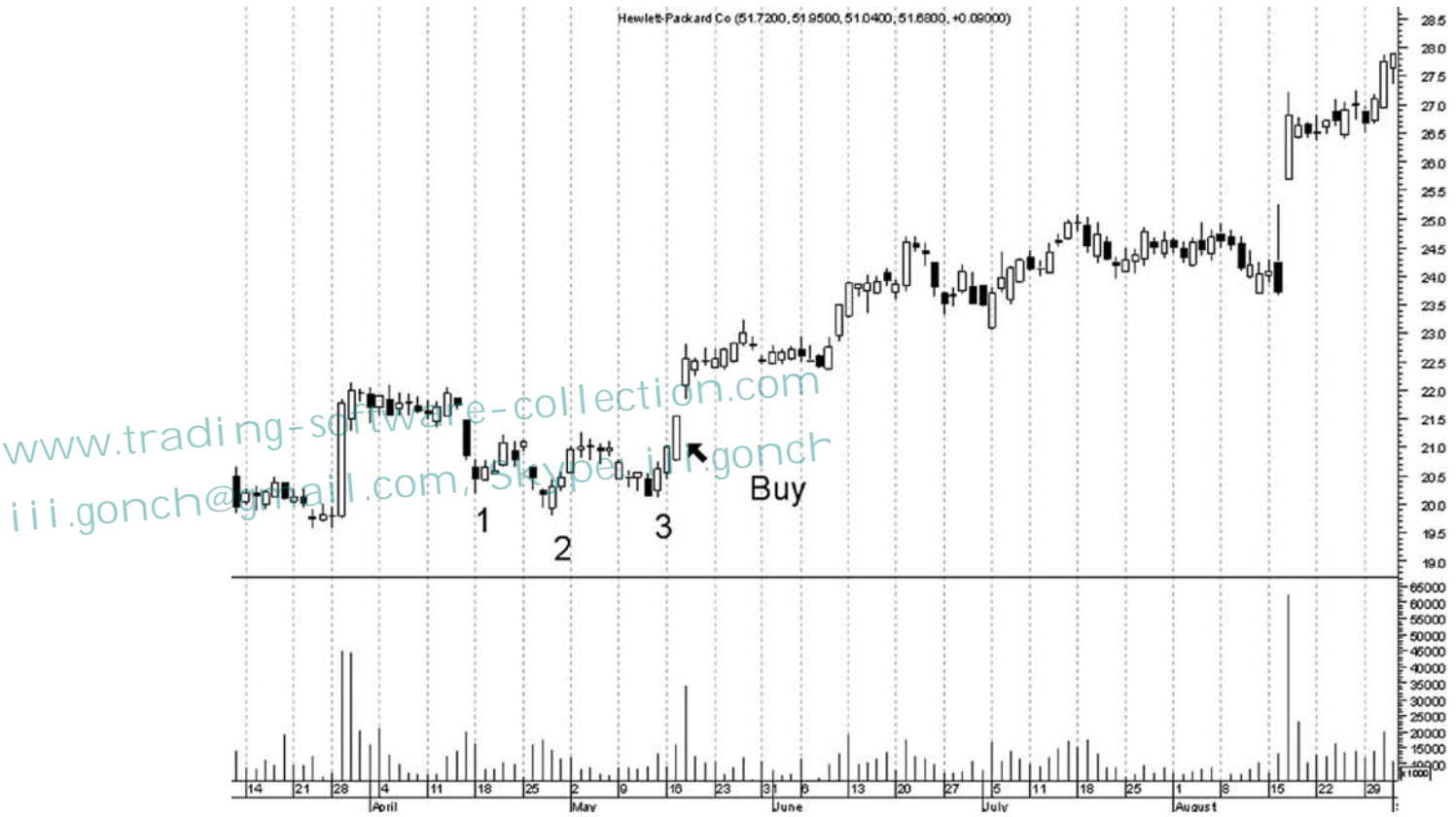
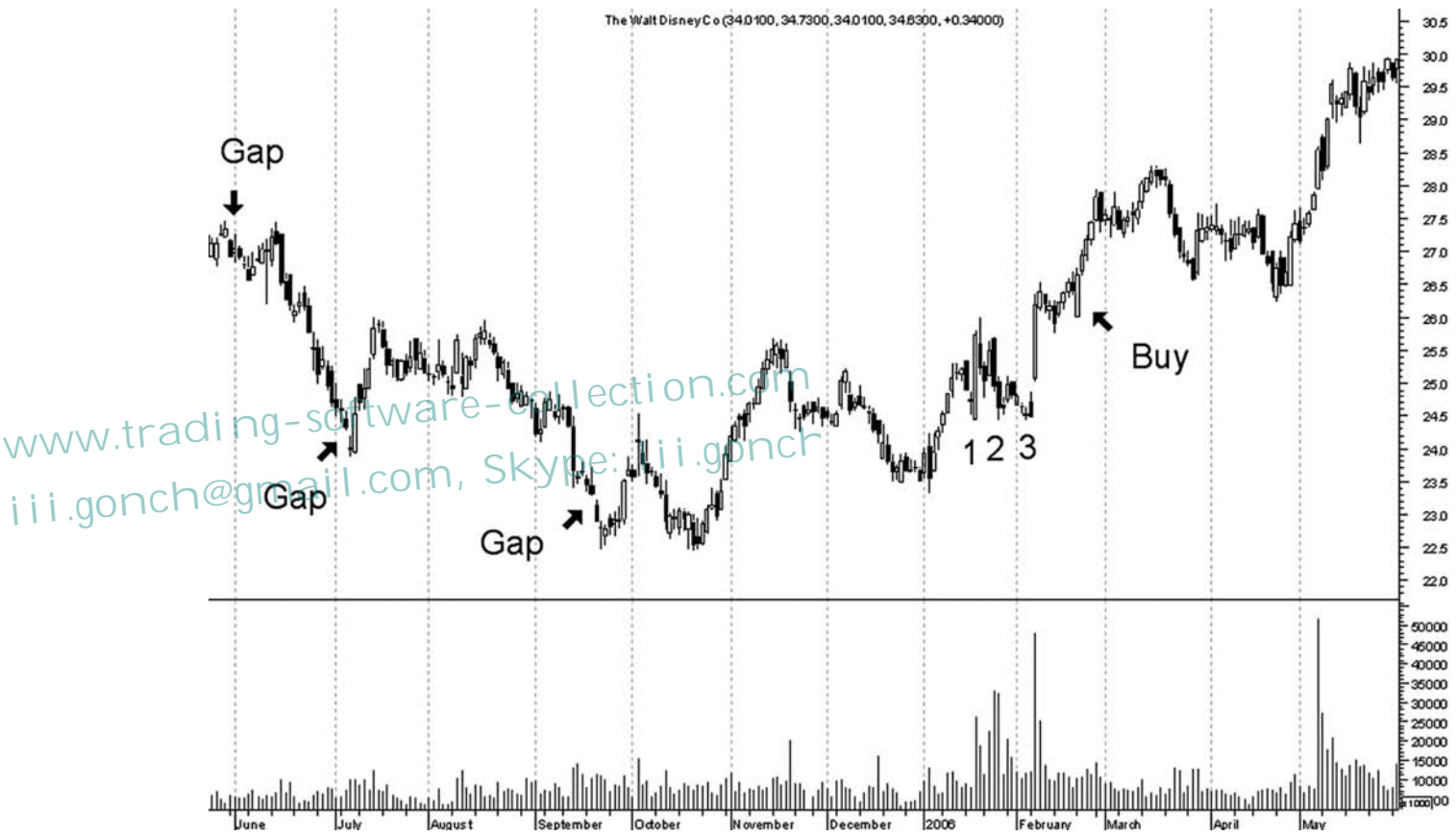**Figure 8.14.** Hewlett Packard (daily) (Metastock Chart Courtesy of Equis International).

Figure 8.15. Disney (daily) (Metastock Chart Courtesy of Equis International).

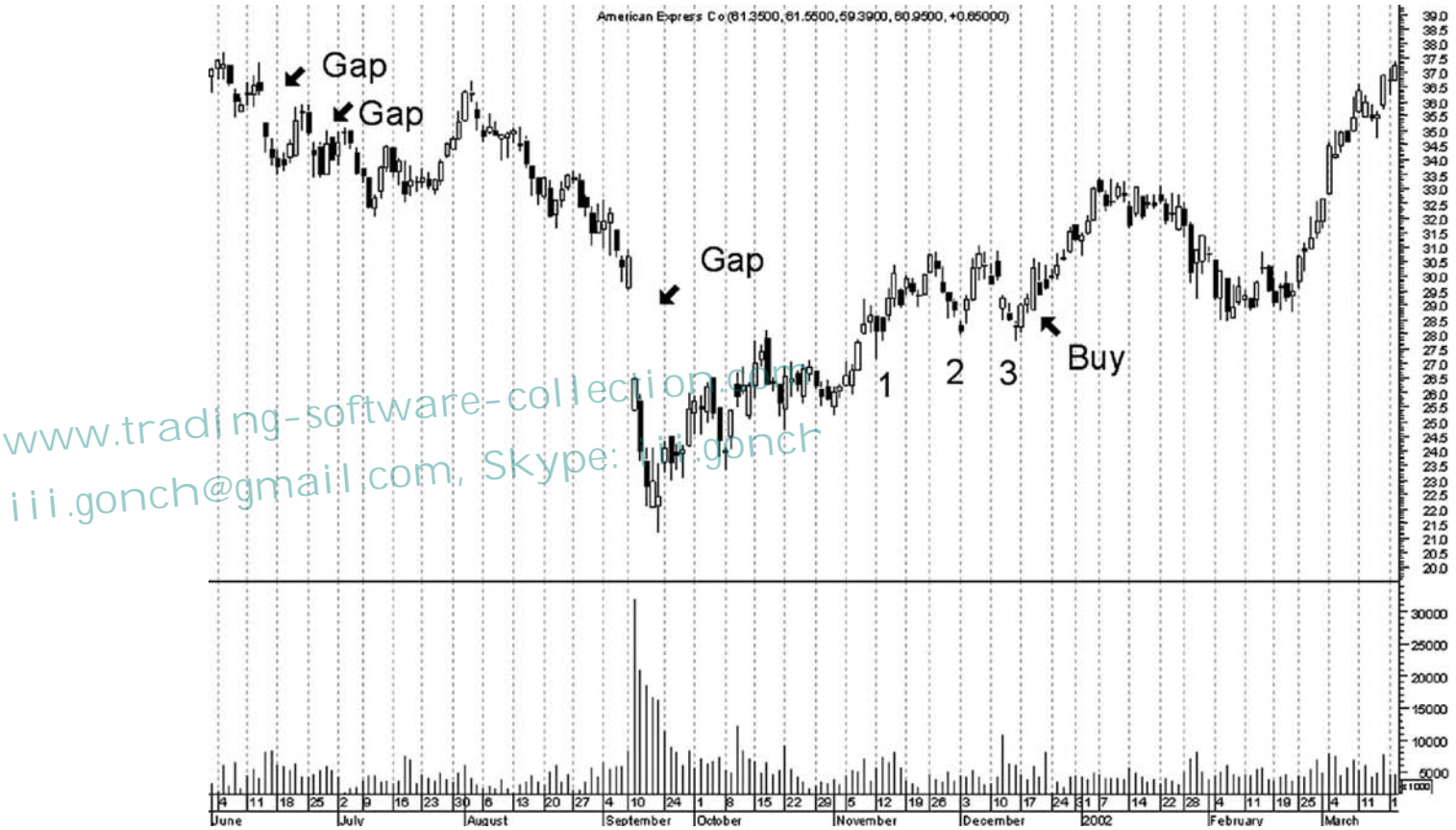**Figure 8.16.** American Express (daily) (Metastock Chart Courtesy of Equis International).

Figure 8.17. American Express (daily) (Metastock Chart Courtesy of Equis International).

Method 4 (San Pei): Buying San Pei within a Trend (Figure 8.18)

Here we use San Pei as a way to jump on to a trend that has already begun. As soon as San Pei appears within the trend, we buy at the close of its bullish 'three white soldiers' candlestick pattern; in that way San Pei appears within an upward trend. We had two buying opportunities here.

Method 2 (San Sen) and Method 4 (San Pei): Buying a Triple Bottom and the Microtrend Following It (Figure 8.19)

Here the market is in a long-term uptrend and has had a lengthy consolidation (from December to March). In March, a triple bottom (San Sen) took place (1, 2, 3). Then, San Pei, a bullish 'three white soldiers' candlestick pattern, appeared after the triple bottom. It signaled the end of the consolidation and a resumption of the long-term trend. We buy at the close the third candlestick that completes the three white soldiers pattern. We are in for a very long trend!

Method 1 (San Zan): Selling at a Triple Top (Figure 8.20)

The triple top (San Zan) (1, 2, 3) is GE's historical high of the year 2000. The previous upward trend has had more than three gaps (not shown in the chart). When a Marubozu appears after the triple top (San Zan), we have our signal to go short. We sell at the close of the Marubozu. The market falls and the bear market for GE begins.

Method 1 (San Zan): Selling Short at a Triple Top (Figure 8.21)

Between November 2001 and March 2002, after its decline in 2000 (see Figure 8.20), GE has an intermediate triple top (San Zan) (1, 2, 3). We have an opportunity to sell short at the triple top when San Pei appears as a 'three black crows' candlestick pattern. We sell short at the close of the pattern. The market falls and a long downtrend begins.

Method 1 (San Zan) and Method 3 (San Ku): Selling the Close of a Gap (Figure 8.22)

Here the idea is to sell at the close of a gap in the best of conditions. The previous upward trend had three consecutive nonintersected gaps. A triple top is also in place. Everything is almost ready for our short trade. Our idea is to sell at the close

Procter& Gamble Co (69.3500, 69.8900, 69.0400, 69.5200, +0.57000)

Buy

Buy

Figure 8.18. Procter and Gamble (daily) (Metastock Chart Courtesy of Equis International).

Exxon Mobil Corp (91.4600, 92.1800, 90.5000, 91.9900, +0.95000)

Buy

1 2 3

November   December   2007   February   March   April   May   June   July

Figure 8.19. Exxon (daily) (Metastock Chart Courtesy of Equis International).
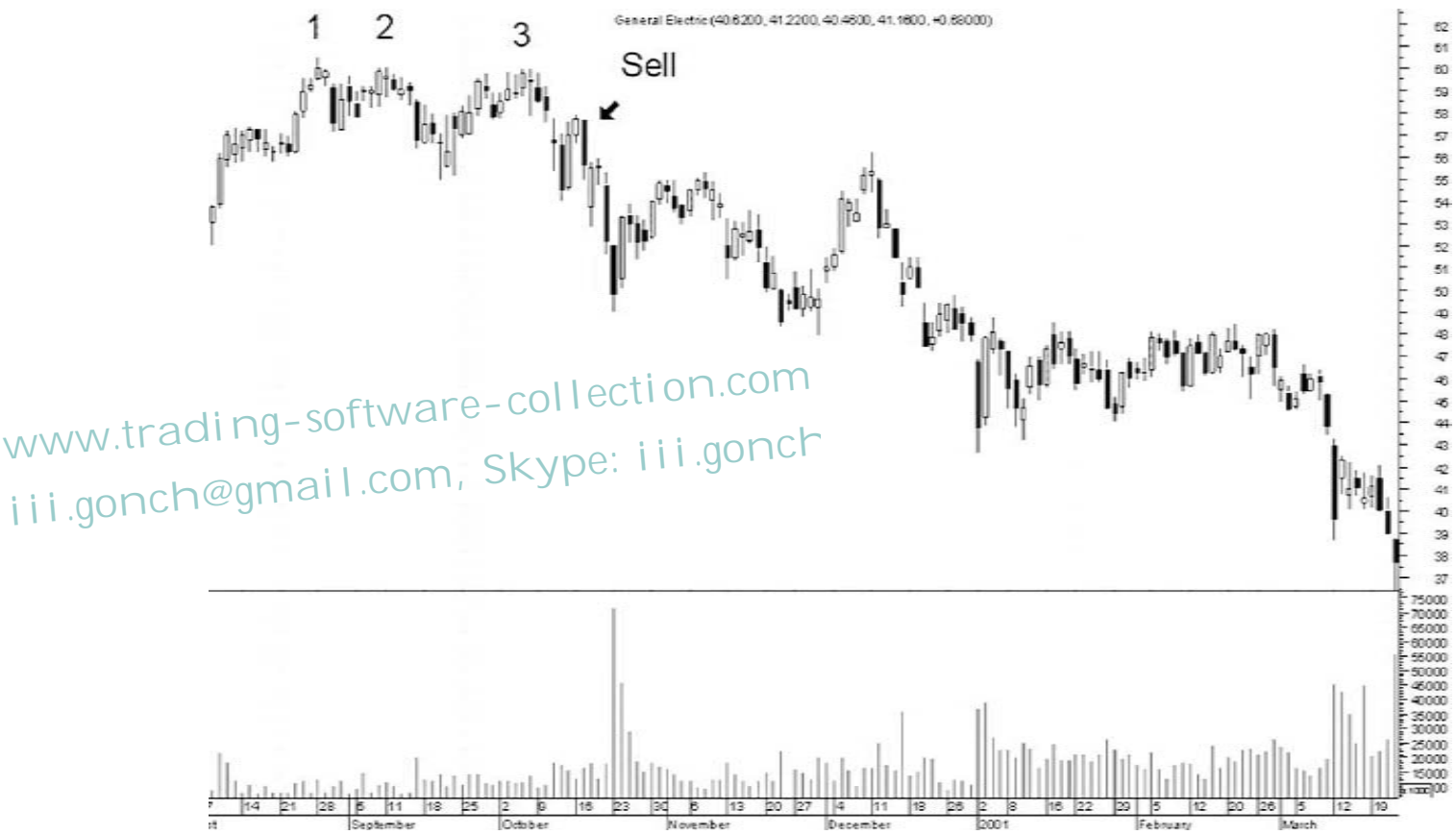
Figure 8.20. General Electric (Metastock Chart Courtesy of Equis International).

Figure 8.21. General Electric (daily) (Metastock Chart Courtesy of Equis International).

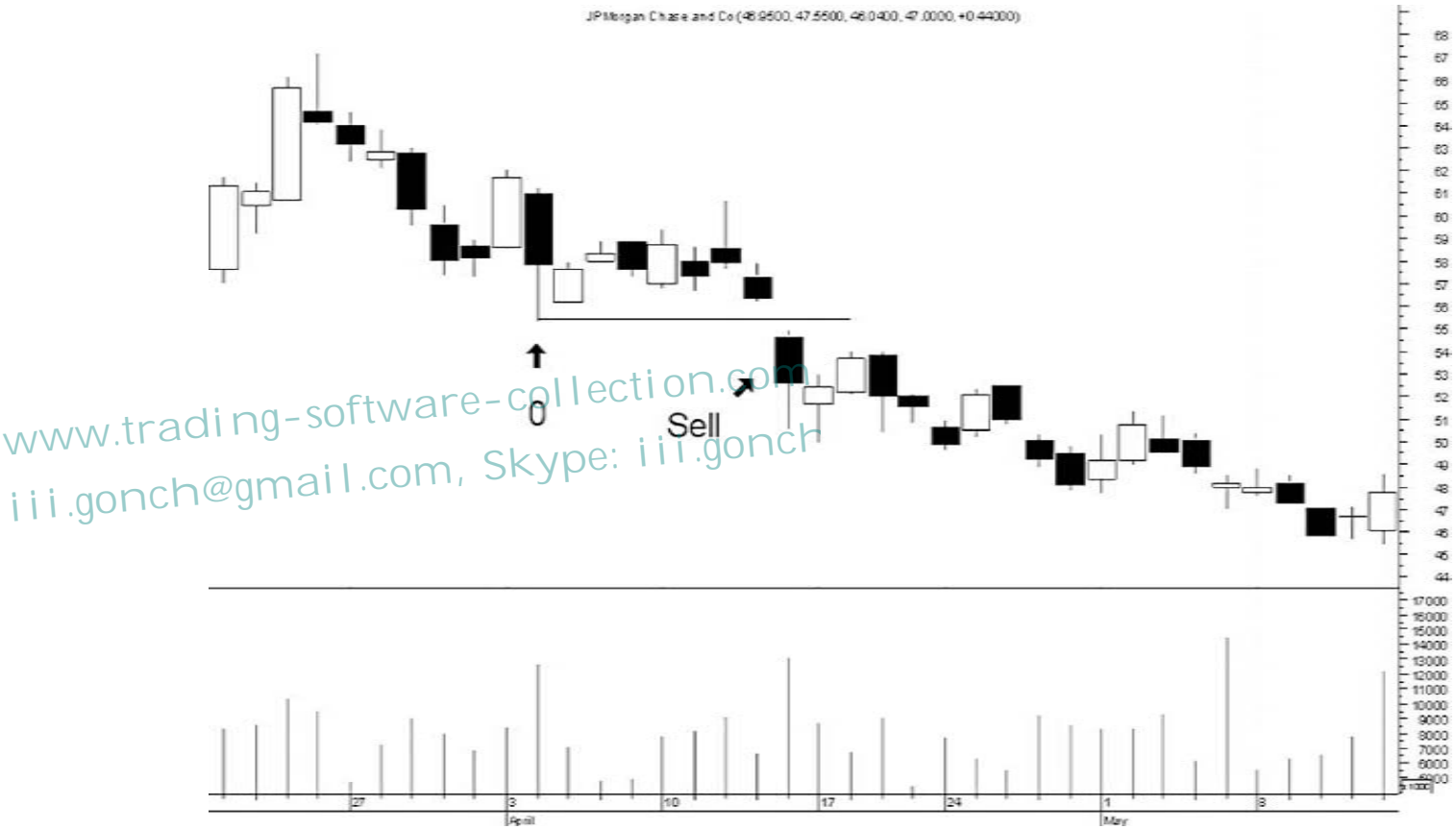**Figure 8.22.** Altria (daily) (Metastock Chart Courtesy of Equis International).

of the last gap, taking advantage of the other elements in our favor, such as the three gaps and the triple top. We notice that the last gap is not too distant from the triple top. We therefore decide to wait until the gap is closed, ensuring that all existing elements are in our favor. Our waiting is rewarded. As soon as the gap has been closed by a San Pei, we sell short. The market falls precipitously.

Method 5 (San Poh): Selling on a Correction (Figure 8.23)

In October, a very long range Marubozu (0) is the origin of a correction. At least three corrective candlesticks take place within the Marubozu. The Marubozu has 15 inside days before the breakout occurs. In November, the breakout occurs. We buy at it. The upward trend continues.

Method 4 (San Pei): Selling a Trend (Figure 8.24)

We had a previous trend with at least three gaps. A triple top (San Zen) (1, 2, 3) is also in place and the last gap of the previous trend is closed. We now want an opportunity to enter the downward trend with the greatest chance of success. Here is where San Pei appears, as a 'three black crows' pattern. As San Pei is a microtrend, the bearish trend is already in progress. We therefore sell at the bearish 'three black crows' pattern at the close of its last candlestick. The downtrend continues.

Method 5 (San Poh): Selling Short on a Correction within a Trend (Figure 8.25)

We have during the ongoing downtrend a candlestick (0) within which we find three corrective inside candlesticks with higher closes against the current trend. When the market reverses, a time will come when the low of the candlestick that contained the correction is broken out. We sell short at the close of the breakout candlestick. The trend continues its downward course. Remember that, even though Sokyu Honma buys or sells on corrections, he never does so against the trend. He waits for the correction to reverse and the former trend to resume its course before buying or selling. This is what San Poh is all about.

Method 5 (San Poh): Selling Short on a Correction (Figure 8.26)

In June 2004, during a downward trend, a Marubozu appears (0). It will be the origin containing a series of inside candlesticks, with at least three higher closes,

Figure 8.23. Altria (daily) (Metastock Chart Courtesy of Equis International).

Figure 8.24. Wal Mart (daily) (Metastock Chart Courtesy of Equis International).

Figure 8.25. Morgan Chase (daily) (Metastock Chart Courtesy of Equis International).
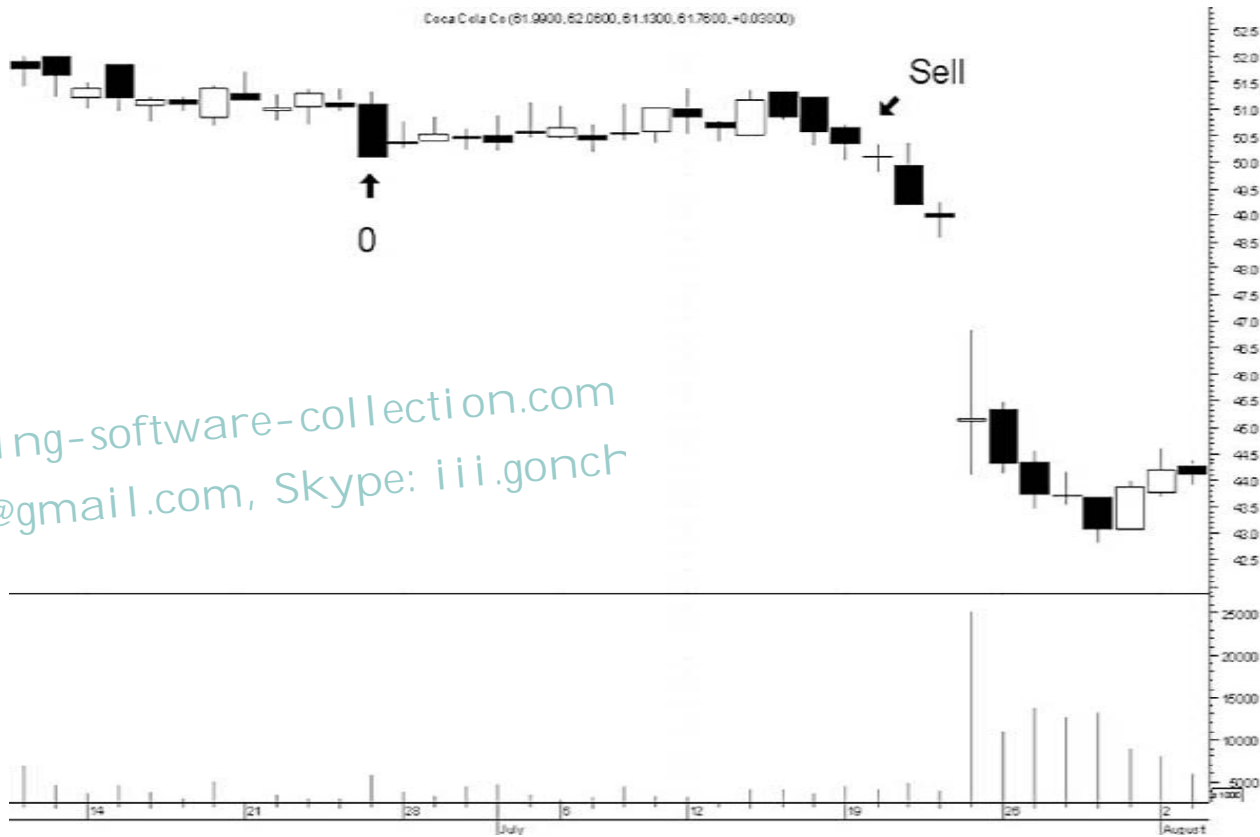
Figure 8.26. Coca Cola (daily) (Metastock Chart Courtesy of Equis International).

against the current downward trend. When the market reverses and resumes the downward trend, a candlestick will break the bottom of the candlestick containing the correction (San Poh). As soon as this happens, we will sell short at the close of the breakout candlestick. Notice how the breakout candlestick completes a San Pei pattern. This unexpected event gives added strength to our trade.

Method 2 (San Sen) and Method 4 (San Pei): Buying a Triple Bottom and Buying during a Trend (Figure 8.27)

Here we have a triple bottom that is in place in March 2007. As soon as the triple bottom is in place, a Marubozu appears, which happens to be the third bottom. We immediately buy at the Marubozu at its close. It tells us that there is thrust enough for the triple bottom to reverse into an upward trend. Shortly after, a San Pei, a 'three white soldiers' candlestick pattern, appears. We buy at it, since it is, in itself, a trend. We continue to ride the trend when, after a short consolidation, San Pei appears again. We buy at it. A third San Pei appears later. We buy at it too. This example shows us that it is possible to ride a trend and get on to it several times during its life.

Method 4 (San Pei): Buying into a Trend (Figure 8.28)

We are in 2006 and McDonald's is already in an upward trend. We want to buy into the trend with a high probability of success. To do this, we wait for San Pei (in this case, a 'three white soldiers' candlestick pattern) to appear, since it is an uptrend. San Pei appears four times during the upward trend, giving us the opportunity to buy into it. Buying is done at the close of the last candlestick of each San Pei pattern. Our stop can be placed at the low of the swing where the pattern appeared, or at the low of the candlestick that originated the San Pei pattern. We can then keep a trailing stop below each swing's low.

Method 5 (San Poh): Selling Short on a Correction within a Downtrend (Figure 8.29)

We are in a downtrend when a corrective consolidation takes place and a San Poh pattern appears within it. The origin is a long-range black candle (0) inside which we find three higher closes against the current trend. As soon as the market reverses and a breakout of the low of the origin of the San Poh pattern occurs, we sell short at the close. Observe how we sell short at the close of the candlestick just after the one where the breakout occurs. The reason for this is that the breakout candlestick closed inside the pattern, and we wanted to be sure that our short sale took place at

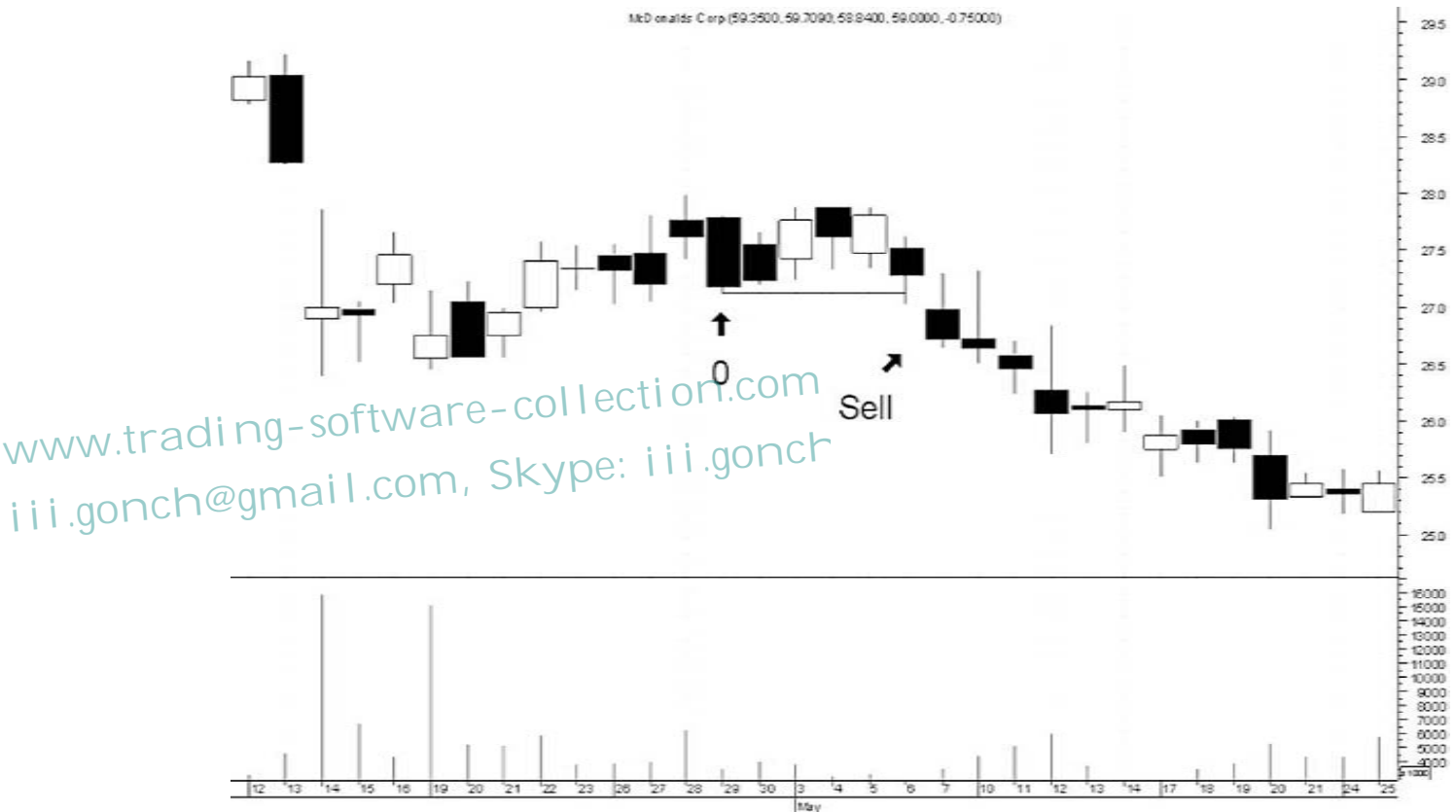**Figure 8.27.** McDonald's (daily) (Metastock Chart Courtesy of Equis International).

McDonalds Corp (59.3500, 59.7090, 58.8400, 59.0000, -0.75000)

Figure 8.29. McDonald's (daily) (Metastock Chart Courtesy of Equis International).

Figure 8.28. McDonald's (daily) (Metastock Chart Courtesy of Equis International).

a close outside of the pattern, the breakout having already taken place. As soon as we sold short, the market resumed its downward trend.

Method 5 (San Poh) and Method 2 (San Sen): Buying a Correction within a Trend and Buying a Triple Bottom (Figure 8.30)

We present two examples in this monthly chart to show how these methods also work for very long time frames and are helpful in studying the long-term conditions of the market.

Our first example (left side of the chart) is a San Poh. Within a monthly candlestick in the upward trend, three inside monthly candlesticks with lower closes took place in 1997. When the high of the candlestick that contains the correction is broken, it became possible to buy at the breakout. We see here that the upward trend resumed its course.

Our second example is a multiyear triple bottom (San Sen) (1, 2, 3). As soon as it was in place, a Marubozu, signaling that there was thrust, gave us a buying opportunity.

Long-term charts with long time frames are useful!

Method 1 (San Zan) and Method 3 (San Ku): Selling at a Triple Top and the Close of a Gap (Figure 8.31)

A triple top is in place after a previous trend with at least three gaps (only the last gap is shown in this chart). The last gap of the previous trend is so close to the triple top (San Zan) that it is worth our while to wait for the gap to close before selling short the triple top. This gives us an added advantage. We therefore wait for the gap to close and a signal pattern to appear. A San Pei ('three black crows' candlestick pattern) arrives, along with the closing of the last gap of the previous trend. We sell short at the close of the last candlestick of the pattern. This is the starting point of a strong and lasting downtrend.

Method 2 (San Sen) and Method 3 (San Ku) (Figure 8.32)

Here we have, at a glance, an interesting example of Sokyu Honma's great market cycle in one chart. After a triple top (San Zan) (1, 2, 3), a downward trend with three nonintersected gaps, and a triple bottom (San Sen) (1, 2, 3), a San Pei phase appears. This signals that the new upward trend is in progress. We buy at San Pei, in its bullish form of the 'three white soldiers' candlestick pattern. We buy at the

Figure 8.30. Microsoft (monthly) (Metastock Chart Courtesy of Equis International).
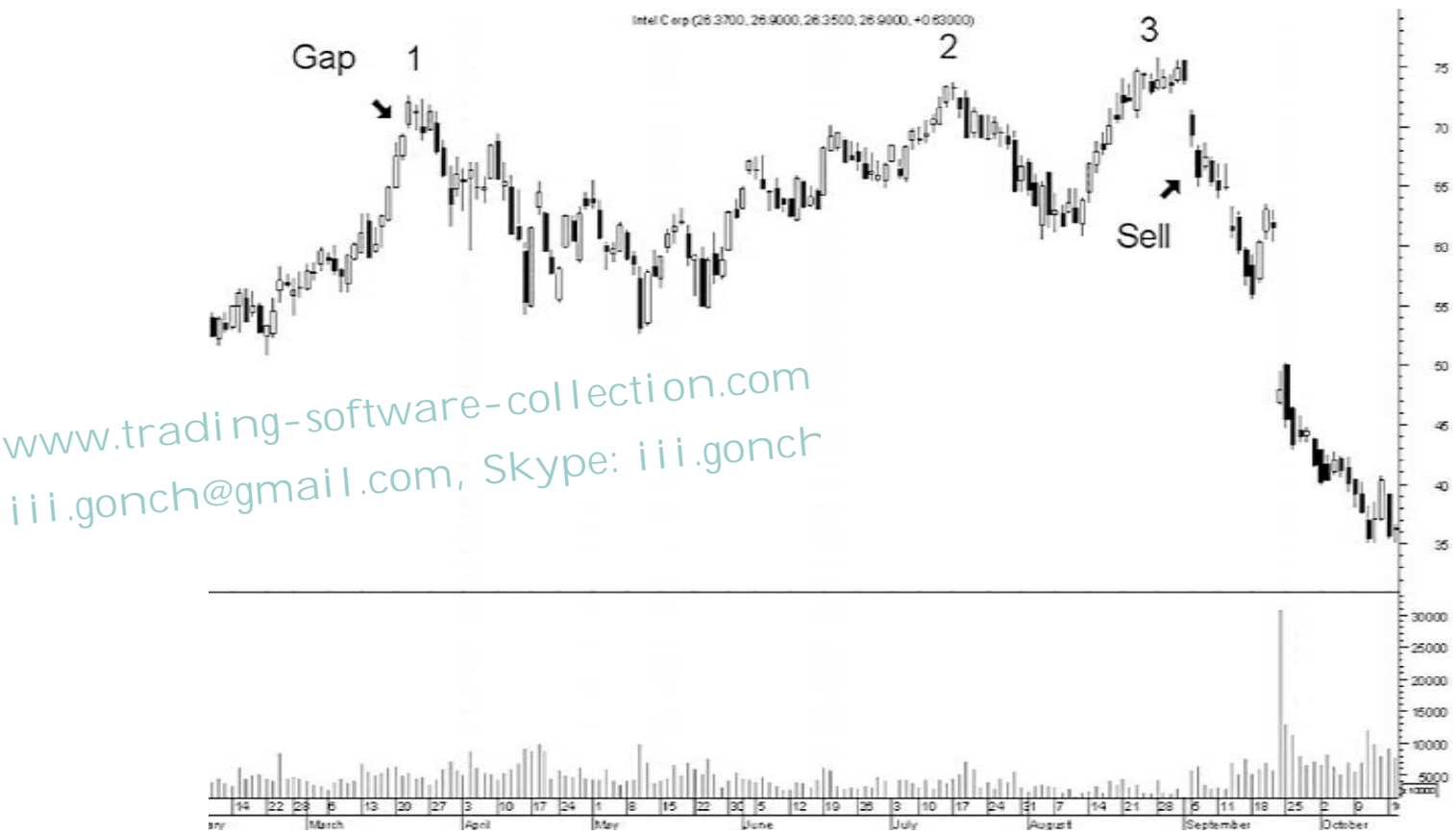
Figure 8.31. Intel (daily) (Metastock Chart Courtesy of Equis International).

Cisco Systems Inc(32.9400, 33.1900, 32.4900, 33.0600, +0.46000)

Figure 8.32. Cisco Systems (daily) (Metastock Chart Courtesy of Equis International).

close of the last candlestick of the pattern. This example gives us a synthetic, visual perspective of the different market phases and their trading methods, as explained in this book.

Method 3 (San Ku), Method 2 (San Sen), and Method 4 (San Pei) (Figure 8.33)

On 12 March 2003, the CAC is at its lowest. We wait for a triple bottom and the closing of the last of the gaps (horizontal arrows) of the previous downward trend. The closing of the last gap occurs first, and then an upward triple bottom takes place, telling us that the downward trend has probably ended and that a reversal is at hand. A San Pei arrives after the higher triple bottom has taken place. It arrives in the form of a bullish 'three white soldiers' candlestick pattern. This is our signal to get into the market. We buy at the close of the third candlestick of the 'three white soldiers.' The market has reversed and we are in a new and lasting upward trend.

Method 2 (San Sen): Buying at a Triple Bottom (Figure 8.34)

The S&P 500 hit its lowest bottom in 2002. It was the second of three bottoms in that year. After hitting its low, it made a third bottom. The San Sen phase was completed. However, the S&P had not gapped three times during its multiyear downward trend. To compensate for this, we decide to ask for further evidence of a reversal. This arrives as a higher triple top in the form of an inverted 'head and shoulders' (higher 1, 2, 3). Our entry signal is a Marubozu that appears after our higher triple bottom is in place. We buy for a long-term trade at its close in the weekly chart.

This is another example of these methods working on any time frame – a weekly chart in this case.

The next chart shows us the trend after our purchase.

Method 2 (San Sen): Continuation (Figure 8.35)

Here we can see the trend that has developed since the San Sen triple bottom. The market continued its upward long-term trend, with its intermediate normal reactions, until the writing of these lines. If you study the chart attentively, you will be able to discover another buying opportunity in the form of a San Pei. This shows that weekly charts can be traded, especially for the long term.

Figure 8.33. CAC 40 (daily) (Metastock Chart Courtesy of Equis International).

Figure 8.34. S&P 500 Index (weekly) (Metastock Chart Courtesy of Equis International).

Figure 8.35. S&P 500 Index (weekly) (Metastock Chart Courtesy of Equis International).

Figure 8.36. NASDAQ (daily) (Metastock Chart Courtesy of Equis International).

Figure 8.37. NASDAQ (daily) (Metastock Chart Courtesy of Equis International).

Method 3 (San Ku) and Method 2 (San Sen) (Figure 8.36)

Before hitting bottom in October 2002, the NASDAQ, during its downtrend, has at least three gaps, of which only the last one is shown in the chart (horizontal arrows). After the last gap was closed, a higher triple bottom (San Sen) (1, 2, 3) took place. The closing of the last gap of the former downtrend (San Ku) and the higher triple bottom (San Sen) that took place after the historical turning point low give us the conditions necessary to enter the market. For this, we need a signal that a new trend can develop from the higher triple bottom. It arrives as a very long range Marubozu. We buy it at the close.

What happened will be seen in the next chart.

Method 3 (San Ku) and Method 2 (San Sen): Continuation (Figure 8.37)

After we bought the Marubozu following the higher triple bottom (San Sen), the NASDAQ went into a lasting uptrending phase with normal fluctuations along the way.

9
Back to the Samni No Den

THE SAMNI NO DEN HAS IT ALL

Here we are, back to the *Samni No Den*. Let us explore it further.

The Samni No Den is where the real trading takes place. As stated previously, the five Sakata methods are only one aspect of the Samni No Den.

In Chapter 3 we mentioned briefly the rules of the Samni No Den, which will now be explored in detail. We want to be able to understand them so that we can apply them in a practical way in our trading.

In the Samni No Den, the trader will find a framework that will ensure that the essential aspects of a trading operation are covered. Trading is not about signals, as some would like to believe. Signals in themselves, although important, are not the key to successful trading. We can even say that success is possible without using trading signals. Signals must sooner or later fail – even the excellent ones. The reason is that signals do not always work. The market will sooner or later outwit any individual signal.

Imagine that you trade all of your assets in only one trade with a signal that has a 99 % probability of success, and you lose. This is exactly what bad trading is about. It does happen!

Traders do not ruin themselves because of bad signals, but because they badly manage their trades and have no plan. Bad traders think that trading is mainly about signals. They buy system after system in search of the trading grail. Never could they be so far from the truth. They should be looking in another direction – having a robust plan.

Despite what most traders believe, good traders can succeed even without the use of precise signals. This is because, for them, trading does not rely on a simple magic formula that tells them what and when to buy.

Sokyu Honma's methods provide an example of this perspective – that trading does not depend on a signal grail, even if such a thing existed. Sokyu Honma was fully aware of the limits of signals and patterns. That is why he was such a great

trader and history remembers him. This is also why the Emperor honored him as a samurai. Sokyu Honma knew how to win because he knew how to lose.

A plan is a necessity. Without one, we are at a loss as traders. The first thing that we need to learn is how to create a consistent and robust plan. Such a plan will enable us to trade for years – maybe for a lifetime. This is why the time and effort that is used in constructing such a plan is well spent. Consider it to be a lifetime investment.

In Sokyu Honma's Samni No Den, we find such a plan, which has all we need in order to trade successfully. This plan is a clear blueprint that we can follow. Of course, it must be adapted to our actual trading conditions and personalities. This plan shows that trading signals are not what are really essential for success.

Studying the Samni No Den will teach us how to create a plan that really works. To make this plan become a reality, there are certain conditions the trader must follow. These conditions imply an attitude, the trader's attitude, given as follows:

1. Totality. We must take everything into account. It is not enough to have market knowledge or to be able to distinguish the market phases and their underlying structure. We also need to know how to structure our trading, our strategy and tactics, risk control, and elements of money management. Above all, we need practical knowledge of ourselves – the kind of knowledge that can be integrated into a system. Our system must express the best in us and what we do best, which is entirely possible.

2. Integration. We must learn to integrate. Taking into account all elements is useless if we do not integrate them in a robust and harmonic methodology to apply flawlessly. Integrating also means that the different elements that will form part of your system will not be contradictory. The different elements of the entire trading operation must work smoothly and easily, without effort of any kind. Finally, integrating means not only the outward integration of the system but also the inner integration of our minds. This results from a deep understanding of what we are doing and why. We do not deserve to trade if we are not willing to understand what we are doing and why we are doing it.

3. Practice. We must learn to practice. We must begin to apply our trading method in the correct way. Perfection takes practice and true knowledge is always practical. Also, practice is where discipline is required. You must be able to practice consistently, in order to enhance your knowledge. You must become aware of the progressive benefits of practice and how your system will evolve within its own boundaries.

4. Forgiveness. We must learn to accept our mistakes and learn from them. Practice brings mistakes. It will teach us what our weak points are and the weaknesses of our system. This will enable us to perfect our personal approach to trading.

Without making mistakes, it would be impossible for us to correct and improve our actions. Mistakes are what make it possible for us to do the right things in the long run. In addition, mistakes bring knowledge of what we should not do. It teaches us to see obstacles so that we may avoid them and turn them into allies.

To be able to do all of this, we need to pay attention to Sokyu Honma's Samni No Den. Let us learn how to trade from him. That is what the rest of this book is all about: learning the teachings of a great trading master in a practical fashion.

To do this, it is our intention to develop the Samni No Den in a way that takes into account our present twenty-first century trading reality. This is entirely possible because the trading principles contained in the Samni No Den and the five Sakata methods are universal in their scope and specific in their application.

The principles that we find in them belong to all times and apply to every trading circumstance. The reason for this is that they belong to the essential core of the market itself, as well as to the trader.

Traders of all times and places can recognize themselves in these principles. Now we need to be able to incorporate these principles so that they become second nature to us. These principles embody not only a market cycle but also a trading cycle. Let us consider that concept.

THE TRADER'S CYCLE AND THE MARKET CYCLE

'Know thyself' is the main precept for trading success. This is not a vague psychological kind of knowledge. It is a very specific knowledge of who we are while trading. It concerns our trading personalities.

When we trade, emotions come into play, as well as perceptions and wishes. Many of these can bias reality, leading to failure. If we want to trade correctly, we need to learn why we want to trade and to accept trading reality in relation to ourselves. Most people simply want the excitement of what they think is trading. This is not a healthy trading attitude.

Trading implies a learning effort and the discipline to accept what trading is. Are we ready to accept this? If not, it is better not to trade.

This acceptance of trading begins with the recognition of what trading really is. Trading is not simply buying or selling in the market. It is much more than that. We could say that buying and selling are only the tip of the iceberg of what concerns trading. We need to have knowledge of the whole iceberg and not just its tip.

For this, we have one of the best possible teachers, Sokyu Honma and his Sanmi No Den of the market. Let us discover the cycles that it contains.

The Samni No Den teaches us about two cycles, the trader's cycle and the market cycle. In other words, the Samni No Den teaches us that there is a market

cycle, which we must acknowledge, but that there is also another cyclical sequence that we must consider, the sequence of the trader's behavior relative to trading.

The market sequence is objective. This means that it is independent of the trader. The market will go through its phases independently of what you do or think about it.

On the other hand, our trading behavior is subjective. It is dependent on the trader's actions and attitudes. Here is where the Samni No Den and its five rules come into play. Let us examine all of this.

As we have already indicated, first there is a market cycle, which is made up of the five phases to be traded, according to the five Sakata methods. This market cycle and its trading methodology are there outside of us. It is objective. It will appear as long as there are markets. Market phases will evolve without interruption, like clockwork.

The trading rules of the five Sakata methods are also objective. They can be compared to a formula that determines the phase of the market's cycle, if certain conditions exist. Our actions or attitudes will not change anything about it.

However, there is a trading cycle or sequence that pertains to us, as traders. If we do not follow this cycle or sequence, our trading will fail, even though there is objective market behavior. This trading cycle or sequence depends on us and has its own rules. That is why we call it subjective. It is our responsibility as traders to ensure that this cycle gets to completion. No one can do this but us.

This objective market cycle and the subjective trader's sequence integrate in trading, producing a composite cycle that integrates the market and the trader. It integrates the market cycle with its five phases with the trader's sequence of actions and attitudes, thus ensuring successful and professional trading.

We have already learned, with the five Sakata methods, about the objective part of market behavior and how we must deal with it, according to what the market itself tells us. Now it is time to learn about the trading sequence that we need to enact as traders in order to trade with good results. By applying this sequence to our trading, we will integrate ourselves as traders with the market. This is key to our success.

Only a deep knowledge of this whole integrated cycle can guide us to success. Deep knowledge means exactly that, a knowledge that is not superficial. Our knowledge must go far beyond what appears to be trading or being a trader to most people on the outside. Trading reality is elusive. If it was not, trading would be easy and everyone would be doing it.

Trading is not for the faint of heart. Trading requires the courage to dig below the surface in order to get to its core. The Samni No Den will teach us what to do to achieve this level of knowledge and commitment.

This path to trading begins in the next chapter and is what gives us our edge.

WHAT MOST TRADERS WILL NEVER DO: THIS IS YOUR EDGE

Let us say it now. Our edge in the market comes from the Samni No Den. Here is where the real magic of trading lies. In other words, if we are looking for the holy grail of trading, here it is. Here is our edge as traders, but we will have no edge at all if we seek it somewhere else.

This edge is not elsewhere for a reason. We are the traders. It is what we do and not what the market does that will ensure our success. This is why looking outside of ourselves is futile. It is as simple as that. This is the secret!

This secret is invisible to most traders. The reason is that traders are always looking beyond themselves. They escape from themselves because they are lured by easy gain or greed. However, trading is difficult. It requires learning, studying, hard work, and lengthy experience. It implies integrating many elements that are not exciting and that will not give us a rush of adrenaline. In fact, most people who trade are trading their wishful thinking. Fantasy rules them. They want an adrenaline boost – some sort of activity to compensate for an inner void of some kind.

This is what makes learning trading so difficult and, at the same time, so easy. It is so difficult for those who hide from themselves and so easy for those who accept themselves.

Yes, it is very easy to trade. It is also very easy once you have learned and have accepted that trading mastery is a long road on which you must integrate things that do not seem interesting at all for most would-be traders.

Trading is very easy once you agree to plan for your trades and to study them deeply, in order to ensure that there are risk control elements and money management elements and everything else that the science of trading tells us to consider. Not all traders realize this, even if told about it. To most people who want to trade or engage in trading, all of this is boring or useless. They simply do not understand, and probable never will.

This is our real edge, our hidden knowledge, and our true trading grail. Do you remember the legend of the grail? Everyone seeks it, but in the wrong places, so, it is obvious that they will never find it.

Even if you published this on the front page of the largest circulation daily, almost no one would hear of it or see the point. Fewer still heed the advice. This is the real secret of why only a few traders do succeed and of why you will succeed if you listen to the trading wisdom of the ages. One thing to remember is that the way to acquire this trading wisdom is by reading, thinking, and practicing. These three things will enable you to make giant steps in your learning.

Great traders are great readers. Trading is a science that has its own literature with which you should become fully acquainted. You should read the treatises of all great traders, such as Livermore, Gann, Wyckoff, Schabaker, Cole, Dunnigan, etc. In more recent times, such people as Tom DeMark, Larry Williams, Victor Sperandeo, Ed Seykota, John Crane, or Marc Boucher have a lot to offer us.

You should also continually think about trading principles, your trading strategies and plans, and how to refine or perfect what you are already doing. This reading and thinking should be accompanied by unending practice of what you read and think. Practicing and experimenting are fundamental. This practice should begin on a very small scale and with amounts that you can afford to lose as part of your learning experience. You should consider such amounts as the tuition you pay the market in order to learn. All of this will put you far ahead of others in the trading game.

10
Learning to Analyze the Markets from a Trader's Viewpoint

ANALYST OR TRADER?

All analysts are not traders, but all traders should be analysts. Analysis of the market is merely one aspect of trading. Trading includes operating in the market. Operating in the market can give unexpected results. In trading, such things as slippage, volatility, and efficiency of execution are things that are present and can decide results.

We can lose, even if we correctly forecast the market direction. For example, a very volatile market could cause all of our stops to be executed, even if our trade is in the right direction. This is a common experience that most traders have had.

Therefore, when you trade, market analysis is never sufficient. Also, most analysts usually fail. Analysts usually fail because the market never works as expected by the majority, and here we mean the majority of professionals, not just a majority of small traders.

Why do these professionals go wrong? There are many reasons. However, the fact is that they are wrong more often than they are right. This is the feeling revealed when professionals are polled. The majority of respondents believe that the market will continue its trend, although a reversal is near.

Fundamental analysis also fails. A book written by David Dreman explains the reasons for these failures. What is incredible is that the margin of failure in fundamental analysis is in the range of 44 %.[17]

Most fundamental analysts fail due to bad market theory or to biases because they are paid to give results that are in accordance with the views of their brokerage houses. The bottom line is that, in general, we cannot trust fundamental analysts. We must find the really good ones. They do exist.

Technical analysis fails, too, and is subject to the same flaws as fundamental analysis, and for the same reasons. For instance, brokerage houses do not favor analysts who warn the public of an imminent reversal at the end of a bull market, and near a reversal that no one expects. The brokerage houses will lose their buyers, if there is a market frenzy precipitated by someone who caused their customers to panic. We should not trust the majority of technical analysts either.

Nevertheless, both types of analyses are important. Fundamental analysis teaches us about underlying value. Technical analysis teaches us about actual price. They do not always coincide. Something of great value can be underpriced and something of no value can be overpriced. The market moves about above or below the true value.

We need both kinds of analyses, but as traders it is technical analysis that is paramount for us. This is because, as traders, we are always dealing with the technical side of the market. Although both kinds of analysts, technical and fundamental, do fail, it is easier to be an analyst than a trader. Even if an analyst is right in the long run, one cannot trade the market based only on his analysis. The trader will find himself in circumstances where the results of analysis are not sufficient to warrant trading the markets.

The trader must be right not only about market direction but also about many other factors, such as volatility, stop placement, asset allocation, etc. Knowing about market direction is never enough to ensure trading success. This is why trading is difficult and not for everyone.

Trading implies actual market action. The trader must account for everything, even for the failure of the best analysis. Trading is far from simply knowing what the market will do and acting on it. The reason for this is that the goal of trading is to make profits, and profits are made with assets. The trader uses the science of managing his assets within a market environment.

This differs greatly from the belief that trading the markets is based only on signals. Trading is a complex business. It must be learned and organized thoroughly before one begins to trade.

To learn how to trade, we will follow Sokyu Honma's Samni No Den. It will teach us the sequence or cycle that we traders must follow. Samni No Den has five rules. Let us review them again:

1. Without being greedy, look at past market movements and study the time/price ratios.
2. Try to buy a *bottom* and sell a *top*.
3. Increase your position after a rise of 100 bags from the bottom or a decline of 100 bags from the top.
4. If your forecast is wrong, try to discover your mistake as soon as possible, close your position and stay out of the market for 40 to 50 days.
5. Close 70 to 80 % of your positions if they are profitable, closing what is left after a top or a bottom has been reached.

The first rule tells us to study the market in a detached manner, maintaining objectivity. The second rule concerns the selection of an entry point. The third rule addresses our position allocation. The fourth rule is about risk control, including stops. The fifth rule also concerns risk control, position allocation, and asset allocation. Asset allocation is implicit in rule 3, since our assets are not all in the market at the same time.

We will now explore rule 1, market movement, and its consequences.

LEARN TO SELECT YOUR MARKET: THIS IS YOUR FIRST STEP

This is where Samni No Den begins, with the study of market movements and their time/price ratios. It is the number one rule and is where we should begin.

This study is not to be confused with the five Sakata methods, which are contained within this number one rule. To study market movements and time/price ratios, we need a tool, a market model.

This tool or market model provides the five Sakata methods. With it, we will be able to determine which phase the market is in. It will give us clues about market behavior.

The first thing to do is to look at markets and analyze them using the five Sakata methods. We will start by identifying the phase the market is presently in, the previous phase of the market, and where the market is going. This is only a first step. Once we know which phase the market is in, its immediate past behavior, and what its next step will probably be within the cycle, we are ready to begin measuring the market.

Measuring the market is absolutely essential in order to understand market behavior. Market phases and their clockwork movement are the foundation and have their measures. These phases are as immutable as the movement of planets in their timeless orbits. However, no market phase ever repeats itself identically.

Not all trends are the same, not all gaps are the same, and not all bottoms or tops develop in the same way. This makes it necessary for us to study and explore the market's present phase. It should be noted that no two traders will necessarily see the same things and/or take the same measurements. Some traders will give more importance to movements and patterns than do other traders within the same market phase. What is very important here is to measure the market accurately.

We should measure every market move within a phase. The more we measure, the more the market will tell us about itself. The simple routine of measuring the market might teach us all we need to know in order to trade. How many traders do we know who measure market moves? Very few!

Identifying the market phases and measuring the moves within each phase will enable us to select our market. Selecting our market is crucial. Many criteria come into play when choosing a market to trade. What markets are we most familiar

with? What is our trading style? What markets within our field of view are the most profitable today?

Identifying market phases and measuring market moves will help us to select our markets. Our first step consists in looking at different markets and identifying the phase they are in. We must also measure their main moves in relation to each other. Have stocks in general moved more than commodities or currencies? Are stocks trending strongly and are currencies rather stagnant? Are commodities moving? How much have they moved? In what market phase are they now?

The main point here is that we need to have a panorama of what the market is doing and be able to identify the phase of each market, as well as the magnitude of the move that has occurred or is taking place in each phase. On this subject, we should know that all markets are not created equal. We cannot trade everything in the same manner. Trading stocks is completely different from trading futures or currencies or commodities.

Each market has its own personality and it takes study, time and practice to become fully acquainted with it. It is therefore better to obtain an overview of the markets and then choose one of them and spend time to master it.

I suggest that you choose stocks, at least to begin with. Stocks are easier to handle than commodities or currencies. They are also easier to trade. All stocks are not similar. Some are more volatile than others. Some trend regularly and are noncyclical, whereas others are cyclical and have wide swings.

This is why we must choose the stocks that we are going to trade according to our trading style. For very short-term trading, we can choose very volatile stocks that have very wild swings. For medium- to long-term trading, we may choose stocks that move more smoothly. In both cases, the highly volatile stocks are to be preferred since that is where big profits are made. However, we could choose volatile cyclical or volatile noncyclical stocks taking into account our time horizon.

Selection can make the difference between average results or outstanding results, which is the reason why we must be so attentive. In the final analysis, selection is more important than timing. Even if we do not have a specific trading signal, we can do well simply by selecting correctly. A stock that has a big move will make more profits for us than will a laggard, even if our timing is not precise. Good selection can save us from many bad trades.

When selecting stocks, we should not select more stocks than we can study and know well. We must select not only our vehicle for trading but also our time window. Let us discuss this next.

TIME WINDOWS DO MATTER!

There are many time windows in a market. The main time windows are the yearly, monthly, weekly, daily, and different intraday time windows of 60 minutes, 30 minutes, etc. The time windows that are usually traded are the intraday, the

daily, and the weekly. Monthly traders are rare. The yearly time frame is used mainly to assess general market behavior over long periods.

With a good market knowledge, as you will have with Sokyu Honma's five Sakata methods, six months of trading history and daily charts could be sufficient. However, it is always better to have as much history as possible and to build your trades using all possible time frames. This gives you an edge and added confidence in your trading.

The time window rule must be understood in order to know about the strength of your trading conditions or signals. The different time windows behave in different ways. The time window rule that I am going to explain will enable you to choose more robust trades and will also help you to know what you are doing when you choose your time frame.

The time window rule is as follows. The strength of a trading signal is directly proportional to the length of the time window selected. What this means is that a signal in a yearly time window is stronger than one in a monthly time window. A monthly time window is stronger that a weekly time window. Finally, a weekly time window is stronger than a daily time window.

The reason for this is that the longer the time frame, the more difficult the market will be to manipulate voluntarily or involuntarily. For example, a sudden, large position that comes in unexpectedly will be diluted by the different time windows. This can be catastrophic in a 60 minute bar, noticeable in a weekly time frame, and a tiny speck in a monthly time frame. Therefore we would be better off to trade the longest time frame possible, within our trading horizon. Our trades will be fewer, but more robust.

Now we must learn how to select a time window. The selection of your time window depends strictly on your trading horizon and your type of trading. If you are a short-term trader, you will probably select a daily time window. If you are a medium-term trader, you will select a weekly and a daily time window. As a very long-term trader, you are better off with weekly and monthly time windows. If, on the other hand, you are a day trader, you should use an intraday time window and a daily time window, even though you would benefit greatly from also taking into account the longer time windows.

This is why we must learn to use time windows. The first thing to learn is that the different time windows must be used in accordance with our specific trading time horizon. In learning how to use time windows, we must consider that time windows reinforce each other. A yearly time window reinforces the monthly time window. In turn, a monthly time window reinforces a weekly one and a weekly time window will confirm the daily one, within which are intraday periods.

This kind of tunneling effect among time windows is very important. It will enable us to avoid unnecessary failed trades. This is why the more that time windows confirm the direction of your trade, the better it is for you, and the more confidence you can have that your trade will succeed.

Now we will turn our attention to the matter of price.

YOU MUST STUDY PRICE

According to the first rule of Sokyu Honma's Samni No Den, we must examine all past price movements and study their price/time ratios. What Sokyu Honma was telling us is that the first step begins with a thorough knowledge of our market. Knowledge of our market means being familiar with all of its movements in terms of price and time.

With regards to price, we must know how many points each market move has. On the subject of time, we must know the duration of each market move. However, we must also study their relationship, the ratio between time and price. We must know how long certain regular price moves take. For example, we must know if a particular stock moves 10 points in five weeks. Measuring will give us all we need to know. We will become familiar with regular moves within our market. We will be acquainted with the moves of the stocks that we trade.

The market will reveal its personality to us. We will become used to the specific behavior of each stock, commodity, or currency. We will discover certain, almost invariable ratios at play behind the movements of whatever we trade.

All of this will simplify our trading and cause us to be very knowledgeable about our market. Measuring is everything, and what we measure are the oscillations or swings. The price oscillates in upward movements, followed necessarily by downward movements. This oscillatory movement is a market's true cycle. Every swing in one direction is followed by a swing in the opposite direction. This pendulum-like movement repeats indefinitely and belongs to the core of the market itself – to its fundamental structure.

We must come to know every market swing in terms of its price movement and duration. However, there is another element. It is the juncture between swings or oscillations. The junctures are the pivots – the market's critical turning points. Each swing ends at a pivot point that is the beginning of a swing in the opposite direction. These pivot points constitute another element of the fundamental market structure.

The fundamental market structure is therefore made up of pivots and swings. Pivots are the beginning and ending points of every move. This is why they are the market's turning points. The move that occurs between two given pivots is the swing. These two concepts of pivots and swings will help us to measure the markets and develop an awareness of the market structure.

Although Sokyu Honma does not mention pivots and swings, they are implicit in his rule, which states that all market moves must be measured. This is why defining pivots or critical turning points is essential. They give us the extremes that will enable us to measure a move in terms of price and time.

Pivots in themselves have a spatial structure that will provide clues about market behavior. For example, a series of ascending pivots within the same trend indicate a rising market. If high pivots are all at the same level and low pivots also share

a common level, you have a consolidation or range during which the market is no longer trending.

Here we may introduce the definition of a trend. Measuring oscillations and knowing their structure enables us to identify a trend. A trend is not only a single swing. It may be composed of a multiplicity of swings between pivots.

What characterizes an uptrend is that its lower pivots are in an ascending series, and the same is true of its higher pivots. This is why we say that the market is making higher tops and higher bottoms.

A downtrend is the opposite figure. A market makes lower tops or high pivots and lower bottoms or low pivots.

With trends, we must measure oscillations. In ranges or consolidation, we must also learn to measure oscillations. We must measure these oscillations in price and time and then must classify them. By classifying market phases, you will learn the type of moves within each: whether it is a trend or a range, and which has been the smallest move, the greatest move or swing, the average swing, the median swing, and the modal swing.[18]

You will learn to identify certain moves or corrections that are more significant than others. Among the swings, I always try to identify what I call the *significative* swings. These are swings that occur only at important market junctures. This can be important if you intend to wait for a correction to buy. Within a trend, it is better to wait for a significant swing.[19] It will minimize your entry risk.

Let us study this within Sokyu Honma's five Sakata methods. Defining market strength according to the five Sakata methods implies that the present phase of the market is within Sokyu Honma's great cycle. It implies also that the market phase has been measured and that its time span is known. For instance, in San Sen, the triple bottom method, we want to know the difference in price and the length of the move between each bottom and its top. We will have four measurements of four swings: bottom 1 to top 1, top 1 to bottom 2, bottom 2 to top 2, and top 2 to bottom 3.

We will also want to know how long it took for each move to be completed – its time length. Additionally, we want to know the duration of the entire triple bottom and the time between successive bottoms.

In San Zan, the triple top, we will follow the same procedure as above. Also, we want to classify triple bottoms and tops by their size, time, price, and position within the market cycle. It is important to define the pivots, bottoms, and tops in order to measure the relative importance of each phase. We want to know if we are at market extremes or if we have a consolidation within a larger trend.

It will be the same for San Ku, the gap method. We want to know the size of each gap, as well as its position. We want to know the time and price that has elapsed between gaps or between bottoms or tops (San Zan and San Sen) and gaps after them.

We also want to know the time and distance of gaps that occur between corrections (San Poh) and gaps within strong trends (San Pei). For San Pei, the strong

trend method, and San Poh, the correction, we also want to measure them in price and time between themselves and in relation to the other phases.

We want to measure everything in every way possible. Then, we want to classify each phase according to price and time. We will then be able to recognize moves for what they really are and to identify their true strengths.

Let us now give our attention to time.

YOU MUST STUDY TIME

Time is everything. A remarkable trader, W.D. Gann, said that time was more important than price.[20] When a significant time change occurs, it means that the market's phase is about to change. For example, if there is suddenly a correction in an upswing that lasts longer than other corrections, we can anticipate a change in the trend.

This time element can be used to analyze every market phase. An above-average duration means a change of some kind is about to occur.

Time cycles are especially important and meaningful. Average trends have their times, as do average double bottoms, double tops, intervals between gaps, and corrections. Their time size will tell us whether the present market phase is within a major whole market cycle or within a smaller market subcycle.

We must classify markets in cycles and subcycles. The great market cycle of Sokyu Honma will have at least five main waves. Each of these main waves will have their subwaves.

A major historical upward movement will have at least three upward moves. These are three waves. If we add the two main corrective moves that take place between the three waves, we have a total of five waves. Knowledge of the time duration of each of these waves is necessary.

Time cycles are more important than price cycles in the sense that, if we are trading time, a price mistake will not be so serious. If we err on price, time will rescue us in the end.

There is only one condition. One must have the patience to wait for the right time. For instance, waiting for a San Poh correction to arrive and to be completed, or waiting for a triple bottom to arrive and to be completed, is more important than knowing the precise entry signal to buy it. When the time has come, the market is ready to move to its next phase. A cycle is really time.

Time has no reality in itself. It is not a thing. Time means nothing if it is not the time of something. When we say that time elapses, we are saying that something is moving relative to something else.

When we say that something is moving, we are saying that something is changing and when something changes, it ceases to be the same as before. This may seem self-evident, but it is not. When we say that time has elapsed in the market, we are really saying that market has moved – that it has changed.

However, recognizing that the market has changed is recognizing that the market has become something else, that it is not the same as before and that it has entered another phase.

This brings us to the essence of time. Time is the measure of a movement and to measure it we need a reference standard, something that, in itself, does not move and in relation to which we can compare movement.

This is what a clock does. It measures all movement relative to a standard movement, the rotation of the earth around its axis, and we have the 24 hour day. Fifteen degrees of earth rotation give us the hour and a quarter of a degree gives us the minute. A rotation around the sun gives us the 365 day year. All that happens is compared to these movements. This is how time is measured.

These measures – the year, month, day, and hour – are natural moves, not arbitrary ones. They are deeply ingrained in the minds of mankind and all activities are related to them. So many cycles operate within this time cycle framework that its importance cannot be underestimated when measuring market activity.

For instance, many fundamental things happen within a year to later repeat themselves in analogous ways on the same dates, year after year: festivities, taxes, quarterly reports, etc. This is the underlying reason why time measures of market moves are so relevant and do matter. They also occur within the main earth and human cycles.

TURNING POINTS AND OSCILLATIONS

Time and price have turning points. We have already explained this. Here, we want to emphasize the spatial structure that these price and time turning points will define.

These main turning points and their durations will repeat themselves in a cyclical manner. In the same way that an upward move is followed by a downward move, so a time duration of a given phase of given importance will be followed by another phase of equivalent magnitude. All these phases will have their specific, relative time frames.

Turning points are critical points. We must define the main critical point for each market phase, not in a precise quantitative way, but in a way that gives us their order of magnitude.

When applying the great market cycle of Sokyu Honma to identify the five Sakata methods, we need to take into account the main time frames of each of these phases and expect them to repeat, never in an identical way, but always in a similar way.

All these points or places where one phase will change to another are critical points or pivots. All of these pivots must be precisely identified.

Critical points and oscillations are the keys to market behavior. If you study the main stock market moves, you will realize that this is true. Take, for instance, the Dow Index. We will see that bear markets account for one third of bull markets

and that secular bull markets have lasted for about 17 years since 1929. In all these moves we can identify the five Sakata market phases and their durations. We will note that they have similar times. Also, during these big multiyear moves, we have had many periods of market stagnation, as well as bear markets or strong market corrections. Such periods of stagnation and long irregular ranges should be avoided.

A careful observation will enable us to see where they occur within the Sokyu Honma great market cycle, in order to avoid them. We should trade only active markets and wait for the right time. Then, we will be profitable more often than not.

Trading inactive markets is not worth the risk or the long waiting period. Our money will be more productive somewhere else during times of relative inactivity. We must jump into the market only when a move is already in progress. We are often in the market when we should not be. We must learn to be patient and to be in the market only at the right time.

The measure of the price and time will give us the way to use the five Sakata methods correctly and efficiently and avoid periods of stagnation. However, from time to time, we will have false signals and markets will not behave as we expected. These false signals are minimized by Sokyu Honma's five Sakata methods and the Samni No Den. Other factors become more important. As false signals will occur sooner or later, we must try to understand not only that they do but also why.

We will now take a look at them.

THE TWO APPROACHES TO MARKET READING

Why do false signals occur? The reason is a lack of information. When a false signal occurs, something is missing. We receive information about something that is not there. This lack of information comes from filtering and smoothing data. Indicators, such as moving averages, will smooth data for us, but this smoothing will cause relevant information to lag behind.

When we have a moving average turning point, prices will have long turned around. If we act upon what the moving average tells us, we could be acting on information that arrives too late. A false signal is issued due to this lag in the information transmission time caused by the smoothing of price data.

This is the problem with mathematical indicators. In general, they are lagging indicators. They give information that is not always on time or accurate. Most indicators will give us false signals. These result in losing trades.

Even though they produce false signals, indicators are still useful. They give us valuable information, since they are able to extract one parameter or element. This is the case, for example, of the moving average. It gives us information about the average market price for a given period of time units and is able to isolate the general average trend. When we wait for a moving average to turn around, we have an indication that the market has turned around too.

In the case of prices crossing moving averages, or even moving averages crossovers, we receive a maximum number of false signals. This is due to the fact that the shorter moving average tells us of movements that are not confirmed by the longer moving average.

This brings us to the problem of the limits of the normal distribution curve. Most indicators rely on this curve as their foundation. This is the case with a moving average. In order to obtain statistical information about market behavior, one must pay a price. This price is information loss. The smoothing will 'evacuate' very valuable information considered not pertinent to the function of the curve. The curve will then become blind to a certain kind of market information that is needed to make an accurate appraisal of its behavior.

This blindness of the averages will result in false signals. False signals are created by a contradiction between what the smoothed information of the average tells us and what the underlying market is really doing. In this sense, there is a distance between indicator-given information and direct-market information. The indicator acts as a screen that separates us from the market truth.

This happens because mathematical statistical-based indicators are quantitative. To obtain quantitative, smoothed information, the price that one must pay is the surrender of quality. For example, a moving average will be blind to the spatial location of critical market pivots and specific oscillations. These spatial structures of pivots can define market behavior at a given point in time. This is important qualitative information that we are missing and means that indicators of such a kind are blind to qualitative, nonquantitative, specific market information. They are, in short, blind to the market's fundamental structure.

We therefore have two approaches: the quantitative approach, which reads market information filtered by statistics, and the qualitative approach, which reads directly the market's structure as it is. Examples of the first approach are indicators such as moving averages, stochastics, MACDs, Bollinger bands, etc. Examples of the second perspective are chart pattern reading, bar chart reading, and all of the techniques that do not rely on averages but on a direct reading of what the market is doing.

The difference between the two approaches is that the information is not real in the first case, although useful. For instance, a moving average price will not necessarily coincide with a real price in the market. It will always be an average. Here we have a typical statistical flaw. If, for example, a price series is 25, 26, 21, the average is 24, a nonexistent price. However, real existing prices, and their locations, do really matter, and not just their averages.

In the second approach, the information is always real. The information always coincides with market reality. This is, for example, what a pivot point or a bar chart count or a triple bottom pattern is.

In all of these cases, we are dealing with real market prices and real market structures. Pivot points are real points and not averages. We call pivot points the real historical turning points. Bottoms or tops are real. The historical high of the

S&P is a real price and the lowest low of last year for GE is a real price that has a precise location in time.

This really matters. This is the first and most important information – information about real turning points, real prices, real time/price units, and their general and specific patterns and structures. This is the quality information that we need if we wish to know what the market really is and how it behaves. We cannot, and should not, dissociate quality and quantity. They form an indivisible whole.

This is exactly what Sokyu Honma provides when approaching the market. With the first rule of Samni No Den, he tells us to measure the real market, its real prices and its real times. With the five Sakata methods, Sokyu Honma gave us some of the best possible tools to evaluate market reality from a qualitative perspective that includes all market information. In addition to avoiding most false signals, this approach gives us the perfect timing tool. In addition, it gives us precise knowledge of the five market phases and how to trade them. They enable us to see the market as it really is. The great market cycle implied in Sokyu Honma's five Sakata methods is all about this and gives us the underlying time and space market structure.

Both approaches, the statistical and the reality-based approach, can be combined. There is no need to deny the validity of statistically based indicators, but simply to acknowledge their limits. Their main limit is their blindness to market quality. By reintroducing quality, using a qualitative market approach, the statistical indicators become enhanced because we compensate for their blindness. In fact, we are recovering the information that the indicators took away from us. We do this by reintegrating the fundamental market structure with statistically based information. Combining both approaches for an efficient market reading can, in this way, constitute a valid approach and may be used in certain circumstances.

In the next chapter we will discover how the market tells us its intentions directly. No indicators are needed.

11
Your Magic Talisman

Now let us deepen our understanding of when the market will be ready for us to act. The market itself gives us the clues that tell us what to do. All that we must do to learn is listen to it.

IT IS ALL ABOUT MISDIRECTION

Things are not always what they seem. If they were, it would be easy for anyone to have a look at the market and to make money. This is not the case. You first must know where to look.

The market will very often go against public opinion. This is because people are so enthusiastic about the market's immediate behavior that they enter a kind of hypnotic trance.

In a bull market, no one wants to be told about reversals or the end of the trend. They all want to be where the money is being made. This is fine as long as the market maintains its trend. The problem with this approach is that enthusiasm takes a very long time to build. It accumulates in a slow, snowballing motion as a result of stories of other people's success in the market.

When knowledge of the successful buyers is widespread and the public is enthusiastic, it is already too late and the market will reverse. Why? Because the all-important buying has already taken place. In fact, very soon the only thing that will matter is selling. The public, fully ignorant of this, believes that it is at the beginning of a move that will last for a long, long time. This is no longer true when the public is fully aware that a bull market is underway.

Why is there such public ignorance? Simple! The answer is 'misdirection.' The public is misdirected by opinion. There is an abysmal difference between 'opinion' and 'knowledge.'

'Opinion' is what you hear around you, what you are told by someone, whether it is the media, a professional, or whoever. It does not really matter who is telling

you about anything. This does not mean that 'opinion' is always wrong. An opinion can be wrong or right, but it is always simply an opinion. What makes it an opinion is that it comes from other people's perception and statements, but not directly from reality.

The opposite of opinion is 'knowledge.' Knowledge will always be true, because it is based on reality and not on what somebody tells you reality should be. Knowledge is always true, because it takes only reality into account. Only real knowledge can tell us the truth about the market. It is this knowledge above all that we must seek.

Awareness of the difference between 'opinion' and 'knowledge' is the key to accurate market reading. It explains why most people are 'misdirected' and become incapable of recognizing the market's true behavior.

There is a children's story called *The Emperor's New Clothes* by Hans Christian Andersen.[21] In this story, an emperor is dressed in invisible clothes by two swindlers. They convince him that he is wonderfully dressed. He then goes into the street, thinking that he is very well dressed, and because he is the ruler, nobody dares to tell him that he is actually nude.

The lesson here, in matters concerning the markets, is that the public is the 'Emperor.' The public thinks that markets are doing well because everyone says so. However, the public is affected by the aggregate wishful thinking that has created a mania, which will end in an exploding bubble. It is also composed of knowledgeable people, who really do not care about the market or the unsuspecting public. These are the persons who crafted the Emperor's new clothes. They are the ones who make you believe that an indefinite bull market is underway and that it will never reverse or, at least, not as long as they are selling you something. They 'dress' the unsuspecting public, the 'Emperor public,' with overpriced stocks on which they earn commissions. However, the public soon discovers, at its own expense, that it is nude. They are also the ones who, when the market begins to reverse, will tell the people that the market is strong and 'the recovery is just around the corner and due next month.'

The problem here is that no one can cry 'The Emperor is nude' and succeed unless the Emperor accepts that he has been fooled. The public accepts that it will be fooled when it bases its actions on market opinion and not on market knowledge.

All magicians know this strategy. Their art is based on misdirection. However, magicians use misdirection to teach us about reality and to amuse us. This is not the case with those market people who misdirect the public and frequently themselves, simply because of their denial of the real market behavior. They are led by wishfulness, greed, or both, and are bound to fail.

Therefore, be aware of this kind of market magic and learn to protect yourself. How? By learning to distinguish between what you hear about the market – 'opinion' – and what you really know about the market – 'knowledge.'

To learn this difference, here is our main key or tool: general conditions. Let us learn about it.

GENERAL CONDITIONS RULE

Knowing only the following could make you rich. *Above all else*, *general conditions rule the markets*.

This is the most overlooked aspect of the market. Very few people look at general conditions and realize the truth about the market. Perhaps no one does this because of the inherent simplicity of this truth, and the fact that general conditions are right under our noses.

It makes one think of Edgar Allan Poe's story, *The Purloined Letter*.[22] In it, a letter is hidden by leaving it in an easily visible place. The protagonist in the story explains that the intellect refuses simplicity to the point of suppressing it. This is why the letter is not found, although it is there in plain view of everyone.[23] This is what happens with the market's general conditions.

Also, to be able to assess general conditions, we need the right tools to describe market behavior. We must be able to look directly at markets without obstruction and see their behavior.

All children have the ability to see what is in front of their eyes. People are so overwhelmed by news and opinions conveyed by the media, analysts, their brokers and friends, professionals, and others that they miss the only element that is really important for making a market judgment – what is before their eyes.

It is all visual. A look at the charts, at the market's behavior in a direct way, is the single most important thing to do. It is more important than anyone's opinion. Looking directly at the market will give an idea of what the general conditions are, and general conditions rule all else.

This is why a master trader, Jesse Livermore, gave such importance to general conditions.[24] This is why Gann, one of the greatest market theoreticians of all times, tells us to first assess the general behavior of the market, i.e. its general conditions.[25] This is also what makes Sokyu Honma's market tools among the best. They give us the knowledge that will enable us to assess market general conditions in a unique way.

Sokyu Honma's great market cycle will enable us to pinpoint the market's behavior and phase at every point in time. We shall learn how to apply this to assess general conditions.

Knowledge of general conditions is our talisman, the touchstone, which will convert the markets into gold for us. This talisman can be found only in one place – in simplicity.

SIMPLICITY IS THE KEY

Simplicity is the opposite of complexity. To convert complex things into simple and understandable things is what intelligence is all about. To be able to reduce all of the apparent complexity and market randomness to something simple that we are

able to grasp intuitively and understand is what knowledge of general conditions is all about.

When things seem too simple, they are often disregarded, although, in fact, they should not be. Intelligence loves simplicity. Einstein said that the most complex thing could be explained to an 8-year-old, if only presented in the right way.

The fear of simplicity very often blinds us to evidence. This is often true in market science. Disregarding what is just in front of us and looking instead for difficult and complex interpretations can be misleading.

Great traders have always opted for simplicity, and so did Sokyu Honma. His five Sakata methods are the art of simplicity itself when it comes to market reading. The same can be said of his great market cycle, which is implicit in his five Sakata methods, each of which contains a key market phase.

Let us now learn to read general conditions in the market. General conditions are the conditions of the entire market at a given moment. Is the market trending? Is it ranging? Are we in a bull market? Are we in a bear market? Are we at the beginning of a bull market? At the middle? At its end?

General conditions will enable us to answer these questions. General conditions are important, because our trades of specific stocks or other kinds of vehicles depend on them. Remember, general market conditions rule. Let us learn to identify them.

LEARN TO KEEP AN EYE ON INDEXES

Indexes are among the best tools for keeping an eye on general conditions. They enable us to know what the market is doing in general and what its general condition is at a given time. They enable us to study the history of the entire market at a glance and to measure it using our Samni No Den first rule.

What really is an index? An index is an average of the prices of a number of stocks. However, this is not the most important thing. An index is really an equity curve, since it integrates the historical value of the market.

Stocks within an index may come and go, but the index itself remains. This is why an index will always be the best representation of the market in general. By reading the index, you will be reading the market's behavior in general. It will enable you to assess the market's general conditions and to select from the best instruments that comprise the market.

Indexes are therefore our favored tools for determining the general condition of the market. This is where Sokyu Honma meets Charles Dow. Charles Dow invented the stock market index. He created the Dow Jones index in 1884.[26] This index enabled traders to read market behavior objectively.

We are now going to apply Sokyu Honma's market cycle to read the indexes. Keeping an eye on the indexes will inform us of the market's general conditions. Once we have an idea of the general conditions, and if general conditions are on

our side, we can proceed to choose the best stocks to trade using the Samni No Den first rule, as well as the five Sakata methods.

However, to assess general conditions better, it is not sufficient to read such indexes as the Dow, the S&P, or the NASDAQ. We also need to read the sector indexes.

LEARN TO READ SECTOR BEHAVIOR

Sector behavior enables us to select our market. By reading sector indexes, we will be able to assess the relative performance of each sector, in comparison to the market in general. Reading the main indexes will give us an idea of the general conditions of the market. Using the sector indices, we are able to refine that knowledge in order to tell how each individual sector is behaving relative to the whole market.

This enables us to focus on the best performing sectors in order to select our stocks from those sectors. Of course, this will depend on our trading strategy. We could use, for instance, a strategy of diversification among sectors. If our strategy is one of selecting stocks in only the best performing sectors, then sector knowledge is absolutely necessary in order to select stocks to trade.

The strength of the sector will benefit the strength of the individual stocks that we select, in the same way that a weak sector will affect all stocks in it, whether good or bad. However, in every case, whether we select our stocks from a broad range of sectors or from a single sector, we will do so with knowledge of market reality.

Sector behavior gives us information about the particular sector and also about the whole market. It will tell us where the main market strength is coming from. It will also tell us where market weakness is coming from. We will learn which sectors are pushing the market up and which sectors are dragging the market down.

All this is information that we need to know before we select our individual stocks.

YOU MUST FOLLOW INDIVIDUAL STOCKS

We have determined the general conditions. We are aware of sector behavior. Now we must choose our individual stocks. It is the individual stocks that we are going to trade, unless of course you trade the indexes.

The method for selecting stocks is simple. We must choose from among the most active stocks and stay away from the inactive ones. Also, we must choose them according to the phase that each is in. For this, we will use the five Sakata methods. They will help us to identify the phase the stock is in, as well as to select the method to trade that phase in the most accurate way.

Identifying the phase of a particular stock will enable us to know where that stock is relative to its own general cycle. Also, it will enable us to know how the stock is behaving relative to the whole market.

The selection criteria will help us to choose, from the most active stocks, those that give us the most profitable entry points, using the five Sakata methods. By measuring the market with our first Samni No Den rule, we will be able to identify those stocks that have the greater profit potential. We may also use, in addition to technical criteria, fundamental analysis as a backup, as Sokyu Honma probably did.

How to use fundamental and technical analysis is a question to answer now. Technical analysis comes from the tools that we already have, with Sokyu Honma's methods for phase identification, market timing, and position taking. Fundamental analysis is a plus that we should outsource. It is difficult to do both kinds of analysis well. Also, the best traders rely mainly on technical analysis.

If we choose an index in order to trade the stocks within that index, we are relying on the fundamental analysis done by those who select the stocks that are included in the index. For example, the 30 stocks of the Dow Jones Industrial Index are among the best representatives of the market.

We can also subscribe to a service that will give us its fundamental analysis of the market. However, it is important not to rely on fundamental analysis but on technical analysis, because that is where our profits as traders lie.[27]

Now we must turn to the question of how many stocks we should own and trade. The answer varies according to your trading strategy. We could have as many as 30 stocks or even more, or as few as only three or four. What is advisable, in most cases, is to trade three or four stocks or more, but keeping them to a maximum of twelve stocks.

We find these numbers in trading practices. Many traders, such as Gann, suggest trading three to five stocks. Livermore used to trade twelve stocks. The twelve stocks trading portfolio has a long tradition in the West that began during the nineteenth century.

We must not, however, limit ourselves to any of these numbers. Instead, we should trade the number of stocks that best satisfies the objectives of our strategy and plan. We will meet this subject again in a later chapter.

YOU SHOULD KNOW ABOUT FUTURES, INTEREST RATES, AND CURRENCIES

We should not know only about individual stocks. We should also have a general knowledge of other market instruments. We should be aware mainly of interest rates, currencies, and key commodities, such as gold and oil.

Everything is related in the markets, as are interest rates and currencies. We should check the long bond and the T-bill prices. We should also check the US dollar

index and the main currencies. This will give us an idea of how the economy and the markets are behaving and will reinforce our knowledge of general conditions.

Interest rates will give us valuable information about the cost of money. In turn, this will provide information about the general conditions of the economy. The reading of interest rates in the market depends on the reading of the other elements.

Futures will also tell us about general market conditions. We should have a look at gold and oil. Their prices depend on what is happening to the economy. Their behavior does not follow a general rule, but will depend on many changing factors. That is why it is important to keep in mind what these factors may be at the time. These two commodities have not always behaved in the same way. This makes it difficult to really know the factors that at any given moment are behind their behavior.

We must not try to assume that we know everything or assume that we know what we really do not. However, by knowing their behavior, we will learn greatly about what is going on in the markets.

The same can be said of currencies. They can give us important clues about the market's general conditions. This is why we must keep an eye on them. If we trade stocks, what the main currencies are doing in relation to the dollar is important. Whether we trade US stocks or foreign stocks, it is essential to have a general knowledge of currencies.

It is important for us to know the actual behavior of all of these instruments, even if we cannot identify precisely the reasons for their behavior. The way to do this is to study the charts of all these instruments. Look at the charts, instead of reading the opinion of fundamental analysts about them.

Charts will tell it all, if we know how to look at them. Identify their main behavior. Use the first rule of the Samni No Den, as well as Sokyu Honma's market cycle and its five methods. If we do this, a global picture of the general market will begin to emerge. Then, we will trade with much more knowledge and confidence.

Finally, remember that there is no fixed rule about fundamentals. That is why we rely, above all, on charts. Let us explore this further.

THERE IS NO RULE: YOU ARE FREE AND THE MARKETS TOO!

Fundamental relationships rise and fall perpetually. There are no fixed rules. The most professional fundamental market analysts get it wrong more often than not. However, charts never lie!

We have seen the stock market go up while interest rates were going up. We have seen the stock market come down while interest rates were coming down, and we have also seen the stock market going up while interest rates were coming down. There is no fixed rule. Consequently, saying that stocks will go up when rates come down is a myth. It is a valid assertion under a given set of circumstances and a false assertion under another set of circumstances.

This is also true of gold and oil. We have seen oil not rise during wars, but we have also seen it rise steadily during wars. Again, there is no rule. It all depends on the underlying reasons and they are not always easy to assess.

We have seen the price of oil and the stock market rise at the same time. Rising oil prices, contrary to what mainstream economics says, can be very good for the economy, in certain cases, and for the stock market. It all depends on where, when, and why things are happening, and the answers are not always the same.

Here is where charts are unique. They give us real information unattainable otherwise. Even if we do not know exactly why things are happening, we will at least be able to assess what is really going on. We will definitely know the market truth.

All of this will put us on the right track if we want to proceed further and analyze the fundamentals. Let us consider an example of how powerful charts can be. If we look at our charts and see, for instance, that oil is rising and has reached historical highs never seen before and if, at the same time, the stock market is rising steadily and consistently on our charts, we will already have learned something. We will have learned that, in this specific circumstance, rising oil prices are probably not hurting the economy or, at least, the stock market sector. This is useful knowledge.

The challenge now will be for us to think about the possible factors behind this market behavior. They will enable us to formulate a hypothesis to explain it.

I have had the experience several times of hearing an economist say things that were the opposite of real market behavior. As soon as I heard him, I immediately went to examine my charts and was able to verify that what was taking place was the opposite of what the economist had said. Then, I understood. Many economists do not look at charts at all. Sad!

This is where economics comes in. The more you know about economics, the more you will benefit from your trading. However, as in trading, we must take the right approach. This is why our economic school of thought does matter as it can help our market success. For instance, a Marxist approach would cause us to become losers in the markets. The same can be said for a Keynesian approach. If your approach is from the Austrian School, you could make a fortune.[28]

There is also what I call a chartist economist – the person who uses charts to assess the economy. By doing this, he will always be attempting to adjust his theory to reality. This is the right thing to do.

Remember that freedom of the market is the key. The reason is simple. The market is made up of free people who decide their actions freely.

This is why things are not always the same or do not follow fixed economic rules, except for the rule of freedom itself, of course. In free markets, relationships change according to the actions of the market operators.

Always remember this. We are free and so is the market. Do not try to impose artificial and fixed theories and relationships on the market. Have a look at your charts first! Then, think before trading!

12
Before Taking a
Position . . . Think!

Before trading, we need to think – to create a strategy and a plan. Trading is not about having a set of buying and selling signals to follow. Trading is much more than that. This is why our first concern is with two thinking modes that we shall apply to the creation of our trading strategy.

STRATEGIC THINKING AND TACTICAL THINKING

There are two levels of thought in trading the markets: strategy and tactics. Strategy refers to the whole trading plan, taking into account all elements that should be included for our trading to be profitable.

Strategy is a long-term perspective. It includes not only market knowledge but also risk and money management. Strategy includes all elements that are not dependent on a specific trade. Strategy is there to stay.

Tactics are the opposite of strategy. They are the immediate specific actions that we take in the market. Tactics will depend on the market, changing from day to day. With tactics, we are always adapting our moves to market changes. We will have a series of tactical moves for these that we will apply when we encounter a given set of circumstances.

Our strategy will contain its tactical weapons as a subset of our general trading plan. We will find our strategic formula in the Samni No Den. Here we have our five rules to follow. They will be our permanent trading sequence, a kind of magical ritual in which all steps must be precisely followed.

The five Sakata methods concern strategy, since they deal with market phases and the entire market cycle. However, they also concern tactics. This is about how to trade and time each market phase specifically.

Even though the Samni No Den deals mainly with strategy, it also contains a tactical element. Scaling our trades, for instance, can vary according to circumstance. However, the Samni No Den *mainly* deals with an aspect of our general strategy when it tells us to scale.

An example from chess illustrates this difference between strategy and tactics. In chess, strategy is the plan with all its elements. For instance, forcing an open game and exchanging material to leave a fight for the end would be a strategic consideration. Tactics, on the other hand, arise during the game itself. Even though we have our arsenal of tactics, such as using forks or skewers, they will arise during the game and we have almost no control of their appearance. We can profit from such circumstances, but do not always create them.

This is also true of trading. We have better control of strategy than tactics. Tactics will arise from market opportunity. Strategy will arise from our thinking to put us in control of our trading.

Let us now look at our strategic elements. We will begin with the first element, general conditions, which we have already mentioned.

GENERAL CONDITIONS AND STRATEGY

This is our first strategic element. Let us review briefly what we previously said about it. We must first assess technically the general conditions of the market. For this, we will use mainly our charts in combination with the first rule of the Samni No Den and the five Sakata methods.

We will use the five Sakata methods to identify the present phase of the whole market, the phase from which it came, and the next phase that it will enter. In doing this, we will measure the time/price ratios of the main market moves. For this, we will apply the first rule of the Samni No Den.

We must use as many elements as possible. We must examine the charts and determine what they tell us about the main market indexes, such as the Dow or the S&P. It is also important to look at the sectors. We must not only identify the present phase within sectors, but also the relative performance between sectors. It is necessary to identify the strong sectors, the weak sectors, and, if possible, compare them to the similar phase that occurred in the recent past. This will tell us if the same sectors are performing strongly today or not.

We should also take a look at interest rates and compare their behavior in the charts relative to the stock market. We should look at charts of both long-term and short-term rates. Then, we should examine the charts of currencies, oil, and metals, specifically gold. You can examine the charts of other commodities, as well.

For this chart study, always use the five Sakata methods, as well as the first rule of the Samni No Den. Experience will teach us which way is most suitable for this.

The more we know at this stage, the better it will be. We need to be fully aware of the general market conditions and let the market atmosphere permeate through us.

Once we have finished this step, we must proceed to select our trading vehicle.

YOUR VEHICLE SELECTION

Vehicle selection is our next strategic move. It is our most important choice since this is the instrument that we are actually going to trade. This selection is more important than precise timing. Choosing the right stock, which is in the correct market phase, is a key decision. This key decision has more importance than the exact entry or exit point when buying or selling that chosen stock.[29] This is why you need to be especially attentive to this step.

Before choosing our vehicle, we must know what we are going to trade. Are we going to trade stocks, bonds, futures, or currencies? Deciding what to trade will depend on our knowledge, experience, and comfort level, as well as on what the markets are telling us.

If you are a beginner, I strongly advise you to trade stocks. You will learn to trade not only at a lower cost in terms of money but also in terms of the learning curve. Once we know how to trade stocks, we could try trading other instruments.

When choosing stocks, we should always choose the most active ones. Within the active stocks, we should look for those that trend better and have better profit ratios for an equivalent move in other similar stocks.

To learn this, we use the first rule of Samni No Den and measure the time/price ratios of these moves in the past. In combination with this, we also use the five Sakata methods to determine the starting and ending points for each phase.

Once we have done this, we can consider our next step – the entry point.

YOUR ENTRY POINT

The entry point is our next strategic element. This strategic element corresponds to the second Samni No Den rule, which says to try to buy at the bottom and sell at the top. Once more, we will use the five Sakata methods with their strategic element, as well as tactical elements, to accomplish this. It is strategic, because it is in our arsenal of entry tactics that are contained in the five Sakata methods.

These strategic moves will become tactical at the moment when the market behavior asks us to choose one of the five methods. Choosing a single entry point is important here. We must define our entry point in nonambiguous terms and stick to it. This entry point will come from one of the five Sakata methods.

We must use the five Sakata methods to select our entry point and then wait for that point to arrive. For instance, we will not enter a San Sen, which is a triple

bottom, until all conditions are satisfied, according to our algorithm in Chapter 7. We should enter our position only when the time is ripe, and not before or after. In this way, we will put the time factor fully on our side.

As you can see, this decision is strategic. We must be fully committed to waiting and wait for the specific Sakata market phase to appear, and then for the conditions that confirm the phase. Once all of this is in place, we will wait for the precise candlestick pattern to appear that should be there. Only then, when all elements are reunited, must we be ready to execute the trade.

Never delay a trade. Act now. This will be excellent trading discipline. It is not as easy as it seems. Being able to execute a trade exactly at the right time, after waiting, requires practice. It also requires self-control. This is why it is so important to do this the right way. It will benefit not only your trading, but also your life.

How should we use the five Sakata methods? Should we trade all of the five methods or phases, or should we specialize in trading only one of the methods? The answer to this question comes again from our trading knowledge, our experience, our personality, and our strategy.

If we are beginners, it is better to practice with only one of the five methods at a time. In this case, I suggest San Sen or San Zan. At first, it is better to become acquainted with one method only.

Once we get acquainted and have become good at trading one Sakata method, we can add progressively the other four methods to our general trading strategy.[30] In this manner, we handle our risk and learning curve better.

Now that we have taken care of the entry point for our trades, following the five Sakata methods, let us consider how to exit our trades.

YOUR EXIT POINT

Exiting a trade is another strategic consideration. Our trading strategy should include it. We should know our exit point before we take a position.

This strategic element corresponds to the second Samni No Den rule, which says try to buy at the bottom and sell at the top. Once more, to accomplish this, we will use the five Sakata methods with the strategic, as well as tactical, elements. We will try to sell as close to a top as possible, not delaying our exit unnecessarily.

Exiting a position is something that is decided beforehand. This decision must be based on our market knowledge, the particular strategy that we are following, and the specific trade that we will engage in, when the opportunity arises. Exits are much more difficult for us than entries. Knowing how to exit is a science and an art. The difference between various ways of exiting our position can alter the results of our overall plan.

Selecting one exit, instead of another, could mean the difference between greater profits or lower profits. Profits are the bottom line. This is why we should test exits to see which ones perform better in profit and in overall risk for our trades.

To select an exit method, we have many alternatives. In trading the five Sakata methods, we use two exits: the third gap exit and the trailing stop. Both of these exits work, but we must test before deciding which is most appropriate. Also, when selecting our trailing stop, we should test many alternatives in order to have a trailing stop that will take us out of the market at the right time. Once more, the right time depends on our general strategy and plan.

We must also mention that there are other kinds of exits. You can use them if they enable you to get better results. The other exit alternatives include time exits, seasonal exits, and predefined targets. If you decide to use them, test them first and then adapt them to your strategy.

Let us now consider another strategic element in our plan: position sizing.

YOUR INITIAL POSITION SIZING

Position sizing is defined by your general strategy. You must know how you are going to allocate your assets. For this, you must test different position sizing alternatives. These position-sizing alternatives are another way of controlling your risk and return. This involves a necessary tradeoff. The kind of position size that you choose can diminish risk, but also diminish your overall returns.

The opposite is also possible. A position-sizing strategy could enhance your overall returns. It is therefore necessary to be very careful when considering your allocation strategy design. The only way to really know how the specific position size that you have chosen will work is by testing. This means that you must test your different position size alternatives.

After testing the different position sizing strategies, tabulate them so that you can classify the results in an easy-to-understand format. By doing so, it will be easier to make a good choice.

When allocating our assets, we follow the third Samni No Den rule. This rule must be taken in its general meaning and adjusted to our individual circumstances and trading style. What the rule tells us is to add to our position when the market rises by a certain amount from the bottom or when the market falls from the top by a specific amount.

For Sokyu Honma, there had to be a certain rise in the price of 100 rice bags from a bottom or a certain drop in the price of 100 rice bags from the top. Only when this rise or drop in price took place would he add to the position. The amount of the rise or the drop in our case must be determined by market conditions.

Also keep in mind the fact that you are not required to add to your position. You will always have an initial position in the market. The important thing is to decide

the amount of this position in relation to all of the positions that you will commit to your trade.

You have basically two alternatives when confronted by the issue of sizing positions: either you buy everything at once or you buy progressively, scaling your positions. Both alternatives have advantages and weaknesses. Which one to choose will depend on your specific trading strategy.

Let us have a look at this.

HOW TO SCALE YOUR POSITIONS

Defining a scale is our first step once we have decided to allocate our assets progressively, as the market moves or declines by definite increments. How do we define those increments? One way of doing this is to test different scale increments and see what they give.

What we must always keep in perspective is the reason behind this scaling, this allocation of resources in a progressive way as the market advances or declines. The reason for this scaled allocation is to move our assets in the direction of the market. If the trade goes in the right direction, we allocate more resources. If the trade goes against us, we stop allocating more resources, with the overall result that our risk will be significantly diminished. Of course, our profits will also be diminished.

If we had allocated all of our resources and the market went in the right direction, our profits would be greater. However, if the opposite occurred, our losses would be greater. The tradeoff here must be decided by the results of the tests of the entire trading strategy and methodology. This means that if the final result of losing and winning trades for a significant sample is improved by scaling, we should scale.

If our final result shows a better result with only one initial allocation, we should then allocate everything at once. However, this also means that our risk management should be in place for each trade.

If we scale, how many times should we scale? We could put our whole position into the market at once, as we have already said, or we could add a second position and then a third one, and so on. There is no fixed rule to tell us how many lots we should use to scale or how we should allocate our assets per trade. There are many possibilities. Everything will depend on our final plan.

The best thing that we can do is to test as many alternatives as would be reasonable. For example, we can begin by testing two positions versus a single position, and then test three positions, and so on. We will, at some point, find an optimal allocation.

Nothing will replace our own testing. However, it is useful to know how traders have allocated their positions. The trading practice gives us some useful examples.

Some classical allocation numbers are 2, 4, and 5. This means that traders often scale in two, four, or five stages, such as buying a total of two lots, four lots, or five lots.

Sokyu Honma's scale only tells us, in the third Samni No Den rule, to add after a rise or fall in the price of 100 bags of rice. He does not tell us how many times to do this or how much to add. However, Sokyu Honma has a minimum of two lots if we decide to scale. One first initial lot is bought or sold, and then a second and final lot is added after this rise or drop in the price of 100 rice bags. With Sokyu Honma, we always add in the direction of the market and never against it.

HOW TO ADD TO YOUR POSITIONS

When adding in the direction of the market, however, we must also retain some flexibility in how we do it. We have seen that Sokyu Honma will add only if the market goes in the direction of the trade.

We have two possibilities. The first is to add in the direction of the market, only when the market is moving in a definite and unique direction. This is what happens, for instance, when we buy at the close of San Pei, the three bar chart power trend. In this case, we are buying at the close of the third bar chart, which is the highest close of all.

The other possibility is to wait for a correction before buying or selling. This applies when the market is momentarily going against us. In this second case, Sokyu Honma would only buy when the market returns to the right direction, as for instance in the San Poh corrective phase within a trend.

What can happen, and we must be prepared for this, is that, after we take a position, we will see the market react against us, but with the trade and its conditions still valid. Imagine that this happens and that, when the market goes again, in the direction of the trade, a second buying or selling opportunity arises below the level at which we bought our first lot. What do we do? We could enter our second position here, but only if all conditions for one of the five Sakata methods have again been fulfilled according to our algorithm. The reason for this would be that the market has satisfied fully the conditions that justify an entry. However, in order to do this, we must already have planned and defined our position sizing strategy.

The final conclusion, in fact, is that in both cases we are always adding in the direction of the market. This fully validates the inner logic of Sokyu Honma's Samni No Den third rule of adding only after a rise or fall in price.

A final aspect to consider when sizing our positions within a given trade is to define the number of points by which the market must move before adding to our initial position. We have many alternatives here also. We can add after a rise or fall of a given number of points, or after a rise or fall of a specific percentage. For instance, we could add after a rise or fall of one point.

We could also add after a rise or fall of 1 %. If, for instance, we have five allocations, we would buy the first at our entry signal, the second after a rise of 1 %, the third after another rise of 1 %, and so on until our fifth position. This would keep us in the direction of the market at a minimal risk, since, if the market went against us, only our first position would be at stake.

When adding, we should do so in small increments. The reason for this is to have all of our positions at the beginning of the move and not at the end of it.

This is in accordance with Sokyu Honma's second rule in his Samni No Den: trying to buy as close to a bottom as possible or to sell as close to a top as possible. This also has a parallel in Western trading practice, where positions are often added after a rise or fall of one price point. We also find greater intervals, of seven points, for instance.[31]

Although it all depends on our trading time frame and general strategy, we have explained the main guidelines to follow.

Let us now turn our attention to asset allocation.

YOUR ASSET ALLOCATION

Asset allocation is our next strategic consideration. It is a fundamental element of any trading plan. Asset allocation is not really considered to be a single item by Sokyu Honma in the Samni No Den. We have included it because it is fundamental to any trading plan that seeks to have efficient money management and risk control.

Sokyu Honma's position sizing is, in a certain way, a kind of asset allocation, although it is not the same. What we mean by asset allocation is the amount of assets to trade, relative to our total trading assets.

Asset allocation answers the question of our total commitment of assets once we have all of our positions in the market. Are we committing all of our assets or only some of them? We must define in advance the total percentage of assets that we are going to allocate. There are many methods of asset allocation. However, we are not going to discuss them here in detail.

There are many books on the subject that can be helpful.[32] I will give you here my favorite asset allocation method. I use percentages and define the percentage of the total assets that will be involved per trade.[33] The way to arrive at an optimal asset allocation is by testing. We must define the total percentage to allocate, and how much of that total we will assign to each of our positions. Either we buy our total percentage at the beginning or we scale. In the second case, we must define the percentage that we will allocate each time that we add to our initial position.

For example, we could allocate 20 % of our trading equity to actual trading. In that case, we could either take a position for that amount at once or we could scale our position. If we scale, we could, for instance, take a position size of 4 % per unit at a time until we complete 5 units (20 %). We could add each of these units

as the market advances, if we are long, or declines by a given number of points or percentage in price, if we are short.

Testing is the only way by which to arrive at an optimal asset allocation within our strategy and in accordance with our risk level. There is very good software available that will help with asset allocation and position allocation. Having this kind of software is an absolute must for the professional trader.

Trading without thinking of asset allocation would be absurd and a great mistake. We should never do it. Never!

One last word needs to be said about asset allocation. The different asset allocation methods all have their advantages and weaknesses. Nevertheless, in the end simplicity, as always, is best.

I have found the best and simplest approach to be the percentage of assets method. It is the one that I use after having looked at many other methods. Whatever method you choose, go first for simplicity.

YOUR STOCK ALLOCATION: TO DIVERSIFY OR NOT

Here we have another fundamental strategic consideration – whether to diversify or not. We find no mention of diversification in Sokyu Honma. The reason for this is simple. He was a rice trader in a rice exchange. He traded a single commodity.

However, our present markets give us the opportunity to diversify among many instruments: stocks, currencies, bonds, commodities, etc. Then again, even in Sokyu Honma, there was a kind of diversification. At least he didn't have all of his assets at once in rice and he scaled his positions. He certainly would have diversified, given the opportunity, if he had lived in our times.

The question for us to decide is whether we are going to diversify among many stocks or instruments or, instead, trade only one. If we are going to trade many items, how many of them should we trade?

Diversification is a must. If we do not diversify, we will lose an opportunity to diminish our risk. With diversification, you will reduce the probability that all of your trades will go wrong at the same time. By diversifying, we smooth our equity curve. Our results will become more homogeneous and less random. Further, by diversifying, we will have the law of large numbers playing on our side. No one can know if a given individual trade is going to succeed or not. For example, almost all trends and triple bottoms that we see in our charts are after the fact. Charts show us only the past. The number of failed would-be trends or triple bottoms is legion.

Even with the best entry signals, we will have trades that will fail. However, what is true for a trade considered individually ceases, in great measure, to be true for trades when taken collectively. If we have many trades going on, it is less likely that we will see them all fail. This is why diversification works and why we should diversify.

Our task now is to specify in advance how many stocks or other instruments to use to diversify our trading. This will depend on our general strategy and also our assets.

There are two main approaches to diversification. The first consists of diversifying among many assets to diminish your risk. This is the 'don't put all your eggs in the same basket' approach. The second approach to diversification consists in having a very small number of stocks, but watching them very attentively. This is the 'put all your eggs in the same basket and watch the basket' alternative.

Some trading experts advise you to have between three and five stocks or instruments, as Gann did. There are others who suggest having twelve companies or stocks. This was the case with Livermore and other traders, who used to buy or sell eight to twelve stocks.[34]

It is also possible to have a large portfolio of 30 or more stocks. However, this alternative needs a highly automated system of very simple execution. Only important assets can justify this. This is why the diversification approach that you choose must depend on your general strategy, comfort level, and assets.

Let us now go to our next strategic element, the stop.

SELECTING A STOP

This is the next element to consider in our strategy. Selecting a stop is what Sokyu Honma's Sanmi No Den fourth rule refers to. We select our stop once everything else is in place within our plan.

Let us recall the fourth Samni No Den rule. It tells us what to do if we make a mistake, i.e. if the trade does not develop, as it should. The rule specifically tells us to liquidate our position immediately as soon as we notice our mistake. This is precisely what a stop is for.

In Sokyu Honma's time, there were probably only mental stops. Today, we can have both – mental stops or automatic executable stops.

This rule is fundamental in our strategy. Consequently, we should always select a stop. Selecting a stop will avoid unnecessary losses and will considerably decrease our entire risk.

Sokyu Honma has a very complete stop strategy. His fourth rule tells us to immediately cut our losses. On this, he agrees with general trading lore. However, Sokyu Honma tells us something extra. His rule states that, as soon as we have cut our losses, we should stay out of the market for 40 to 50 days.

This is what we could call not only a trade stop but also a trader's stop. The trader himself is taken out of the market. This will enable him to regain again his clarity of mind. The trader will be able to regain his equilibrium and objectivity before he returns to the market 40 to 60 days later. This will certainly benefit his trading. He will also let his unconscious mind teach him. He will come back as a more knowledgeable and better trader who has learned from his mistakes.

This stop rule of Sokyu Honma is also a 'market stop' since the market also exits from us. The advantage of this is that the market can evolve during this time and show us better what it will do next. This market stop enables the market to evolve, thereby dissipating any confusing or unclear period, which was probably the period during which the trade failed.

The 40 to 60 days also means an important market cyclical period in this case. In 40 to 60 days, the market will certainly be able to show us better where it is going. Therefore, this period or cycle of 40 to 60 days is a period for the market itself to reorganize.

To sum up, Sokyu Honma's stop technique in his fourth Samni No Den rule gives us a 'trade stop,' a 'traders stop,' and a 'market stop.' This is consistent with his rule of three.

This triple stop technique was easier when trading only one market, the rice market, but it can be adapted to our markets as well. It is possible, for instance, to diversify our trades and use the rule.

To use the rule we can, for instance, make three trades in three different stocks. If all three trades go poorly, we will exit our trades and not re-enter the market for 40 to 60 days. Of course, to use this strategy, we must integrate it beforehand in our plan and test it. We must use it only if it fits.

We could also use other time periods. We should adapt them to our trading time frame. For instance, if we are day traders, 40 to 60 days would be too long. If that is our case, we should rather think in terms of 40 to 60 hours, rather than days. It is up to us to explore the different possibilities and adapt them, if convenient, to our trading plan. The best thing here is, once again, to test.

If, in the case of our three trades, only one or two trades go wrong, we will have two alternatives. If our final average result is positive, we will not exit the market for 40 to 60 days.

In the contrary case, we will exit the market for 40 to 60 days if our final average result is a loss. This makes sense, since failing three trades would mean, in Sokyu Honma terms, that something was wrong, either with us or with the market. Applying this would cause us to trade less, but better and more efficiently. It is not the number of trades or frequency that matters, but our overall results. Profits rule.

As to stops, there are many kinds of stops and many ways of using them. We have left this subject for a later chapter.

Let us now see how to exit a trade.

13
How to Exit a Trade

A VERY IMPORTANT DECISION: HOW TO EXIT YOUR TRADE

Closing or exiting a trade is our last strategic consideration, and a most important one. How to exit our trades is something that we must define in advance. There are many methods for exiting trades and we must choose the one that best suits our specific trade and our general trading strategy.

Knowing how to exit can determine your success as a trader. Often the exit is more important than the entry. You could enter the market randomly and still succeed. What we cannot do is enter and exit the market randomly and succeed. We need an exit for each trade that gives us the best possible profit.

This is why we must study carefully how to exit our trades. Our study must be done before we trade. It must be part of our plan and we must know our precise exit formulas in advance.

The Sokyu Honma exit formula is found in the fifth and last rule of his Samni No Den. In that formula, he teaches us how to exit. He also gives us important clues in general about the exit strategy. We will refer constantly to this rule during our discussion of exits in this chapter. Let us also add that this rule is the symmetrical opposite of Sokyu Honma's second and third rules. Read them again and you will discover why.

The main tenets of the rule are to exit partially – 70 to 80 % of the positions – as soon as a reasonable profit has been attained and to exit what remains, and reverse positions, when the market reaches a top or a bottom. However, there are many ways in which to close a trade and all of them are valid. Again, it is a question of testing the exit in your trading strategy that works best. We shall consider many of those exiting methods. However, Sokyu Honma's method works very well, even though it may not be suited to all trading personalities.

When we close or exit, our trade stops. There is a similarity here between an exit and a stop. This is quite evident when we use a trailing stop that has the double function of exit and protection. The trailing stop keeps us in a trade, but will exit us from the trade, as soon as the market turns around by a specified amount. This is why, when we think of exits, we must also think of stops.

We should keep this in mind when devising the method to close our trades. In our own examples in this book, we have used two exit methods. The first method we have used is the third gap exit. The second method we have used is the trailing stop. This was for illustrative purposes only, even though they work well.

As the exit selection depends on your strategy or plan, you are well advised to consider the different ways of closing a trade. Let us examine them.

THE PRICE FACTOR CLOSING STRATEGY

Using targets is one of the available exit methods. It consists mainly of setting, in advance, a number of profit points to be made. As soon as the market reaches its target, we exit the trade.

The number of points to gain before exiting a trade must be defined beforehand, and not during the trade. In order to establish an appropriate target, it is necessary to test it before using it.

A target must not be arbitrary. You must take into account your risk/reward and your win/loss ratios when testing. The use of a target is justified only if the reward compensates for the risk. The risk/reward ratio must be adjusted to take into account the win/loss ratio. The lower your percentage of wins, the higher your reward must be relative to your risk.

In general, the profits that are achieved with the use of target stops to exit tend to be lower than those gained using other ways of exiting the markets, such as a trailing stop. The third gap exit is quite similar to a target. However, it is not exactly a target, since a number of points is not defined in advance. As for the trailing stop, it has the advantage of maintaining the trade as long as it is profitable.

The Sokyu Honma exit technique includes this kind of nonfixed target exit. When there is a profit according to the rule of the third gap, for instance, you exit 70 to 80 % of your positions. The other positions remain until the market reaches a bottom or a top, depending on whether you are long or short. Then, you reverse your position as soon as the next corresponding Sakata method has all of its entry conditions in place.

What is interesting about this fifth rule is that Sokyu Honma seems to favor triple bottoms and triple tops for final exits and for initiating new positions at a reversal. In Sokyu Honma's methodology, we do not have a trailing stop. A trade is exited when it goes wrong and is closed at a loss, or when it reaches its market target, such as a third gap, or a market top or bottom, at a profit.

This is a simple formula that works. However, it must be tested against the other alternatives, such as trailing stops, to see which works best.

Using trailing stops also provides a good exit method. When using them, you must include a volatility margin. You must allow enough room for the market to oscillate in without triggering a premature exit. The way to do this is to test different possible trailing stops. Be sure to adjust them to satisfy the needed risk/reward for your trades.

Let us now have a look at time as an exit.

THE TIME FACTOR CLOSING STRATEGY

Using time targets is another possibility for exiting trades. This can be a very powerful and profitable exit strategy. In this case, we have a fixed time limit for our trade to develop. As soon as the time limit has been reached, we close our trade. For example, assume that we decide on an exit in five days. We then exit on the fifth day after our entry.

Many alternatives are possible. We could exit in a time frame as long as a year or as short as a minute. It all will depend on the time window we are trading in.

The way to know if we should use a time exit is to test it. There are traders who are very successful using time exits. Also, the time exit has the advantage of not eroding profits so much.

Using trailing stops or other exits can often leave potential profits on the table. This is true also of using a time frame. However, the time frame will give the market all of the amplitude it needs to develop the position.

This needs a careful study of time cycles. Some traders use time periods of 3 days, 10 days, 30 days, 80 days, and more after entry and then they close the trade. We could test many other time periods. What is important is to find the best time frame.

The advantage of time frames is in their simplicity. We know that on a given date, we will automatically exit our trade. This can help us to trade in a more relaxed fashion.

A seasonal exit is a variation of the time exit. Many commodities can be traded with the use of a seasonal exit. In this case, we exit our trades in a given month of the year. We also find this approach in the stock market in the well-known strategy of 'buy in October and sell in May.' This is a valid exit strategy.

If we use a seasonal strategy, it should be tested, along with some variations in the time periods. This will enable us to verify that the strategy works for our system. This testing will enable us to get a better feel of our market and make adjustments, if necessary. Once again, testing is a must. Whatever you do, you should always test first.

Let us now consider whether we should exit all of our positions at once, or do it progressively, as Sokyu Honma suggests in his fifth rule of the Samni No Den.

EXIT ALLOCATION

Each kind of exit – the total exit or the partial one – has its advantages and its weaknesses. In any event, you have two choices.

This is not a decision to make during the trade. It is a decision that you must plan in advance. The final decision must depend on the results of your tests.

Let us explore the advantages and disadvantages of these two ways of exiting the market. First we will consider exiting partially. Here, if we follow Sokyu Honma's advice, we would exit 70 to 80 % of our positions as soon as we have our planned minimum initial profit in order for our system to work. We would then leave 20 or 30 % of our positions until the market reaches an extreme – top or bottom.

The advantage of this is that we would keep some of our profits while reducing our risk. At the same time, we leave an amount that represents additional profits. As long as the market continues its trend, we will not be leaving profits on the table for 20 to 30 % of our positions.

The weak point of this method is that if the positions that we have left become losers, they will erode the profits that we gained on our winning trades. However, the theory behind the method is that the market will continue to move in the same direction, more often than not.

Anyway, we must test this to verify whether it is true within our system. We must confirm that the market will continue on its same course.

It is always possible to add a trailing stop to what is left of a position. That would reduce the risk of an unexpected, strong reversal.

The second alternative is to exit all of our positions simultaneously. This creates the same problem as in the case where we had not exited some of our positions. If the market turns around, we can be forced to give up the profits from all of our positions and not simply from those that we had left until the end.

However, the opposite is also true. If the market does not reverse before it is due, exiting all positions at the same time will be more profitable for us than exiting partially. In that case, we are better off to hold all of our positions until the end. The choice will depend on our tests. The resulting risk/reward ratios and the win/loss ratios will tell us what is best.

The point here is that we must make a choice before we trade. We should know beforehand whether we are going to exit partially or totally.

Even though Sokyu Honma's exit technique works, test it and compare it to other alternatives. No two systems give the same results and there is no fixed rule for this matter.

We have now finished our study of trading strategy and its elements, according to Sokyu Honma's methods. We have studied how to trade his fundamental ideas within the framework of our markets and of our actual trading knowledge. In the rest of this book, we will meet a few issues that every trader should think about when trading Sokyu Honma's methods.

Let us begin with risk.

14
How to Manage Your Risk

THE RISK IS YOU!

It is essential to manage risk. Most traders fail due to a lack of risk management. They either overtrade or do not work their plan and all of its elements.

What is important to understand is that we comprise the only real risk in trading. We are our own risk. In the last analysis, we are the only ones who are responsible for our results. When you trade, you are trading yourself. We will only get out of our trading what we put in. If we blame the market, we should really blame ourselves, instead. There is no one else to blame.

How we trade is what we are. Trading is only a mirror of our strengths and weaknesses, as will be our results. This is why, in order to really control our risk, we should begin with ourselves.

What we should understand first are our weak points, relative to trading. There are many flaws in our individual behavior that can immediately bring catastrophic results to our trading. We are not speaking here of trading psychology, but of tangible and specific trading procedures. For example, do we keep records of our trades? Many people do not. Persons who do not keep records do not test anything or have any coherent trading knowledge. In the long run, they always fail. Do we know our risk/reward ratio? Do we know our win/loss ratio? If we do not, it is better if we do not trade.

In summary, do we know today what we should be doing as traders and are not doing? Those are our real weaknesses. Let us examine them.

Are we organized? We cannot aspire to trade if we are not organized. A failure to organize could be our ruin, as much as overtrading is. In fact, if we overtrade, we probably do so because we lack a sense of organization. Organizing means giving life to what we do – making it organic, similar to a living thing – to something that works organically and achieves its goals. This is what we want for our trading. To organize, we must think in terms of priorities. We need market knowledge and

trading knowledge. Then, we must be able to prioritize our knowledge to build our trading strategy step by step.

When we trade, we must study the market, our trading system, our position allocation, our asset allocation, where to place our stops, etc. We should also know everything about our system before and after testing it. Accomplishing all of this in an orderly way is being organized in matters that concern our trading.

We will have built an organic system that will enable us to trade efficiently. If we are not organized, we will never achieve a coherent trading strategy and practice. This is easy. Go slowly at first and take simple steps.

Are we logical? This is another aspect of the trader's mind. We need to understand the relationships between the different elements that we must incorporate in our trading. We must know not only what to do but also why we should do it. A contrary example is provided by traders who buy systems that they apply without really understanding them.

The same can be said of a trader who excludes important elements from his trading arsenal. For example, if a trader excludes risk/reward ratios or asset allocation or position sizing, it is basically because his thinking is faulty. He does not understand what he does or why. We may forgive this trader for his ignorance, but the market will not.

Have we synthetic minds? Trading implies an ability to put together many things. This is the case when we build a system and when we apply it. Even the simplest of systems, such as a system based on only one entry rule – to trade only one thing – will require putting together many elements.

It is important to have the ability to get to the core of a system, to its key element that ties the rest of it together, and to learn how and why it does. To be able to synthesize information is important for trading.

Do we tend to think before we act? Alas, this is not the case with most traders. They trade on a whim, without planning or following a system or understanding it. All trading should be based on very careful reflection and thought. All elements and scenarios should be considered before we trade.

How is our trading life curve? Every trader has a life curve. It can be ascending, flat, or downwards. The important thing here is not what you do or what you have done. Instead, the only thing that matters here is whether you have an ascending learning curve – whether you are expanding your trading knowledge and trading practice.

If you read about trading, study the markets, and practice and learn from your mistakes, you are heading down the right path. This is not true of most traders. Many traders do not want to learn about the markets. As a result, they repeat the same mistakes – year after year, over and over again – for a lifetime. It is essential to break this pattern.

The elements that we have considered can be riskier for our trading than the worst of market conditions. All of our trading results mirror our trading qualities.

Here, we should add a word about Sokyu Honma. He certainly was not like everybody else. He was a special person, which is why he became an excellent trader. If he was honored as a samurai by the Emperor of Japan, it was because he really was one. A samurai is responsible for himself. He has the courage and the strength of character to discipline himself. Sokyu Honma was a very special person because he did all that was necessary to become one. His qualities made him a great trader.

It is because of the qualities that trading demands from us that we should develop, and to which, above all, we should be attentive. If we are, we will reduce and control our risk, and excellent trading will naturally follow.

Let us now look at risk in relation to markets and trading systems.

THE ELEMENTS OF RISK

There are many types of risk in trading. It is important to be aware of them. We will consider market risk, vehicle risk, and money management risk.

Firstly, let us discuss market risk. By market risk, we mean the risk of the market, as a whole, collapsing. For example, this is what happened in 1929, 1987, and 2001. This kind of risk will affect all of our positions. If we had been in the stock market on those dates, we would almost certainly have been hit.

The point here is that this kind of risk cannot always be avoided. It can just happen, and it cannot be forecasted. This is true for the simple reason that forecasts do not always work.

Let me explain. When market risk comes into play, forecasts are irrelevant. The reason is that we cannot always correctly forecast a market catastrophe. Even if we could, we should integrate the fact that it can, and will, happen to us.

In the same way that some analysts correctly forecasted the major market crashes, many did not. Trading systems should never depend on always being right. Market risk is a reality that should be acknowledged. It should be integrated into our system. This happens automatically when we do not overtrade.

If our asset allocation, position allocation, stops, and all other elements of our system are well formulated and in place, nothing too bad should happen. If a market catastrophe does occur, we will simply have a loss that our system has already accounted for. In the long run, a well-devised system should be a winner overall in its trades. In brief, such a system will account for market risk.

Vehicle risk is our next kind of risk. This is the risk of losing because our chosen trading instrument does not work. In this case, the stock or commodity that we bought or sold did not work as we thought it would. Again, our system will take care of this. If our system has a reasonable risk/reward ratio and win/loss ratio combined, we will have a winning system, even though we will have some losing trades. If all the elements of a trading system are in place, we have nothing to fear.

Our next item is system risk. This is the risk that, at a given moment, our system will stop working for a lengthy period or even indefinitely. This can happen to any system. This risk, also, must be accounted for beforehand. This is what Sokyu Honma's Samni No Den does for us. The way to protect ourselves from this risk is by including all of our management tools in it.

Asset allocation and position allocation, as well as stop placement, will enable us to have our system fail without bringing ruin. Our working capital will still be there, if the worst does happen. However, this should not happen to a sound system that is based on fundamental market structure and principles. It happens mainly with statistically based systems that do not have solid market structure foundations.

Then there is money management risk. This is simply the risk of not having a sound money management structure, of having incomplete or bad money management, or of not following our money management rules, even if they are sound.

After dealing with these risks, we must account for the risk of lack of knowledge, of not having an adequate market knowledge base. An ignorance of market behavior can be fatal.

THE RISK OF NOT UNDERSTANDING MARKET BEHAVIOR

Market knowledge is fundamental. Studying technical analysis is a must. Modern and classical analysis should be studied. Also, a great deal of practice is required until we can feel the market. We need a feeling based on knowledge, study, hard work, and practice. We do not need the kind of irrational, impulsive feeling that many people have.

Sokyu Honma's methodology, his five Sakata methods and his Samni No Den first rule, are excellent teaching aids for acquiring sound market knowledge. Many traders take a risk by trading with insufficient market knowledge. This lack of knowledge will cause many mistakes.

Here are a few mistakes that we can mention:

1. Bad timing comes either from inadequate market analysis or from limitations in the sensitivity of the indicators used. Our signals can be too early or too late, or simply wrong.
2. Choosing the wrong vehicle is another common mistake, such as buying without having studied a large sample of possible trading vehicles. Vehicle selection is choosing the right stock, commodity, etc. As already mentioned, the selection can be more important than our entry. It is important to always trade the most active markets and choose the vehicles that are on the move and favored by general conditions. Once more, Sokyu Honma and his five Sakata methods, as well as the first Samni No Den rule, come to our rescue.

3. As we have already seen, not knowing how to diversify correctly entails a risk that can be easily avoided. Correct diversification comes from market knowledge. We should be able to select the best stocks to trade within a large enough sample. The five Sakata methods and the first rule of the Samni No Den are invaluable tools for doing that.
4. Not knowing how to scale our trades also entails risk and comes from a lack of market knowledge and study. To allocate our positions, we must first define a scale or interval at which to add our new positions. For this, we must study the stocks or other vehicles that we have decided to trade in. Here the first rule of the Samni No Den can help us. As always, we must measure, compare, and test.
5. Untimely exits also imply risk that comes from not having sound market knowledge and experience. We may sacrifice profits or even ruin our system by an untimely exit. If possible, we should find ways to stay in a trade as long as it is profitable.

I have shown you a sample of risks that result primarily from a lack of market knowledge. In order to avoid them, we must read, study, and practice until we have theoretical and practical knowledge of trading and markets. The methods of Sokyu Honma can be an excellent beginning and serve you well for a lifetime.

Let us explore the risk of not having a plan.

THE RISK OF NOT HAVING A PLAN

Simply put, not having a plan leads to ruin for the trader. Not having a plan necessarily means losing. No trading success is possible for someone who does not plan. We must plan.

Strangely enough, most people who trade do not have plans. Some of them think that they have a plan because they trade a canned system, which they purchased. A trading system that you purchased or tailored by yourself is not a plan. A trading system is only one of the elements that belong to a trading plan.

It is imperative to have a trading plan. Not having one is risk number one. There is no greater risk than this. All of your trading efforts should be focused on your plan. It comes first.

Of course, it is assumed that you have enough market knowledge, trading knowledge, and money management knowledge to create at least the simplest of plans, which are also usually the best. Why do most people not trade according to a plan or want to hear about plans? The main reason is bad information about what trading really is, combined with the fact they have been lured away by signals.

Most people who trade are looking, year after year, for a magical system, the trading grail, and the perfect entry and exit signal. For them, this is what trading is all about – buying or selling on signals on given market patterns that will enable them to profit from the markets. This is not trading! Further, it is the most common

illusion and trap that has ever existed. It is a kind of veil that blinds most would-be traders.

Even with the best of market signals, we will lose without a plan. Market signals, patterns or trading systems will never make a trader profitable.

Only trading within a plan, considered as a whole, will make a trader profitable. All else will cause the would-be trader to become a loser. Therefore, do not think in terms of systems or signals. Think trading!

Another reason for not wanting to plan is what is called a 'coup' in French. This is a big, unique, lifetime win in the markets, simply because someone bought at the right moment. These 'coups' are normally wins due to chance.

The winner of a 'coup' laughs at plans and is proud of his ignorance. He already owns his Ferrari. The gods were on his side. He therefore does not want to hear anything about plans or risk control or money management of any kind next time. He will say such things as, 'to trade, all you need is money and then take a plunge' on a tip, a dream, a feeling, an opinion, or whatever. Of course, on the next occasion, when he buys just around the 'big bear,' he loses everything. He could have profited and turned his luck into the beginning of knowledge, but he did not. Let us hope that he was at least able to keep his Ferrari!

For us, trading is a difficult business that must be learned and practiced. Forget any easy way! Forget the idea that buying and selling is trading. Trading is much more than that. It is the ability to integrate all elements necessary to minimize risk and be profitable in the markets. All else is not real trading or being a trader. Forget it!

Now let us study the risks of not having the different elements that our plan needs in order to succeed. We will begin with asset allocation.

THE RISK OF NOT ALLOCATING ASSETS

Asset allocation, as we have already mentioned, is fundamental. It will help you to avoid the risk of overtrading. In trading, stop placement is not enough. It is imperative that we allocate our assets in accordance with the risk that we are willing to accept.

Unnecessary losses, or even ruin, can come from not taking asset allocation into account. This happens when all assets are placed on a single trade. If the trade goes wrong, devastating losses can occur and it may be difficult for the trader to recover, financially and psychologically. If $100 000 is transformed into $50 000, it then becomes necessary to earn 100 % in order to recover the initial assets. Yes, a loss of 50 % means having to earn 100 %. This is not done easily or quickly. Now, imagine incurring a loss of 70 % of your assets, turning $100 000 into only $30 000. This means that the trader must earn 230 % on what remains of his assets. This all happens because of overtrading and not implementing an asset allocation strategy. Of course, if it happens, it is devastating.

Ruin is almost certain without asset allocation. Asset allocation should be a function of our risk. If we want a risk of, say, 20 %, the assets should be allocated accordingly. Also, do not trust stops. They should never become substitutes for asset allocation. The market can trade right through all of our stops and leave them nonexecuted. This is theoretically possible.

We must always take the worst-case scenario into account. Market catastrophes do happen – and will happen – and one day we will have to trade through them.

Survival of the trader must never depend on stops, but on correct asset allocation. Appropriate asset allocation will depend on many factors, such as portfolio risk, market risk, volatility risk, vehicle risk, etc. As mentioned previously, there are many good books that deal with these subjects. In addition, we must learn to be flexible. For instance, if we decide to trade very volatile stocks, we will need a tighter asset allocation strategy. In this case, we could be allocating, for example, 20 % of the assets to a specific set of trades, with a 10 % stop for the positions.

However, in other cases, it would be possible to be fully invested. With blue chips and high diversification, it is possible to be fully invested. It all depends on the system and the strategy. However, as a rule, we must never leave control of our assets to the market.

Let us always allocate our assets to avoid any damaging or devastating risk.

THE RISK OF NOT DIVERSIFYING

As we have said before, risk comes from a lack of market knowledge. It also often comes from greed, from hoping for a single, big gain – the market jackpot, the 'coup.' The truth is that no one knows the future, especially traders. You can never know for sure how a given stock or commodity will behave.

It is all a matter of probabilities. The best analysis is always after the fact. The most important knowledge of the future is that we know nothing of it. In any case, I do not. The sun is going to rise tomorrow? Maybe!

The only way to trade, therefore, is by going with probabilities, and as Sokyu Honma knew, to trade the past and not the future. Probabilities are the key, and probabilities always mean diversification. Even if you trade only one thing, you need many trades. You diversify in the number of trades and their timing.

If you trade many stocks simultaneously, you are decreasing the possibility of all trades going wrong by diversifying. In statistics, what is true of the individual is not necessarily true of the group as a whole. As we bet on probabilities, we put statistics on our side by diversifying. Also, our equity curve will become smoother. That is why we should always try to diversify. Avoid a 'jackpot' syndrome.

The impossibility of knowing the future with certainty makes good prophets avoid predicting it. It is sufficient to be able to describe market behavior here and now! Even the best analysis can go wrong, will go wrong, and does go wrong from

time to time. It will go wrong for us, even if we are the best of analysts and first among the 'gurus.'

In this sense, it is best for a trader to be able to be wrong – and actually be wrong – and survive, thanks to good trading, planning and execution, rather than being the person who had predicted the last crash, but did not survive the next one.

In fact, the trader who predicts a crash and survives because of his prediction is a bad trader. At the other end, the trader who predicts a crash but survives due to his trading abilities is a good trader.

Predicting crashes is not difficult. What is difficult is surviving them when they happen unannounced. This is what trading is really all about – putting probabilities on our side. With sound diversification and sound asset allocation, you will survive and profit, and be better off than most prophets and market 'gurus.'

THE RISK OF NOT SCALING YOUR POSITIONS

Not scaling our positions is only a minor risk. We can build a strategy without the need to scale. However, even if this is true, it is also true that scaling can diminish our risk in some instances. The advantage of scaling, as we have previously stated, is that we only add when the market goes our way. If the market is not going our way, we avoid placing trades that would become losers.

What is important here is to test our strategy to see if our overall risk is diminished, by scaling, relative to our final profits. We have Sokyu Honma's scaling strategy in his Samni No Den third rule. You can test it and try it when trading the five Sakata methods algorithm.

Let us now discuss something else about stops and stop placement.

THE RISK OF NOT HAVING A STOP

You must always have a stop. The reason for having a stop is to avoid unnecessary losses from a specific trade. This means limiting losses for each trade. Again, remember that stops are not substitutes for asset allocation. A stop merely prevents an unnecessary trading loss. It is not money management. It is trade management.

Stops form only a part of a money management and risk control strategy. Stops are directly market-dependent. They adjust risk for a specific trade within a specific market condition.

For example, if we buy a stock and know that we will have a losing trade if it goes down in price below a certain level of support, it will make no sense to hold on to the position. The stop enables you to avoid adding unnecessary losses to a given trade. That is why you must always use a stop of some kind. In a later chapter, we will expand on this subject.

Let us now consider the risks of not following the rules of your own system and trading plan.

THE RISK OF NOT FOLLOWING YOUR RULES

Often, a trading plan is created that is not followed later. Many plans that are not followed are often not good enough to follow. In those cases, it is better not to trade the plan in the first place. However, here we will consider good plans whose rules are not followed because of a lack of discipline. Let us see what happens when rules are not followed.

If the rules are not followed, market history will become useless. If we do not follow the plan, all market knowledge will be wasted. The best analysis will not give satisfactory results and the trades will not succeed. Statistics will no longer work. Trading signals work only when they have been tested and show probabilities in our favor. If we do not follow the signals, they will lose all of their statistical validity for us.

By not following asset allocation rules or diversification rules, one risks having devastating losses and ruin. Plans become useless unless they are followed. The greatest market risk of all is not following the rules of the trading plan. Ruin will certainly follow. However, if you have a good plan and follow its rules, success is almost assured. In order to have a good plan, we should study both of Sokyu Honma's methods.

Let us now overview the two areas of trading risk. We will take a look at risk now from a different perspective.

SUBJECTIVE AND OBJECTIVE RISK: THE SECRET THAT SOKYU HONMA KNEW

We have seen that risk comes from two main sources: from the market itself and from the trader and his method. Market risk in itself is unavoidable. Only a thorough study of the market can, sometimes, protect us. Also, the unexpected does happen.

That is why we must never leave our trading exclusively to the markets. Markets are only one side of the trading equation. We, and what we do to protect ourselves and become successful, constitute the other side.

This second aspect of trading is where the real risk lies. The main risk is not preparing ourselves and at the same time not integrating in a trading plan all the elements that will contribute to success and protect us from market risk.

Trading must always be envisioned as a whole. The actual trading process is only a small part of the whole, although very important. This is why we must take all of the elements of trading into account.

Market risk comes from the objective side, the market, and is only one of the aspects of trading. What the trader is and does, his whole plan and methodology, are the source of subjective risk. We must protect ourselves from both kinds of risk. For this, we need complete and thorough planning. Sokyu Honma knew this well, as his trading methods show.

This is why he had two methods. A first method integrated all of his trading steps, the Samni No Den of the market. A second method, his five Sakata methods, covers market behavior and patterns, and how to trade them. In this way, subjective and objective risks are fully covered.

Finally, let us say something about the risk and reward relationship and what we should think of it.

RISK AND REWARD IN TRADE SELECTION: A NEW PERSPECTIVE

We can think of the relationship between risk and reward from a different perspective. This perspective differs from what mainstream theory teaches about risk. What mainstream theory usually tells us is that the more risk we accept, the greater our reward. Large risks carry large rewards. What our beliefs are about this relationship can impact our trading significantly. Therefore, we must be careful before accepting mainstream opinion on this subject.

I thought and wrote about this subject when lecturing about Dow theory in 1995 for the Bank of France. It occurred to me that there was a possibility that the mainstream theory about risk and reward was wrong.

The fact that I could envisage other possibilities was what first caused me to doubt the traditional view. Here are the different possibilities:

1. High risk that results in high reward.
2. High risk that results in low reward.
3. Low risk that results in low reward.
4. Low risk that results in high reward.

These four possibilities are all true. There are circumstances in which all have been proven to exist. In each case, we must try to minimize our risk while maximizing our reward.

This is not what mainstream thought believes. The mainstream way of thinking leads to high risk taking, and high risk taking is not the way to profit from the market.

If the four possibilities are true, we must find the market singularity in which low risk is accompanied by a high reward. If we look around, we will discover many occasions when this is exactly the case.

In addition, the most interesting market opportunities carry the lowest risk and not the highest. This is contrary to mainstream thought. Our main job is to find these 'market singularities' where risk is in an inverse ratio to reward (i.e. low risk = high reward). From an absolutely logical ideal, the perfect trade would be the risk-less trade. Anything that approaches this comes closer to the perfect trade. This is more or less what we could call the 'ideal model comparative proof.'

A second proof comes from mathematics and logic. The lower the price, the nearer it is to zero. This means that, for any price range, risk and reward are in

equilibrium at the midpoint. The closer we approach zero from our midpoint, the lower the downside (risk) becomes and the greater the upside potential (reward).

Market data verifies this. If we buy near a bottom, we diminish our downside and maximize our upside profit potential. This is why we are minimizing risk and maximizing reward. At the same time, in this case reward will occur in an inverse ratio relative to risk.

This is where Sokyu Honma comes in again. His two methods, the Samni No Den of markets and his five Sakata methods, provide a unique way to find these market singularities. The five Sakata methods algorithms offer specific conditions under which trading risk is minimized and reward is maximized, which correlates with the second rule of his Samni No Den in which Sokyu Honma told us in an explicit fashion to buy as near a bottom as possible and to sell as near a top as possible. According to his methods, this is where our trading singularity will be found. In Sokyu Honma, risk is minimized in such a way as to be the inverse of reward, which is maximized.

As traders with this perspective, this is what we should try to find. We need to seek the singularity in which an opportunity of a trade with very low risk and a high reward is offered to us.

In order to find this special condition, we need, above all, patience. We should not jump on to any old trade. We should wait until only the very best opportunities are present, and the very best opportunities will be there when all conditions of Sokyu Honma's two methods are fully present and are ready to be traded according to our plan.

Let us now discuss stop placement, expanding once again our previous notions on this subject.

15
All You Will Ever Need to Know about Stops

When we consider the subject of stop placement, we must do so in relation to trading Sokyu Honma's methods and how they help us to decide how to place stops.

THE SUPERSTITIONS ABOUT STOPS

There are many superstitions about stops. The famous injunction, 'always use a stop,' is one of them. If it is true that we must use some kind of stop, it does not mean that we must use a traditional stop.

'Always use a stop' is not necessarily true. In many cases, stops make trading a hassle or do not work. Many traders have their stops caught by the market and executed, only then to see the market turn around.

This happens very often. Of course, they will tell us that we were better off with our stop. Ridiculous! We can lose a great deal of money using stops if we use them just for the sake of using them.

It is true that we need stops. However, sometimes it is not convenient for us to use a stop in the normal way. If we do, we will constantly lose on potentially good trades. For instance, a time stop is also a stop. This means exiting the market after a given period. Also, when we close a trade, it is a stop. It is therefore important to use the right kind of stop.

Using very tight stops will usually cause us to be stopped. For instance, using a two- or three-point stop, as Gann suggests, will not work. It is a myth. Gann was right. His three-point stop meant something different from what most followers of Gann tell us. A myth is an obsession that was once true, but is now out of context.

It is not our purpose to explain Gann's stops here. All we want to do is to warn you against the many myths that you will encounter when trading opinions. This is why you should always test what you read before using it.

WHAT A STOP IS AND IS NOT

We have already mentioned this before, but it is worth repeating. A stop is only relative protection. No stop provides absolute protection. The market can easily go through our stop. If it does, our stop may not be executed when we most need it. Alternatively, our stop may be executed too late. Then our losses could be devastating. We should avoid this by all means.

All that stops do is enable us to control the market risk for a particular, specific trade of our system. Market risk is not trading risk. Trading risk comes from factors other than the market, such as how we allocate our assets or what our position allocation policy is.

Stops should not be asked to do what they cannot and should not do for us. They should only be asked to give relative protection and then we will obtain it. We should not depend on stops for all of our risk protection.

Let us now learn how to place stops correctly.

HOW TO PLACE A STOP THAT IS ALMOST NEVER CAUGHT

Stops must be based on market behavior. This requires us to study market conditions. There are cases when a market will explode to the upside or to the downside. In these cases, the market will not look back and a very tight stop is possible. However, this is often not the case. It is better to allow the market a little room in which to fluctuate.

In order to find convenient stops, we must first use rule 1 of the Samni No Den. This tells us to study market fluctuations and their time ratios. A knowledge of market oscillations is necessary for adequate stop placement.

We should classify market fluctuations. This will indicate the volatility range, the space below and above our trade, that we must leave untouched to permit the market to continue to oscillate without needlessly stopping our trade. The secret is to let real fluctuations decide our stop placement. Then, we should adjust our risk/reward ratio accordingly and test our system. It is also generally best to use large stops, rather than tight stops, in order to allow the market to move.[35]

We have two main kinds of stops: price stops and time stops.

PRICE STOPS

This is the simplest and best-known stop. This is the stop that we place below our entry if we are long or above our entry if we are short. This kind of stop is frequently

caught because it is too tight. This is why, based on our study of fluctuations, it is better to allow the market a wider margin of fluctuation.

In general, the only reason for our stop to be caught should be that the trade has gone wrong because of a market reversal, or that the market has an unusual fluctuation that could signify a risk of reversal. By giving the market a wide margin, we are avoiding the risk of our stops being caught by market noise only. This is what happens to most traders. Because of market noise, their stops are caught without any really good underlying reason.

How do we sort out this problem? With the classic price stop, the only way is by studying market oscillations and market entries and their oscillatory patterns.

Let us now study the second kind of stops, time stops.

TIME STOPS

Time stops do work. They can enhance profits significantly. They can also be combined with larger price stops. Time stops have an inner logic of their own that we need to be aware of. The logic is based on the market's cyclical movement. Markets develop within certain periods. This can be one month, three months, six months, one year, or even longer.

Many strategies work better with time stops than with any other kind of stop. Time stops usually do the work for us. This is, for instance, true of seasonal stops.

When we exit, the market will have made its move in a way that it would be difficult for us to forecast. Here, the average cycle works in our favor. This is why, in order to use fixed time stops, we need to test different time periods. These time periods should, in most cases, follow the time windows rule.

This means that if we are trading intraday, our trades generally should not last more than one day. We should exit the market at the close of the day, at the latest.[36] If we are end-of-day traders, our trades should last no more than a week. This means trades of between one and five days in duration. If we are weekly traders, our trades could last a maximum of a month. This means between two weeks and four or five weeks. If we trade monthly bar charts, our trades could last for one month or longer.

These are only useful guidelines. We must exercise some flexibility when using them. Everything will depend on our test results.

We also have certain, useful, known time periods, like three months, six months, or one year. For example, if we buy a portfolio of stocks and hold it for six months, we can avoid the risky period between May and the end of October. However, we should always make a test.

We do not always need a price stop. In certain cases, we can use only a time stop. This must be done in such a way that our time stop will not be our only risk control strategy.

In addition, we need asset and position allocation. This will depend on our system and overall plan. Our asset allocation and position sizing will depend on the average results of our trading tests. The testing of our entry and exit signals when applied to our vehicle selection will give us the optimal asset allocation and position sizing.

As stated previously, there are good books, as well as software, on the subject to help us with this kind of analysis. Remember that real trading implies an overall plan.

YOU HAVE THE LAST WORD, BUT BE CAREFUL!

As we have already seen, there is no unique rule governing stops. Our stops will depend mainly on our market strategy. They are an additional aid available to help us to control our risk. We should never trust stops for our final results.

Stops should never be a substitute for asset allocation or position sizing. These two elements have priority. They always come first while stops come after. Do not forget this! What is important to remember is that we should always have some kind of stop, even if it is not always the type that we hear about.

Let us say it once more. No stop fully protects you against risk. Use stops, but do not trust them with your trading future. Always study market oscillations before choosing your correct stops.

There is a final type of stop, which is the one used by Sokyu Honma. This stop can be deduced from his Samni No Den fourth rule. Here, Sokyu Honma tells us to close our position and exit the market as soon as we discover that we have made an error in our forecast.

What does this really means? To understand what he said, we must relate it to his great market cycle and his five Sakata methods. In the five Sakata methods, we find the five market phases and how to trade them. This is why they are called methods. In our algorithm, we will find a particular way to trade each phase.

Sokyu Honma did not tell us about price stops or about time stops. His stops, if we must give them a name, would be called 'market structure stops' or, if we prefer, 'market phase stops.' Within his perspective, realizing that we have made a mistake means that the market has changed its phase, but not in accordance with what we expected. According to Sokyu Honma, before exiting we must therefore wait to see the market change its phase into one that reverses the original market conditions of our initial trade. Only then should we exit the market.

Let us consider a few examples. Suppose that we enter a position in San Sen, the triple bottom method. The only reason to exit the market would be if this triple bottom ceases to be true. It would no longer be true if the market goes below the triple bottom and continues its downtrend move. This gives us a natural place, based on market structure, to place our stops. In this case, we should place our stop below the triple bottom, or at least below the Marubozu or three white soldiers that was our entry signal.

The same would be true for San Pei, the trend in three bar charts. If the market declines below your San Pei original bar chart, you should exit the market. This is to say that the market structure should rule our exits in the event that our trade goes wrong. This is not the thinking of Sokyu Honma alone. Many Western traders, such as Gann, advised us to place stops while taking the market structure into account. Gann said that we should place our stops under a swing bottom or over a swing top. Therefore, in placing our stops, we should always take market structure and phase reversal into account.

We will now mention something that you should consider when integrating stops into your system. When building your trading system and plan, leave stops until the end.

Stops should never be what make our system profitable. First create a trading strategy and system that is profitable and sound in itself. Only after we have a robust and solid system should we think about stops. Stops are an add-on to our strategy but our strategy should never, ever, be based on them. Only when something that works is created should the stops be added.

Let us now approach the way to build a trading system that works for us, based on Sokyu Honma's two methods.

16
Putting It All Together in a Simple but Winning Approach

We will now put everything that we know together to obtain a winning system. The first step in putting it all together is self-knowledge. Why? Simple! We are the point of departure. Trading begins with us!

KNOW YOURSELF

When we speak of self-knowledge, we are referring to a very practical and specific self-knowledge – the knowledge that a trader has of himself as a trader. This means knowing our assets and weaknesses as a person who trades. For this, we must know the kind of trader we are – specifically and item by item.

Do we have any theoretical knowledge of trading? Are we familiar with the main elements of trading? Do we have knowledge of risk control and money management? We should answer these questions. Our first step is to have a general knowledge of trading and money management. This book gives you Sokyu Honma's methodology on this subject. Study it.

We should also know the kind of market approach that best suits us. Do we have a tolerance for losing? Can we lose seven trades in a row and withstand the losses? Could we trade a system that wins only three trades in ten but is an overall winner? Or do we need a system that wins more frequently?

The answers to these questions are important in order to assess where we stand as traders. We should also know our limits in advance. Are we disciplined? If we have a winning system, do we have the discipline to follow its rules?

This seems easy, but it is not. I am not saying that we only need discipline in order to follow rules. I am asking if we are able to do it with a system that has

been proven to work. Most people cannot, even if their systems work. There are many systems that do work, but with scarcely anyone to apply them consistently.

Are we ready, knowledgeable, and willing for this disciplined approach? In most cases, discipline is useless because the underlying systems are bad and do not work. They do not work because of flaws in the systems themselves or because they are psychologically unsustainable.

This brings up another point. We should begin trading in a consistent way what we are comfortable with. For example, we should not begin to trade futures if we have not already had experience with stocks. We should first become good stock traders. Only afterwards, if we want to, should we become futures traders. Let us trade first what we already know and have experience in and leave the rest for later.

When choosing our system, let us first develop and use the talents that we already possess. For example, if we are not disciplined enough for short-term trading, let us begin with long-term or medium-term trading, which definitely are easier. We should be realistic about who we are. Practice and study will uncover our trading personality. Let us have a go at it.

Now that we have more or less defined our trading personality and are familiar with both of Sokyu Honma's methods, the next step is to create a definite trading plan.

THINK YOUR PLAN

In order to develop a definite trading plan, we must start by thinking about plans. Most people do not. They think about trades, trading systems, and entry and exit signals.

The first thing that we should learn is to think about plans, not trades. We must begin now to think about a complete trading plan. We begin by making a list of the elements that we need for our plan.

Lists are the beginning of wisdom. Write down everything that we can think of concerning our plan. We will list our ideas. Then we should begin to develop them, to expand on them in writing just a few lines. Have an idea notebook in which to write this down. Ideas come at the least expected moment. Carrying a notebook will stimulate your creativity.

Create trading strategies, using Sokyu Honma's methods. Create many strategies. Whether they are terrible or terrific does not matter. Write them down. Do not worry about the results. We should not edit ourselves at this stage. Simply put down every system that you can think of.

For example, you could write down that you are going to trade the first method in your algorithm for the five Sakata methods, that you are going to trade stocks from the Dow 30 to begin with, that you will test 20 years of history in your charting software, that you will implement each item of the Samni No Den, etc.

HAVE A PLAN: MAKE IT COMPLETE

Once we have written down our ideas for one or many plans, and how to build them, we should decide which one to create. When creating our plan, we must use the five Sakata methods and the Samni No Den. Include in it all the Samni No Den rules and add everything necessary to create a robust plan. Think in terms of general strategy. Think always about the entire trading procedure.

We should begin by first testing our market strategy, using the Sakata algorithms in conjunction with the five Samni No Den rules. All of them should be used. Add asset allocation and general money management to this.

After that, we should adjust our plan. Test it again. Ensure that everything fits well. If they do not, make the necessary adjustments. Do this until you have a smooth, well-tested, and working system.

HAVE A PLAN: MAKE IT SIMPLE

We should always prefer a simple system to a complex one. If we are going to choose one from many possible trading strategies, we should pick the simplest. Trading simple strategies will enable us to learn faster and better. This will also give us the confidence in our system that we need to have.

When choosing exits and entries, try to trade the simplest ones. Do not trade entries or exits that need complicated situations or require too much explanation to our broker.

We should adopt a simple money management and risk control procedure. We must always integrate asset allocation. We will do that at first, if not always, in the simplest way possible, by allocating our trading assets as percentages of our total assets.

HAVE A PLAN: TACTICS FIRST

Once our plan is ready, let us think about tactics. This is where our trading action will be. Here is where we 'pull the trigger.' Here is where we actually enter and exit the market.

Action is found in tactics; strategy is in waiting. Tactics are the specific Sakata methods. Each of the five Sakata algorithms includes a tactical issue where, when everything is in place, we pull the trigger. This is why, when we are still thinking about creating our plan, we must define our tactical approach. We cannot and should not ever leave tactics to the last. Let us not say, for instance, 'Hey! A triple bottom is in place, let's trade San Sen now' unless we had planned for it beforehand and tested market history with our chosen stocks.

We are not going to decide our tactics one hour before a trade. Our tactical arsenal should have been in place already and tested. If, for example, we have only planned to trade triple bottoms San Sen, we will not trade a last minute San Pei. Everything we do must be part of our plan, particularly our tactics. Pulling the trigger must be planned in advance too.

In the beginning, it is good advice to limit our tactical approach to what we can do best. If possible, choose only one method. In this way, we will become familiar with trading Sokyu Honma's methods. Choose from the five Sakata methods the one that you think you can do best.

When we are ready to trade, when our tactics and strategy are in place and all the elements of our trading plan are complete, we must test our plan, but first on paper. This test is not paper trading. This is done using testing software, with historical price data, to verify that everything is working smoothly according to our plan. Only then comes our next step, building the prototype.

NOW BUILD A PROTOTYPE!

Now that our plan works on paper, we should try it in real trading in the real market. For this, we must build a prototype. Our finished plan is the starting point for this.

A working prototype is always the first step. When he thinks of something new, every creator or inventor will build a working prototype of his idea. This is the reality test. We should do the same with our trading system and the plan that we have devised to trade it. Now that it works on paper, we must test it in the market.

We must build a scale model of our plan for this. This scale model will be our prototype. It is our trading system executed on a very small scale. This means that we will trade our plan with the smallest amount of money possible. Forget about making money here. All that matters is proving that our plan really works.

We will not only prove that our plan works but actual trading will enable us to test our plan, adjust its elements, and perfect it while trading it for real. All of this will spare us unnecessary risk.

Not having a prototype would be like launching a manned spaceship without having tested it in advance. It would be suicidal.[37] It is the same with a trading system and plan. They should first be tested on a small scale and for a reasonable length of time.

Now that we have our prototype and our plan is adjusted for trading on a very small scale to see how it behaves in real trading, it is time for the next step, trading our prototype.

17
Trade Now!

TEST YOUR PROTOTYPE

Trading our prototype to see how it works is the first step. Many things that we had not noticed when testing our plan on paper will surface here. We will become aware of any handicaps that our plan has. We will detect any execution problems, slippage, etc., that it may have. It is essential at this stage to note everything that works and that does not work.

Let us write down all of our observations of our prototype's performance. Also, we should record our observations of ourselves when trading the prototype. Does our prototype behave as smoothly as it did on paper? Does it works better than on paper, worse than on paper, or exactly as planned? Why? Are we comfortable when trading our model? Where are we most comfortable? What do we dislike about our system – its effect on our trading personality?

We must note all of the foregoing and list our observations. Then, after a period of observation, we must adjust the prototype if it needs further adjustment. If it works as planned, we must use it.

IF IT WORKS, USE IT FOR A TIME

We should continue to use our prototype for a while – always on the same small scale – until we have accumulated a significant sample of trades. This will enable us to detect any bugs in our system or plan.

During this period of real-time testing, we should be very careful not to expand our trading, even if we are tempted to do so. For the moment, we should stay with our system as it is. We must use it until we are really familiar and comfortable with it. The reason for this goes far beyond the need to detect any bugs or weaknesses.

Using our system will enable us to do this. However, we will obtain something much more valuable. The reason to continue to trade for a prolonged initial period is not to detect bugs or perfect our system, but simply to acquire faith in what we are doing. Faith is practical working knowledge. It comes from results. If you can verify that your system is working effectively, you will have faith in it. This will build your trading confidence.

Faith is the beginning of knowledge. It is the initial spark of practical knowledge that tells us, in advance, of our future results. We can compare faith to the first step of a ladder – a first step that enables us to glimpse the full road ahead of us and gives us confidence to follow it to its end where we will reach our destination.

It is this practical faith in our trading system and plan that we want to build. This faith is what will give us sufficient confidence to trade. Without confidence, we will lose courage with our first loss. We must avoid this by all means. Fear is paralyzing. Fear always comes from the unknown. It is one thing to know the theoretical behavior of a system and quite another to see it really work.

Building trading confidence is necessary for trading success. Our prototype will accomplish these two things for us: (a) verifying that we have something that really works and (b) ensuring that we have the necessary confidence to trade without fear. Once this is done, the next step is to expand our trading.

EXPAND YOUR TRADING

Expanding our trading must be done only when we have full confidence in our system. This confidence comes from practical knowledge of its workings. We must never expand our trading before acquiring this confidence. If we do so before the time is ripe, we will undermine all of our trading efforts.

Expanding our trading is an act of courage. However, courage is always coupled with intelligence. Then courage is a virtue. Unintelligent courage is not courage. It is temerity, the road to ruin.

This is why expanding our trading needs, first of all, a robust base: a working trading system and a plan with which we are familiar in practice. Only then, can we expand and go beyond our actual limits.

Only after having traded our prototype successfully for a reasonable time, and having acquired full confidence in our system and strategy, can we think of expanding our trading. To do this, we must plan carefully. We must calculate how much we are able to expand our trading, taking into account the assets that we have. We should expand our limits progressively. We should proceed step by step, as if climbing a ladder. This step-by-step procedure will add to our confidence.

We expect to find that, as we expand our trading size, our strategy and system will continue to work as planned. No unnecessary fear will undermine our system and our courage will grow. The idea is to go beyond our limits, to always exceed or stretch our comfort zone, but in a way that will increase our trading knowledge,

our trading confidence, and our trading courage. We must expand our comfort zone intelligently. This means that we will always be based in reality. The ground must be more solid than it was before, not less.

Within this expansion of our comfort zone, and going beyond our limits, is a requirement that we become perpetual students of trading and the markets. Trading knowledge is what will make us rich. In fact, it is our most valuable asset. If we continue to expand our trading knowledge everything else will come right. Let us always be on the side of learning.

THE TIME HAS ARRIVED FOR ALL THOSE TRADING PSYCHOLOGY BOOKS

Now that we have something that really works and have experience in trading our system, the time has come to begin to read trading psychology books. It was not the time to do this before. Most trading psychology does not work. The reason for this is that nothing – not even the best psychology – can make a bad plan and a worse system work.

We should face the fact that psychology is useless if we begin with a system that does not work and is not profitable. Most people who fail psychologically at trading have one main excuse for it: their system does not work! This is why they 'didn't pull the trigger' or 'forgot to take all the trades.' In fact, they were being protected from trading a bad system.

It is only when we have a good system that works that psychology can be helpful. We should forget psychology until we discover what works and how to trade.

Imagine trying to fly a plane based on psychology after someone gives you just a few rules and a manual. Yes, you could read a flying manual, jump into a plane, and have the 'discipline' to 'follow all the rules of your system.' I wish you luck!

Only when you are a trader, and profitable, can you begin to think about psychology. Then all of those books can help you to enhance your trading. However, at every stage of your trading, even as a beginner, there are a few things that will benefit you.

The first thing is focus. Concentrate fully on finding a system that works and on creating a complete trading plan around it. If you are not ready to focus on trading, you will never be a trader. Trading is hard work. It is not possible to be good at things on which we do not focus and concentrate our attention fully. Focus comes first.

Next, avoid clutter. Simplify, simplify, simplify. The fewer things we have on which to focus and concentrate, the better at them we will become. Create a simple trading plan based on a simple trading system.

Lastly, let us always be prepared, as Sokyu Honma was and every true samurai is. This means being prepared before things happen. This will help us to avoid surprises and is the secret of successful warriors. Of course, let us not forget that

trading is a war against the markets and ourselves. The way to win is by being ready, now!

Once we have done all of the foregoing, we may feel free to plunge into all of those psychology books – the good ones, the bad ones, and the ugly ones. You will learn a lot from them.[38]

Now we will discuss something that we seldom hear about – trading philosophy.

18
Some Thoughts about Trading Philosophy

We always hear about trading psychology, but rarely about trading philosophy – at least never in the sense that we mean here. In fact, philosophy is the science from which psychology was born.

Philosophy is defined by philosophers as 'the love of wisdom.' This love of wisdom is as important to trading as psychology, if not more. This is especially true when trading by Sokyu Honma's methods. His whole methodology rested on it. Philosophy was at the core of his method. This philosophy is called 'Bushido' in Japan.[39]

Let us now examine the differences between the philosophy of trading and the psychology of trading.

TRADING PHILOSOPHY IS NOT TRADING PSYCHOLOGY

Trading philosophy is concerned with the underlying universal principles of reality, as applied to trading and the trader. This differs completely from trading psychology.

This is what Bushido is about. Etymologically, Bushido means the way of the warrior. War for samurai was twofold. It was both the fight to master oneself and the fight to master life. They were one and the same.

Trading psychology concerns the mind, personality and behavior. Trading philosophy involves the principles that rule the trader's mind and life. Trading philosophy makes trading psychology and trading action possible. Trading philosophy concerns truth and reality in its specific relationship to trading and to the trader's life.

TRADING PHILOSOPHY RULES IT ALL: IT IS THE UNIQUE KEY TO TRADING SUCCESS

Without a trading philosophy, the reality of the market will always escape the trader. Trading philosophy, in the case of Sokyu Honma, the Bushido, was his underlying knowledge. It helps to explain his attitude and his outstanding results as a trader.

Bushido is not theoretical knowledge. It is eminently practical. It is knowledge in action and has never existed as a written code in Japan. It is the inner law of reality that samurais apply in their lives.

Bushido philosophy, as applied to trading, consists of active principles and causes that guide the trader. These active principles belong to the trader and the market alike. The principles share a common underlying core. This is true not only in war but also in all areas of human action, which is why the Emperor bestowed the honorary title of bushi on Sokyu Honma. His trading personified the principles of bushi.

Causes must precede effects, and the Bushido principles are the cause of Sokyu Honma's success. Sokyu Honma's methods must rest on bushi principles if they are to succeed. This is why, above all, we must seek to understand and live by the Bushido principles, as applied to trading. This is the way to success when trading by Sokyu Honma's methods. We can explain and illustrate this.

Phenomena are not reality. By phenomena, we mean what things appear to be in the world around us. By reality, we mean what things really are. This is important in order to understand Bushido philosophy and Bushido trading. In Bushido philosophy, the world is constantly changing. Its underlying reality is change. Nothing has permanence. Instead, everything flows. This is also true of markets and traders.

In this ever-changing world of markets, the only thing that matters is meaning (i.e. the principles underlying change). If we master these unchanging principles, we master market reality and can yield to it. Knowledge of them enables us to have change as an ally on our side. This is essentially what trading the markets is about. This is time mastery, since change occurs in time.

The trader seeks not to impose on the market but to yield to it in an intelligent way. He acts in harmony with the market and in harmony with his own mind. This is essential Bushido – knowing that what we perceive is not the final truth. The only underlying truth is change and its principles. For the trader, this means market flow and mind flow.

This is not psychology as psychology deals with mind and behavior. For example, fear is a mind behavior so fear is a psychological element. However, fear is not cowardice, as fearlessness is not courage. Courage is a philosophical virtue, a Bushido virtue. It is beyond the mind and rules the mind.

The same can be said about the flow and cycles of yin and yang. For Bushido, yin and yang are the two opposite poles around which all revolves.

This understanding of underlying change, oscillating permanently between these two poles, is not psychology. It is philosophy. It is above mind and rules mind, as

well as all else. The understanding of this bipolar change is what explains not only how markets move but also how traders' minds move. As a principle above them, it explains both.

Markets are always oscillating with upward and downward swings. They are always moving between two opposite poles, yin and yang, up and down, slowly and quickly, etc. The trader's mind also oscillates between fear and greed, agitation and peace, etc. Oscillations between poles are at the inner core of all change. This is the law of change and is philosophical, not psychological. It is a Bushido law.[40]

Learning these philosophical principles is learning to see behind appearances. It is learning about the core of underlying reality upon which all change rests and which all change obeys. For the trader, learning about these philosophical laws means learning the foundations of all market change, its oscillations between yin and yang, and its active and passive poles. It is also learning about himself as a trader, how he oscillates between fear and greed, attachment and detachment, courage and temerity, etc.

This was the philosophical core of Sokyu Honma's method. This core was and is, today, central to Bushido. This core enabled Sokyu Honma to build this cyclical method, encompassing all market phases that oscillate between two poles or extremes. Knowing that markets oscillate between two poles is the foundational knowledge for any trader. Not understanding this behavior of reality makes it difficult, if not impossible, to understand and master trading.

This is also confirmed by Western trading knowledge. All exceptional traders know intimately that the key to the markets and their minds can be found in this oscillating nature. From this vibrational or oscillatory core will emerge the three kinds of practical knowledge that a trader needs. Let us look at them.

THE THREE LEVELS OF TRADING: TRADERS' MARKET KNOWLEDGE, TRADERS' PSYCHOLOGY, AND TRADERS' PHILOSOPHY

In order to trade according to Bushido philosophy, we must have three kinds of trading knowledge. These are knowledge of the market, knowledge of traders' psychology, and knowledge of their philosophical principles. These three types of knowledge must be integrated in a harmonious whole.

These three kinds of knowledge are practical. They are knowledge in action. In Bushido, real knowledge is not theoretical knowledge, but action according to principles. A trader will show his true trading knowledge in the action of trading itself. It is here where these three kinds of knowledge integrate.

A Bushido trader needs to know the underlying principles of the market, specifically its oscillatory, ever-changing reality. These oscillations and their opposite poles must be studied. Possession of this knowledge of the ever-changing market reality is dependent on a trained mind, with proficiency in studying and acting in an attentive and focused manner. Attention, focus, and singleness of purpose are

the signs of a trained mind. These are psychological traits to which market study and action must be attached.

Thirdly and lastly, this market and mind integration will, in turn, depend on firmly grounded and practiced philosophical Bushido principles. These principles enable the trader to understand the markets, as well as his own mind, in order to obtain successful action. These principles are above mind and market, and form the ground of practical wisdom.

Among these Bushido principles, we find justice, courage, sincerity, loyalty, honor, and benevolence. Every successful trader knowingly or unknowingly applies them. This is why great traders, such as Sokyu Honma, are true philosophers according to Bushido. For Bushido, knowledge is the way of wisdom that leads to success. Therefore, the Bushido trader must first seek wisdom – trading wisdom. The rest will come by itself. Let me explain.

SAMURAI TRADERS KNOW THAT IT IS ALL ABOUT WISDOM

Trading wisdom is founded on three main principles. No trading success is possible without them. Sokyu Honma's success in his own trading relied on them.

The first principle is commitment to true knowledge – a loyalty to what is true. As a trader, this means accepting market truth and trading truth. In the West, this would be called faith in the trader's method and action. This faith is a commitment to market truth. It is not a blind faith in a system.

Faith comes from having a successful working knowledge. It is first-hand knowledge that something works. From this comes a glimpse of the future, a knowledge that the method will continue to work if certain guidelines are followed correctly. This is what having true faith in one's system and trading method consists of. It comes from having experienced positive working results. When you apply Sokyu Honma's method and see its positive results, your faith will begin to grow. This faith must then be slowly expanded and, as confidence also builds, success will come naturally. This comes from having good foundations.

When your market knowledge is based on solid foundations, such as those provided by the five Sakata methods, faith will ensue. The faith that market knowledge is possible and can be developed will be born.

The second trading philosophy principle is the belief that the trader has the capacity to trade the markets confidently and successfully. It is knowing not only that it can be done but also that he can do it. Becoming a trader depends on implementing a set of principles that will enable trading as a whole. This can be done only by someone who knows that he can apply those principles and be successful with them.

We can sum up this principle by saying that traders must believe in their trading selves to succeed. If a trader does not believe, deep within himself, in his trading ability he will not persevere or succeed. This is why this particular belief is so

important. It confirms that reality for us is a set of beliefs. It also explains and illustrates why belief creates the link between the real trading world and us.

The third philosophical foundation of trading is the love of trading. Traders love trading. Someone who trades in order to make money but does not like trading is not likely to succeed. Bushido calls these the principles of sincerity and benevolence.

Sincerity means having a true heart about something. The trader who loves trading is true to trading deep in his heart. Benevolence applies in the sense that the love of trading will overcome any weakness or difficulty along the road.

A love of trading, if real, will enable the trader to overcome any obstacle and persevere until he succeeds. Trading is difficult. It implies work, study, and making mistakes along the way. Only a passion for trading will enable a trader to overcome all obstacles. This is the real secret. This is what made Sokyu Honma a bushi. He was sincere about his trading and really loved it. He was also forgiving of his mistakes and failures. This enabled him to build upon his success and overcome his failures.

There are other Bushido qualities that are necessary for trading success and essential for a trader to integrate into his trading life if he wants to apply any methodology, system or plan successfully. We identify four main qualities.

The first is what Bushido calls justice. Justice in Bushido has a different meaning than in the West. Justice, for Bushido, is acting in accordance with the right way. For a Bushido trader, such as Sokyu Honma, it means trading in accordance with the appropriate trading principles. It is making a trading decision at the right time in the right place and with the right tools and elements. It is the art and science of the correct decision. This is justice for Bushido as applied to trading. Without this ability, no trader could ever be successful.

Traders need also courage, another of the Bushido key virtues. Without it, the trader will never be able to pull the trigger when he should. Courage is the opposite of temerity. Courage in Bushido has a very precise meaning. It is knowing what must be done and doing it. Temerity is acting without sufficient knowledge.

The coward is the one who, knowing how and why and when he should act in a certain way, does not do so. The trader who has a system that works and has integrated it within a plan that assures his success in the long run is courageous when he acts on his method.

Temerity describes a trader who trades a half-baked method or system that seems to work, but has not been fully tested or, if fully tested, has not been integrated within a complete and robust trading plan. Most unsuccessful traders act with temerity, which they often confuse with courage.

Successful traders are courageous. Courage is necessary in order to trade a robust and successful plan. Courage enables you to take action with something that really works and with full knowledge of why and how it works. Courage never involves blind action. Only temerity does.

Traders act on knowledge, but never on impulse. All temerity must be excluded when trading. When courage is present, fully controlled trading is enabled and success must come.

Another condition needed to trade successfully is detachment from results. The Bushido trader will try to do his best while trading. He will leave the results of his actual trades, good or bad, to the market. Nobody can know if an individual trade will succeed or not. However, each trader will know whether or not he has tried his best. That is the point of detachment.

With detachment comes quietness and calmness, a central issue for Bushido. Real wisdom is exhibited by the trader who keeps calm in the middle of a market storm. This detachment comes from restraint and self-control, which enable him to follow the rules of his plan in a disciplined and persevering way.

In Bushido, the trader who tries to do his best without attaching himself to the results of his action must have a sense of honor. This means nothing for the trader, except trying to do his best on any occasion. This means not leaving out anything that is needed for success.

The honorable trader makes his professionalism a point of honor. He will never accept, or be happy with, second-rate work. Performing up to the highest standard possible is his aim. Honor is the key to success. It provides a warning against negligence and laziness. The lazy trader who neglects money management, risk control, or any other element of his plan does not have a very highly developed sense of honor, as is asked of Bushido.

Another condition needed is prudence. This means practical knowledge and it is essential to Bushido. It makes us respect market strength. We must be respectful of markets. Prudence also makes us attentive to self-knowledge, to know our weaknesses and strengths. These two aspects, market outward reality and self inner reality, must always be accounted for in trading.

This prudent attitude is shown by not overtrading. Overtrading means a lack of practical knowledge of ourselves and a lack of market knowledge.

Bushido trading involves a practical knowledge of markets and ourselves in order to become wise traders. Trading wisdom is the final end of Bushido, as applied to trading.

We can now see the importance of Bushido. It is a practical philosophy for the ultimate foundation of trading psychology and market knowledge. No successful trading can be achieved without combining all these elements from Bushido philosophy. This is the ultimate secret of Sokyu Honma's great success.

Now, it is also our secret and our real edge.

YOUR REAL SECRET EDGE!

Applying the principles of Bushido is our secret edge. Let us use them! These principles will enable us to have a plan that works and in which nothing is neglected or left to chance. It will also teach us how to trade with courage. It will enable us to proceed step by step until we have extended our comfort zone to the maximum.

Going beyond our comfort zone does not mean overtrading or using massive or inadequate leverage, or acting with temerity. On the contrary, it means acting with full and prudent knowledge and with temperance.

Most people who trade are looking for the trading grail in the wrong place. They are looking for the magic system that always wins, with unflawed signals. The real trading grail is found in the integration of trading philosophy, trading psychology, and market knowledge.

It is all about trading wisdom, and we can be wise. Here is where the true edge lies for us. It is here where Sokyu Honma's real trading secret lies, waiting for us to use it.

In the end, the market is only a mirror of ourselves. We will take from the market only what we put into it. Bushido gives us the key to this ultimate secret of trading. What we know and do as traders, the way in which we act, is what the market will reflect back to us in the end. Let us act wisely and success will necessarily come.

The trading grail exists. Sokyu Honma had it in his possession and so too may we have it!

Conclusion

Sokyu Honma offers us an integrated approach to the markets and trading. This approach consists of two main aspects that form the foundation of his two methods.

His first method is the Samni No Den of the market. We call it his subjective method, because it gives the rules that the trader must follow while he trades. These rules teach a trader how to measure the market, where to enter and exit, how to correctly position size his assets, how to exit the market when he is mistaken, and how to position size his exits if his trade succeeds.

Sokyu Honma's second method, the five Sakata methods, gives the trader an objective view of market structure and its cycles. The market is seen as a clockwork-like machine with five phases that repeat themselves. According to this second method, the market goes through a series of phases or cycles, which make up the entire market cycle. We have named this five-phased complete cycle 'Sokyu Honma's great market cycle.'

These five market phases are San Zan, the triple top, San Sen, the triple bottom, San Ku, the gaps, San Pei, the trending phase, and San Poh, the corrective phase. To trade any of these five phases, the other four must have been present. As we have seen, we are trading the whole market structure in each single trade.

In tabular form, we have given an algorithm in Chapter 7 that gives the elements that enable us to time our trades, according to each of the five market phases. In Sokyu Honma's five methods, we find one of the best market timing tools ever designed. Not only does it teach us market timing, but also, and even better, we learn about the market's core structure. This algorithm should not be considered to be unchangeable. It is only a point of departure for thought and innovation. It is important to create our own variations and then test them.

Both methods synthesize, in one whole, the trader's behavior and the market's behavior. We cannot emphasize enough that both methods must be traded as a whole. In order to trade them, we must build a sound plan with the best that money management can offer.

Special attention should be given to correct asset allocation, position sizing, and diversification. We should never trust our results on market behavior only. We

should also never let stop placement override asset allocation, position allocation, and diversification. It is a correct attitude and correct planning that make trading success possible.

A correct attitude will depend, in part, on trading psychology. Trading psychology teaches us how our set of beliefs and emotions can limit or expand our trading. However, above all, our success will depend on a trading philosophy that teaches us the core principles of market reality and the trader's mind, but from a higher and more powerful perspective.

This higher perspective is the Bushido samurai philosophy. It contains the secret of Sokyu Honma's success and explains why the Emperor of Japan bestowed the title of bushi on him. Bushido, as applied to trading, teaches us, among other things, that all of reality oscillates between two poles, yin and yang. Consequently, so do the markets and traders' minds. Markets oscillate between opposites – tops and bottoms, high and low volatility, etc., while traders' minds oscillate between fear and greed, discipline or lack of it, etc.

Bushido teaches us courage, correct action and all the conditions needed to control our trading lives, helping us to escape the vagaries of lack of discipline and chaos. Bushido is the root of trading success and the core of Sokyu Honma's trading success. He has given us the most valuable legacy and inheritance that any trader could hope for. This success can now be ours.

Let the spirit of Sokyu Honma guide our trading!

Appendix
What Is a Candlestick?

We have assumed that you already know what a candlestick is. If this is your first encounter with candlesticks, you will find an explanation of what one is here.

The best way to understand a Japanese candlestick is by comparing it to a Western bar chart. A candlestick has the same function as a bar chart. A bar chart tells us a price range, an opening, a high, a low and a closing, for a given period. This period can be as short as a few seconds or as long as a day, a week, a month, a year, or more. We have four elements in a bar chart: the opening price, the highest price for that period, the lowest price for that period, and the closing price for that period.

Here we have two examples of a bar chart:
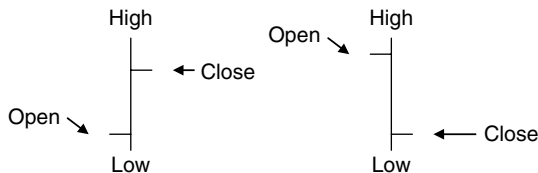
The first of our examples, to the left, is an ascending bar chart. This means that the price for the day, week, etc., closed above the opening price. The chart shows an upward day. The second chart, on the right, is a descending bar chart for a day, week, etc. On this chart, the price closed below the opening price.

We will now translate this into candlestick language. A candlestick has an open, a close, a high, and a low, just like a bar chart. However, the distance between the open and the close is enclosed by a rectangle and is called the 'body.' The segments beyond the rectangle are called the 'shadows.'

In an ascending candlestick, the body is white to signify that the closing price was higher than the opening price. In a descending candlestick, the body is black

to signify that the close was lower than the opening price. Here are three examples of an ascending white candlestick, a descending black candlestick, and a Doji candlestick, where the open and the close are the same.
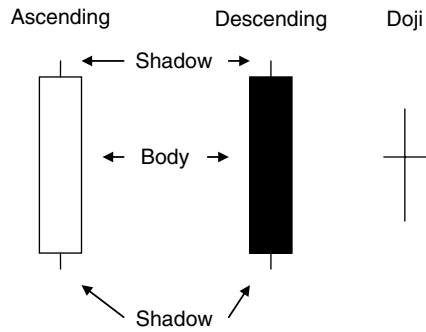
There are many books and websites in which you can find more information about how candlesticks are constructed, as well as the different candlestick patterns in use.

Notes

1. Steve Nison tells us that the candlestick vocabulary has 'battlefield analogies' and that Japanese military conditions became part of candlesticks, since trading required many of the skills needed 'to win a battle.' We can add that trading is a war that must be fought with strategy and this has made it a part of samurai philosophy (see Steve Nison, *Japanese Candlesticks Charting Techniques*, NYIF, 1991, p. 14).
2. Seiki Shimizu, *The Japanese Chart of Charts*, Tokyo Futures Trading Publishing Co., 1986, p. 26.
3. Steve Nison tells us that 'it is unlikely that Honma used candle charts,' and adds that 'it was more likely that candle charts were developed in the early part of the Meiji period in Japan (in the late 1800s).' (Steve Nison, *Beyond Candlesticks*, John Wiley & Sons, Inc., 1994, p. 14). Then, he adds this about candlesticks: 'Although they are shrouded in mystery, the candles probably started in the early part of the Meiji period (from 1868)' (Steve Nison, *Beyond Candlesticks*, John Wiley & Sons, Inc., 1994, p. 18).
4. For Gann, the time/price ratio is essential, with time more important than price. He tells us that 'Time is the most important factor of all' and 'The time factor will overbalance both Space and Volume' (W.D. Gann, *How to Make Profits in Commodities*, Traders Press, 1976, p. 56).
5. Gann also tells us that there is a 'time to stay out of the market.' He says this about it: 'Long periods of rest and relaxation protect your health and help your judgment' (W.D. Gann, *How to Make Profits in Commodities*, Traders Press, 1976, p. 11).
6. This second part of the method, which is also a second method in itself, derives from the Samni No Den first rule.
7. To our knowledge, no author has recognized the importance of the five Sakata methods and their relationship to candlesticks until now. Nowhere have these five methods been presented in relation to the fundamental market phases they represent. None of the aforementioned authors use the five Sakata methods to provide the basic market structures that must be used to validate the different candlestick patterns.

   Seiki Shimizu in his *The Japanese Chart of Charts* makes a detailed explanation of Japanese candlestick patterns and other Japanese tools. However, the five Sakata methods are single individual patterns for him and are not related to the fundamental market cycle or used to read and validate existing candlestick patterns. Also, he does not integrate candlesticks into Sokyu Honma's two methods, the Samni No Den of markets

and the five Sakata methods. His perspective is definitely incomplete. This is his weak point. His strength is the thorough and detailed explanation of candlestick patterns and their meanings.

Steve Nison does not even mention the five Sakata methods in his excellent book *Beyond Candlesticks* and in his book *Japanese Candlestick Trading Techniques*. He limits himself to mentioning the titles of Sokyu Honma's works without explaining, even summarily, the five methods. These are the weak points of Nison's work. His strong point is the detailed and exhaustive approach to individual candlestick patterns and the explanation of other trading indicators that are sometimes used in conjunction with candlesticks.

Gregory Morris's book *Candlestick Charting Explained* (McGraw-Hill, 1992, 1995) has the merit of devoting one chapter to the five Sakata methods, but he considers them to be individual figures and does not recognize their link to the fundamental market cycle and its phases. This is why Morris does not use the five Sakata methods anywhere in his trading approach and why they are not mentioned in any of the following chapters of his book. These are his weak points. His strong point is his explanation in depth of the most significant candlestick patterns and mentioning and explaining in one chapter the five Sakata methods, even though he does not relate them to trading in the following chapters of his book or grasp their link to the market cycle and its phases.

Gary S. Wagner and Bradly L. Matheny, in their book *Trading Applications of Japanese Candlestick Charting* (John Wiley & Sons, Inc., 1993), tell us that 'the Five Sakata Methods are composed of 4 specific patterns. . . .' In their chapter on candlestick history and origins, they briefly describe each of the five patterns of the five Sakata methods, but always considering them simply as patterns that have no practical use, and they do not link them to the general market structure and its phases. This is why they are not mentioned again in their book and are not used at all for their trading approach. Their weakness is in isolating candlestick patterns and not relating them in any way to the original Japanese trading methodology of Sokyu Honma. Their strength is the clear presentation of candlestick patterns and the modern indicators that are used along with trading them.

We have shown the weak and strong points of the leading books on Japanese candlesticks that are available today. We want to make particular mention of the fact that this book, *The Secret Code of Japanese Candlesticks*, is the only book available that places candlesticks within the context of their original Japanese trading methodology – the two methods of Sokyu Honma.

8. This book is the only work that has linked the five Sakata methods to the five fundamental market phases that they represent. We have defined a set of precise trading rules that correspond to each of the five phases. We have singled out the fact that each of the five market phases has a specific trading strategy pertaining to it. Also, we are the first to have articulated the five Sakata methods within the cyclical market structure that they define and to which they belong. We have named this structure Sokyu Honma's great cycle in memory of the eighteenth century Japanese master trader who enabled us to rediscover it.

9. See note 2.

10. W.D. Gann, *How to Make Profits in Commodities*, Traders Press, 1976, p. 42.

11. Dunnigan gives 'thrust' its full importance and scope in trading (William Dunnigan, *New Blueprints for Gains in Stocks and Grains*, FT, Pitman Publishing, 1997, p. 122).

12. W.D. Gann, *How to Make Profits in Commodities*, Traders Press, 1976, p. 42.

13. See Richard W. Schabaker, *Technical Analysis and Stock Market*, FT, Pitman Publishing, 1997, pp. 249–261.

14. See Jesse L. Livermore, *How to Trade in Stocks*, Traders Press, 1991, p. 27, and also Edwin Lefévre, *Reminiscences of a Stock Operator*, John Wiley & Sons, Inc., 1994.

15. 'Rule 4: buy and sell on 3 weeks advance or decline' and 'Rule 6: buy or sell individual stocks on reactions of 5 to 7 points' (W.D. Gann, *45 Years in Wall Street*, Lambert Gann Publishing Co., 1976, p. 8).

16. In fact, the more parameters there are, the more degrees of freedom are taken and the less efficiently the system works.

17. The forecast error of analysts 'as a percent of reported earnings' was 44 % for the 1993–1996 period (David Dreman, *Contrarian Investment Strategies: The Next Generation*, Simon & Schuster, 1998, pp. 91, 92).

18. The mean swing was calculated by adding the lengths or sizes of a set of swings and dividing the result by the number of swings in the set. The median swing is the value in the middle of a set of swings that have been arranged in order of size. The mode swing is the swing size that occurs most frequently in a given set of swings (see note 17).

    Each market has its own vibration key. Victor Sperandeo is a good example of a master trader for whom the study of the fluctuations of each market is the key. To be able to buy gold in October 1999, he studied the time/price history of this market since 1981. He measured and tabulated all movements that had durations of three weeks to three months. He found 18 such moves. The measures of these were: minima, 9.4 %; maxima, 68.8 %; and median, 15.2 % (see Victor Sperandeo, *Trader Vic – Methods of a Wall Street Master*, John Wiley & Sons, Inc., 1994, p. 172).

19. See notes 13 and 14.

20. See note 3.

21. The Emperor's New Clothes, in *Hans Andersen's Fairy Tales*, Oxford World's Classics, Oxford University Press, 1998.

22. The Purloined Letter, in *Complete Stories and Poems of Edgar Allan Poe*, Doubleday, 1984. This short story contains many other teachings that are applicable to trading.

23. This is the power of charts. They teach us to see the market reality that is in front of our eyes. In Edgar Allan Poe's, *The Purloined Letter*, one of the characters says: '. . . the over-largely lettered signs and placards of the street, escape observation by dint of being excessively obvious.'

24. Livermore constantly insists on the need to study general conditions (see Edwin Lefèvre, *Reminiscences of a Stock Operator*, John Wiley & Sons, Inc., 1994, p. 69).

25. For Gann, the first rule is to determine the trend of the general market (see W.D. Gann, *45 Years in Wall Street*, Lambert Gann Publishing Co., 1976).

26. Charles Dow created his first index in 1884 of the 11 most active transport companies. In 1886, he created a second index of the 12 most active industrial companies. In 1916 the index was enlarged to contain 20 companies, and again in 1928 to contain 30 companies.

27. Martin Schwartz lost at playing the markets while he worked as a securities analyst. This caused him to react, distancing himself from fundamental analysis, and recognizing that technical analysis was a superior way to win. From then on, he became a trader using mainly technical analysis and market timing tools (Martin Schwartz, *Pit Bull*, Lessons from a Wall Street's Champion Trader, HarperCollins, 1998, pp. 16, 23).

28. Contrary to the current belief, Keynes, in fact, lost heavily in the markets. He was almost wiped out in the 1929 crash. This was due to his flawed economic thinking. He was not able to predict either the crash or the Great Depression at a time when the Austrian economists already knew that the New Era Boom was about to end. For a complete explanation, see Mark Skousen, *The Making of Modern Economics: The Lives and Ideas of the Great Thinkers*, M.E. Sharpe, 2001. Mark Boucher uses Austrian School economics plus market timing to trade the markets. Austrian economics enabled him to anticipate moves in his trading portfolios. His Midas fund had many years of above average returns. See the chapter on Austrian Alchemy in his course *The Science of Trading*, IRA, 1996.

29. Mark Boucher explains why vehicle selection is best. Vehicle selection beats market timing by 10 to 1 and profits come mainly from Vehicle Selection (see Mark Boucher, Stock Selection 20, in *The Science of Trading*, IRA, 1996).

30. Linda Bradford Rashke advises to first specialize in mastering one pattern only (see Laurence A. Connors and Linda Bradford Raschke, *Street Smarts*, M. Gordon Publishing Group, 1995, p. 2).

31. Jesse Livermore added, after the initial position, each new lot after a one-point rise (Edwin Lefèvre, *Reminiscences of a Stock Operator*, John Wiley & Sons, Inc., 1994, p. 84). Cliff Steward, in 1951, advised to add after a rise of 3 to 5 points in stocks under $25 and of 5 to 7 points in stocks over $25 (Cliff Steward, *Magic of Making Money in the Stock Market*, Sacred Science Library, 2003, p. 10).

32. Some good money management and asset allocation books are Ralph Vince, *The New Money Management*, John Wiley & Sons, Inc., 1995; Nauzer J. Balsara, *Money Management Strategies for Futures Traders*, John Wiley & Sons, Inc., 1992; and Fred Gehm, *Quantitative Trading and Money Management*, Irwing, 1995.

33. Although not a specialist in money management, Larry Williams is my favorite. He goes to the heart of money management and explains the advantage of using a percentage of total assets as an asset allocation method. He has the virtue of simplicity. Read the chapter on money management in any of his books.

34. Jesse Livermore used to trade between 8 and 12 stocks. These stocks were among four sector groups. This means he used to follow 2 to 3 stocks per group (Jesse Livermore, *How to Trade in Stocks*, Traders Press, 1991, p. 35, and Edwin Lefèvre, *Reminiscences of a Stock Operator*, John Wiley & Sons, Inc., 1994, p. 182). Cliff Steward also advised during the 1950s to have between 8 and 12 stocks (Cliff Steward, *Magic of Making Money in the Stock Market*, Sacred Science Library, 2003, p. 30). Gann, in his rules, suggests trading 4 to 5 stocks (W.D. Gann, *45 Years in Wall Street*, Lambert Gann Publishing, 1976, p. 16).

35. Larry Williams is in favor of using large stops. He says, 'The secret of day trading is big stops' (Larry Williams, *The Definitive Guide to Futures Trading*, Vol. II, Windsor Books, 1989, p. 146). This concept applies not only to day trading but also to all time frames.

36. Larry Williams says that holding positions until the close is better, to enhance profits. He tells us this is due to the fact that once a move is underway, it will tend to continue, meaning that the close will be near the high, rather than otherwise. We think that this concept is valid for all time frames, even though he applies it here to daytrading (see Larry Williams, *The Definitive Guide to Futures Trading*, Vol. II, Windsor Books, 1989, p. 132).

37. The difference between the Apollo projects and the Shuttle projects is illustrative of deficient testing, the result of not asking the questions, the answers to which would protect against worst-case scenarios. Jim Longuski, an Aerospace engineer, who worked for the Jet Propulsion Laboratory, tells us how the Apollo engineers asked all of the worst-case scenario 'what if' questions that were taken into account in the Apollo missions. This was not the case, he tells us, with the Shuttle missions, where many important 'what if' questions were left 'unanswered or poorly answered.' This example illustrates the difference between good planning and bad planning and the consequences in reality. The same thing can be said of trading, for which we must plan beforehand for any bad thing that could happen before even thinking of 'launching' our prototype in real trading. For the NASA example, see Jim Longuski, *Think Like a Rocket Scientist*, Copernicus Books, 2007, pp. 51–53.

38. Among the best trading psychology books today, we have Mark Douglas, *The Disciplined Trader*, NYIF, 1990; Ari Kiev, *Trading to Win: The Psychology of Mastering the Markets*, John Wiley & Sons, Inc., 1998; and Van K. Tharp, *Trade Your Way to Financial Freedom*, McGraw-Hill, 2006.

39. Bushido is a practical, unwritten, philosophy that is the foundation of samurai life. It has been transmitted orally. It has no foundational scripture. However, a few books were written about Bushido from the nineteenth century on. The book on Bushido that is regarded as a classic was by Inazo Nitobe, a nineteenth century Japanese, who was the first to write a comprehensive study about Bushido philosophy in order to explain it to Westerners (Inazo Nitobe, *Bushido, the Soul of Japan*, Echo Library, 2006).

40. All of Sokyu Honma's methods were based on this fundamental principle of reality that applies to trading: markets oscillate between two poles, yin and yang. In a book attributed to him, the *Fountain of Gold*, he explains that markets oscillate between yang (bullish market) and yin (bearish market). For him also, yin is contained in yang and vice versa. This is why a bull market contains the seed of a bear market, which contains in turn the seed of the next bull market (see Steve Nison, *Beyond Candlesticks*, John Wiley & Sons, Inc., 1994, p. 15).

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