

Connors Research Trading Strategy Series

An Introduction to ConnorsRSI 2nd Edition

By

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Section 1

The ConnorsRSI Indicator

Connors Research has been developing, testing, and publishing quantified trading strategies since the mid-1990s. During that time, we have had the opportunity to evaluate a great number of different technical indicators and to assess their effectiveness in predicting future price action. Now we've taken the next step and created an indicator of our own: *ConnorsRSI*. The purpose of this guidebook is to describe the indicator itself and also to provide a well-defined, quantified trading strategy that utilizes this new indicator.

ConnorsRSI is a composite indicator consisting of three components. Two of the three components utilize the Relative Strength Index (RSI) calculations developed by Welles Wilder in the 1970s, and the third component ranks the most recent price change on a scale of 0 to 100. Taken together, these three factors form a *momentum oscillator*, i.e. an indicator that fluctuates between 0 and 100 to indicate the level to which a security is overbought (high values) or oversold (low values).

Before we discuss how to calculate ConnorsRSI, let's review Wilder's RSI. RSI is a very useful and popular momentum oscillator that compares the magnitude of a stock's gains to the magnitude of its losses over some look-back period. Wilder himself believed that 14 periods was the ideal look-back. We often use the shorthand notation RSI(14) for the 14-period RSI. The formula below computes RSI(14) for a series of price changes:

$$RSI = 100 - \frac{100}{1 + RS}$$

RS = Average Gain / Average Loss

Average Gain = [(previous Average Gain) x 13 + current Gain] / 14
 First Average Gain = Total of Gains during past 14 periods / 14

Average Loss = [(previous Average Loss) x 13 + current Loss] / 14
 First Average Loss = Total of Losses during past 14 periods / 14

Note: "Losses" are noted as positive values.

RS = Average of x days up closes / Average of x days down closes

If we wanted to compute RSI for a different number of periods (N), then we would replace 14 in the formula above with N, and replace 13 with N-1. Regardless of the number of periods used in the calculation, the result will always be a number between 0 and 100. Traders who use RSI(14) typically look for values greater than 70 to identify overbought conditions, and values less than 30 to indicate oversold conditions.

Our previous research has shown that using shorter look-back periods makes RSI more effective in predicting short-term price movements. We have published many strategies that utilize RSI(2), as well

as several that use RSI(3) and RSI(4). Changing the number of periods also has an effect on the RSI levels that best identify overbought and oversold conditions. For example, an RSI(2) value of less than 10 is usually a reliable indicator of an oversold condition, while an RSI(2) value over 90 is a good benchmark for an overbought condition.

Now let's turn our attention back to ConnorsRSI. As mentioned previously, ConnorsRSI combines three components, and as you might guess, they are all elements that our research has repeatedly shown to have significant predictive ability:

Price Momentum: As we just discussed, RSI is an excellent way to measure price momentum, i.e. overbought and oversold conditions. By default, ConnorsRSI applies a 3-period RSI calculation to the daily closing prices of a security. We will refer to this value as RSI(Close,3).

Duration of Up/Down Trend: When the closing price of a security is lower today than it was yesterday, we say that it has "closed down". If yesterday's closing price was lower than the previous day's close, then we have a "streak" of two down close days. Our research has shown that the longer the duration of a down streak, the more the stock price is likely to bounce when it reverts to the mean. Likewise, longer duration up streaks result in larger moves down when the stock mean reverts. In effect, the streak duration is another type of overbought/oversold indicator.

The problem is, the number of days in a streak is theoretically unbounded, though we could probably place some practical limits on it based on past experience. For example, we might observe that there have been very few instances of either an up streak or a down streak lasting for more than 20 days, but that still doesn't get us to a typical oscillator-type value that varies between 0 and 100.

The solution is two-fold. First, when we count the number of days in a streak, we will use positive numbers for an up streak, and negative numbers for a down streak. A quick example will help to illustrate this:

Day	Closing Price	Streak Duration
1	\$20.00	
2	\$20.50	1
3	\$20.75	2
4	\$19.75	-1
5	\$19.50	-2
6	\$19.35	-3
7	\$19.35	0
8	\$19.40	1

The closing price on Day 2 is higher than on Day 1, so we have a one-day up streak. On Day 3, the price closes higher again, so we have a two-day up streak, i.e. the Streak Duration value is 2. On Day 4, the closing price falls, giving us a one-day down streak. The Streak Duration value is

negative (-1) because the price movement is down, not up. The downward trend continues on Days 5 and 6, which our Streak Duration reflects with values of -2 and -3. On Day 7 the closing price is unchanged, so the Streak Duration is set to 0 indicating neither an up close nor a down close. Finally, on Day 8 the closing price rises again, bringing the Streak Duration value back to 1.

The second aspect of the solution is to apply the RSI calculation to the set of Streak Duration values. By default, ConnorsRSI uses a 2-period RSI for this part of the calculation, which we denote as $RSI(Streak,2)$. The result is that the longer an up streak continues, the closer the $RSI(Streak,2)$ value will be to 100. Conversely, the longer that a down streak continues, the closer the $RSI(Streak,2)$ value will be to 0. Thus, we now have two components -- $RSI(Close,3)$ and $RSI(Streak,2)$ -- that both use the same 0-100 scale to provide a perspective on the overbought/oversold status of the security we're evaluating.

Relative Magnitude of Price Change: The final component of ConnorsRSI looks at the size of today's price change in relation to previous price changes. We do this by using a Percent Rank calculation, which may also be referred to as a "percentile". Basically, the Percent Rank value tells us the percentage of values in the look-back period that are less than the current value.

For this calculation, we measure price change not in dollars and cents, but as a percentage of the previous day's price. This percentage gain or loss is typically referred to as the one-day return. So if yesterday's closing price was \$80.00, and today's price is \$81.60, the one-day return is $(\$81.60 - \$80.00) / \$80.00 = 0.02 = 2.0\%$.

To determine the Percent Rank, we need to establish a look-back period. The Percent Rank value is then the number of values in the look-back period that are less than the current value, divided by the total number of values. For example, if the look-back period is 20 days, then we would compare today's 2.0% return to the one-day returns from each of the previous 20 days. Let's assume that three of those values are less than 2.0%. We would calculate Percent Rank as:

$$\text{Percent Rank} = 3 / 20 = 0.15 = 15\%$$

The default Percent Rank look-back period used for ConnorsRSI is 100, or $\text{PercentRank}(100)$. We are comparing today's return to the previous 100 returns, or about 5 months of price history. To reiterate, large positive returns will have a Percent Rank closer to 100. Large negative returns will have a Percent Rank closer to 0.

The final ConnorsRSI calculation simply determines the average of the three component values. Thus, using the default input parameters would give us the equation:

$$\text{ConnorsRSI}(3,2,100) = [RSI(Close,3) + RSI(Streak,2) + \text{PercentRank}(100)] / 3$$

The result is a very robust indicator that is more effective than any of the three components used individually. In fact, ConnorsRSI also offers some advantages over using all three components together. When we use multiple indicators to generate an entry or exit signal, we typically set a target value for

each one. The signal will only be considered valid when all the indicators exceed the target value. However, by using an average of the three component indicators, ConnorsRSI produces a blending effect that allows a strong value from one indicator to compensate for a slightly weaker value from another component. A simple example will help to clarify this.

Let's assume that Trader A and Trader B have agreed that each of the following indicator values identify an oversold condition:

- $RSI(\text{Close},3) < 15$
- $RSI(\text{Streak},2) < 10$
- $\text{PercentRank}(100) < 20$

Trader A decides to take trades only when all three conditions are true. Trader B decides to use ConnorsRSI to generate her entry signal, and uses a value of $(15 + 10 + 20) / 3 = 15$ as the limit. Now assume we have a stock that displays the following values today:

- $RSI(\text{Close},3) = 10$
- $RSI(\text{Streak},2) = 8$
- $\text{PercentRank}(100) = 21$
- $\text{ConnorsRSI} = (10 + 8 + 21) / 3 = 13$

Trader A will not take the trade, because one of the indicators does not meet his entry criteria. However, Trader B will take this trade, because the two low RSI values make up for the slightly high PercentRank value. Since all three indicators are attempting to measure the same thing (overbought/oversold condition of the stock) by different mechanisms, it makes intuitive sense to take this "majority rules" approach. More importantly, our research has shown ConnorsRSI to be superior to any other momentum indicator that we've tested.

Section 2

ConnorsRSI Base Performance

With any indicator that you use in your trading, it is helpful to know how the indicator behaves, and what it's telling you about the security price. Our goal with ConnorsRSI was to develop a superior momentum oscillator which would produce low values for oversold stocks and ETFs, and high values when those securities are in an overbought state.

To determine whether we had achieved our goal, we ran the following test. We created a universe of approximately 6,000 highly liquid stocks. Starting on January 2, 2001, we looked for every stock in the universe which had the following characteristics on that day:

1. At least 200 days of trading data available
2. Average daily volume over the past 21 days of at least 500,000 shares per day

Each stock that met our criteria was placed in one of twenty different "buckets" corresponding to its ConnorsRSI value at the close of trading on that day. Stocks with ConnorsRSI(3,2,100) values of less than 5 went into the 0 bucket. Those with ConnorsRSI(3,2,100) values greater than or equal to 5 and less than 10 were placed in the 5 bucket, etc. all the way up to the 95 bucket, which contained stocks with Connors RSI values of 95 to 100. This process was repeated for every trading day through February 28, 2014.

Next, for each of the 20 buckets we calculated the five-day return of each stock for every day in the test period, and averaged those values within each of the 20 buckets. In simple terms, we determined the typical 5-day price move (as a percentage) of a stock whose ConnorsRSI value fell into a particular bucket.

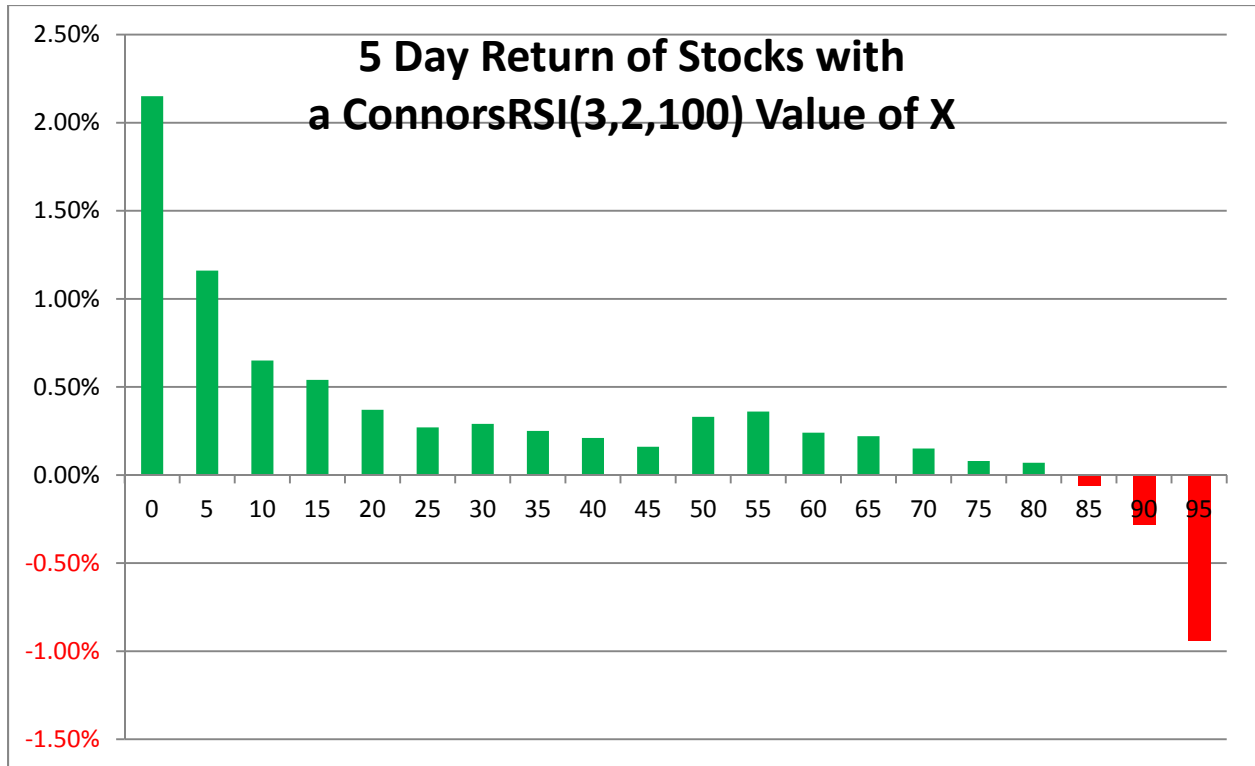
We expected that stocks that were oversold (those with low ConnorsRSI values) would increase in price, while those that were overbought would decrease in price. As you can see in the table below, this is exactly what happened.

ConnorsRSI(3,2,100) Bucket	5-Day Return
0	2.15%
5	1.16%
10	0.65%
15	0.54%
20	0.37%
25	0.27%
30	0.29%
35	0.25%
40	0.21%
45	0.16%
50	0.33%
55	0.36%
60	0.24%
65	0.22%
70	0.15%
75	0.08%
80	0.07%
85	-0.06%
90	-0.28%
95	-0.94%

You can see that as the ConnorsRSI value goes below 20, the 5-day returns begin to increase substantially. Stocks with a ConnorsRSI value in the range of 0 to 5 (the 0 bucket) experienced an average price increase of 2.15% over the next five trading days.

We see the inverse behavior at the top end of the ConnorsRSI range: as the value moves above 80, the 5-day returns are increasingly negative, with stocks in the 95 bucket showing a 0.94% price decrease over the following five days.

For those of you who are more visually oriented, the chart below shows the same information as the table above:



Now that we've looked at ConnorsRSI in isolation, let's move on to the *ConnorsRSI Pullback Strategy* rules to see how the indicator performs as part of a complete system.

Section 3

ConnorsRSI Pullback Strategy Rules

Pullback trading is one of the most popular forms of trading amongst traders. The good news is that when it's done correctly it can be very lucrative. The not so good news is that over the past two decades there has been a proliferation of published pullback strategies which have little or no edge at all.

In this Strategy Guide, we will present a strategy which utilizes ConnorsRSI in combination with other indicators to identify when a pullback has occurred. Each of these indicators and their contribution to the strategy will be described in the next chapter. Multiple exit triggers were also tested, allowing you to select a variation of the strategy that complements your overall trading plan.

Before we go on, let's look at exactly what a pullback is and why it's important.

What Is A Pullback?

A pullback occurs when a security whose price has been moving higher sells off, i.e. the price of the security drops. Most people trade pullbacks based on daily bars, although some traders seek out intraday pullbacks while others use longer time frames. The common theme is that traders are attempting to identify stocks that they feel have pulled back too far and will likely regain their upward trend. This movement back toward the longer-term trend is known as *mean reversion*.

There are numerous ways to identify pullbacks, ranging from simply "eye-balling" a chart all the way up to using indicators such as Fibonacci numbers. Although these techniques work for some traders, we prefer a more precise, quantified approach. With exact entry and exit rules in place, we want to see robust test results for the majority of the many combinations of parameters that we're testing, and for those results to be consistent across the entire testing period (2001 through early 2014). Such solid results indicate that we are not simply *curve fitting* or *cherry picking*.

When trading short-term pullbacks, the best results occur when you hold the position for at least a few days. Often stocks pull back sharply and snap back strongly. There is no way of knowing ahead of time how far that upward move will be, so it is crucial to have well-defined exit rules in place which allow for the rally to play out.

Now let's move on to the ConnorsRSI Pullback Strategy rules. As with all of our strategies, in this guidebook we will present you with quantified rules for entering and exiting trades. In addition, we will show you how different variations of the rules have performed over time, so that you can select the variations that best complement your own trading plan.

Here are the entry rules for the ConnorsRSI Pullback Strategy:

1. The stock price must be above \$5 per share.
2. The stock's average daily volume over the past 21 days (one trading month) must be at least 250,000 shares per day.
3. The stock's 10-day Average Directional Index (ADX) is above 30.
4. Today the stock's lowest price is at least W% (W = 2, 4, 6, or 8) below the previous day's close.
5. Today's close is in the bottom X% (X = 10 or 25) of the day's range.
6. The ConnorsRSI(3,2,100) value of the stock is below Y, where Y = 5, 10, or 15.
7. If the above rules are met today, buy the stock tomorrow on a further intraday limit Z% below today's closing price (Z = 4, 6, 8, 10).
8. Exit the position when the stock closes with a ConnorsRSI(3,2,100) value above N (N = 50, 60, 70 or 80), exiting at the closing price.

Let's look at each rule in a little more depth, and explain why it's included in the strategy.

Rule 1 helps us steer clear of "penny stocks" and other highly volatile, unpredictable companies. Though price is never a guarantee, we have found that \$5/share is a good price floor for selecting more stable stocks.

Rule 2 assures that we're in highly liquid stocks which can be readily bought and sold, with tight bid/ask spreads.

Rule 3 confirms the strength of the recent trend. ADX is non-directional, so it will quantify a trend's strength regardless of whether it is up or down. However, the next three rules will establish the fact that the stock is currently in a down trend.

Rule 4 identifies a basic pullback: a significant sell-off, measured as a percentage of the previous closing price. Since this rule uses the low price for the day rather than the closing price, we don't yet know what today's overall price action looks like, but we do know that the stock faltered in a meaningful way.

Rule 5 gives us more visibility into today's price action. Closing range is calculated as:

$$\text{Closing Range} = (\text{Close} - \text{Low}) / (\text{High} - \text{Low})$$

For example, if today's Low price was \$12.00, the High price was \$12.50, and the Closing price was \$12.05, then the closing range would be:

$$\text{Closing Range} = (12.05 - 12.00) / (12.50 - 12.00) = .05 / .50 = .10 = 10\%$$

While **Rule 4** tells us that the stock stumbled, **Rule 5** lets us know that it did not recover significantly before the end of the trading day, which in turn is a good indicator that the price is likely to fall further tomorrow.

Rule 6 is the key to determining the quality of the pullback. Our research has shown that the lower the ConnorsRSI value is, the larger the bounce is likely to be when the stock recovers.

Rule 7 allows us to enter the trade at an optimal price. We're taking an already oversold stock as measured by ConnorsRSI (3,2,100), and then waiting for it to become even more oversold on an intraday basis. Because the intraday price drop is occurring for a second consecutive day, it's often accompanied by a great deal of fear. Money managers get especially nervous and often tell their head traders to "just get me out" after they have made the decision to sell. This panic helps create the opportunity.

Rule 8 provides a well-defined exit method. Few strategies have quantified, structured, and disciplined exit rules. **Rule 8** gives you the exact parameters to exit the trade, backed by over a decade of historical test results.

Let's see how a typical trade looks on a chart. For this example, we'll use a value of 4% for the sell-off (W), 25% for the closing range (X), A ConnorsRSI (Y) value of 10, and an entry limit (Z) of 8%. We will exit when ConnorsRSI closes above 70.

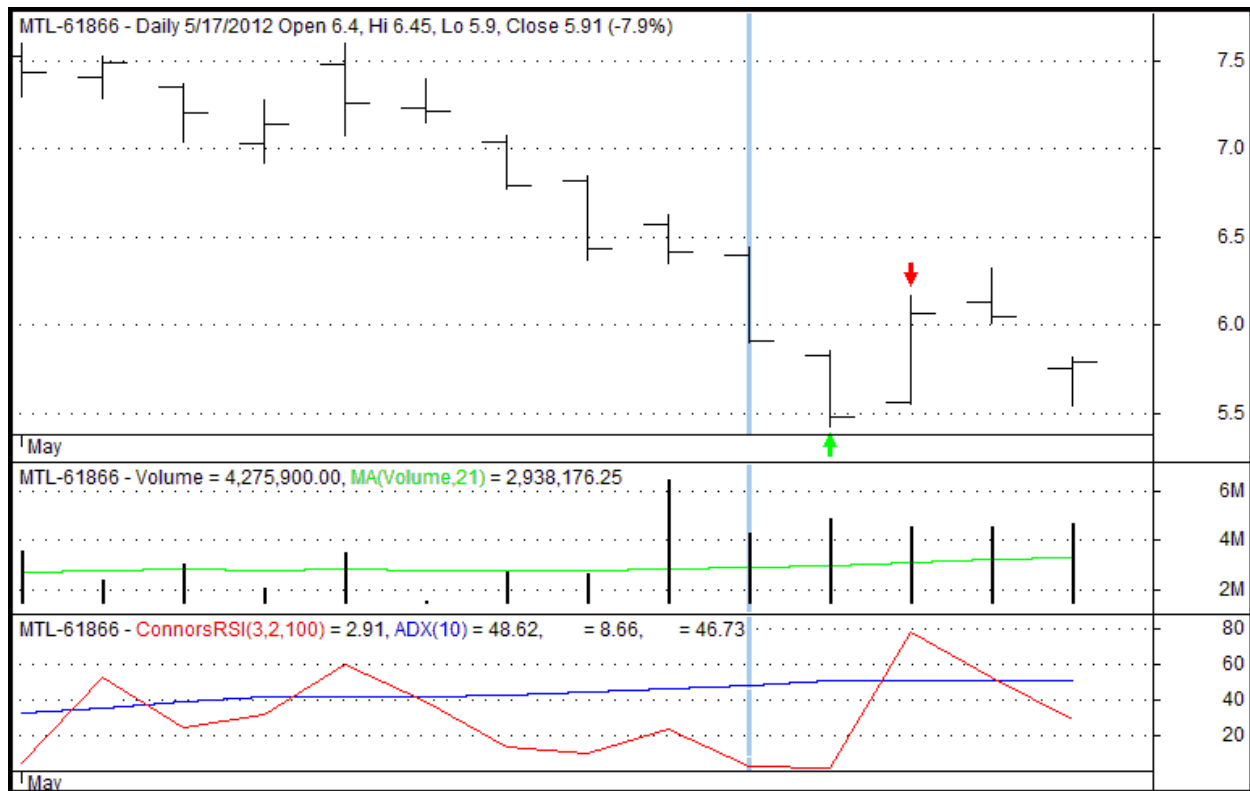


Chart created in Amibroker. Reprinted courtesy of AmiBroker.com.

Figure 1: Setup, Entry and Exit signals for MTL

On the chart above, the top pane shows the price bars in black, the vertical gray line marks the currently selected day which is also the setup day, the green up arrow indicates the entry day, and the red down arrow indicates the exit day. The middle pane displays the volume as vertical black histogram bars, and shows the 21-day moving average of volume as a green line. The bottom pane shows ConnorsRSI as a

red line, and ADX as a blue line. Now we'll confirm that each of our entry and exit conditions was correctly met.

Rule 1 requires the price of the stock to be above \$5 per share. For the days shown on the chart, we can see that the price has ranged from just over \$7.50/share to just under \$5.50/share, thus meeting our condition.

Rule 2 requires that the 21-day moving average of the volume be greater than 250,000 shares/day. The average volume has been between 2 and 4 million shares lately, and on the setup day it was 2.9 million, so we've far exceeded this requirement.

Rule 3 states that ADX(10) must be above 30. On the setup day the ADX(10) value is 48.62.

With our selected input parameters, **Rule 4** tells us to look for a low price that's at least 4% below yesterday's close. On 5/16/2012 (the day before the setup), MTL closed at \$6.42. Therefore, today's low must be below

$$\$6.42 \times (100\% - 4\%) = \$6.42 \times 0.96 = \$6.16$$

The actual low price on the setup day was \$5.90, so we have met the criteria for this rule.

Rule 5 requires that the closing price be in the bottom X% of the day's range. We selected 25% for this exercise, so our calculation goes as follows:

$$\text{Closing Range} = (\text{Close} - \text{Low}) / (\text{High} - \text{Low}) < 25\%$$

$$(\$5.91 - \$5.90) / (\$6.45 - \$5.90) < 0.25$$

$$\$0.01 / \$0.55 < 0.25$$

$$0.018 < 0.25 \rightarrow \text{TRUE}$$

In this case, we could have simply looked at the chart and easily seen that the closing price was extremely close to the day's low, and therefore almost certainly in the bottom 25% of the day's range. In other cases, the chart may not make this so obvious, and you'll have to do the math

Based on our strategy parameters, **Rule 6** requires the ConnorsRSI(3,2,100) value to be below 10, which it is (the value shown on the chart is 2.91).

Rule 7 tells us that now that our setup conditions have been met, we should set a limit order to enter on the next trading day. Our strategy parameters specify that we will use 8% for this limit order. That means that our limit price will be set at:

$$\$5.91 \times (100\% - 8\%) = \$5.91 \times 0.92 = \$5.44$$

The actual low price on 5/18/2012 was \$5.42, which meets our criteria with two cents to spare. We would enter this trade when our buy order gets filled at the limit price of \$5.44.

Rule 8 specifies that we will exit the trade when ConnorsRSI(3,2,100) closes above 70. For this trade, that occurs on the very next trading day, which is on Monday, 5/21/2012. We exit at or near the closing price of \$6.07, giving us a profit of over 11.6%, excluding commissions.

As you review the explanation above, notice that Rules 1 through 5 were true for most or all of the days leading up to the setup day. Price, volume, and ADX were all at acceptable levels. There were a couple of decent sell-off days, as well as closing prices in the bottom 25% of the day's range. However, 5/17/2012 is the first day that all of these conditions were met and ConnorsRSI dropped below 10. That's why this indicator is the centerpiece of the entire strategy.

Let's quickly go through one more example. Since we'll be focusing on exits in a later section, we'll continue to use an exit of ConnorsRSI(3,2,100) > 70. However, we'll change the other strategy parameters as follows:

- Sell-off (W) = 2%
- Closing Range (X) = 10%
- ConnorsRSI(3,2,100) = 5
- Entry Limit (Z) = 6%

Here is the chart, which uses the same conventions as Figure 1:

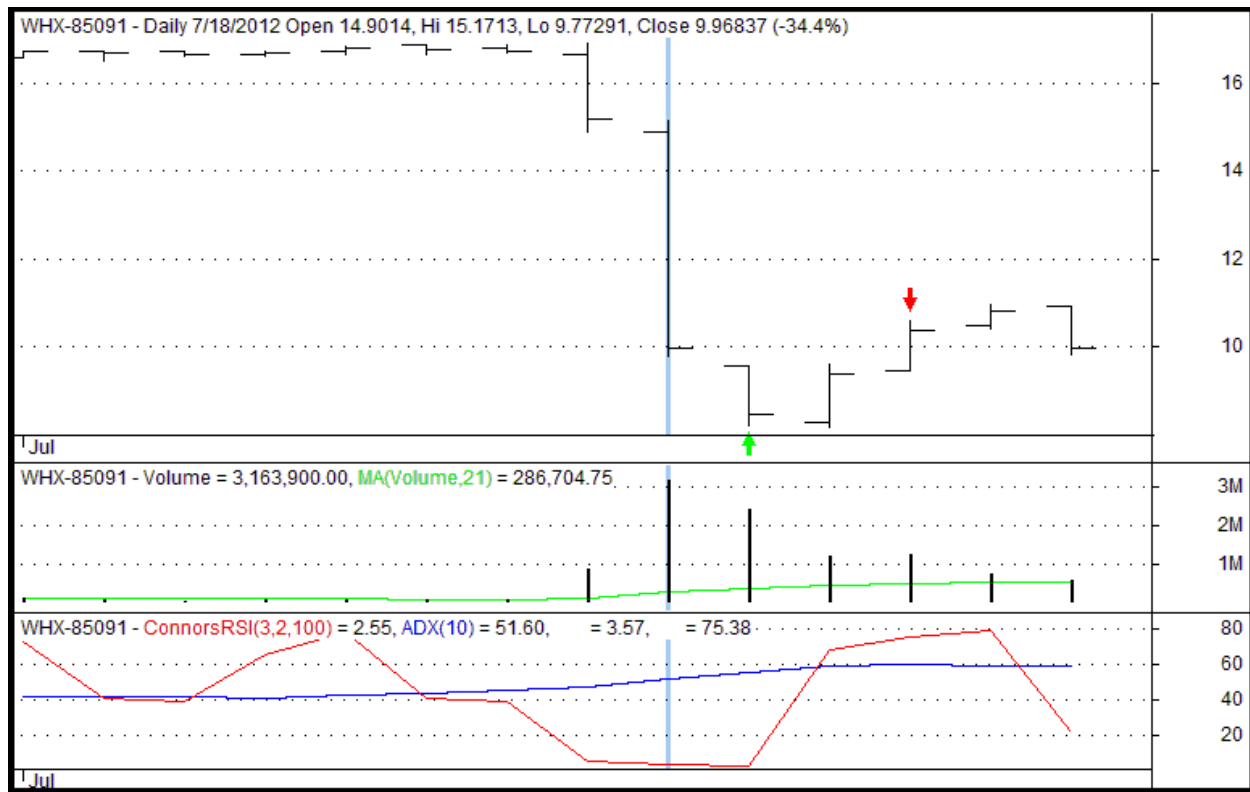


Figure 2: Trade signals for WHX

The closing price of \$9.97 fulfills the **Rule 1** requirement of \$5/share or greater.

The 2-day average volume of 286,704 meets the **Rule 2** criteria of 250,000.

The ADX(10) value is 51.60, far above the **Rule 3** requirement of 30.

We can see that on 7/17/2012 (the day prior to the setup day shown by the gray vertical line) the price of WHX closed a bit above \$15, while the low on 5/18/2012 was below \$10. A little mental arithmetic tells us that the sell-off was over 30%, so there's really no need to do the exact math to verify that we've exceeded the 2% sell-off target, thus meeting the **Rule 4** requirement.

Likewise, it's obvious from the chart that the closing price on 7/18/2012 was in the bottom 10% of the day's range, satisfying **Rule 5**.

The chart shows us that the ConnorsRSI(3,2,100) value was 2.55 on the setup day, which means that the criteria for **Rule 6** has been met.

Rule 7 tells us to enter a limit order 6% below the setup day's closing price of \$9.97. That means our limit price for 7/19/2012 will be:

$$\$9.97 \times (100\% - 6\%) = \$9.97 \times 0.94 = \$9.37$$

The actual price on 7/19/2012 falls all the way to \$8.20, but we will enter the trade at the limit price which we determined in advance: \$9.37.

Finally, as per **Rule 8**, we exit the trade when ConnorsRSI(3,2,100) closes above 70. This occurs two trading days later, on Monday, 7/23/2012.

In the next section we'll take a closer look at exit methods, and then we'll dive into the test results so that you can determine which strategy variation(s) are the best fit for your own trading.

Section 4

The Role of Exits

Up to this point, we have been focused mainly on the entry rules for the ConnorsRSI Pullback Strategy. But entries are only half the story. You don't make (or lose) money until you exit the trade, so having a precise, quantified exit method is crucial to generating predictable returns. Unfortunately, many published strategies either gloss over the exit rules completely, or they rely on vague directives such as "exit when you reach your profit target". Since they don't specify how to calculate a reasonable profit target, this is basically equivalent to saying "exit when you feel like you've made enough money", which is not very helpful at all.

Let's talk conceptually about entries and exits for a moment. Both entry and exit rules can be thought of in terms of how strict they are, i.e. how easy or difficult they are to achieve. You might also say that strictness is a measure of how frequently or infrequently the rule conditions occur. For oscillators such as ConnorsRSI, values that are closer to the extremes (0 and 100) are more strict (less likely to occur) than values that are in the middle of the range.

Stricter entry rules will be satisfied less frequently than more lenient entry rules, and thus a strategy that relies on the stricter rules will generally generate fewer trades than a strategy whose entry rules are more easily satisfied. With a robust strategy, the reward for fewer trades is generally a higher gain per trade, on average. We'll quantify this in the next section when we look at test results. For now, allow us to simply state that if you buy a slightly oversold stock, it's most likely to have a moderate rebound. But if you wait for a stock that's extremely oversold, the chances are much higher that it will have a significant bounce and create a bigger profit.

The strictness of exit rules has little effect on the number of trades generated by the strategy. However, just like the entry rules, stricter exit rules typically result in higher average profits. Why? Because stricter exit rules tend to keep you in your trades for a longer time, giving the stock more time to experience the mean reversion behavior that we're attempting to exploit with a strategy like the ConnorsRSI Pullback Strategy. Thus, for entries the tradeoff is between more trades and higher gains per trade, while for exits the tradeoff is between shorter trade durations and higher gains per trade.

For this strategy, we've decided to keep the exit methods very simple. It turns out that ConnorsRSI is not just a great entry indicator; it's also a very reliable method for measuring the degree to which we've captured the mean-reverting price bounce. Therefore, our exit methods simply wait for ConnorsRSI(3,2,100) to reach a predetermined level. We've found that values in the 50 to 80 range are the most effective exit indicators, and we will present test results for ConnorsRSI = 50, 60, 70 and 80.

With these different exit methods in mind, we can revisit a previous example to see the trade duration/profit tradeoff in action. Here's the chart for WHX that we dissected previously:

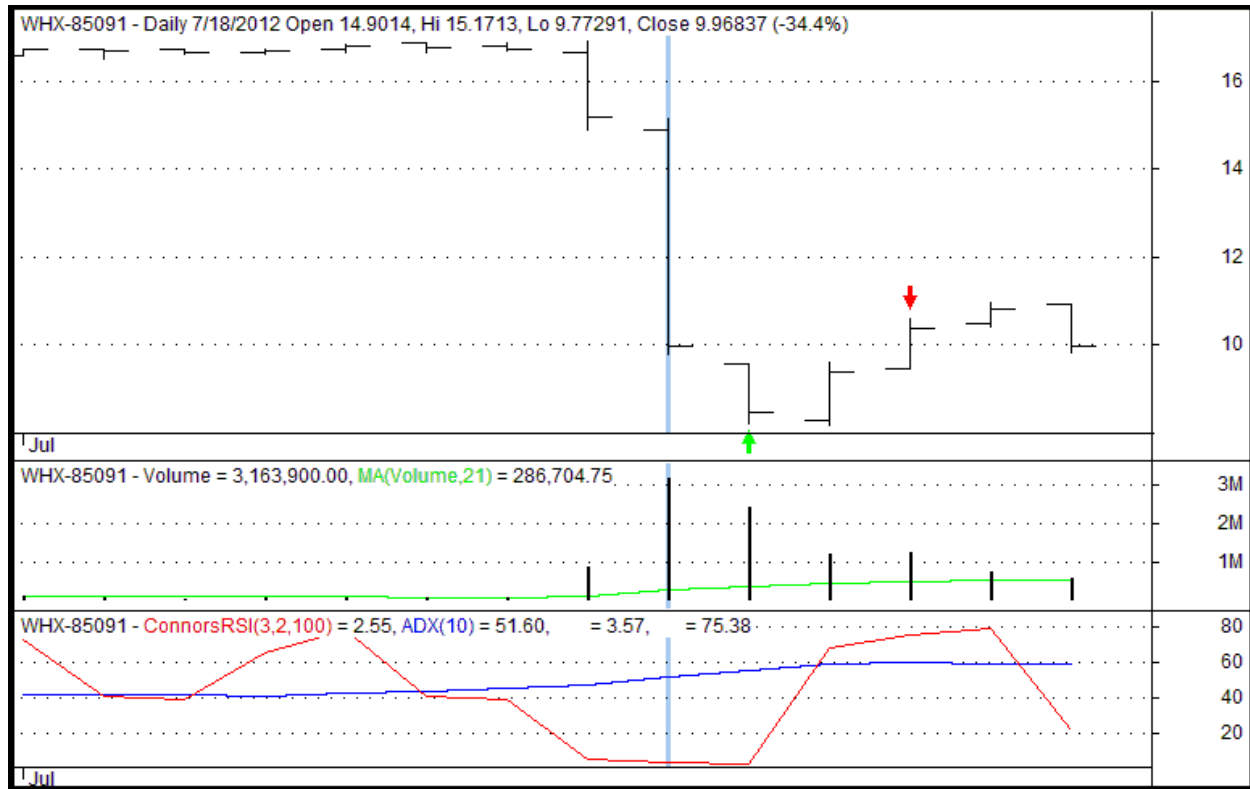


Chart created in AmiBroker. Reprinted courtesy of AmiBroker.com.

Figure 3: The Effect of Exits

Notice that on the day following the trade entry, the ConnorsRSI(3,2,100) value rose to around 68. If our exit criteria had been a ConnorsRSI value of 65, then we would have exited the trade after one day, at a price around that day's close of \$9.39.

Our actual exit occurred two days after entering the trade. The ConnorsRSI(3,2,100) value on this day was 75.48, so if our criteria had been a value of 70 or 75, we would have exited on this day near the closing price of \$10.37. We would have achieved a higher profit, but our trade duration would have been double what it was with the more lenient exit.

Three days after the entry, ConnorsRSI(3,2,100) closed at 79.16, and the price closed at \$10.82. Thus, if our exit criteria had been between 76 and 79, we would have stayed in this particular trade for a total of three days, but would have achieved the maximum potential profit.

Finally, it's worth noting that ConnorsRSI(3,2,100) never went above 80 before the price started to decline again. In other words, if we make our exit criteria too strict, there's a danger that we won't exit the trade before the profits start to evaporate. Our research has shown that using a ConnorsRSI value of 85 or higher as an exit indicator is too restrictive to be effective, and will typically cause your overall results to suffer.

Section 5

Test Results

We can never know for sure how a trading strategy will perform in the future. However, for a fully quantified strategy such as the ConnorsRSI Pullback Strategy described in this Guidebook, we can at least evaluate how the strategy has performed in the past. This process is known as “back-testing”.

To execute a back-test, we first select a group of securities (sometimes called a watchlist) that we want to test the strategy on. In our case, the watchlist is comprised of stocks traded on U.S. exchanges. No ETFs, options, futures or other derivative products are included. Next we choose a timeframe over which to test. The longer the timeframe, the more significant and informative the back-testing results will be. The back-tests for the ConnorsRSI Pullback Strategy start in January 2001 and go through February 2014, the latest date for which we have data as of this writing. Finally, we apply our entry and exit rules to each stock for the entire test period, recording data for each trade that would have been entered, and aggregating all trade data across a specific strategy variation.

One of the key statistics that we can glean from the back-test results is the Average % Profit/Loss, also known as the Average Gain per Trade. Some traders refer to this as the “edge”. The Average % P/L is the sum of all the gains (expressed as a percentage) and all the losses (also as a percentage) divided by the total number of trades. Consider the following ten trades:

Trade No.	% Gain or Loss
1	1.7%
2	2.1%
3	-4.0%
4	0.6%
5	-1.2%
6	3.8%
7	1.9%
8	-0.4%
9	3.7%
10	2.6%

The Average % P/L would be calculated as:

$$\text{Average \% P/L} = (1.7\% + 2.1\% - 4.0\% + 0.6\% - 1.2\% + 3.8\% + 1.9\% - 0.4\% + 3.7\% + 2.6\%) / 10$$

$$\text{Average \% P/L} = 1.08\%$$

For short-term trades lasting three to ten trading days, most traders look for an Average % P/L of 0.5% to 2.5% across all trades. All other things being equal, the larger the Average % P/L, the more your account will grow over time. Of course, all other things are never equal! In particular, it’s important to consider the Number of Trades metric in combination with Average % P/L. Assuming that you use approximately the same amount of capital for each trade that you enter, you’ll make a lot more money on ten trades with an average profit of 10% per trade than you will on one trade that makes 20%.

Another important statistic is the Winning Percentage. This is simply the number of profitable trades divided by the total number of trades. In the table above, 7 of the 10 trades were profitable, i.e. had positive returns. For this example, the Winning Percentage is $7 / 10 = 70\%$.

Why do we care about Winning Percentage, as long as we have a sufficiently high Average % P/L? Because higher Winning Percentages generally lead to less volatile portfolio growth. Losing trades have a way of “clumping up”, and when they do that, the value of your portfolio decreases. This is known as *drawdown*. Those decreases, in turn, can make you lose sleep or even consider abandoning your trading altogether. If there are fewer losers, i.e. a higher Winning Percentage, then losses are less likely to clump, and your portfolio value is more likely to grow smoothly upward rather than experiencing violent up and down swings.

Let’s turn our attention to the test results for the different variations of the ConnorsRSI Pullback strategy. First, we’ll look at the 20 variations that produced the highest Average % P/L.

Top 20 Variations Based on Avg % P/L

# Trades	Avg % P/L	Avg Days Held	Win %	Sell Off %	Closing Range	Entry ConnorsRSI	Entry Limit	Exit Method
479	14.79	7.13	78.29	8	10	5	10	CRSI > 80
596	13.71	7.10	77.85	6	10	5	10	CRSI > 80
886	13.69	7.55	77.09	8	10	10	10	CRSI > 80
480	13.67	3.23	79.58	8	10	5	10	CRSI > 70
480	13.45	2.16	80.00	8	10	5	10	CRSI > 60
747	13.32	7.42	76.04	8	25	5	10	CRSI > 80
663	13.26	7.14	77.68	4	10	5	10	CRSI > 80
676	13.20	7.16	77.81	2	10	5	10	CRSI > 80
480	13.14	1.84	80.00	8	10	5	10	CRSI > 50
750	12.84	3.22	79.47	8	25	5	10	CRSI > 70
597	12.82	3.21	78.89	6	10	5	10	CRSI > 70
751	12.61	2.15	78.96	8	25	5	10	CRSI > 60
665	12.51	3.11	79.25	4	10	5	10	CRSI > 70
597	12.47	2.17	79.06	6	10	5	10	CRSI > 60
678	12.42	3.13	79.20	2	10	5	10	CRSI > 70
1104	12.41	7.51	76.09	6	10	10	10	CRSI > 80
1438	12.40	7.88	75.87	8	25	10	10	CRSI > 80
751	12.37	1.80	78.96	8	25	5	10	CRSI > 50
920	12.33	7.39	75.98	6	25	5	10	CRSI > 80
597	12.31	1.83	79.56	6	10	5	10	CRSI > 50

Here is an explanation of each column.

Trades is the number of times this variation triggered from January 1, 2001 – February 28, 2014.

Average % P/L is the average profit or loss for all trades, including the losing trades, expressed as a percentage. The top 20 variations have all shown positive gains ranging from over 12% to nearly 15%.

Average Days Held is the number of days on average the trade was held. In all cases it's less than eight days, and in several cases around two days.

Win % is the percentage of signals which closed out at a profit. The top 20 variations have all been in the 75% - 80% range, an extremely high level in a world where most successful traders hope to be correct 55%-60% of the time.

Sell Off % corresponds to Rule 4 of the strategy. It is the minimum required drop in price on the setup day, expressed as a percentage.

Closing Range is specified by Rule 5 of the strategy. It is the maximum allowed difference between the closing price and the low price of the day, expressed as a percentage of the total daily range (high – low).

Entry ConnorsRSI is the maximum allowed ConnorsRSI(3,2,100) value on the setup day. This value corresponds to Rule 6 of the strategy. Notice the preponderance of the ConnorsRSI threshold of 5. This highlights the fact that the more oversold the stock is, the higher it will typically rebound.

Entry Limit is the intraday pullback used to trigger an entry. This means that the buy trigger occurs the next day Z% below the closing price on the signal day, as described in Rule 7 of the strategy. Therefore if today generates a setup, the signal is executed only if the stock pulls back further tomorrow. In our testing we looked at 4%-10% limits. As you can see, 10% dominates the list above, further reinforcing the fact that the larger the intraday pullback, the greater the edges.

Exit Method is the method used to determine when to exit the trade. Many of the top 20 variations as measured by Average % P/L used an exit method of ConnorsRSI(3,2,100) > 80, meaning that we exit the trade on the first trading day where the ConnorsRSI(3,2,100) value is greater than 80 at the close. This is what we expect based on our previous discussion of how stricter exit criteria generally lead to higher gains but also longer trade durations.

What we see above are 20 different variations of the ConnorsRSI Pullback strategy which show consistent behavior over more than thirteen years. The key is to choose the variation or variations that best complement your overall trading plan and then apply them in a systematic, structured manner.

Now let's now look at the 20 highest performing variations as measured by percentage correct.

Top 20 Variations Based on Win %

# Trades	Avg % P/L	Avg Days Held	Win %	Sell Off %	Closing Range	Entry ConnorsRSI	Entry Limit	Exit Method
480	13.45	2.16	80.00	8	10	5	10	CRSI > 60
480	13.14	1.84	80.00	8	10	5	10	CRSI > 50
1057	11.66	3.08	79.66	2	25	5	10	CRSI > 70
1031	11.75	3.08	79.63	4	25	5	10	CRSI > 70
480	13.67	3.23	79.58	8	10	5	10	CRSI > 70
597	12.31	1.83	79.56	6	10	5	10	CRSI > 50
750	12.84	3.22	79.47	8	25	5	10	CRSI > 70
924	12.20	3.15	79.44	6	25	5	10	CRSI > 70
678	11.92	1.81	79.35	2	10	5	10	CRSI > 50
665	12.51	3.11	79.25	4	10	5	10	CRSI > 70
665	11.99	1.81	79.25	4	10	5	10	CRSI > 50
925	11.79	1.77	79.24	6	25	5	10	CRSI > 50
678	12.42	3.13	79.20	2	10	5	10	CRSI > 70
1058	11.27	1.76	79.11	2	25	5	10	CRSI > 50
1032	11.37	1.76	79.07	4	25	5	10	CRSI > 50
597	12.47	2.17	79.06	6	10	5	10	CRSI > 60
751	12.61	2.15	78.96	8	25	5	10	CRSI > 60
751	12.37	1.80	78.96	8	25	5	10	CRSI > 50
925	11.92	2.13	78.92	6	25	5	10	CRSI > 60
597	12.82	3.21	78.89	6	10	5	10	CRSI > 70

When looking at the variations which have been correct the most often, we see a broader array of strategy parameters. However, the Win Rates are all very close to 80% for the time period from 2001 through February 2014. Such consistent results from a variety of strategy variations over a long period of time confirm the robust nature of the ConnorsRSI Pullback strategy.

For some traders, the most important metrics for evaluating a strategy may revolve around capital management. For these traders, it's acceptable to give up a portion of the gains if they can get their money back more quickly so that it can be deployed elsewhere. So, let's take a look at the strategy variations that have the shortest trade durations as measured by Average Days Held.

Top 20 Variations Based on Average Days Held

# Trades	Avg % P/L	Avg Days Held	Win %	Sell Off %	Closing Range	Entry ConnorsRSI	Entry Limit	Exit Method
1032	11.37	1.76	79.07	4	25	5	10	CRSI > 50
1058	11.27	1.76	79.11	2	25	5	10	CRSI > 50
925	11.79	1.77	79.24	6	25	5	10	CRSI > 50
751	12.37	1.80	78.96	8	25	5	10	CRSI > 50
1522	8.89	1.80	75.76	2	25	5	8	CRSI > 50
665	11.99	1.81	79.25	4	10	5	10	CRSI > 50
678	11.92	1.81	79.35	2	10	5	10	CRSI > 50
1475	8.98	1.81	75.53	4	25	5	8	CRSI > 50
597	12.31	1.83	79.56	6	10	5	10	CRSI > 50
1000	9.52	1.83	76.50	2	10	5	8	CRSI > 50
1303	9.37	1.83	75.29	6	25	5	8	CRSI > 50
2167	6.82	1.83	73.28	4	25	5	6	CRSI > 50
2261	6.67	1.83	73.64	2	25	5	6	CRSI > 50
480	13.14	1.84	80.00	8	10	5	10	CRSI > 50
975	9.63	1.84	76.41	4	10	5	8	CRSI > 50
1831	7.44	1.84	72.75	6	25	5	6	CRSI > 50
1416	7.27	1.85	74.01	4	10	5	6	CRSI > 50
1477	7.07	1.85	74.14	2	10	5	6	CRSI > 50
1043	9.94	1.86	75.26	8	25	5	8	CRSI > 50
861	9.86	1.87	75.96	6	10	5	8	CRSI > 50

As you might expect from our earlier discussion, the strategy variations with the shortest trade durations are dominated by the most lenient exit that we tested, which is an exit when ConnorsRSI(3,2,100) is greater than 50. All 20 of these variations have average durations of less than two days. What you might not have expected is to still see average gains per trade of 6.7% - 13%!

Section 6

Trading Options Using the ConnorsRSI Pullback Strategy

*Please note that the options section in the majority of the **Connors Research Trading Strategy Series** is the same because the strategy set-ups often involve large moves in brief periods of time. In our opinion, and confirmed from friends who are professional options traders (one with over three decades of experience); there is one best way to trade moves like these.*

Options trading has been a major growth industry over the past 5 years in the markets. This is because spreads have tightened, liquidity has increased, and the ability to easily trade complex options has never been simpler.

We'll now focus on applying options trading to the short-term market moves we have just learned. Like everything else in this Guidebook, there are definitive rules as to how to execute an options trade when a strategy signal triggers.

Here is what we know based upon the data:

1. The majority of the moves from entry to exit have been held a very short period of time (2-7 trading days).
2. The average gains per trade have been large – well beyond the normal distribution of prices over that short period of time.
3. A high percentage of the moves have been correct.

When we look at this type of behavior, it can lead to many strategies but one strategy stands out (and this has been confirmed by professional traders). **The strategy is to buy front month, in-the-money long calls.**

Why front month in-the-money long calls? Because they will move the closest to the stock itself. And the closer an option moves with the stock, the greater the gain will be on a percentage basis when the move is correct.

Here are the rules.

1. A signal triggers.
2. Buy the front month in-the money call. If you were to normally buy 500 shares of stock, buy 5 calls (every 100 shares should equal one call).
3. Exit the options when the signal triggers an exit on the stock.

Let's go further:

1. What does in-the-money exactly mean here?

In this case it's defined as one or two strike prices in the money. If the stock is at 48 and strikes are \$5 apart, then buy the 40 or 45 calls.

2. What does front month mean?

Because the holding period is so short, you want to trade the options whose monthly expiration is the closest. If the closest month is 7 trading days or less from the front month's option expiration date (meaning the second Thursday before or closer) use the following month as the one to trade.

3. What happens if I'm in the position and it expires yet the signal for the stock is still valid?

In this case, roll to the next month. You're trading the stock signals so you want to have exposure to that signal.

4. What about liquidity and spreads?

There's some discretion here. There is no hard and fast rule as to what exactly liquidity means in options. For example, compare the liquidity of your stock to SPY, which is extremely liquid compared to a blue chip stock. Both can be considered liquid, but the blue chip's option will be less liquid than SPY.

Assuming there is active volume in the options, look at the spreads. If the option is trading 3.00 bid - 3.30 offer, the spread is 10%. Can you really overcome a 10% spread? Not likely. Now compare this to an option that's trading at 3.25 bid - 3.30 offer. This is far more acceptable and tradable.

5. What are the advantages of buying call options instead of the stock?

Assuming the spreads and liquidity are there, the advantages are large:

1. Greater potential ROI on capital invested.
2. Less money tied up.
3. Less points at risk. This means if a stock signals at 50, it can lose up to 50 points. The options can only lose up to the premium you paid. So, if you bought the 45 calls, the risk is only the premium.
4. There's greater flexibility. For example, let's say the stock triggered a buy signal at 50 and you paid 5.50 for the 45 calls. If the stock immediately moves higher (let's say to 56); you have choices here. You can exit, or you can roll into the 50 calls getting most of your money out and now turning this into a nearly free trade if you believe that prices will continue to run.

There are numerous examples like this and you can find these types of strategy opportunities in most options books. But trading anything exotic or different than simply buying the calls is against the advice of the many professionals we posed this question to.

In conclusion, options provide traders with a good alternative to buying the stock outright. The structured methodology for our strategies is: front-month, in-the-money, with equivalent sizing (1 option per 100 shares), and exiting when the signal exits.

The above options strategy, in many experts' opinion, is the best and most efficient strategy based upon the historical data from these signals.

If you would like to go further with Options we recommend our [Options Trading with ConnorsRSI](#) strategy guidebook. You can purchase it directly from our website:
<http://store.tradingmarkets.com/ebooks/options/connors-research-trading-strategy-series-options-trading-with-connorsrsi.html>.

Section 7

Additional Thoughts

1. As you have seen throughout this Guidebook, the ConnorsRSI Pullback strategy has had large quantified edges when applied in a systematic manner.
2. There are literally hundreds of potential variations for you to use. By adjusting the input variables described in the rules, you can customize how the ConnorsRSI Pullback strategy will perform for you. Want more trades? Look at variations with a smaller Sell Off % or Entry Limit or a higher ConnorsRSI entry threshold. Bigger average returns? Check out the variations that have the strictest entry criteria (high Sell Off % and Entry Limit % and/or low entry value for ConnorsRSI) and longest durations (ConnorsRSI 80 exit method). Want to get in and out of trades more quickly to reduce overnight risk and free up your capital for other trades? Try the variations that utilize the ConnorsRSI 50 exit method. Once you understand how the strategy variables affect the results, you can identify the variation or variations that best fit your trading style.
3. What about stops (and we include the answer to this in all our Strategy Guidebooks)?

We have published research on stops in other publications including in our book [Short Term Trading Strategies That Work](#).

What we have found is that stops tend to lessen performance and in many cases they completely remove edges. Yes, it feels good when a stock keeps moving lower and lower and a stop got you out. On the other side, the research which is backed by up to two decades of test results on many short-term trading strategies suggests that stops get hit often and accumulate many, many losses. Few trading strategies can overcome these aggregated losses.

For many traders stops are a must. Psychologically it allows them to take trades, especially difficult trades. Whether you use them or not is a personal choice. On the whole though, the edges you see in this strategy and many other short-term strategies are lower when stops are applied to them. Again this is a personal choice only you can make for yourself. We know successful traders in both camps.

4. Slippage and commission were not used in the testing. Factor them into your trading (the entries are at limit prices so slippage is not an issue) and make sure you are trading at the lowest possible costs. Most firms are now allowing traders to trade for under 1 cent a share, so shop your business, especially if you are an active trader. The online brokerage firms want your business.

5. As you have seen here with the ConnorsRSI Pullbacks strategy, there are large edges in stocks which sell-off and then sell-off further intraday. These trades are often accompanied by fear and uncertainty and this is when large edges appear. Seek out these trades because, as you have seen, they've been lucrative for many years.

We hope you enjoyed this Second Edition of an **Introduction to ConnorsRSI**. If you have any questions about ConnorsRSI or the strategies in this guidebook please feel free to email us at info@connorsresearch.com.

If you are interested in additional ConnorsRSI trading strategies, we offer a variety of ConnorsRSI Trading Strategy Guidebooks that you can [learn more about on our site](#).

We also offer ConnorsRSI add-on module code for AmiBroker, MetaStock, thinkorswim and TradeStation. You can request links to download that code [here](#).

Finally, ConnorsRSI readings are freely available for over 3,500 popular stocks and ETFs on our TradingMarkets Analytics website at: <http://analytics.tradingmarkets.com/Screeener/>.

About the Author

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Mr. Connors serves as Chairman, CEO/Co-Founder of The Connors Group which publishes and distributes financial market information and technology.

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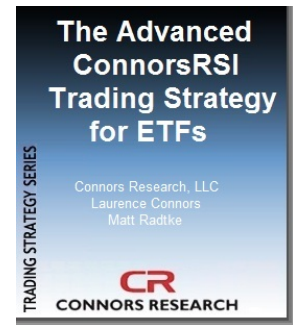
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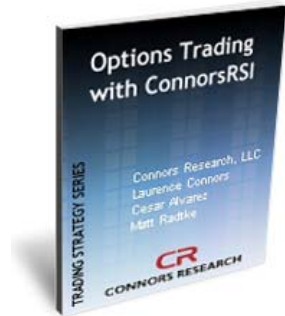
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In contrast, our definition of “strategy” is a set of **quantified entry and exit rules** which you can execute precisely time after time. We support these rules with historical test results that allow you to select the variations of the strategy that will best complement your own trading plan.

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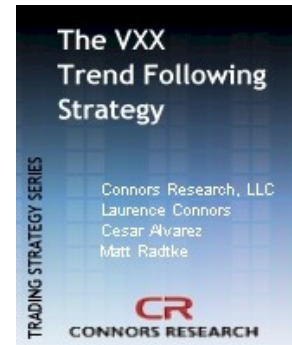
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