



LINDA BRADFORD RASCHKE:

The rituals of trading



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Linda Bradford Raschke's career has spanned the stock, options and futures markets, ranging from the trading floor to the office of her money management firm. Her recipe for success after 20 years in the game? Hard work, preparation and sticking to the basics.

BY MARK ETZKORN

Those who have been lucky enough to attend one of Linda Bradford Raschke's infrequent speaking engagements know she is a rare breed: a professional trader who can explain practical trading concepts in plain English. Her peers simply know her as one of the hardest working and most dedicated traders in the business.

Her trading career has encompassed the stock, options and futures markets, both as a private trader and a money manager. She has been profiled in Jack Schwager's *The New Market Wizards*, CNBC anchor Sue Herera's *Women of the Street*, and any number of magazine and newspaper articles. She also is co-author of *Street Smarts*, a popular book on short-term trading strategies.

Raschke started out as a floor trader in the early 1980s, spending a total of six years trading options at the Pacific Stock Exchange and the Philadelphia Stock Exchange, before making a successful transition to "upstairs" trading — no mean feat, considering the high failure rate of floor traders who try making a living away from the pits. She began managing money in 1993, while continuing to aggressively trade her own account. She trades a variety of markets, but concentrates on short-term trading in the S&P futures.

Raschke still devotes long hours to analyzing the markets and preparing for each day, even though she's been trading professionally for 20 years. She is a strong believer in daily rituals and disciplines that keep her trading focused, even if they don't immediately impact her trading decisions. And she practices simplicity, bypassing complex indicators in favor of price-based techniques that identify (for example) pauses or pullbacks within trends.

She took a break from her evening analysis routine to discuss the lessons every trader needs to learn and how she approaches the markets.

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"Sometimes a failed signal can have even greater forecasting value than the original signal."



AT: *Would you categorize yourself as a systematic or discretionary trader?*

LBR: Discretionary — I pretty much always have been. I came from the trading floor, and in that environment you learn to become a kind of tape reader, in a way. But I also spent years testing trading concepts, much of it with Steve Moore [of Moore Research Center]. We tested a million patterns and tendencies, and did a lot of modeling.

I've come up with some great sys-

tems, but I use them as indicators, with discretion, because I need to have that control (*laughing*). The systems have forecasting value — they give me an idea of the probabilities of the market continuing in a certain direction. That doesn't necessarily mean I get in where the system would, or manage the trade the way the system would. If a particular system is signaling a buy or a sell, I might look to scalp in the direction of that system's signal.

Also, sometimes a failed signal can have even greater forecasting value than

AT: *Do you routinely reverse positions?*

LBR: I don't stop and reverse at all. But I will look for failed signals because very often they can result in strong moves in the opposite direction. They just don't happen as often, so your trade frequency is lower. But if you have something that

careful about using market orders. In a trading range environment, your initial trade location is far more critical, so you have to price (*use limit*) orders.

If I'm trading in a good volume, trending market, I can take my time and sell at the market when I want to get out. But in a trading range market, I have to be working an offer ahead of time: If I buy the S&Ps at 1,420, I need to have an offer out there at 1,424. Because if it runs up and pops through 1,425 and I try to sell at the market, I might be selling at 1,422.

You know, there are so many misconceptions about short-term trading. Even

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works, say 70 to 80 percent of the time, there's a pretty darn good reason why it doesn't work those times it fails. You actually learn more from the signals that *don't* work.

So let's say I make a system based on a failed holy grail buy trade — one that fails to hold the moving average. First, if a grail buy trade fails, I know I'm not going to look to buy pullbacks in that market. Second, because there must be a good enough reason the system went short, perhaps it has forecasting value of a downside move of *x* number of bars or days. Therefore, I'm going to look to trade from the short side.

AT: *Do you think your trading style is a natural outgrowth of your experience as a floor trader?*

LBR: Well, understanding order flow is helpful, but it's probably more helpful to understand the type of environment you're trading in these days. In a high-volume market, in a trending market — for Pete's sake, use market orders. If you're in a sloppy, choppy environment like we are right now (mid-May) where the volume is contracting as a seasonal function — people are exhausted after the first four months — you have to be

as a floor trader, I could have a position on with a directional bias lasting two to three months and I would continue to trade a stock or market leaning to one side.

What you do is supplement those longer-term positions with lots of scalping.

That's pretty much what I do now. I'll sit with positions much longer than people might think, but I can still scalp S&Ps for five minutes at a time.

A general rule of thumb is that the more volatility a market has, or the longer the length of the intraday line — the S&Ps are a good example — the shorter the time frame you can scalp on.

AT: *What do you mean by the "intraday line?"*

LBR: It's how much ground a market's intraday swings cover during the day. Say the S&Ps rally six points, sell off 10 points, then rally another four points. They're unchanged at the end of the day, but they've moved a total of 20 points when all is said and done.

For a short-term trading style, you really need that activity back and forth during the day, and there aren't that

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many that have it. Even the T-bonds don't have that much.

AT: *How long is your average short-term trade?*

LBR: In the S&Ps, my average holding time is around 10 minutes. But I position trade the Nasdaq futures. I've stayed with Nasdaq positions two weeks or so. They trend more than the S&Ps, but the bid-ask spread is very wide — around \$1,000 — and there's a lot of noise.

AT: *Do you use limit or market orders for these trades?*

LBR: I trade at the market on 90 percent of my trades.

AT: *You once said that you believed in forecasting price direction but not magnitude. How do you manage your positions and take profits?*

LBR: Let's say I go long and the market starts to show some upside impulse. First, you want to see some price and volume in that direction. I monitor everything by whether short-term continuation patterns set up.

If I'm in a long trade and it starts to break out to the upside, I want to see continuation patterns on an hourly chart — little bull flags, triangles and so on. When a market breaks out and there's some momentum, there are usually three pushes up. On an hourly chart,

all at once. I try to find the best entry I can — somewhere I can easily manage risk. Once you see that spot, you might as well get in and put your whole position on.

If you put the entire position on at once, that's the closest you can get to your risk point. When you average a position, what happens is you'll always average the losers but you'll never put more on to your winning trades when they start to go up.

Averaging is a really bad habit — unless you're in a very volatile market and you've already planned on putting the position on in two parts. But I've



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those may develop over a two- or three-day period. The market should continue to hold its gains. The minute you see it give back more than it should, you get out on the first reaction or pause.

AT: *Do you scale out of positions?*

LBR: I usually do my trades in two pieces. I try to stay with a position as long as I can and take half off. I usually don't average into trades; I usually go in

found averaging does more harm than good most of the time.

As far as getting out of trades, if the market reaches a price objective and you're really not sure if it's going to continue, you have to at least take half the position off.

AT: *Is your trading based more on direct price action or on the indicators or systems you mentioned earlier?*

LBR: Ninety percent of what I do is price-based. Indicators are just derivatives of price. So the actual price action is always going to be one step ahead of any indicator.

The best things indicators do is tell you when there are either new momentum highs or lows, which signals continuation. It doesn't matter what you use — an oscillator, stochastics, an average true range function. I use pure rate of change — there are a million ways you can do it.

At least you can quantify indicators. It's difficult to back-test pure price patterns. So, for assessing market tendencies and modeling purposes, indicators are useful. But when I'm actually trading, I'm looking at price and thinking, “Okay, this market was down in the morning, now it's starting to make new highs on the day.” Or, “We opened below yesterday's low, and now we've rallied back to unchanged.” I do a lot more with price levels and pivots: Can we test the Globex high? Can we test the two-day high? Can we pull back to the moving average. That's what I do.

AT: *What time frame charts do you watch during the day?*

LBR: To watch the market intraday, I have 30-, 60- and 120-minute for each market I'm watching. That gives a pretty good road map. If you can't see something with that, then there's really nothing going on. On one of those time frames you'll always see either a retracement pattern, like a bear flag or a bull flag, or you'll see a test of a key support or resistance level. The market's either retracing or testing — that's about all there is to it.

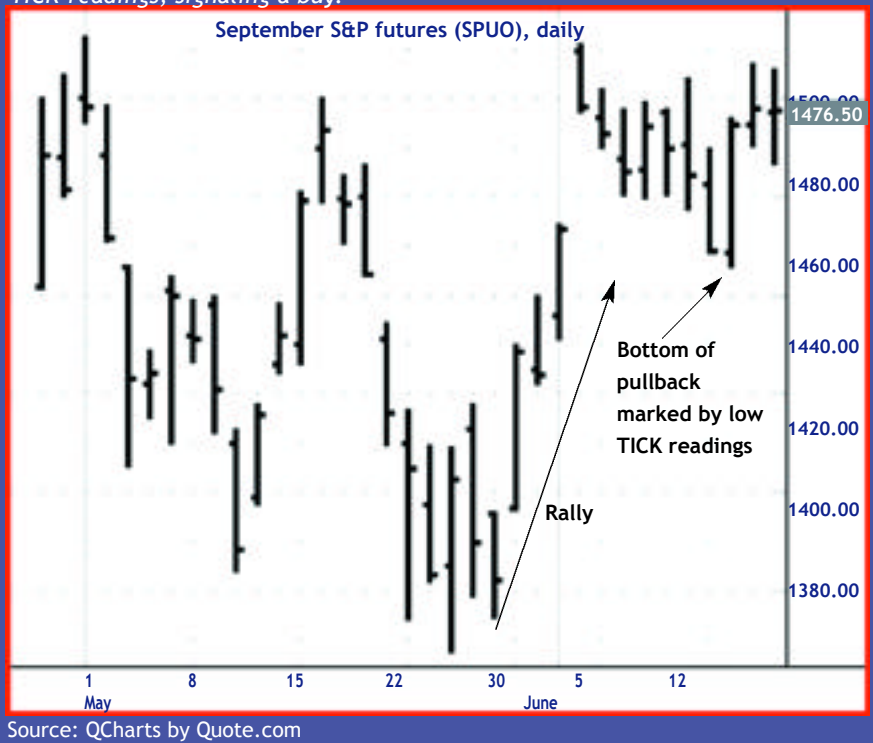
AT: *What else are you monitoring during the day for your shorter-term trades?*

LBR: For intraday trades, I'm usually just watching the tape, so to speak. Sometimes I'll watch a one- or five-minute chart, but I'm usually watching the levels intraday, and the TICKs (*the difference between up-ticking NYSE stocks and down-ticking NYSE stocks*) and the TRIN (*an indicator that compares advancing issues/declining issues to the up volume/down volume ratio*).

AT: *What specifically are you looking for?*
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FIGURE 1 CATCHING A PULLBACK

A typical short-term trade: A pullback in the S&Ps is accompanied by low TICK readings, signaling a buy.



LBR: I use the TICKs like a momentum oscillator: If the TICKs are making new highs, I'll look to buy the pullbacks. For example, recently there was a rally up in the S&Ps for about two weeks, followed by roughly a five-day correction. The TICKs hit -400, -500 yesterday and this morning (June 13), and it was the first time they corrected in a week and a half — that was a buy signal (see Figure 1, above). It's similar to when an oscillator rallies and becomes extremely overbought and pulls back a little bit. The TICKs behave almost exactly the same way. But I use them to confirm a trend as well. For example, this afternoon the ticks kept making new highs, which confirms the move to the upside.

The TICKs behave differently to the upside than they do to the downside. The bottoms of sell-offs will be accompanied by negative TICK extremes, like -1,000, for example. Tops are characterized much more by complacency, with a lack of TICK readings. It's similar to the VIX (the Chicago Board Options Exchange volatility index) dropping down very low, reflecting low implied volatility levels. I watch the VIX, too.

AT: How many trades do you make a day?

LBR: Anywhere from two to six trades in the S&Ps and three trades in other markets.

AT: Do you trade stocks as well as futures?

LBR: Yes. Trading stocks keeps me fresh, but you can't trade with the same leverage you can in the index futures. With

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the futures, you can bang them out and you don't have to worry about the short side. Unfortunately, I can honestly say I've never bought a stock and had it rally 50 points — I've missed out on the Internet game (laughs).

AT: How do you decide how much you'll risk on a trade or where you'll place your stops?

LBR: You need to have some kind of initial risk point. In just about any market, except for coffee or S&Ps, I risk \$500 per contract. That makes it really easy. That gives the positions (in the markets I trade) enough room to work or not work.

You have to think in terms of getting into a market and having a general window so if your timing is off a little, you

still have some time to see how the trade should be managed. But you need that initial insurance or risk point. So even though I usually start out with \$500, there are times when I don't want to risk that much.

After you've put on the position and established your initial risk, you manage the trade, which consists of getting out if it's not working or tightening the stop. In the S&Ps, if the trade is just a quick scalp where I'm trying to grab two to four points, I'll risk three points. For a longer position trade, I'll risk up to 10 points.

But it also depends on volatility. If the market is really swinging around, you have to give the trade a little room. I'll use a 100-point stop in the Nasdaq futures. That's big — \$10,000 per contract, but I trade them on a longer time frame, so I don't mind doing that.

AT: How long did it take you to develop your current trading style?

LBR: I've always been price-sensitive and I've always been a tape reader. But in the 1980s I was much more countertrend than I am now. When I started managing money in 1993, my trading style really changed.

First, I made it a policy to never aver-

age a trade, whereas in the '80s, when I was just trading my own money, I used to scale into trades all the time. You have a lot of sleepless nights. My account had five times the volatility it has now.

I also started using much less leverage. And I started looking for more trades that constituted pullbacks within trends rather than trying to guess when a market had gone too far.

AT: What are some of the basic principles you think traders should follow?

LBR: I try to break trading down into four areas, each of which is important to your bottom line.

The first one, which is the one everyone wants to concentrate on, is the initial

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trade methodology — setups, indicators, patterns — that determine whether to buy or sell, at what level and when.

The second is execution. This is probably the most overlooked area of trading. Your execution skills account for at least 50 percent of your bottom line. When do you buy at the market? When do you work a bid? If you use a limit order, sometimes you'll miss a trade — it's a shame to price yourself out of a 10-point move because you're trying to get an extra quarter-point. But on the other hand, you don't want to pay up at the market all the time, because you can give away too much, especially in a thin, trading-range environment.

Also, how do you exit your trades? How do you work your stops? Do you know how to bracket a trade? Say there's a position you want to get in — you work a bid underneath as well as a buy stop above the market, so you're at least guaranteed of getting in.

There's very little literature on this subject, but I see more money lost because of poor execution. People can lose money even when they're right on the market. For example, they're trying to exit a trade with a limit order and the market misses it by two ticks and then goes 10 points against them.

I could go on and on. It's one of those things you can give people tips and direction on, but it's only going to improve with practice. You have to get in there and make the trades and get a feel for how things work. That's where you get confidence, too. If you feel confident you're buying and selling in the right manner, you'll probably make three times as many trades.

There's no right or wrong. I probably trade with 90 percent market orders, but I have a friend who will never use a market order. It depends on the type of trade you're trying to execute and how good your general timing is.

The third element is money management. There are a lot of factors that fall into this category — it's so much more than how much you risk or where you place your stop. It's about how much leverage you use and when you use it. Do you have correlation in your portfolio? What are you going to do when your account draws down 10 percent? Do you step up your trading or do you cut back?

Finally, there's psychology. It's not about “Oh, I can't pull the trigger,” or “I over-trade.” It's about things like staying motivated and not burning out. Trading can be a wearing, stressful profession. Let's say you've been a trader for 15 years. How do you push yourself to get to the next level? How do challenge yourself? How do you keep yourself in a groove where you're not thinking about the markets too much?

Also, are you analyzing your tendencies? For example, many people tend to make money in the morning and give it back in the last hour of the day.

You could add a minor fifth category: Organization and structure. How do you structure your business and working environment. Do you keep worksheets? Do you log market numbers? Do you keep records of trades and analyze what you're doing?

AT: Are you talking about analyzing your trade performance?

LBR: Yes. But the record keeping is more of a ritual for me. I actually log lots of numbers — without ever really looking at them later. But the simple practice of writing them down somehow sends the information to somewhere in my brain where I can access it later.

I have a fax service I put out every

night. The work I have to put into that is great preparation for the next trading day. I go over game plans in around 20 markets, even though I might only act on a couple of the scenarios. If I'm monitoring my account, my positions and the prices I'm entering them at, I'll do twice as good as if I hadn't. The routine and ritual are wonderful tools for managing anxiety and stress.

AT: Do you actually experience much stress from trading?

LBR: I tend to feel the effects of stress at the end of the year, the end of the quarter and the end of the month. So this year, I put in my business plan that I would close out all positions at the end of the quarter.

AT: Will you back away from trading on a bad day, or for a certain amount of time, if you've hit a certain drawdown level?

LBR: I never walk away when I'm down. Never. It's important for me to get that money back. It's makes me angry that I lost that money in the first place. If I walked out of the office, I couldn't relax. I'm so involved in this I don't even like taking vacations. If I were on a beach on an island somewhere, I wouldn't know what to do with myself.

But I have my horses, so I can go out riding after the close. I spend time with the horses every day. It takes my mind completely off the markets. After that, I can do my analysis at night with a fresh eye. You have to have something that allows you to walk out of the office and leave trading completely behind. Other than that, the only time I really “walk away” is when I speak at trading conferences.

AT: What do you tell people who want to become better traders?

LBR: Get a good, basic foundation in technical analysis. By that I mean study basic chart patterns. Do yourself a favor and ignore all the oscillators and neural nets and the fancy little indicators and [instead] fully understand things like gap theory, trendlines and continuation patterns. Murphy's book, Schabacker's book, Edward & Magee are good sources (see “Raschke's reading list,” opposite). Understand the definition of a trend and the principles of confirmation and non-confirmation Dow put forth. Learn chart

FIGURE 2 CONTINUATION PATTERNS: BULL FLAGS

Continuation patterns such as the bull flags shown here offer "the best risk-reward ratios of any technique out there," according to Raschke.



patterns, Schabacker's and Wyckoff's books, to understand what goes on in distribution and accumulation areas, things like springs and upthrusts (see "Trading springs and upthrusts," p. 40), and volume tendencies.

These are really good principles that

and finding out they don't work. You have to test lots of different styles and markets until you find what works for you. And you might find out that you're a two-minute S&P trader, or that you like volatility breakouts, or something else. But you need patience, because it

"The minute the market gives back more than it should, you get out on the first reaction or pause."

will hold up in any market, in any time frame. Understanding simple trendlines and chart patterns, and when to trade continuation patterns vs. when you're in a trading range, testing environment is probably the best thing you can do.

It's interesting. These people wrote about the markets when there were no computers, so everything they wrote about was really price-based. And you also discover these people spent 80, 100 hours per week studying the markets. It makes you appreciate how much time it takes to really understand price behavior and the markets. For me, it's a life-long journey. I've been doing this for 20 years, and I learned a lot this past year.

New traders seem to spend the first three years trying out different things

takes time to find what fits your personality. And you'll learn something from everything you look at in that investigative process.

AT: Given what you said about understanding basic chart analysis, do you think simpler trading ideas work better than complex ones?

LBR: Oh, absolutely. Listen, all you need to do is understand bull or bear flags (see Figure 2, above). If you can recognize those on a chart and understand that those points have the best risk-reward ratios of any technique out there — where you can get the most bang for your buck in the least amount of time and use the most leverage — you don't need anything else. 🎧

Raschke reading list

Here are a few trading books mentioned by Linda Raschke throughout the course of the interview, as well as a couple of extras she recommends.

- *Technical Analysis and Stock Market Profits*, by Richard Schabacker and Donald Mack:

Raschke on the book:

"He [Schabacker] was actually the true father of technical analysis as a science. He was the one who classified many of the chart patterns — rounding tops and head-and-shoulder patterns, rising wedge, different kinds of gaps.

"In fact, his nephew was Robert Edwards (co-author of *Technical Analysis of Stock Trends*; see below). So Edwards & Magee's material was really Schabacker's stuff, but drier. Schabacker's book included lots of interesting insights on trading and human nature."

Other books:

- *Technical Analysis of Stock Trends*, by Robert D. Edwards and John Magee;
- *Profits in the Stock Market*, by H.M. Gartley (an "old classic");
- *Technical Analysis of the Financial Markets*, by John Murphy;
- *How I Trade and Invest in Stocks and Bonds*, by Richard D. Wyckoff; and
- *The Amazing Life of Jesse Livermore*, by Richard Smitten ("a good read, for fun").