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Simplicity is best:

Trading insights from

Linda Bradford Raschke

PHOTOS BY SUSAN GREENWOOD

Trader Talk

INTERVIEW WITH
LINDA BRADFORD RASCHKE

Raschke: Keep it simple

Linda Bradford Raschke has learned how to trade through trial and error and has come up with a system: Keep it simple. She started out as an equities trader on the floors of the Pacific and Philadelphia Stock Exchanges, and now lives in Florida, trading for herself and an offshore fund. She understands the floor's nuances and applies those to her trading today. These basic methods from her early days still serve her.

Omega Research Magazine: Not even from off the floor, but when you first started trading upstairs, how has your style changed over 15 years of trading?

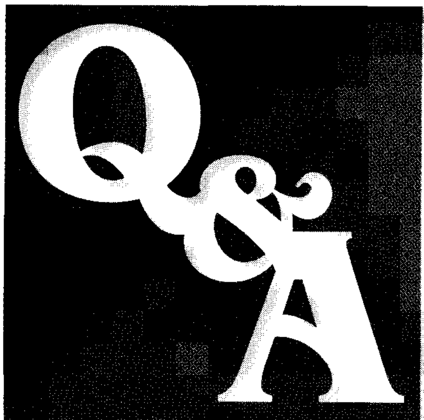
Linda Bradford Raschke: When you're on the floor, obviously you're a lot more active. You can make from 500 to 1,000 different trades or contracts a day. When you get off the floor, the first thing that happens is your time horizon extends a little bit. On one hand, [that's a] handicap, and on the other, it could be considered a luxury of not knowing or not having to take the other side of order flow. Because when you're on the floor, your job is to supply liquidity. The fact that you see the order flow coming in is extremely positive, [but] you're still expected to sell. So you know the [market] is going higher, but you're selling at what you might perceive to be high prices, but then you have to scramble to hedge it.... [So] you always end up being in a sort of countertrend type of mode. Most floor traders end up being countertrend, but they end up being nimble enough that they can work their way around that on those very large, high-volume trend days.

When you get off floor and manage money, the larger size you manage, the less flexibility you have to being a countertrend trader because you lose the liquidity to be nimble and get it back, and you're not on the floor to take advantage of the extreme prices. So once you're off floor, it's more important to be aware of

what the main trend is. Probably the one exception is the [Standard & Poor's 500 Stock Index] market because things do tend to get too extreme in the S&Ps. I just know intuitively a lot of day-traders tend to trade the S&Ps looking for the reversal points as opposed to entries into an existing trend.

ORM: **Is that what you do?**

LBR: Well, fortunately there is room to do both styles. Probably the most obvious pattern for a trend reversal in the S&P — and you usually get about two to three intraday trend reversals — is, in other words, the S&P will rally up for about an hour or two, then correct back for an hour or two. So you usually get two or three main turning points during a trading day, and those tend to be marked by divergences on oscillators on five-minute charts or on tick divergences or on breaks. In other words, there are a lot of external clues that a trader can cue off of for the reversal point. There's still plenty of room, or, as a trader would say, length of line, which is the amount of intraday swings, where you can let the market tip its hand. It starts going up in and around the very first pullback. The S&P intraday sets up lots of mini-flag patterns. [It] has this large thrust down, then it consolidates or pauses and gives a small technical flag, and then there's a continuation. That will usually give two or three main signals in each direction.



[The S&P is] really the only market out there that can accommodate both trading styles. Probably that's because there's not an underlying cash market, like with corn or wheat. That's the strongest thing that differentiates it. The currencies, there's not really a cash market, but, on the other hand, the way the banks work, it's such a strong, persisting trend mentality once things get going, all the dealers know who's on the inside. Whereas with the S&P, you have a lot of people who are entering for different reasons unrelated to trade or price location. For example, a pension or mutual fund might get x number of dollars that constantly get reinvested at the beginning of the month, and they have to put that money to work. You don't have that factor in other markets.

ORM: **You are not a system trader, you're a technical trader, right?**

LBR: I've done a lot of system development and a lot of testing, and that's been incredibly educational, and that in and of itself has changed my style of trading tremendously. I'll give you one instance. I did a lot of work a couple years ago on volatility breakout systems, which look for range-expansion type patterns. I traded at first in small size, fairly religiously — for me that's about 70% [laughs]. I did all right with it. It's a bit of a grind, but it's still fun, and you'll win on average, and it's like, I get the name of the game. You have to do it for about a year and a half, and you start to understand the numbers behind it, and maybe what you're capturing is a lower percentage of those outlier events, but those extreme events really pay.

A volatility breakout system is one of a few ways that can really allow you to enter a trending market. If you're a countertrend trader, you'll never get a pullback to enter. It teaches you that buying strength is okay. That's a very difficult thing for a floor trader to do is buy strength or sell weakness....

What trading a volatility breakout system teaches you when you have a range expansion day is that there are incredibly high odds you will have some morning follow-through. Just because the market is at an extreme does not mean that you fade it. You have to be discriminating as to what type of volatility extreme you're going to fade, but the odds are going to be much more in your favor if you go with that range expansion of the volatility breakout. Then look to maybe fade at the next stage. But even so, it's telling you that obviously there are more buyers or sellers, so you want to find some way to enter in the direction of that volatility breakout. That's something only a system is going to teach you.

The problem I've found with doing absolutely mechanical [trading] is it's fine if you're doing it on five or 10 contracts, you grind it out, you can see the numbers work out over time. Yes, you have whipsaws or drawdowns, probably bigger than you imagine, because that's how systems work, but miraculously it makes it all back. I did some volatility breakout systems with my CTA, first on the domestic market and then later on on the overseas markets. I found that when you jump the [transaction] size way up, like 50-100 contracts, the execution really became critical. The slippage factor diminished the return [so] that it really wasn't worth trading. It was worth trading on five contracts, but

on 100 contracts, the slippage would start to overcome any gains the system had. And the thing was it wasn't every trade; a lot of times you get great execution, but it would be one out of every 20 trades where you happen to be in the coffee market on the wrong side and you have to get out. Well, that one out of every 20 trades, trying to get out with only a certain amount of liquidity, is very tough to do in a volatility breakout system.

[A mechanical system] teaches you proper principles of trading. It still teaches you to go in the direction of momentum. You don't want it to sit there and fade a market, which means go against it, or sell it because it's up or buy it because it's down. You want to be doing that, as a trader, when you feel it's a selling climax or it's some type of divergence or it's at the end of the move. It becomes much more important for a trader, be systematic or discretionary, to differentiate where you are in the overall structure of the market. That's where the basic technical analysis comes in.

For a systems person, the better [he is] able to differentiate where [he is] in the overall structure of a move, and use that as a filter for the system, the better [he] will be able to improve performance. And it might just be something as simple as saying, "Is this range expansion move coming at the point of a breakout, like at the end of a consolidation when you're starting a fresh leg of a move, or is this range expansion coming late in the move where there might not be a whole lot left on the table?"

These are the things that become more of a challenge for the trader as far as the basic technical analysis. If [he] wants to have an underlying foundation of Elliott wave analysis or Wyckoff or Dow or any of these [methods] ...that frames things out better for us. If [a trader] can incorporate some of these into [his] system, as opposed to, oh, it's a volatility breakout, that's where [he] wants to go with the stuff.

I know people who went with artificial intelligence [and] tried to capture some of these components, but I don't think they went about it in the right way. I personally don't know how successfully it can be done. The answer lies in the system's ability to incorporate a higher time frame.

For example, if you are doing your system signals off of a daily chart, it might become a lot more critical if you can incorporate into that software platform something that can analyze where you are on the weeklies. In other words, is this a new momentum high or low on the weeklies, or is this divergence? The tough thing is there aren't a whole lot of software programs out there that have that ability to look a multiple time frames. That's the only way to get a sense on a methodical or systematic basis of where you are in this overall technical structure. Probably the closest the people have come is looking at the classic momentum readings. If it's in a new momentum high, you're in a third wave of an Elliott wave structure looking for that pullback, and it makes a divergence on the fifth.

The two advantages that a mechanical system offers are, one, it forces you to take trades. As a general rule of thumb, all the studies out there — this is my opinion, but it's backed up by all these studies that were done by the FCMs — that look at the 5% of accounts that are profitable, and the 95% of accounts that aren't profitable, find that, guess what, the 5% accounts that are profitable have the highest activity level. Truly, if you look at a volatility breakout system, your average net profit might be $65 a trade. So it becomes a function of your activity level.

I have a friend who has a good quote: "There's a dance to dance every day." Activity level tends to be correlated with the individual's profitability. Volatility breakout systems generally tend to be one of the more active types of mechanical systems. They force you to take lots of trades. If you're running a portfolio of 20 different markets, you will probably get six different signals a day, and when that means six different positions, and maybe exiting a couple positions, [that's] a lot of activity for one person to handle. But this is good — this is your job.

Number two, [mechanical systems] give you a definite risk point. There is a definite money management point, which is very hard for most discretionary traders to follow.

The tough thing for any trader to swallow, be discretionary or systematic, is that most of the studies show the minute you add any stops to a system, it degrades the system. So why put in a stop when there's such incredible odds that you'll get stopped out at the low tick. But the point is once you are out of a trade, it allows you to start looking at a fresh trade, number one, and you can't afford to have too big of a loss because it will either damage your account capital wise, or it will damage your head mentally wise.

***ORM*: Your style of trading then is a mechanical system that uses technicals?**

LBR: No, I'm not using a mechanical system — I've just done a lot of system testing that slowly

confirms a profile of market behavior, so I can say to myself, "Gee, if there's a big, wide range bar or range expansion day [then my testing backs up my intuition]." I know intuitively by now — especially by being on the wrong side enough times — that there's an 80% chance, or incredibly high odds, it will go further the next day. Therefore, if I'm on the wrong side of the market, [I] don't want to be in it because I can get in a at a better spot tomorrow. So, all this constant system testing still just confirms what the trader might instinctively feel upstairs, but is not able to quantify or know how to use.

I personally like looking at good old-fashioned chart patterns. Those are the things that I've found really haven't changed. If a market makes a new level, a new high or new low, there's pretty high odds that a new high or a new low will be taken out or at least tested. So anytime you have a new high or new low, you would want to be looking to buy the pullback to at least see if there's a test, if not another leg. Anytime there's a volatility contraction, which occurs at the end of any consolidation, I know there are pretty high odds that whichever way I'm positioned, it's going to move the other way [laughs]. I'm being facetious. You can't predict the direction at those points, but the market would tip its hand. And it might have a false breakout to one side first but come out the other side, and that's just part of the game.

You know there are certain things the market's going to do, and you can't control it. But probably the more obvious patterns that are more recognizable don't happen all the time, but the market will definitely let you know when it has trapped one side of the market's participants. For example, if you had a selling climax or a buying climax, which might appear in the form of a very large bar up and then a very large reversal down, or if, vice versa, a big V-type of pattern, then you have to recognize that for what it is, and say the market's telling you something and then go in that direction. It's a very basic concept.

Or, if you had a triangle and the market breaks out to the upside then reverses, takes out support and comes out the downside, sometimes those "fakeout" signals can be the strongest ones because it's trapped one side of the market's participants, and it's going to keep on moving in the opposite direction until it squeezes them out. So there are certain times when the market tips its hand and forecasts its next move. By that I mean four to five days, the next leg. Sometimes it's very hard to see out very much beyond that, at least for me. Sometimes you can tell if you have a clear pattern on the weeklies — it's much more apparent — but sometimes you just have to take it one step at a time.

***ORM*: You've said before you still use three basic patterns. Are you considering support/ resistance one of those?**

LBR: Sure, that's how you quantify your risk by the nearest support and resistance. There is nothing else, other than if you wanted to just pick an arbitrary fixed dollar amount that might suit you mentally.

***ORM*: What is your pain threshold?**

LBR: One of the things I use to manage my risk is leverage. To me that is an important part of money management — how leveraged you are. As a general rule of thumb, I trade on pretty light leverage...like one contract per $100,000. It doesn't sound like very much, but you can do a lot with that. Keep in mind, if you are looking at soybeans and corn and wheat, you've got three correlated markets. If you're looking at S&Ps and bonds, although this relationship has been a little bit divergent over the last month or two, the financials are highly correlated markets.

***ORM*: How do you do your homework?**

LBR: It's most important that when I come in for the day, I still have a bias. It's not an opinion, but I still have sort of a game plan, like, the market closed strong, there should be some morning follow-through. So I'm looking for a rally, but that rally's probably not going to get very far because [it was] so overbought from the day before, maybe it was a wide-range bar up, so I know it's going to be a follow-through, so maybe that's going to be a good point to look to short in the morning.

[I'm not] looking to put on a major position because on the daily bars, for example, if I look at this S&P right now, boy, 1000 is such an alluring level. I know everybody is looking at it, and there's no reason why the market can't go up there. It's not technically horribly weak or anything. I know people got pretty bearish on all this Asian stuff, and I know the bonds are making new highs, so I would want to respect that.

I find that if I do all my analysis off of the dailies, I have a pretty good idea in my mind where the market stands. Then if I just watch what happens during the day, it becomes more

of a concept or principle, as opposed to looking at a one-minute chart and trying to catch every jiggle....

So what I try to do at night is do all my analysis off the daily charts, then during the actual trading day, the less I have to look at intraday charts, the better. If you try too hard, it's not going to happen. You just have to do your homework and be prepared, and then if the market starts acting like you think it should act, then you jump all over it. For example, I'm looking at these grain markets right now [early January], and I was looking at corn because it seems on Friday it pushed the bean market down really hard, and corn was just sort of grudging. It wasn't really going down — it didn't close at the lower end of its range — it kind of closed in the middle of its range after making new contract lows, and it was like a perfect test.

If it's not really selling off anymore, I'm going to go in and buy some, especially if it closed strong. I could probably even go home long on the close. These are all things that are said at night when the markets are closed and you're not influenced by the daily action because it's very easy to be influenced by the market going up. That's great. If it's going down, it's bad. You have to know ahead of time where the overall structure is. So corn, naturally when you want to buy it, it gaps up a point, which is actually okay because then it's, like, let's see if it holds its gain. Then it pulls down a little bit, and I think, "Well, I'll go in and buy a little bit." Then it goes a little bit further through me, but not by much. Then it closes very well — it closes in my favor — so I take a trade home overnight. It closes at a profit, so it means it probably has high odds that I'll get more tomorrow.

The point is that you see the setup the day before the market, even if it opens up and starts to pull back, that it still holds its gains on its pullback. I don't even think it pulls back to unchanged. It opened up a penny and a half, it pulled back a penny. If it's up half a penny on the day, it's still positive, and then it started to climb again in the afternoon. That's a great way to enter a market when it starts making highs in the afternoon, or new lows in the afternoon. What a great signal.

Nothing says you have to sit there and be a genius and have a crystal ball and buy and sell on the opening. I love nothing more than waiting for those mid-day reversals, like where a market makes new lows on the day, then starts to come back up and make new highs on the day, I'll jump on board. So truly it's become that I do my homework at night and then it's a patience game. It's waiting to see if the market does what it wants to do, and then once it does, you know, just having the confidence to say, "OK, it's doing just what I thought it would; therefore, I should be in that market."

***ORM*: Do you have programmed into your system a signal for when a certain pattern occurs?**

LBR: Oh yes. I have three main things I look at. I always like looking at the market in terms of using an intermediate-term oscillator, and the thing that I've always used — just because I've used it since 1980 — is this charting service called Security Market Research, which has been out there for 38 years and still puts out their little daily chart books, where you can call up on the hotline and press "oscillator number," which, of course, we all have on our computer. But I'll tell you, there's nothing like doing it by hand. If I could emphasize one thing to people, [it would be] you get such a different feel learning to chart something by hand instead of just looking at your computer at night. It makes all the difference in the world. I can't stress that enough.

***ORM*: Are you paying attention more to the nuances of the day?**

LBR: I can't tell you how many old timers [chart by hand]. Not only does it go to a different part of the brain, it sort of internalizes it, and you get in the habit of looking at trendlines, of being more aware of significant chart points. I can look at a chart, but the next day if I don't have that daily chart right in front of me, it blanks out. So it really helps [to] solidify your game plan.

So I look at the difference between a three- and a 10-day simple moving average, a 3-10 oscillator. It's standard on any charting software package. And most oscillators are a crutch for just showing you what's there in the bar chart anyway. You can count the pushes up on an oscillator — one, two, three. Or you can count the pushes up on a bar chart — one, two, three. It's just that the oscillator will probably highlight some divergences a little bit better, unless you've conditioned yourself to look for that test. You can train yourself to see everything in a bar chart that an oscillator will tell you.

I like looking at a 20-period moving average because that represents to me a value area or a

mean or a regression-to-the-mean type of thing. I look at that as a basic support/resistance level in a trending market. It means nothing in a sideways market, but in a trending market, I use it as my support/resistance level.

If I'm being very aggressive or if I'm looking for aggressive divergences, I'll look at a two-period rate of change. It's something I've done for years, and it's a noisy line and doesn't work well in markets like the sugar market that can kind of chop around for three months, but it works well in the S&P and bonds, and that sort of helps me get my rhythm, of the buy day/sell short day type of rhythm, which was expounded in [George] Douglas Taylor's book, *Taylor Trading Techniques*. That concept of buy day/sell short day, is most important because when [it's a] buy day, I get long and hold it overnight and carry it through the next day. So it takes a great deal of psychological pressure off of me. I made a trade, where do I get out? I don't care. I'm holding it overnight, unless it closes against me.

It's hard enough to make a decision to get into a market, let alone to get out of it in the same day. So it's mentally easier: buy day/sell day/sell short day. What is my job today? Look for a spot to short that market. If you came into the bonds and you were just looking solely to short the bonds today — of course, the bonds made record highs, they're up a point and a half today — but if someone told you your only job was to make one short trade for the bonds today, guess what, you would have done it, and you could have taken out 5-10 ticks. But so much of the game is defining what you're going to do, instead of feeling like a leaf that's getting tossed back and forth in the wind, to and fro. Half the game isn't getting the direction right, it's just having some game plan at all.

So, the 3-10 oscillator, the two-period ROC, and a 20-period exponential moving average, and then there are indicators that measure the degree of volatility contraction in the market. But again, the eye can train itself to see that on the bar chart anyway. Like if you have three bars that are really dinky, going nowhere sideways, that's a good enough proxy. But you could quantify that in terms of some type of range index or an ADX.

I just make note if it's the narrowest range of the last seven days because that's about all I can digest. That's about 95% of my analysis, and it's greatly in the Kiss method — keep it simple, stupid. It doesn't mean I haven't played with everything else out there, like neural nets. I have, but those are more for the mental gymnastics. They're fun. You have to differentiate what's a hobby vs. what's real and what's going to work for you in the marketplace.

***ORM*: Stocks vs. futures: Do your methods differ in each of those, like IBM vs. corn?**

LBR: No, not at all. Behavior is what makes market patterns. You can never predict an individual's behavior, but you can predict the way at times a crowd will move.

The same patterns that show up in futures show up in stocks. That doesn't mean there aren't differences between futures and stocks, just like there are differences between individual stocks. But there are differences between the individual futures. For example, a market like cotton or live cattle is going to trend a lot harder than the S&Ps will. The same thing with stocks; there's going to be a big difference whether it's high cap stocks vs. over-the-counter Nasdaq stocks; whether it's in vogue or out of vogue, like a Microsoft vs. junk stocks.

I love stocks because I don't think there's quite as much noise in them. The patterns are cleaner. I find the weeklies on stocks incredibly clear. The patterns that set up with the weeklies on stocks are just about perfect. Much more perfect than the weeklies on the futures markets. It's very easy to see a pullback on the weekly chart on the stocks, more so than the weeklies on coffee, which could come after this huge spike or climax. It looks different.

Stocks are much more forgiving, and they're not as highly leveraged, obviously, so there's going to be a big difference there.

You also can trade stocks on a longer time frame. It's easier to buy a stock and hold it for, if not a couple weeks, a couple months, with greater piece of mind. A lot of times in the futures markets, if you don't take your profits, they're gone.