

Trader toolbox

In a follow-up to our
February interview
with trader
Linda Raschke,
we discuss more
of the indicators
and strategies
she uses each day.

BY MARK ETZKORN

You can take the trader away from the floor, but you can't take the floor away from the trader. Case in point, Linda Raschke.

Raschke, who currently trades privately and runs a real-time online trading room (see "Linda Raschke keeps up the pace," February 2004, p. 66), started as an options floor trader on the Pacific Coast Stock Exchange in 1981, then followed that with a stint at the Philadelphia Stock Exchange.

Although it has been 17 years since she left the pits and switched to off-floor trading, Raschke says the market principles and analysis techniques she developed during those days remain integral to her trading today. In fact, some of the tools

she uses now, such as the "3-10" oscillator (see "Indicator checklist," p. 78), are essentially the same ones she picked up from her original mentor more than 20 years ago.

Raschke says trading "upstairs" required some adjustment, although initially everything progressed well enough. Relying solely on a Quotron screen (a simple price quote display that was prevalent in the 1980s), Raschke says she racked up 45 successive profitable weeks, in part because the technology was so conducive to the tape reading skills she had honed on the exchange floor. But when she got her first analysis software in 1987, she lost money for three months.

"It was a distraction in a way," she says. "It was like a tennis player who's always played on clay switching to grass."

Setbacks and limitations don't typically make compelling trading stories, but Raschke is fairly open about past missteps and trading realities, including the fact that she went bust early in her floor trading career and even today doesn't always hit

the ball out of the park, so to speak. True to many traders with floor experience, she focuses on consistency — smaller trades with high probabilities.

"It took me 11 years to hit a big home run," she says. "It was in the early '90s, in soybeans — a short-term trade that got big. There was a buy divergence on the 3-10 oscillator. I bought at \$4.80, looking for a move to \$5. That was the year of the [Mississippi River] flood and I ended up holding on to the position for two more points (a \$10,000 move per contract)."

Part of what Raschke says she tries to accomplish in her trading room is realism about individual trades as well as trading as a whole — that home runs are the exception, not the rule, and mistakes happen to everybody.

"I always try to communicate my own errors and bad fills," she says. "People need to know these things happen to everybody."

Raschke advocates a practical approach to trading. She points out that many would-be traders quit their jobs when first attempting to trade professionally, and the stress of trying to make money out of the gate can be debilitating.

"It's like being in college," she says. "You still have to pay the bills when you're going to school — you have a night job at a bar, or something else. It's very difficult to trade when you're freaking out about how you're going to pay the rent."

Notes and numbers

We first spoke to Raschke in November 2003. When we caught up with her again in early January she had just finished updating many of the tests and studies that support her trading.

She says she does not design or test full-blown trading systems as most people are used to thinking of them — specific sets of rules for entering, exiting and placing stops. The stacks of notebooks in her office filled with pattern statistics and market tendencies are more like signposts she uses to guide trade decisions at a given time.

"The things I test mostly consist of basic "counting" or modeling market tendencies," she says. "Let's take the example of a daily S&P bar that closes in the upper 20 percent of its range. The odds are approximately 75 percent that the next bar will trade above the high of this bar, but there's only a 50-percent chance it will close above it. In other words, the pattern forecasts the market should trade above the most recent day's high, but it has no forecasting value regarding the close. That would be a basic model or tendency.

"In terms of actually trading, a model like that could influence a situation a couple of ways," she says. "First, it could make me lean toward holding an existing long position overnight because of that 75 percent expectation of follow-through the next day. Or, if the market opens the next day near or slightly below the previous close, you could play for a challenge of the previous high — again, because you know the 75 percent odds of it moving above that high."

Many of her notebooks contain market activity she logs by hand, mostly during the several hours of analysis she performs after each day's close. Raschke finds writing things down helps burn them into her brain.

continued on p. 78

Linda Raschke's office setup

Computers: The office includes 23 networked CPUs (plus one laptop PC). "The nice thing is the office is always toasty warm," Raschke jokes. "The bad thing is we live in Florida and thus spend most of the time trying to cool down the office!"

Monitors: 15 ViewSonic flat-panel monitors.

Internet connection: T1 line, plus satellite Internet.

Backup power: An independent generator that can keep the office up and running for five days in the event of a power outage.

Analysis software and data feeds

1. **Aspen Graphics** (www.aspenresearchgroup.com): Multiple workstations, each with four monitors, plus an in-house server for the Aspen/SP Comstock high-speed satellite data feed.

2. **Trade Station 2000i ProSuite** (www.tradestation.com) with **eSignal** (www.esignal.com) data feed and **Trade Station 7.2** with **TradeStation Internet data** feed.

3. **Insight** (www.insight-trading.com) for stock analytics, with **Comstock** (www.comstock-interactivedata.com) high-speed satellite feed.

"We use different software applications for different purposes," Raschke says. "Aspen is our main charting application, and by having our own in-house server, we can write our own applications to run off the database using DDE links. Insight can perform stock analytics and rankings the other applications can't. TradeStation can do backtesting and system monitoring.

"It is also essential that we have three different data feeds coming into our office for backup purposes, since we are managing money."

Execution platforms

For index futures and bonds: Photon (www.photontrader.com)

For currency markets: Baxter-FX (www.currencydealing.net)

For stocks: REDiPlus (www.redi.com) and TradeStation (www.tradestation.com)

Indicator checklist

These are some the indicators Raschke uses most often in her trading and analysis.

1. 3-10 oscillator. The 3-10 oscillator is "something I've been using since 1981," Raschke says. "It's the difference between a three-day simple moving average and a 10-day simple moving average. Plus, there's a second line which is a 16-period simple moving average of the 3-10 line."

"On a chart, I usually just alter the settings for an MACD (*moving average convergence-divergence indicator*), changing the moving average type from exponential to simple and the moving average lengths to 3, 10 and 16."

2. 14-period ADX (average directional movement index). This indicator is used to gauge trend strength (see Holy Grail trade setup in main story).

3. Keltner Channels, which are trading bands that consist of lines placed 2.5 average true ranges on either side of a 20-period exponential moving average.

4. Two-period rate of change (ROC) on daily charts.

5. TICK/TIKI highs and lows.

"I created a tick based exclusively on the top-600 trading stocks but truthfully, I've found the standard TICK to be the best. I'll also look at the TIKI spikes. When the TIKI is +26 or -26, it's usually a good indication a basket or program was fired off."

6. Closing breadth: 10-period SMA of NYSE advancers minus decliners.

7. Put-call ratio. Raschke uses a five-period simple moving average on the put-call ratio. "The put-call ratio has been the No. 1 sentiment indicator. It used to be the TRIN."

For articles related to these indicators, see "Additional Active Trader reading" on p. 80.

"You'll always see things most clearly when the markets are closed," she says. "You're at your most objective then."

"I'm a big fan of worksheets — I'm not normally that organized a person," she continues. "Log your trades. Run your trading like you would any other business."

Grail setup

Although she trades with discretion, Raschke is adamant about the necessity of having statistics and strategies to understand the markets and focus her trading. For example, she says her "gut feel" regarding the direction of a consolidation breakout leaves a little to be desired.

"I'm wrong 90-percent of the time," she says, laughing. "Use me as a countertrend indicator—I just know if it's a low ADX (*an indicator that measures trend strength*), I'm going to be wrong if I try to guess."

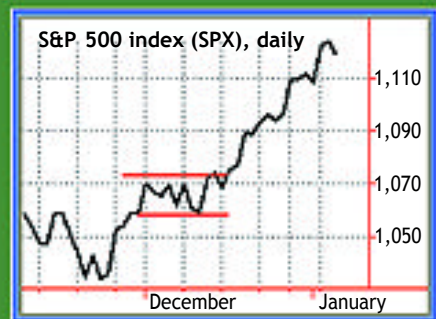
Raschke does actively monitor numerous defined trading strategies, including a pullback technique called the "Holy Grail" setup. The strategy is designed to catch corrections in markets that have shown evidence of increased momentum, with the average directional movement index (ADX) and a 20-day exponential moving average (EMA) providing the setup. (For more information on these indicators and others she uses, see "Indicator checklist," left).

Raschke describes an example from December 2003 on a 30-minute S&P chart, which is shown in Figure 1 (below).

"The market had a long consolidation period — what I call a sideways line, which is basic, classic technical analysis — essentially the first two weeks of December," she says. "The market broke out and made new highs. On Dec. 18 and 19 the ADX jumped way up and the 3-10 oscillator signaled new momentum

FIGURE 1 "HOLY GRAIL" SETUP

After the S&P 500 broke out of an early December consolidation (daily chart, right), the Holy Grail setup was used to capture pullback opportunities in the emerging uptrend. On Dec. 18, 2003, the ADX pushed above 30 (after the 3-10 oscillator had indicated a new momentum high earlier in the day), signaling increased trend strength. On Dec. 19, price pulled back to the 20-day EMA, which provided the entry point.



Source: TradeStation



Source: MetaStock

highs. So, there were all kinds of signs of a momentum increase.

"When that happens, I want to buy the retracements," she continues. "On the 30-minute time frame, the ADX rose above 30, so we'll buy the first retracement to the 20-period EMA and look to exit on a push to new highs."

The setup can form on different time frames, a characteristic Raschke points out was particularly relevant in this case.

"When the market breaks out of an extended trading range and makes new momentum highs, there is a sequence that typically unfolds," she explains. "Price first pulls back to the 20-bar EMA on the 15-minute chart — even a five-minute chart — then the same retracement will occur on the 30-minute chart, then the 60-minute chart, then the 120-minute time frame. By then you should be looking for a top."

"This [move in the S&P] developed into a nice sequence," Raschke continues. "Because the market continued to create new upside momentum, another Grail buy setup occurred on the hourly chart on Dec. 23, and then another formed on the 120-minute chart on Jan. 2."

"But each retracement has to be preceded by a 14-bar ADX reading above 30 on that time frame," she explains. "The best setups will have confirming factors like the 3-10 oscillator making new momentum highs."

Raschke also looks to the 3-10 oscillator to indicate when a move might be losing strength.

"Also, you'll often find 120-minute sell divergences (*when price moves up and the 3-10 oscillator moves down*) at the end of price runs," she says. "It corresponds to the end of a swing up or down on the daily time frame."

Looking abroad

A phenomenon Raschke noticed in 2003 was the leading nature of some European stock markets (particularly the EuroStoxx and the German DAX indices) relative to the U.S. market.

"We used to lead foreign markets, but for the past five months we've been seeing more instances of the DAX leading the U.S. markets," she says.

"There were periods a few months ago when the European markets were

blatantly leading our markets," she explains. "They were the first to make new highs on the year. When our market was retracing in August and testing the lower end of that weekly trading range it was forming, [European markets] were not. They were holding up in the middle

about three times," she notes. "What you'll find is, if you pull up a 15-minute EuroStoxx chart in the morning, and let's say the chart looked like this (*she points to a strongly uptrending chart*), I could just buy the S&P futures right then and have [very high odds of a] winning trade because the

"Initiating a trade is the easy part. It's a much more active process once you have a trade on and you have to manage it."

of that weekly trading range. They turned up first and started the upswing toward making or testing new highs.

Raschke finds these overseas comparisons useful on a micro as well as macro scale.

"The DAX is more indicative of Dow-type stocks, while the EuroStoxx is more indicative of the S&Ps and is actually the more active, liquid trading contract by

two markets are so highly correlated.

"You'll see the same little mark-up if I put up a chart of the S&Ps without any night-session data," Raschke continues. "If I come into my office early, I might be able to do this any time from 7 a.m. (ET) onward, but I'll also use the DAX in the first hour the S&P futures are trading."

"It really does pay to watch those markets." 📊

Additional Active Trader reading

- "Linda Raschke keeps up the pace," February 2004, p. 66
- "Linda Bradford Raschke: The rituals of trading," August 2000, p. 56
- "Keltner Channels," December 2002, p. 88
- "Weighted and exponential moving averages," July 2002, p. 76
- "Put/call ratio," May 2002, p. 90
- "Price oscillator," January 2002, p. 76
- "Average Directional Movement index (ADX)," September 2001, p. 126
- "Moving average convergence-divergence (MACD)," July 2001, p. 88
- "Advance-Decline line" (breadth analysis), June 2001, p. 86
- "TICK/TIKI," March 2001, p. 112
- "True range," January 2001, p. 94
- "TRIN (Arms Index)," December 2000, p. 88
- "Momentum and rate-of-change (ROC)," October 2000, p. 82

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