The 5 Critical Trading Rules Successful Traders Never Break

(Based on Hedge Fund Level Quant Research)

Thank you for taking the time to learn how to be a profitable trader. Nothing is more important to your financial future than taking the time to learn these critical, must use, trading rules. It took me, Steven Gabriel, more than 10 years to learn these rules after a lot of trials and successes while trading the stock market. By trade, I am a physician, and I first traded stocks in the bull market of the 1990's. I was doing my internship training in the beautiful state of Hawaii, and I had borrowed an additional $20,000 in student loans and invested in the stock market. I was a tech nut, and I had invested in all of the tech wonder stocks from CSCO to JDSU to INTC and AOL. It was unbelievable, while my co-residents were eating Ramen noodles, I was living the high life. Then, it all came crashing down .

That's when it all started . I decided at that moment, that I would put the same amount of time that I had put in to medicine, in to learning how the stock market really worked. I realized that if I could make that much money in the market, that learning how to trade was an endeavor worth learning. I first started with trading "how-to" books, and I realized all they had in them were people's opinions. I was used to the research that was being done in the medical literature, real studies that tested in a way that if you did x-then y usually happened. Soon, I tried to do my own research using pen and paper—and, it definitely helped.

When I met Cesar Alvarez, everything changed. Cesar had worked at Microsoft in the Excel division, and literally could make Excel do anything. We could test anything, and over time—we tested, and tested, and tested. We found some real themes in the market. Concepts and themes that we found to be true in most forms in the market. Many of these concepts are the basis of trading systems, and quant based hedge funds today. Many money managers succeed today because of this work. The most important thing you can do to become a successful trader is to learn these Rules, understand them, and apply them. For me, it has meant millions.

The secrets we share in this handbook are the 5 most valuable techniques to be profitable. Cesar and I adhere to these rules in all of our strategies, and it is what has led Cesar and I to literally generate more than $2,000,000 in trading profits in our trading careers starting with 5 figure accounts. Even more important, not following these rules will cause you to lose over time. Compounding losses will cause you to lose EVERYTHING. For anyone who has gone through a period like this, it is impressive just how fast it happens.

For those of you who don't know Cesar Alvarez, he is probably the only person doing the level of research happening at hedge funds like Renaissance Technologies, SAC Capital, Morgan Stanley, and Citadel—that is available to small traders ($10,000-$10,000,000). If you look at his background at Microsoft (Excel division, of course), and in trading research, used by money managers and prop traders—it is divine.

To make this simple—

5 Trading Rules that Consistently Make Money

1) **Buy Weakness**
2) **Pick Exit Criteria Ahead of Time**
3) **Have the Stock Wind at Your Back**
4) **Have the Market Wind at Your Back**
5) **Have a Plan**

The Baseline

Throughout this document we will be looking at supportive data using all of the S&P 500 stocks from 1/1/2003 to 12/31/2018.

Because of this, it's important to have a reference or control to refer to in comparing the benefits of these rules to the baseline.

Here is the performance of all of the S&P 500 stocks from this time frame if you had held the stocks for 5 days

Entry Rules	Exit Rules	Avg. % profit/loss	% Winners
Buy everyday	5 days later	.24	53.6

CRITICAL TRADING RULE #1
Buy Weakness

We all know the trading books all say to buy strength, but no matter how you slice it, buying weakness produces better trading results. This is true even in very short time frames and intermediate time frames. Don't get caught up in the hype of buying stocks that are up or breaking out. On average, that is a quick way to financial ruin.

Here is some data that shows that buying weakness creates outperformance.

Entry Rules:
Here are 3 tests, looking at weakness

The results are:

Entry Rules	**Exit Rules**	**Avg. % profit/loss**	**% Winners**
RSI (2) <5 (short term very weak stocks)	5 days later	.54	55.4
RSI (5) < 20 (intermediate term weak stocks)	5 days later	.55	55.1
RSI (10) < 20 (a bit longer term weakness)	5 days later	.65	54.0

These categories have thousands of trades, and as you would expect, if you tighten up the parameters you get better returns with fewer trades.

There is an edge with buying weakness. And the opposite is true as well; there is a negative expectancy with buying strength.

If there is any one trading rule to swear by, this is it…

This rule alone can make you millions over your life time.

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Visit www.AlvarezQuantTrading.com to learn more about trading

CRITICAL TRADING RULE #2:
Pick Exit Criteria Ahead of Time

PICK EXIT CRITERIA AHEAD OF TIME…

And, there are only 2 profitable choices

1) a fixed amount of time, or
2) a technical indicator looking for strength

The classical teaching says to sell when the stock falls or use a stop loss, and that will save you from big losses.

The truth is, that you will compound your losses and be ruined. Essentially, you lose money by lots and lots of small losses. And, if you've used this classical teaching, you know what we're talking about.

Here is data that will show you just what happens if you keep selling when your stock is weak. And, yes, it makes sense that every once in a while it will be the beginning of a big selloff. But the reality is, that the majority of times it's not. The majority of times, people say the sky is falling, it doesn't. Every once in a while, the sky does fall, but, for the most part-that is unpredictable, and part of the cost of doing business. In Vegas, sometimes, a patron wins a $1,000,000 jackpot, and yes, that hurts for the house. But, the house keeps playing the odds, and over time it works.

You do not make money selling into a selloff. Here's the 1 rule Jim Cramer is right about, in his words, "no one makes money selling in to a panic"

Here is data that demonstrates the concept.

Instead of just holding for 5 days (the prior exit criteria)—let's try letting the winners run, and only get out, if we have a 4% sell off—and hold indefinitely, otherwise.

Here are the results:

Entry Rules	Exit Rules	Avg. % profit/loss	% Winners
RSI (5)<20	4% trailing stop	-.05	39.1

What about if we tightened up that loss percentage to just 2%, that's all we can lose, right?

Here are the results:

Entry Rules	Exit Rules	Avg. % profit/loss	% Winners
RSI (5)<20	2% trailing stop	-.13	41.7

Look what happened after we used a sell off, or weakness to get out of our positions. It took our profitable entry, and made it unprofitable.

NEVER SELL ON WEAKNESS, once you enter a position, wait until strength comes before you sell, or have a fixed time length to hold your positions either one works much better than selling on weakness.

Now, let's look what happens when we exit our trade when it is strong rather than weak.

RESULTS:

Entry Rules	Exit Rules	Avg. % profit/loss	% Winners
RSI (5)<20	RSI(5) > 65	1.05	69.1

Or…

Entry Rules	Exit Rules	Avg. % profit/loss	% Winners
RSI (5)<20	RSI(2) > 70	.70	66.6

Overall, this shows that getting in on weakness and exiting on strength, or even just a fixed length of time is much more profitable than waiting for weakness in the stock, or what some traders call a breakdown.

REMEMBER, we are using all S&P stocks and this is not a system where we are testing just a few stocks. This shows you the average stock market behaviors, which is by far the most important and impactful trading information that you can apply to your own trading.

CRITICAL TRADING RULE #3

The stock price must be over the 200MA

Have the stock's wind at your back. The stock price must be over the 200MA.

These are not stocks that have just pulled back and are down some; these are stocks that are CRASHING, or are losing significant momentum, or just weak. Based on the historical stock market data, these are stocks that are falling below their 200 day simple moving average. If a stock can't hold above that technical indicator, it is generally a bad sign.

Will there be times that the stock quickly regains its losses and goes above the 200 days simple moving average? YES. But, again, on average, that is not a bet you should make. That bet loses money over time.

Yes, it feels like you are being a hero, and there's something fun about going against the crowd. But the data shows that when you buy stocks that become out of favor, on average, the performance is worse than stocks that are not. The real risk is that there is a much higher chance in these stocks that you will end up in a stock that is experiencing what we call a "volatility expansion," meaning, a stock that is just starting to go straight down in a big way. The difficulty with these stocks is that you need a lot of winners to make up for just one of those losers.

As we described above, we define "CRASHING STOCKS" as stocks that are below the 200 day Moving Average. Over time, buying stocks below the 200MA causes you to lose money because there is a significant chance of a big, high volatility move to the downside.

Here is data that demonstrates this.

RESULTS:

Entry Rules	Exit Rules	Avg. % profit/loss	% Winners
1. RSI (5)<20 2. Close>200 day simple moving average	RSI (5)>65	1.36%	72.0%

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Visit www.AlvarezQuantTrading.com to learn more about trading

Here we see how we can improve our results by not touching those stocks that are potentially going in to crash mode.
Conclusion: stay away from stocks that are trading under the 200 day moving average.

CRITICAL TRADING RULE #4
The S&P 500 index must be over the 200MA

DON'T BUY STOCKS WHEN THE S&P 500 INDEX IS BELOW THE 200 DAY MOVING AVERAGE.

In other words...."*Have the Wind at Your Back*"

We call this a "market timing" component. Every trader should have a rule that increases the chance of the stock market going up in general. It goes with the saying, that a *"rising tide lifts all boats."*

This concept has been written about by many great traders including the great, Jesse Livermore, and William O'Neill; the idea is that if the market is weak, it is very hard for any stock to do well, PERIOD. 75% of the stocks follow the direction of the overall market. The problem is, is that most of these traders know this is true, but they do it more by "feel" rather than by hard data.

Just like "DON'T BUY STOCKS UNDER THE 200 DAY MOVING AVERAGE," we are now adding, "DON'T BUY STOCKS THAT ARE OVER THE 200 DAY MOVING AVERAGE IF THE S&P 500 INDEX IS NOT ALSO OVER THE 200 DAY MOVING AVERAGE.

Here is what adding that rule looks like in terms of improving performance on average

RESULTS:

Entry Rules	**Exit Rules**	**Avg. % profit/loss**	**% Winners**

1. RSI (5)<20 2. Close>200 day simple moving average 3. S&P 500 Close> 200 day simple moving average	RSI (5)>65	1.29	71.8

Interestingly, when you look at these numbers the average profit/loss is slightly lower as well the percentage of winners. So why would we say that the data suggests we should add this rule?

The answer is volatility, and drawdowns.

With the market also being over the 200 day moving average, the worst trades literally go from being 70-80% losers to being 30-40% losers. If you are trading using these rules and you go through a volatility period where trades are losing that much—it is too hard to handle for any trader. Also remember that bad trades tend to cluster in time, they are not spread out evenly over your trading lifetime. This makes it even harder to psychologically and financially stay with your plan. So, even though you are giving up a very slight amount of overall performance, you do this for the benefit of a significant decrease in volatility of your account value.

In the big picture, this critical rule will have you in all cash sometimes. Remember, cash is a position. Greed is one thing that destroys all traders. Had you gotten out when the S&P went under the 200 day moving average you would have avoided the biggest crashes of our time, 1998, 2008, 2011. It's hard, to execute because at these times your account is usually down. We as traders hate that. All we want to do is try and get it back. We know that we can't get it back by being out of the market, but over time, this will save you a lot of money. This is the difference between the great traders, and the gamblers.

Which leads to…

CRITICAL TRADING RULE #5
Have a Plan

Write down your rules are to enter a trade. Write down your rules for getting out of trade. There are lots of situations to consider. One big one is how will you deal with missed trades?

IF YOU FEEL YOU MISSED IT…DON'T ACT

This is the only one of these rules that is an emotional check rather than a technical rule, although it pertains to trading execution. In all of our years trading this most critical rule has kept us in check.

If when you are trading, you would take a trade, and it starts moving and you didn't execute when the rules said you should—it causes a gnawing and uncomfortable emotion. It is the feeling that the train is leaving the station without you. It is the feeling that you missed it. It is the feeling that you knew what to do, and others are making money and you are not.

In that scenario, don't act. You missed the trade. There will be other trades and other opportunities for you. If the trade has moved, the edge is gone.

Final Thoughts

The whole purpose of this document is to expose you to where there are statistical edges in the stock market. This is not about being right or wrong, this is about making money. It's about playing the odds. It's about being the house, not the gambler.

With these 5 rules, if you stick to them, you will have a more statistically advantaged way to trade. These rules are a guideline that top hedge fund managers use to generate fantastic returns. These rules have served us well over the years, and we hope that you will be profitable with them as well.

Good luck trading,
Steven and Cesar

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