Introduction to Types of Traders: Part III

A stock trader refers to a person or entity engaging in the trading of equity securities, in the capacity of agent, hedger, arbitrageur, speculator, or investor. Several different types of stock trading strategies or approaches exist including scalping, momentum trading, technical trading, fundamental trading, swing trading, day trading etc. So far we have discussed about all the above strategies other than day trading. This week's article attempts to critically review the strategy of day trading.

Day Trading

Day trading is defined as the buying and selling of a security within a single trading day. This can occur in any marketplace, but is most common in the stock market. Typically, day traders are well educated and well funded. They utilize high amounts of leverage and short-term trading strategies to capitalize on small price movements in highly liquid stocks. Day traders serve two critical functions in the marketplace: they keep the markets running efficiently via arbitrage and they provide much of the markets' liquidity. This article will take an objective look at day trading, who does it and how it is done.

The profit potential of day trading is perhaps one of the most debated and misunderstood topics on these days. Day traders often seek to make profits by leveraging large amounts of capital to take advantage of small price movements in highly liquid stocks. Here we look at some common day trading strategies that can be used by retail traders.

Entry Strategies

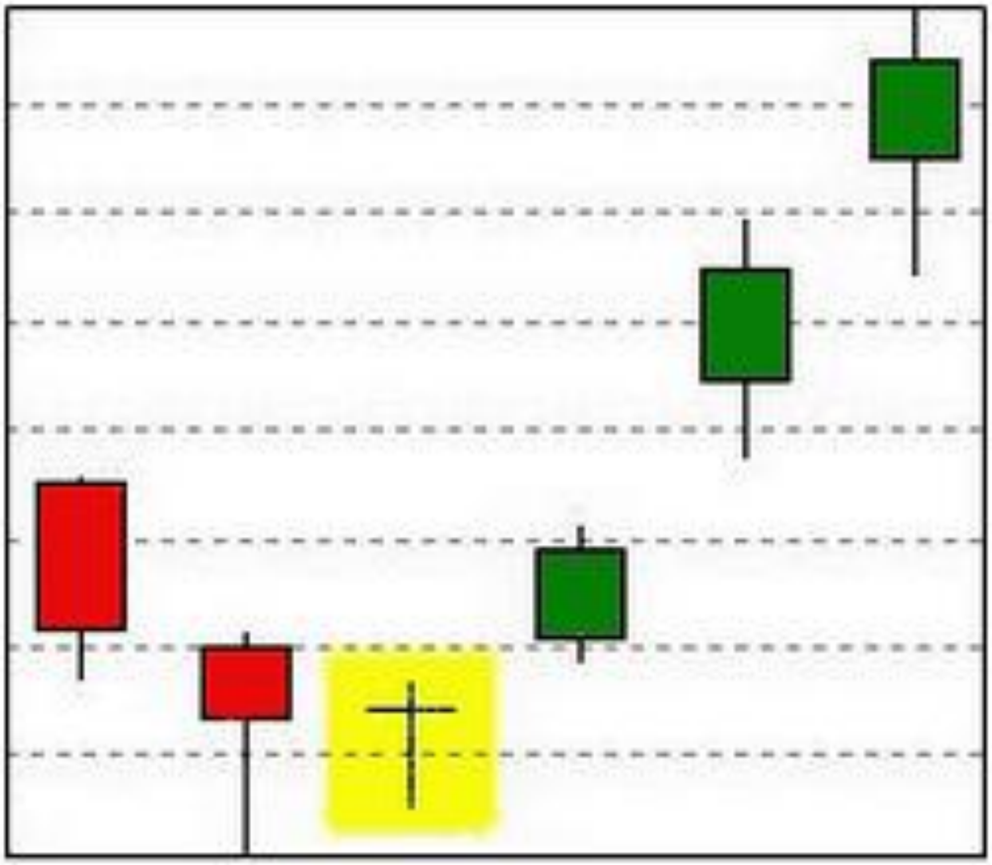
Certain stocks are ideal candidates for day trading. A typical day trader looks for two things in a stock: liquidity and volatility. Liquidity allows you to enter and exit a stock at a good price (i.e. tight spreads and low slippage). Volatility is simply a measure of the expected daily price range - the range in which a day trader operates. More volatility means greater profit or loss.

Once you know what kinds of stocks you are looking for, you need to learn how to identify possible entry points. There are three tools you can use to do this:

- Intraday Candlestick Charts - Candles provide a raw analysis of price action.
- Real-Time News Service - News moves stocks. This tells you when news comes out.

We will look at the intraday candlestick charts and focus on the following three factors:

- **Candlestick Patterns** - Engulfing and dojis
- **Technical Analysis** - Trendlines and triangles
- **Volume** - Increasing or decreasing volume



Typically, we will look for a pattern like this with several confirmations:

- First, we look for a volume spike, which will show us whether traders are supporting the price at this level. Note that this can be either on the doji candle, or on the candles immediately following it.
- Second, we look for prior support at this price level. For example, the prior low of day (LOD) or high of day (HOD).
- Finally, we look at the order book state, which will show us all the open orders and order sizes.

If we follow these three steps, we can determine whether the doji is likely to produce an actual turnaround, and we can take a position if the conditions are favorable. Typically, entry points are found using a combination of these three tools.

Finding a Target

Identifying a price target will depend largely on your trading style. Here is a brief overview of some common day trading strategies:

Strategy	Description
Scalping	Scalping is one of the most popular strategies, which involves selling almost immediately after a trade becomes profitable. Here the price target is obviously just after profitability is attained.
Fading	Fading involves shorting stocks after rapid moves upwards. This is based on the assumption that (1) they are overbought, (2) early buyers are ready to begin taking profits and (3) existing buyers may be scared out. Although risky, this strategy can be extremely rewarding. Here the price target is when buyers begin stepping in again.
Daily Pivots	This strategy involves profiting from a stock\'s daily volatility. This is done by attempting to buy at the low of the day (LOD) and sell at the high of the day (HOD). Here the price target is simply at the next sign of a reversal, using the same patterns as above.
Momentum	This strategy usually involves trading on news releases or finding strong trending moves supported by high volume. One type of momentum trader will buy on news releases and ride a trend until it exhibits signs of reversal. The other type will fade the price surge. Here the price target is when volume begins to decrease and bearish candles start appearing.

You can see that, although the entries in day trading strategies typically rely on the same tools used in normal trading, the exits are where the differences occur. In most cases, however, you will be looking to exit when there is decreased interest in the stock.

Determining a Stop-Loss

When you trade on margin, you are far more vulnerable to sharp price movements than regular traders. Therefore, using stop-losses is crucial when day trading. One strategy is to set two stop losses:

1. A physical stop-loss order placed at a certain price level that suits your risk tolerance. Essentially, this is the most you want to lose.
2. A mental stop-loss set at the point where your entry criteria are violated. This means that if the trade makes an unexpected turn, you'll immediately exit your position.

Retail day traders usually also have another rule: set a maximum loss per day that you can afford (both financially and mentally) to withstand. Whenever you hit this point, take the rest of the day off. Inexperienced traders often feel the need to make up losses before the day is over and end up taking unnecessary risks as a result.

Evaluating and Tweaking Performance

Many people get into day trading expecting to make triple digit returns every year with minimal effort. In reality, many day traders *lose* money. However, by using a well-defined strategy that you are comfortable trading, you can improve your chances of beating the odds.

How do you evaluate performance? Most day traders evaluate performance not so much by a percentage of gain or loss, but rather by how closely they adhere to their individual strategies. In fact, it is far more important to follow your strategy closely than to try to chase profits. By keeping this mindset, you make it easier to identify where problems exist and how to solve them.

The Bottom Line

Day trading is a difficult skill to master. As a result, many of those who try it fail. But the techniques described above can help you create a profitable strategy and, with enough practice and consistent performance evaluation, you can greatly improve your chances of beating the odds

Source : .investopedia.