Principles of Trading Series:

Critical Trading Strategy Components – Part 1a

By Thomas Poh – 26 Mar 2020

The market finally seems to have entered into a consolidation phase after a Tsunami styled selloff. While the market picked up the pieces and re-calibrate its bearings, perhaps this is also a good time for us to reflect on our trading styles and habits. If nothing else, it will prepare us for the next wave as the volatility returns.

A lot of us talk about our market views and trading strategies but not many of us take a systematic approach towards planning and executing one. Let's ask ourselves, how many times did we have the correct assessment of the market but yet came out short? What happened? I mean, we had the right view to begin with. Shouldn't that should be half the battle won? Why did we end up not making or even losing money? A fellow trader once shared with me this saying, "The saddest thing that can happen in trading is to have the right view but yet lose money". Wise words indeed. So what went wrong?

The answer is simply this. Having the right call of the market direction is nothing but the first step in forming the winning trading strategy. In fact, there are a few more components that form the trading strategy that are actually more critical than direction. It is arguable that one would even conclude that Direction is the least difficult component to decide because it is ultimately a digital decision. It is either up or down. In this series of "Critical Trading Strategy Components", I shall share with you what the other components of a winning trade strategy are. We shall begin with "Product".

Product

In the planning of a trading strategy, choosing the right product is essential to our success. The reason is because each market product and instrument behaves differently. This can due to the differences in product specifications, locality of which the product is traded, market participants of trading that product etc. For example, let's just assume

All rights reserved - PZH Consultants Pte Ltd
Disclaimer: www.pzhconsultants.com/disclaimer

we have a bullish view of the stock market. So the immediate response for the novice trader is let's just buy! But the next question he should be asking be instead, "what should I be buying that will allow me to express my view in the most efficient and effective manner?"

The Chinese stock market from mid-2014 to mid-2016 clearly illustrates the importance of choosing right horse for the race. Back in July 2014, PBOC started slashing interest rates. The Chinese stock market naturally reacted very well to the news and rallied. At that point of time, all Chinese stock market indices rose. However, HSCEI which consist of red-chips listed in HK was clearly lagging behind SHCOMP, the onshore Chinese SHCOMP index.

This market phenomenon is interesting because most of the stocks in HSCEI are cross-listed in SHCOMP. Ie. There should not be a significant difference in their prices across the two exchanges. The reality is that, there is and that price difference continued to widen even as both stock indices rallied through the 2015 equities boom. To the trader that expressed his bullish view via HSCEI, he might think that although it is not rallying as fast as the onshore market, a win is a win and the gap might eventually narrow.

Unfortunately, the lower relative return is not the only problem that had plagued this long HSCEI strategy. As we all recall (some of us painfully), the Chinese stock market eventually tanked as the bubble burst in Apr 2016. What followed is that both SHCOMP and HSCEI collapsed. However, from the chart, we can see clearly that although both indices suffered, SHCOMP retained a healthy portion of the bull run while HSCEI eventually went LOWER than where it had started before the bull run. For the trader who picked the wrong product (HSCEI) to express his bullish view, he had suffered a lower return during the rally and eventually ended up with a loss. The wrong of choice of index here ended up being disastrous. You did not make as much on the way up but lost a lot more on the way down! This example can extend to the importance of choosing the right individual stocks even when the market is in a broad-based rally. Even though the rising tide will raise all ships, the fundamentally weakest stocks will be the ones dropping the fastest when the market turns.

Thomas@PZHconsultants.com www.pzhconsultants.com

All rights reserved - PZH Consultants Pte Ltd
Disclaimer: www.pzhconsultants.com/disclaimer

Regardless if we are looking at a single stock or index, it is also important to pick the right product of the same underlying stock/index to express our view. The most common way to go long a stock is to buy the stock. However, there are other ways to go long which I will cover in my next article of Critical Trading Strategy Components. Stay tuned!

Thomas@PZHconsultants.com www.pzhconsultants.com

All rights reserved - PZH Consultants Pte Ltd
Disclaimer: www.pzhconsultants.com/disclaimer