

“Don't Put All Your Eggs Into One Basket” How to Diversify Your Day Trading

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Today's Agenda

- Stock portfolios
- Types of diversification
- Diversity opportunities with day trading
- Example with sample trade plan with typical performance metrics
- Advantages of diversification

Stock Portfolio Diversification

- 10 -20 or even 20-25 stocks
- Long positions
- Long time horizons – position trading style
- Average stock is about 80% correlated to the overall market
- Spread out by different industries or sectors
- Recent addition of ETFs has greatly improved diversification
 - Currencies
 - Commodities: agriculture, metals, energy
 - Foreign markets
 - Inverse ETFs
- Risk management in balance between positions including cash

Day Traders and Diversification

- Often not a priority
- Looking for the Holy Grail
- Short trade time horizon
 - > but need to maintain long term perspective!
- Trading accounts are often smaller than longer term position accounts
- Risk per trade is often higher and risk management often overlooked
 - > more accounts blow up!
- Good news: Day traders actually have greater opportunity for diversification and therefore risk management

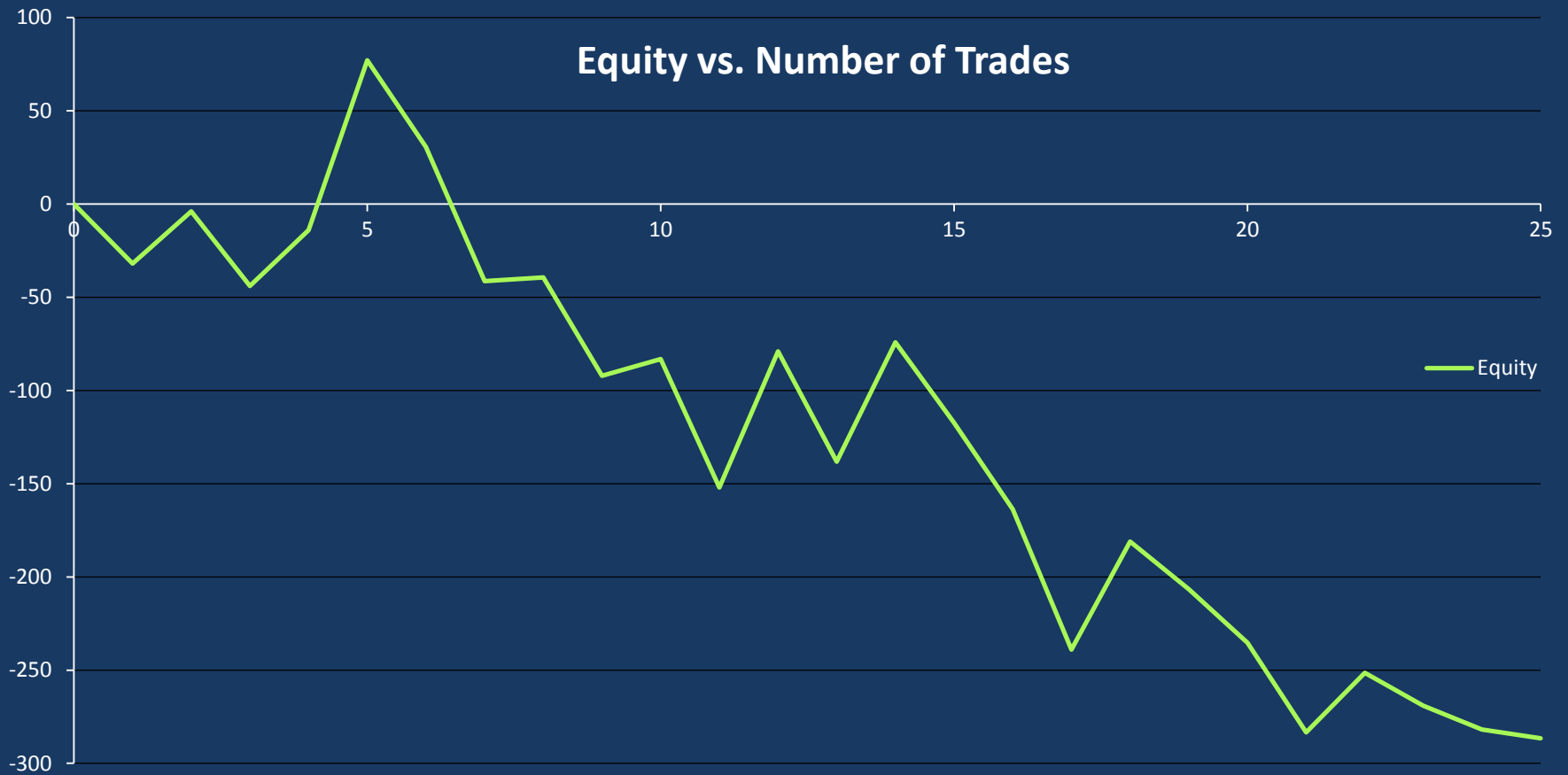
Diversification Opportunities

- Swing trading
- Position trading
- Markets
 - Stocks
 - High trading volume
 - Volatility
 - Futures
 - Stock Indexes – DOW, Russell, Nasdaq, DAX
 - Commodities – grains, agricultures, metals, energy
 - Treasuries
 - Forex
- Systems

Day Trading Diversification

- System
 - Trending
 - Fading
 - Scalping
- Time of day – trading sessions
- Day of week
 - News
 - Scheduled reports
- Charting intervals
 - Time bars
 - Tick bars
 - Volume bars
 - Range bars
 - Renko bars

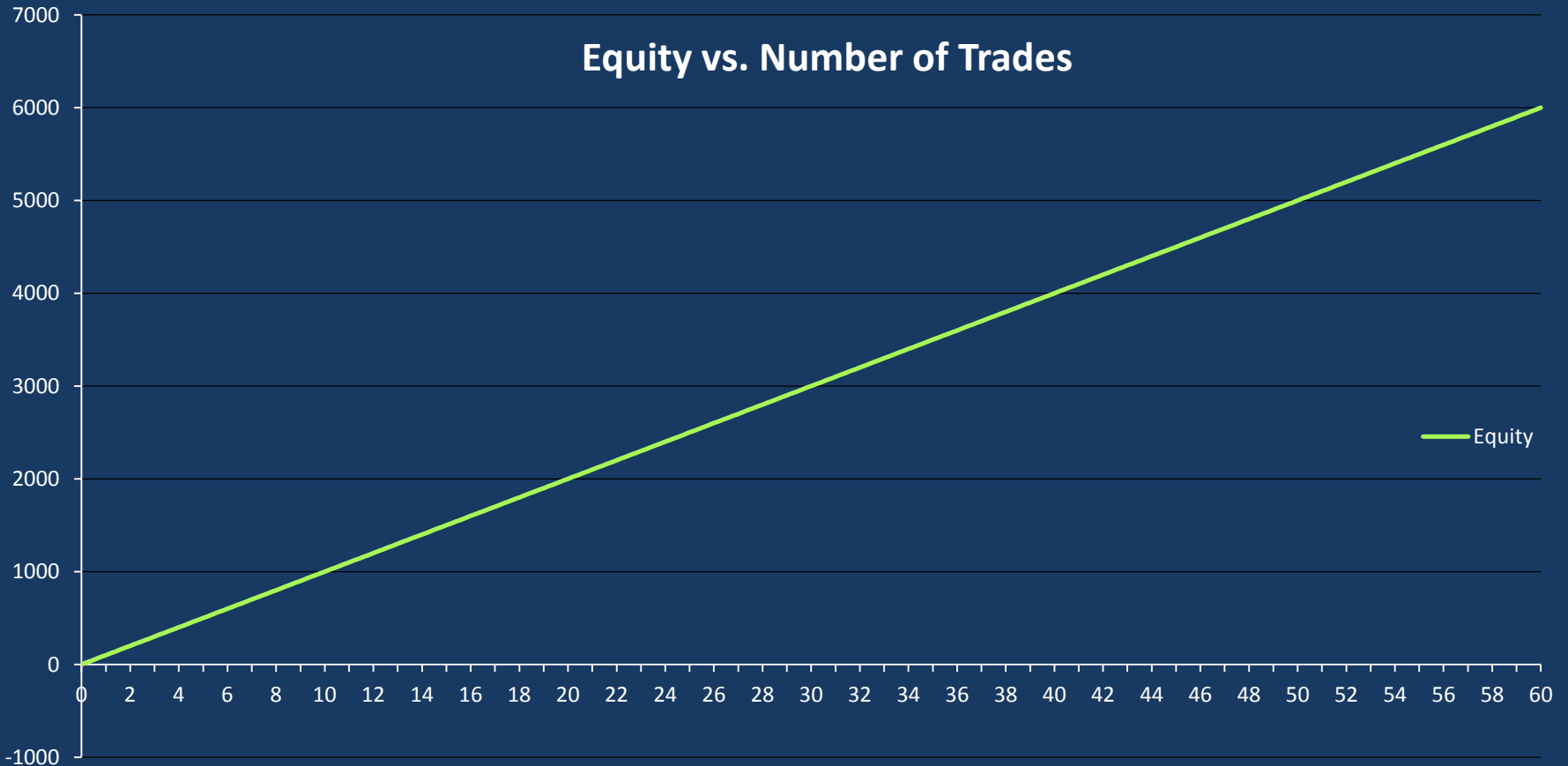
Equity Chart for One Week



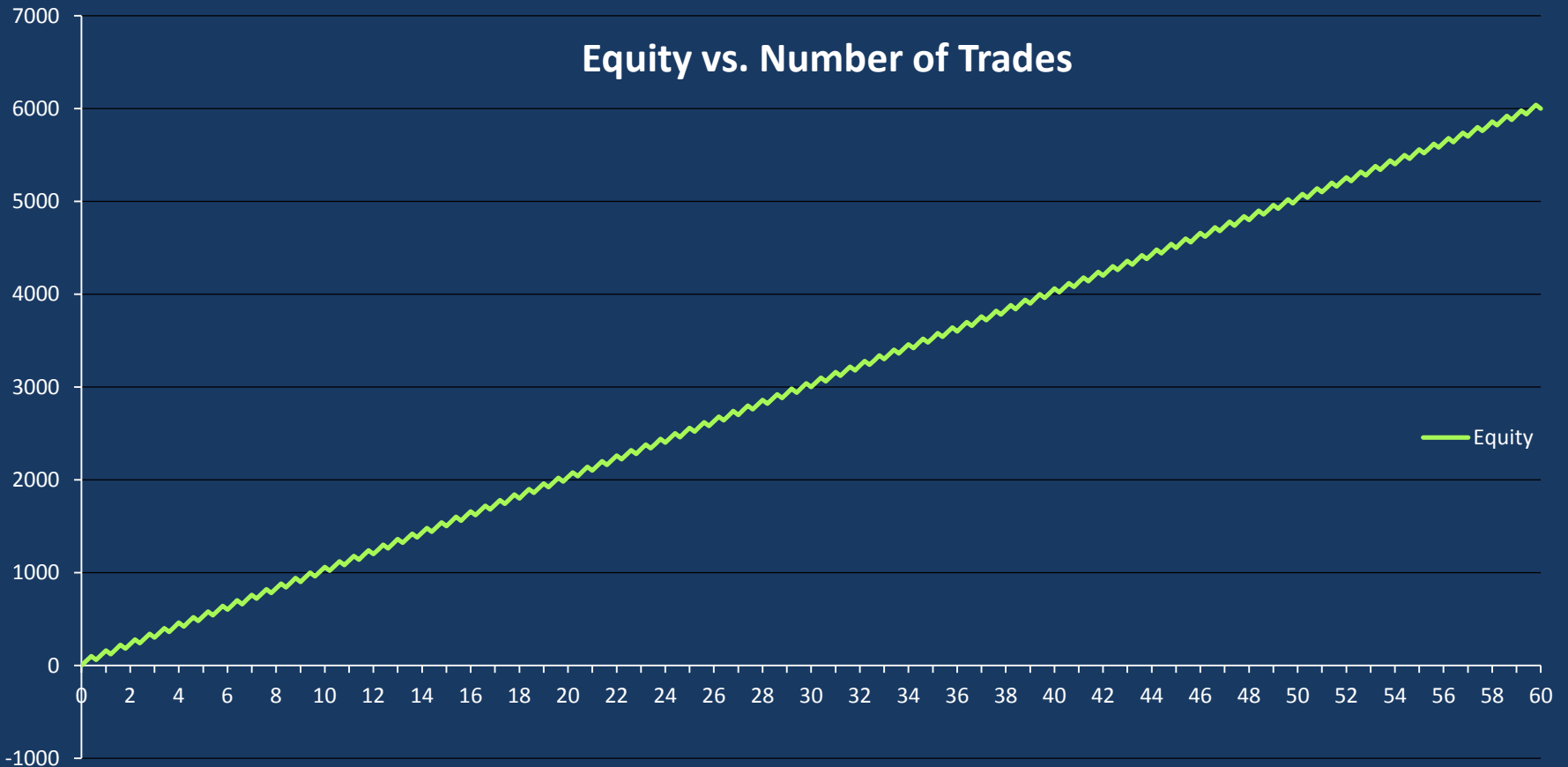
Sample Trade Plan Performance

- Probability of win: 67%
(Total winning trades / Total trades)
- Average win: 50
- Max win 100
- Average loss: 40
- Max loss: 80
- Profit Factor: 2.5
(Win% * AverageWin) / (Loss% * AverageLoss)
or (gross win / gross loss)
- Average profitability per trade: 20
Statistical Expectancy or (Win% * AverageWin) – (Loss% * AverageLoss)

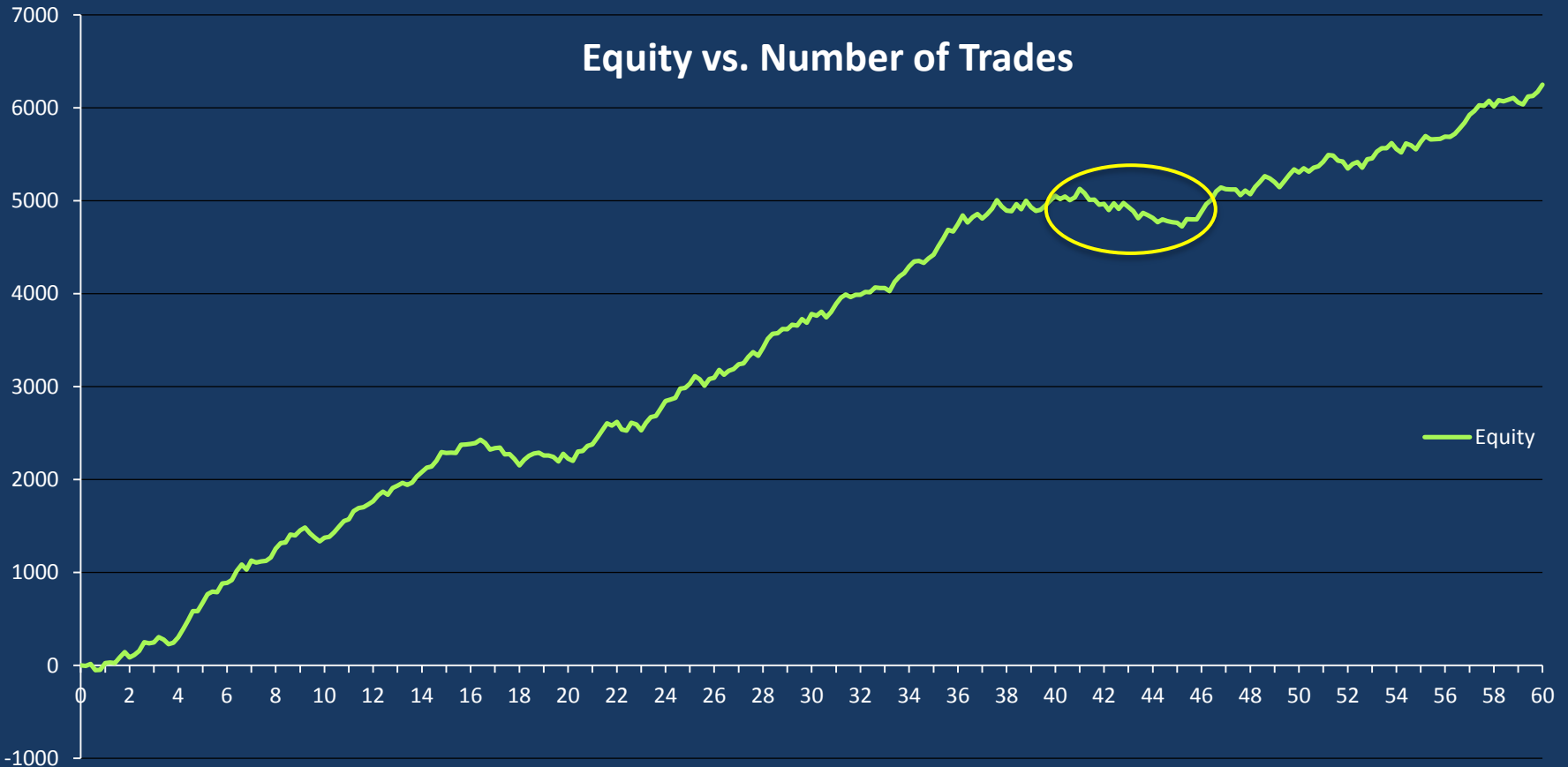
Equity Chart Expectancy



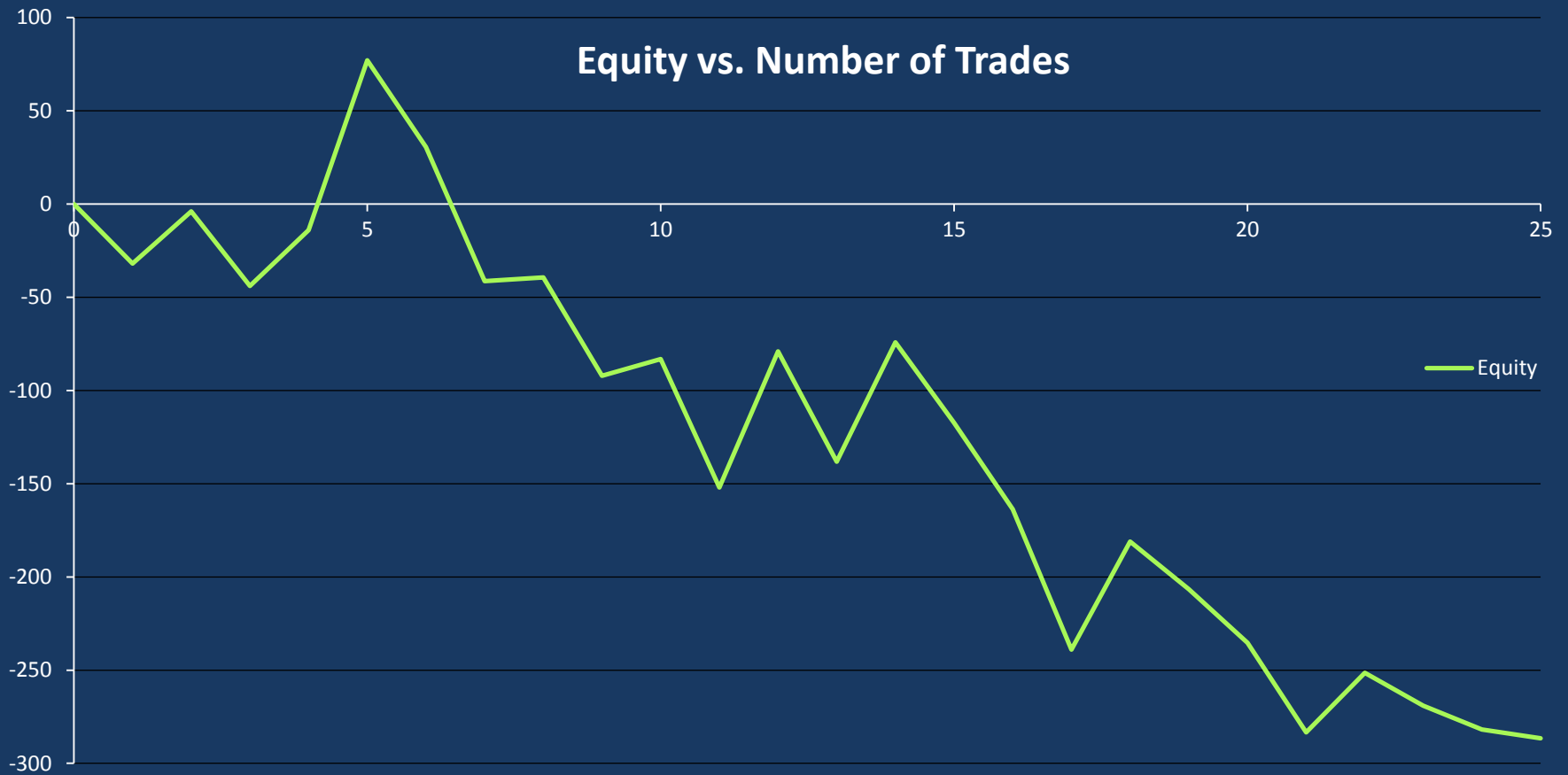
Equity Chart: Win Rate 67%



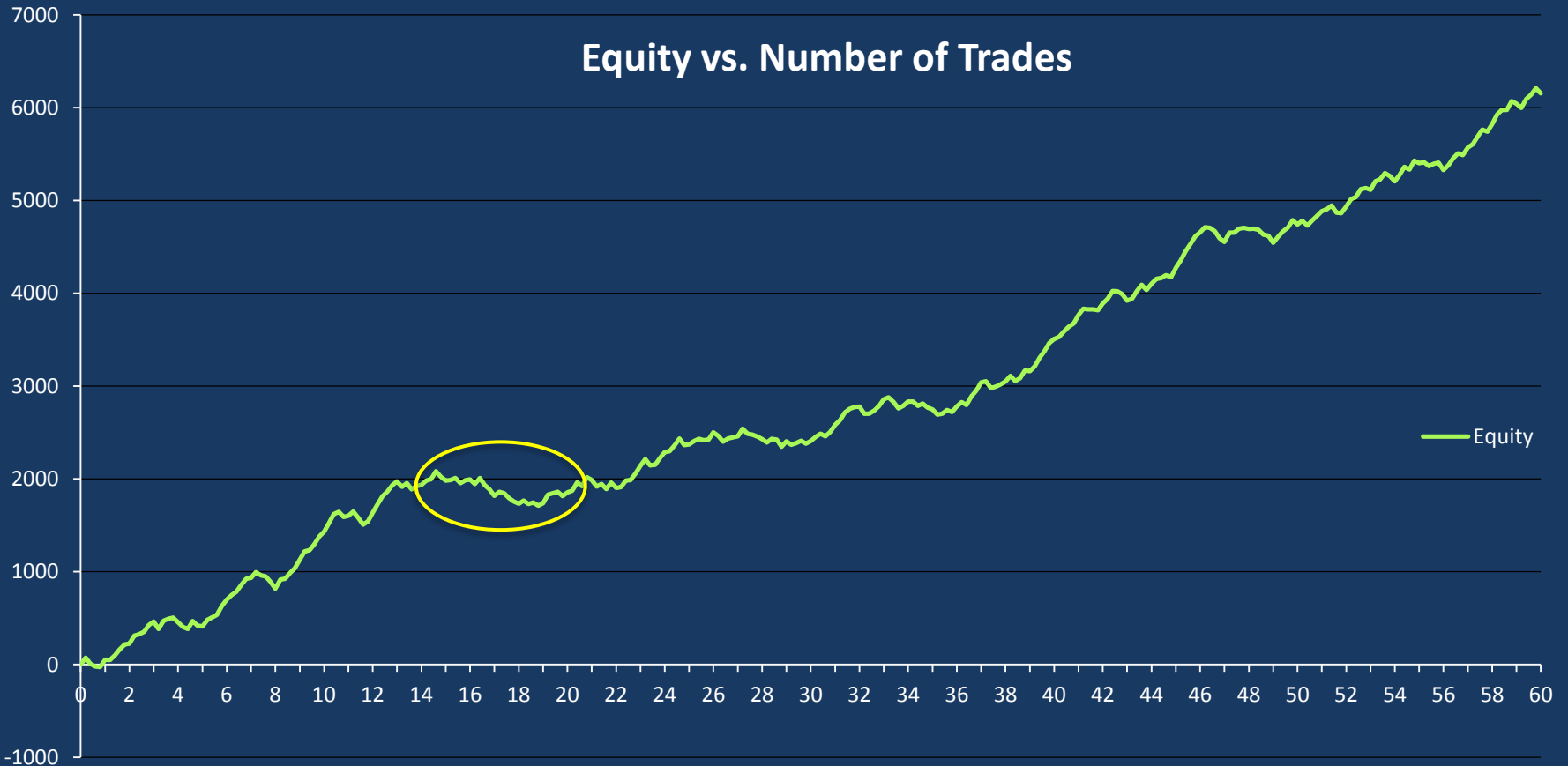
Equity Chart Market 1: 3 months



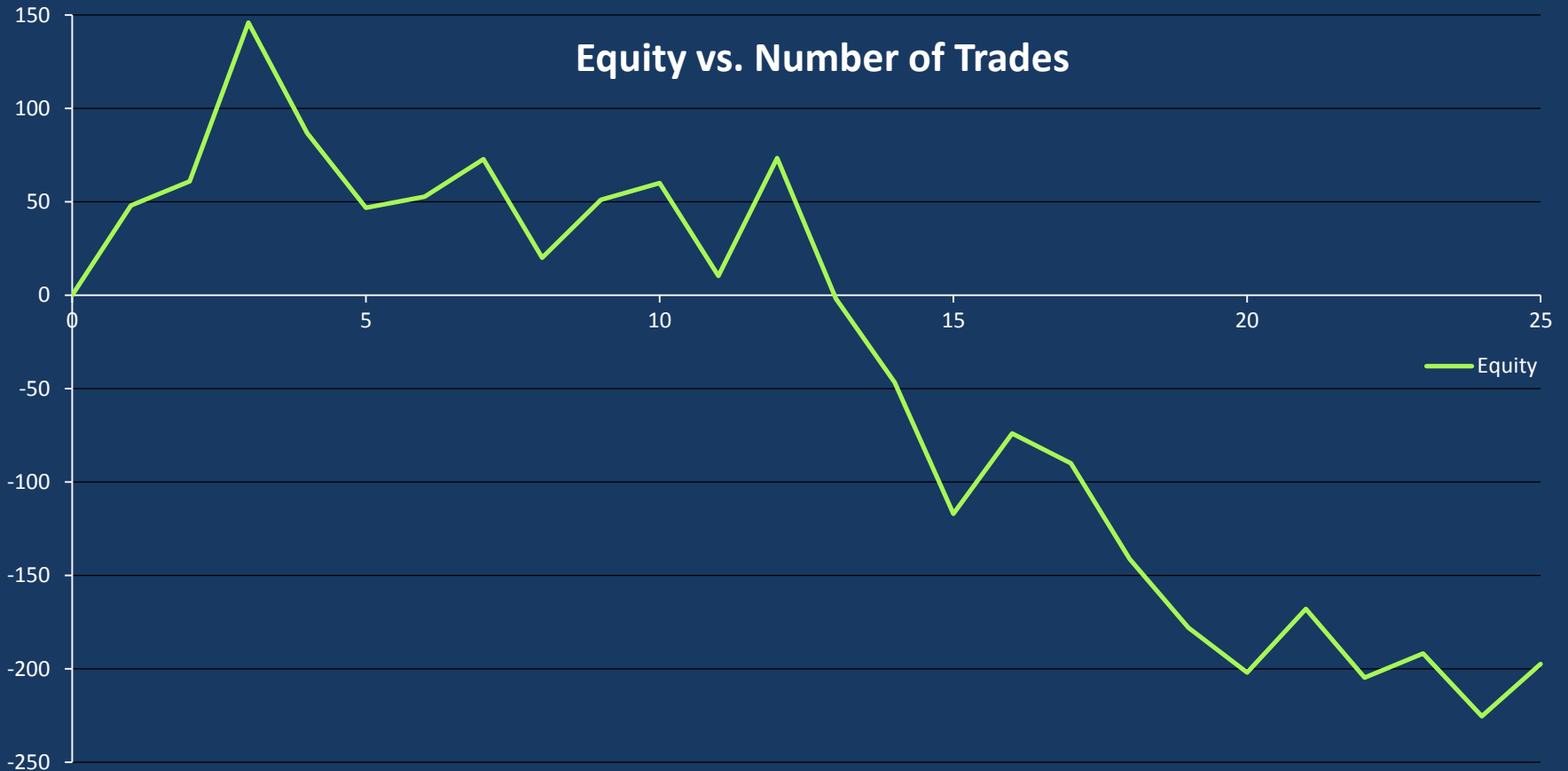
Equity Chart Market 1: 1 week



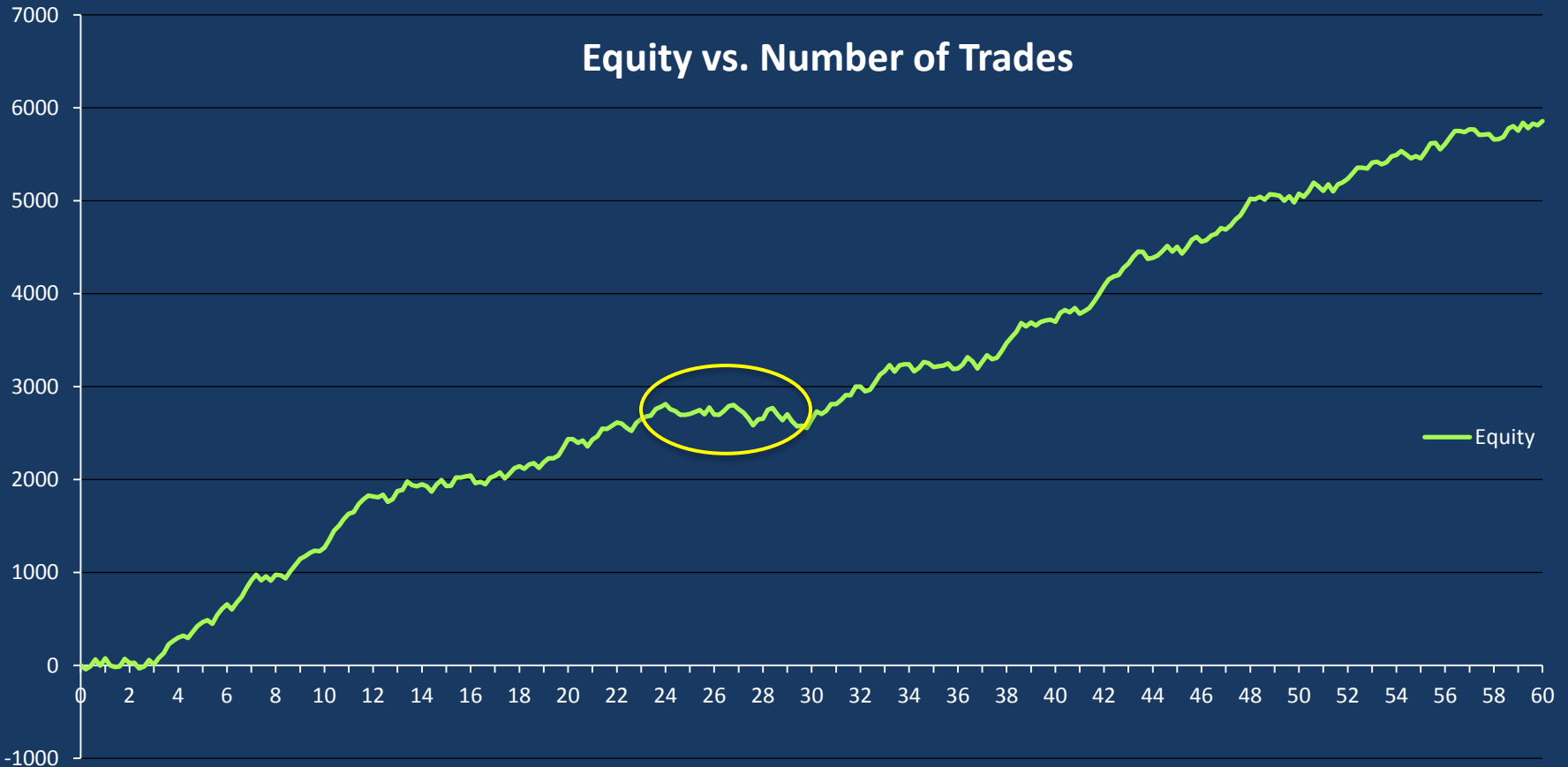
Equity Chart Market 2: 3 months



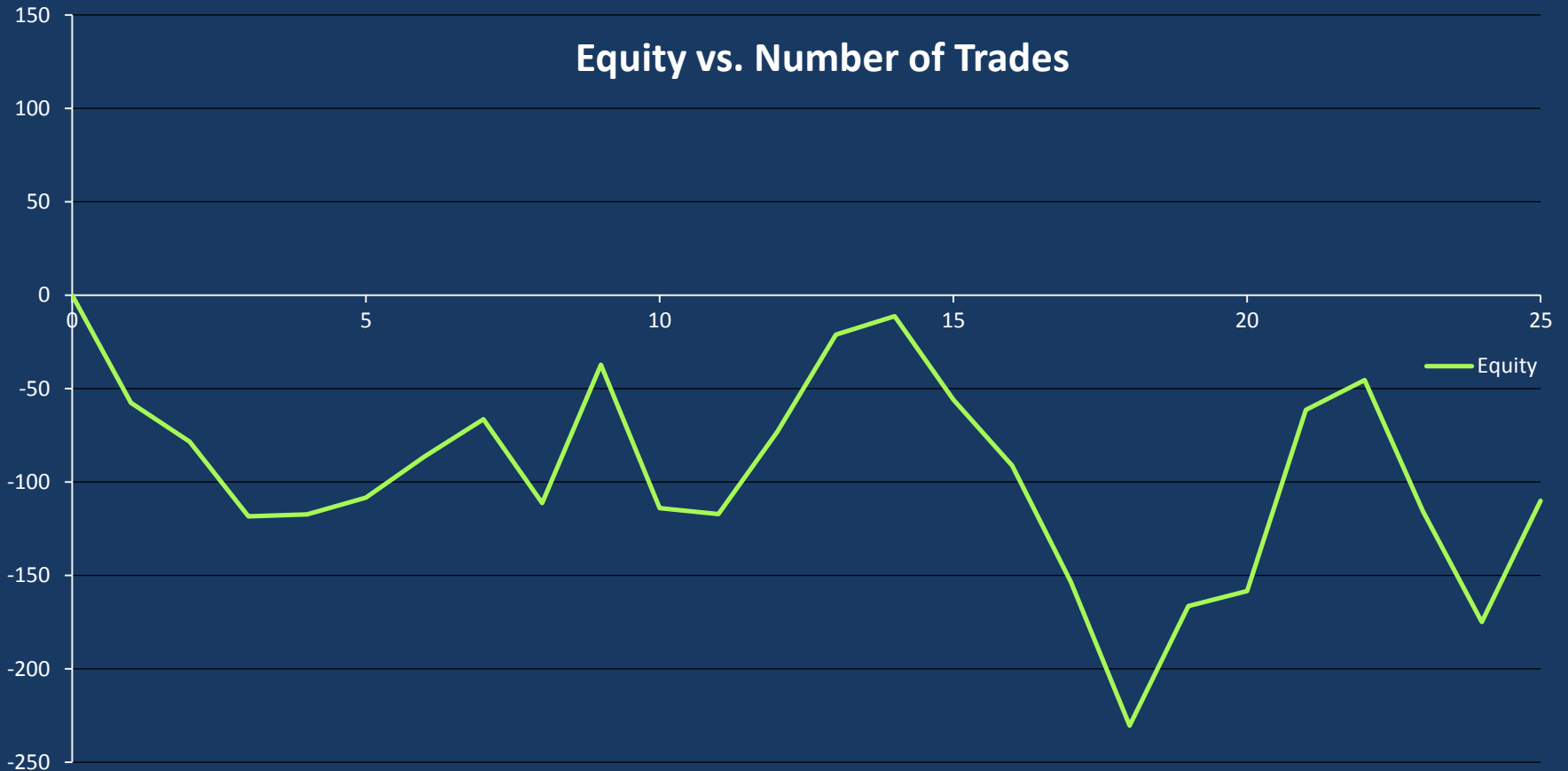
Equity Chart Market 2: 1 week



Equity Chart Market 3: 3 months



Equity Chart Market 3: 1 week



Trending vs. Consolidation



Trending vs. Consolidation

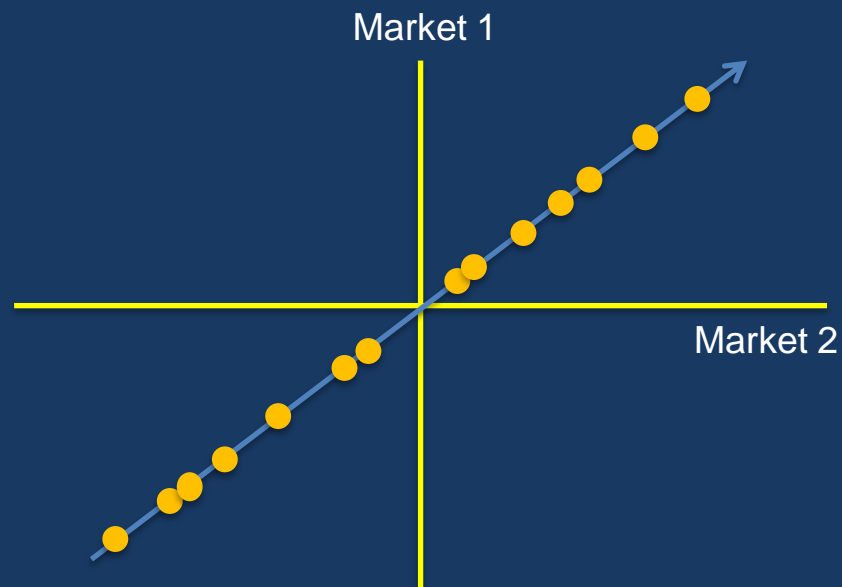
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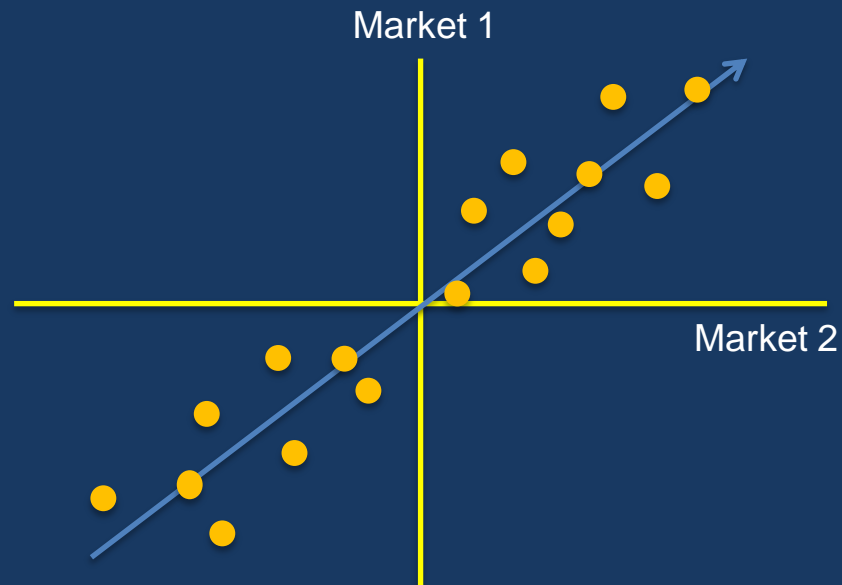
Correlation

- Linear Correlation
- Statistical relationship involving dependence between two variables
 - shows how strongly market movements are related
- r is the correlation coefficient
expressed as a value between -1 and 1 (-100% and 100%)
- $r = 0$: no correlation
- $r = 1$: perfectly correlated
- $r = -1$: perfectly inversely correlated
(negative linear relationship)

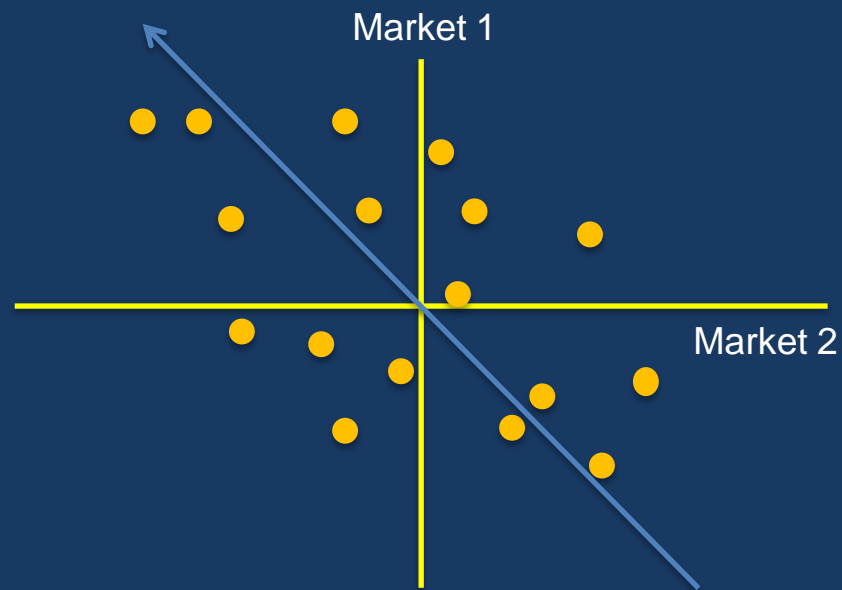
Correlation: $r = 100\%$



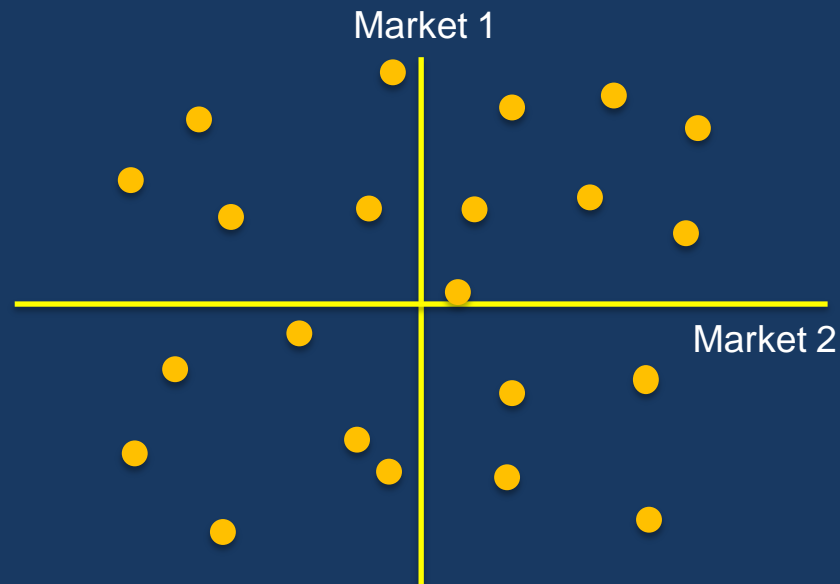
Correlation: $r = 80\%$



Correlation: $r = -60\%$



Correlation: $r = 0$



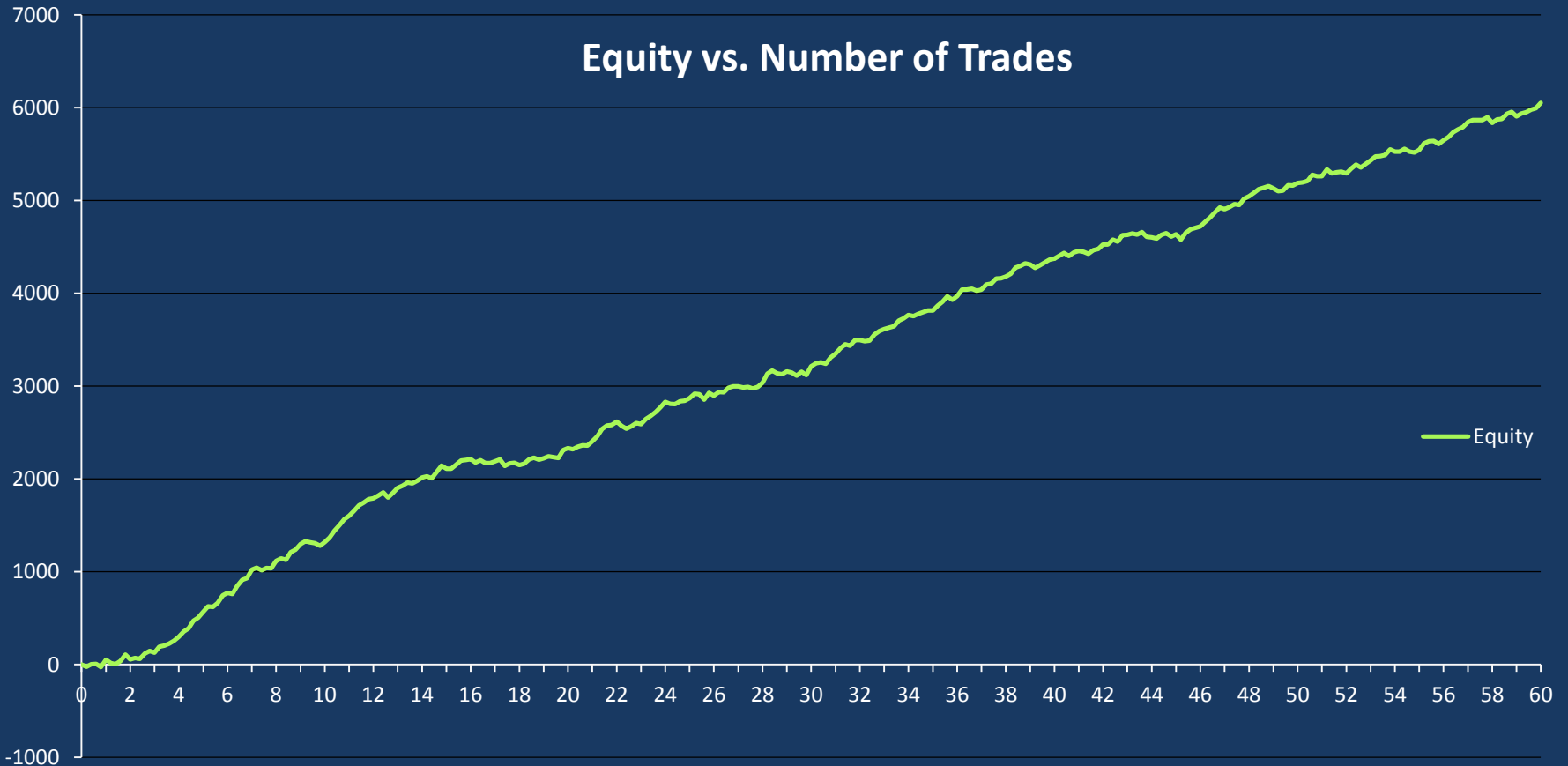
Correlation

5min correlation

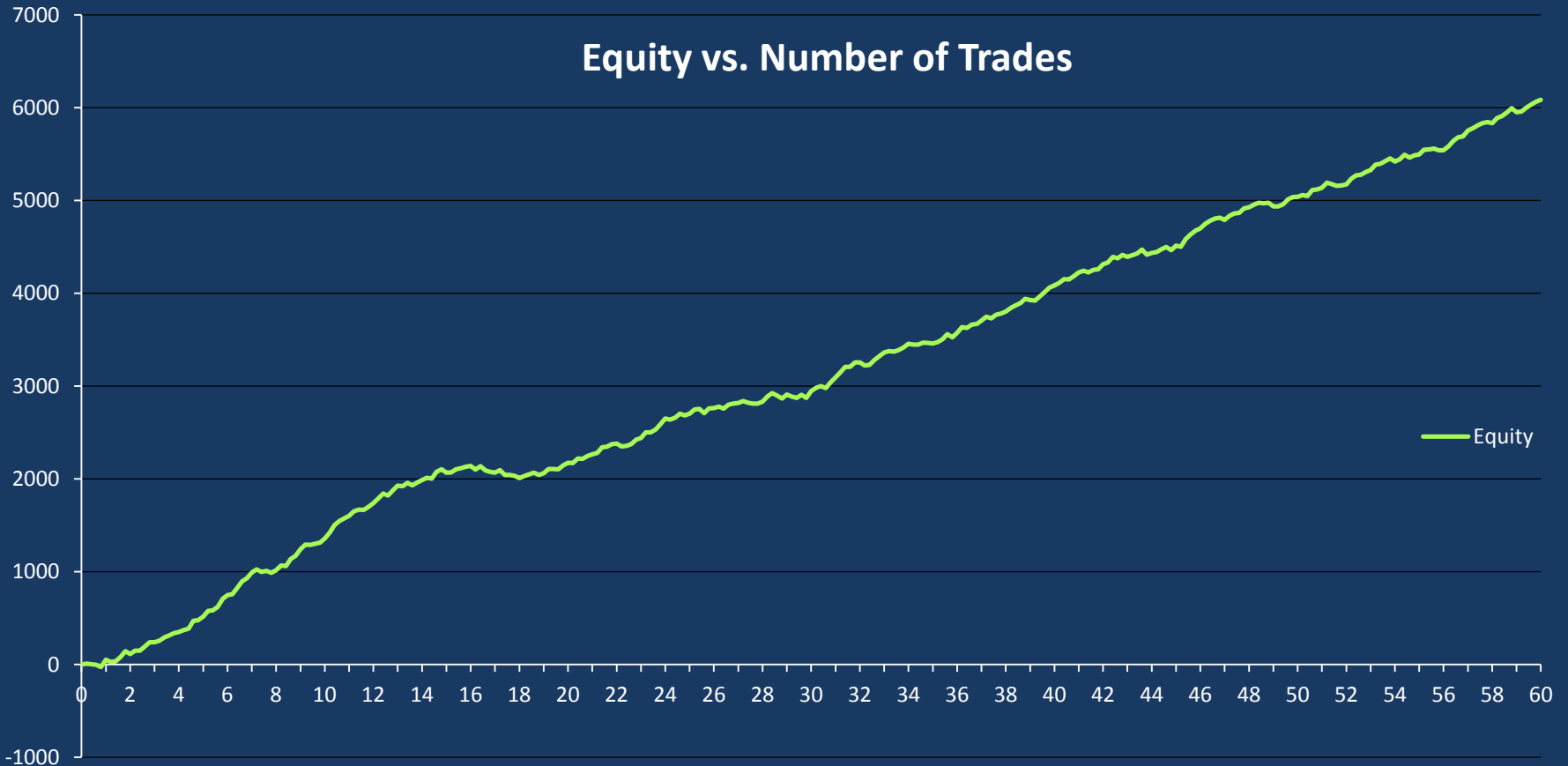
	AUDUSD	EURJPY	EURUSD	GBPUSD	NZDUSD	USDCAD	USDCHF	USDJPY	
AUDUSD	100.0	97.9	98.2	94.0	98.5	-95.4	-93.2	48.7	AUDUSD
EURJPY	97.9	100.0	100.0	93.8	97.1	-95.4	-92.0	57.8	EURJPY
EURUSD	98.2	100.0	100.0	95.8	97.2	-96.4	-94.2	44.8	EURUSD
GBPUSD	94.0	93.8	95.8	100.0	94.7	-97.2	-89.0	38.7	GBPUSD
NZDUSD	98.5	97.1	97.2	94.7	100.0	-94.9	-91.9	48.8	NZDUSD
USDCAD	-95.4	-95.4	-96.4	-97.2	-94.9	100.0	90.2	-44.4	USDCAD
USDCHF	-93.2	-92.0	-94.2	-89.0	-91.9	90.2	100.0	-36.7	USDCHF
USDJPY	48.7	57.8	44.8	38.7	48.8	-44.4	-36.7	100.0	USDJPY
	AUDUSD	EURJPY	EURUSD	GBPUSD	NZDUSD	USDCAD	USDCHF	USDJPY	

- www.forexticket.co.uk, and click on “Forex Correlation”
- Correlation above 80 is high, and the two markets move in the same way
- Correlation below 80 is low, and the two markets move in the opposite way
- Correlation between 60 and -60 is low, and the two markets do not move in the same way

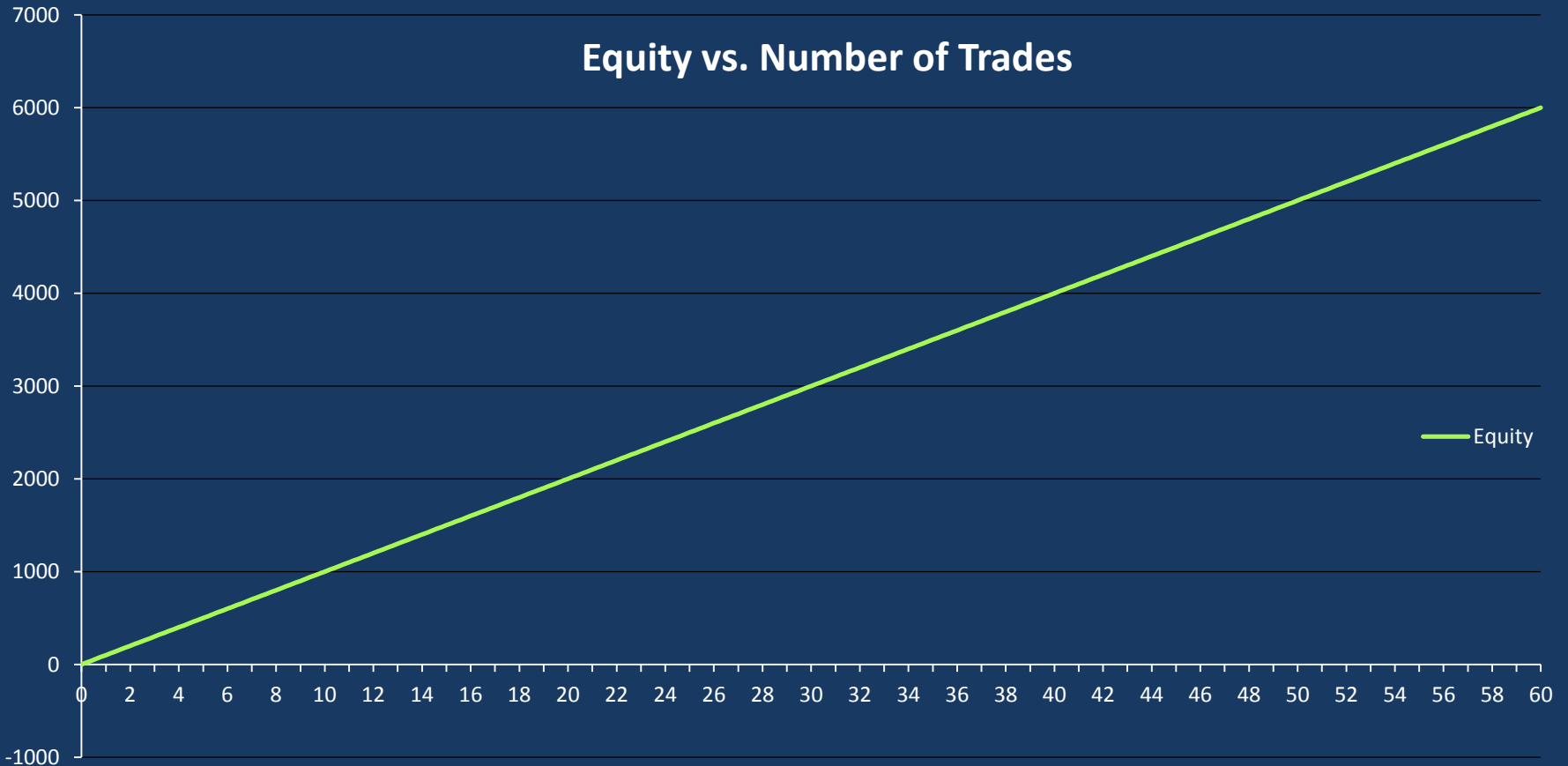
Markets 1 and 2



Markets 1, 2, and 3



Equity Chart Expectancy



Diversification – The Holy Grail?

- Mathematical
 - Smoother equity curve
 - Smaller risk per trade
- Psychological
 - Smaller drawdowns
 - Less time in drawdown
 - Easier on the trading psychology
- Holy Grail of trading?

Day Trading Diversification Examples

- Two markets at one time
 - Market 1: volatile market, for example stock index or commodity
 - Market 2: slow market, for example treasury futures
 - Or two forex markets
- Two or more markets in succession
 - Market 1: forex
 - Market 2: crude oil futures
 - Market 3: stock index, Russell 2000
 - Market 4: agriculture commodity, wheat, soybeans
- Look at performance results by day of week
 - Use a performance analysis tool
 - Pick a couple of markets to trade on different days

Diversity – The Holy Grail?

- System trading –based on positive expectation that certain conditions will repeat enough to make a profit
- We can not predict next trade
 - Need to keep looking at the forest, not the trees
 - Trends and consolidation
- Always lean on the system

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