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THE OWL...

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The Owl... this Issue

A Newsletter for Subscribers to THE MANUAL PROJECT

WELCOME TO THE OWL FOR APRIL 2001! This issue focuses on *cycles* in two very diverse ways. As you all know, I highly recommend that all traders maintain two separate accounts...one account for *trading* in whatever manner one chooses, and a second account for *income*. I recommend the income account (approximately 50% of your resources) to be managed according to the principles of the *covered call income strategy* and to be supplemented with what I have described as the *combo strategy*. What does this have to do with cycles? *Nothing*. And in a sense this is its strongest virtue. It is a strategy that is intended for constancy *regardless* of market conditions. It is a strategy that is *not* intended to be subjected to

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Thinking about Cycles

Russell Arthur Lockhart, Ph.D.

WHAT ARE CYCLES? The dictionary tells us that a cycle is an "interval of time during which a characteristic often regularly repeated event or sequence of events occurs." Note the two aspects of this definition: an *interval* of time and a *repeated* event. An example of correct usage, the dictionary says, is "sunspots increase and decrease in intensity in an eleven year cycle." Here we see the interval of time as eleven years, and the repeating event is the rise and fall of sunspot activity. Note especially that the *fact* of such a cycle provides no explanation whatever as to whatever may be causing such changes in sunspot intensity.

Another definition of *cycle*, is the "orbit of a celestial body." Long before the celestial mechanics were understood, the cycles of the sun, the moon and the planets were observed. These cycles became enormously important in human behavior. The word *cycle* comes from the Latin word *cyclus* meaning "regularly turning." This word in turn came from the Greek word ?????? meaning "circle." And this word came from the Indo-European root KWEL-¹ meaning "revolve," "move around," "sojourn," "dwell." From this same root come such words as *culture*, *teleology*, *wheel*, *circle*, *cycle*. The word's roots give a vivid hint of how important cycles are in the formation of

the trader's machinations. It is intended not only as a steady income generator, but as a means of surviving the trade wars intact. This past year has seen one of the most vicious bear markets in history so it has been a good time for a test of the covered call strategy. *Dadcat* has been a devoted follower of the strategy and I have invited him to share with you the results of his implementation of this strategy during this most difficult period in the markets. I think you will find this most enlightening! Thank you *Dadcat*.

In "Thinking About Cycles," I begin to illustrate how the information contained within the first 30-minute pricetime square reveals so much about the cycles that will occur during the trading day. This is just to whet your appetite and will be continued in greater detail in the coming issues of THE OWL.

In the meantime, good trading all!

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Resources...

-- Recommendations for Your Library
[click to order from Amazon.com]

Essential readings in cycle theory...

J. M. Hurst

[*The Profit Magic of Stock Transaction Timing*](#)

H. M. Gartley

[*Profits in the Stock Market \(with Charts\)*](#)

Larry Pesavento

[*Planetary Harmonics of Speculative Markets*](#)

Robert C. Miner

[*Dynamic Trading*](#)

W. D. Gann

[*How to Make Profits in Commodities*](#)

culture, and in humanity's sense of "purpose" (teleology). We organize our day around the cycle of the sun, all our concepts and measures of time have been developed from the cycles of the sun, the moon and the planets. The very order of week days is determined by the regular cycles of the planets. The essential constancy of these cyclical phenomena gave rise to the development of *calendars*. And the fundamental constancy of these cycles and the *beliefs* such constancy engenders has shaped mankind's relationship to what we call the *future*.

These observations lead to the general conclusion that a *cycle is a circle is a calendar*. "To come full circle," is an expression that embodies the idea of "return" from an "original" point in time to a "future" point in time that can be recognized as a "completion." When we note the "beginning of the year" we are pointing simultaneously to a *known* point in the future, the year's completion and the beginning of the *next* year in the great circle of years. Note that the "return" is never to the same exact place in time...after all, a year has been added to the register of years, so we are at a unique place in time.

These simple observations about the character and meaning of *cycles* are important for our study of the financial markets. All human behavior is governed by a variety of cyclical patterns (birth, aging, death; brain waves, menstrual cycles, heart beat; presidential cycles, economic cycles, cycles of flooding, drought, famine—an endless list). The financial markets too are governed by cycles. Even the most cursory examination of a chart of prices reveals a constant cycling between highs and lows. While this cycling is the most obvious feature of prices in any financial market, it is the least understood in the sense that *when* these highs and lows will occur is the most difficult feature of markets to determine. Quite obviously, if we knew *when* a market low was in place, the sensible thing to do would be to *buy*. And, if we knew that a market high was in place, the only sensible thing to do would be to *sell* (and to go short). If cycles occurred with sufficient regularity to produce these obvious lows and highs, no one would have trouble doing the sensible thing.

Here we must return to one of our initial observations, namely, that the *fact* of a cycle does not tell us the *cause* of the cycle. Thus, we may observe a cyclical low in the market

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every four years (for example), but we do not know what causes such lows. Moreover, as noted above, each point in the cycle also is "unique" (as a new year is unique) and while prices may arrive at a low on schedule, such a low may be substantially *higher* than the previous low. This points to a crucial observation relating to cycles: *cycles alone cannot be used for investment or trading decisions*. The reason, of course, is that cycles relate to *time* and yet must always be related to the context of *price* levels. One cannot make decisions on time alone, even if one accepts Gann's dictum that *time is the most important factor*. Likewise, investing or trading on price alone is likely to produce the most common experience of investors and traders alike: *most will lose money*.

Clearly then, in thinking about cycles, we want two things: (1) a method for *relating* price and time, and (2) a clear sense of what to expect from time in relation to price. The second is easiest to answer. To consider the sunspot example: what do we expect to happen at the end of 11 years? If sunspot intensity has been increasing toward this eleventh year cycle point, clearly what we are expecting is *change*, that is, that at some point near the eleventh year, the intensity of sunspot activity will begin to decline. It is the same for financial markets. Time cycles, to the extent that we can discern them, must be regarded as potential points in time when price will *change*. Of course, we mean something more than simple change in price, for prices are changing every few seconds. What is meant, of course, is that *direction* of price will change. And, of course, by direction is meant, *trend*. Thus the purpose of paying attention to cyclical analysis is to identify points of time *in the future* when the current trend may be expected to *change* direction. Thus it is attention to *time*—*not* price—that will fundamentally enable the trader or investor to "buy low, sell high."

But we also know, that knowledge of time alone will not suffice. The trader and investor needs a method for relating price *and* time. A little thought reveals that the "price" that is watched so assiduously, is in relating better described as *pricetime*, for prices at any particular moment are the constant result of the interaction between extentional and temporal factors. It can be no other way.

What are we looking at when we look at prices in a chart? We are seeing movement, up and down, in a geometric space defined by price on one axis and time on another. Thus what we are seeing is obviously a result of price and time interacting. A little thought begins to reveal a fundamental fact about the relation between price and time: for any segment of time and price, these two factors are related by the geometry of a right triangle.

No matter over what period of time, or what degree of price, the relationship between these two factors is always a right triangle. That is, any price *change* takes *time*. Because we know the mathematics of right triangles, we know that when price equals time, then *pricetime* must equal the square root of 2, or 1.414. Thus, the square root of 2 describes a fundamental relationship between price and time. We also know, that the *angle* of this relationship is 45 degrees. (See Figure 1.)

Now how might we use this thinking in relation to actual price data?

Consider the 30-minute *opening* method. This method, defines a *constant* time (30 minutes) and defines the high and low price *range* during that 30 minutes as the price that "squares" time. The trading day then consists of 13 such squares. Figure 2 illustrates the sequence of squares. On a price chart, these shapes may not *look* like squares. However, we make the assumption that price and time are *equal* under these conditions. To the degree that this assumption is correct, the characteristics of the initial *pricetime* square will provide important *pricetime* information in the *future* of the trading day.

The first information the square provides, is the filling out of *pricetime space*. This refers to the structuring of the geometric space of price and time with multiples of the original *pricetime* square (Figure 3). The major 45 degree angles (up and down from the origins of these squares) form a "lattice" structure in the price time space. Generally, these lattice lines will form the major trend lines as well as support and resistance lines throughout the trading day. This is an important concept because it means that trend as well as support and resistance (as well as targets) are importantly determined by what happens in the first *pricetime* square.

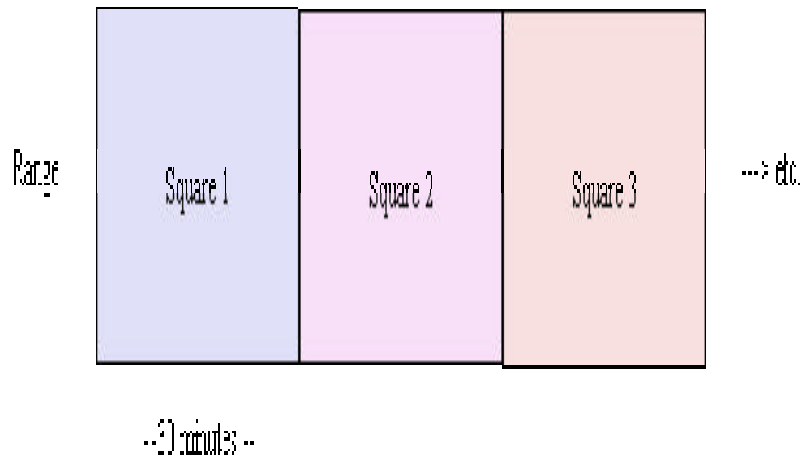
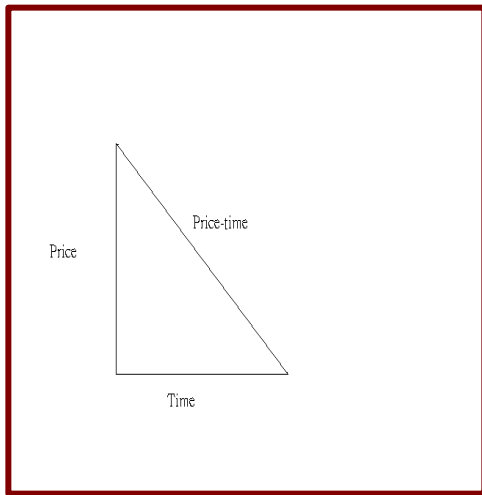


Figure 1. Pricetime as hypoteneuse of A right triangle.

Figure 2. Initial range square and its repetition throughout the day.

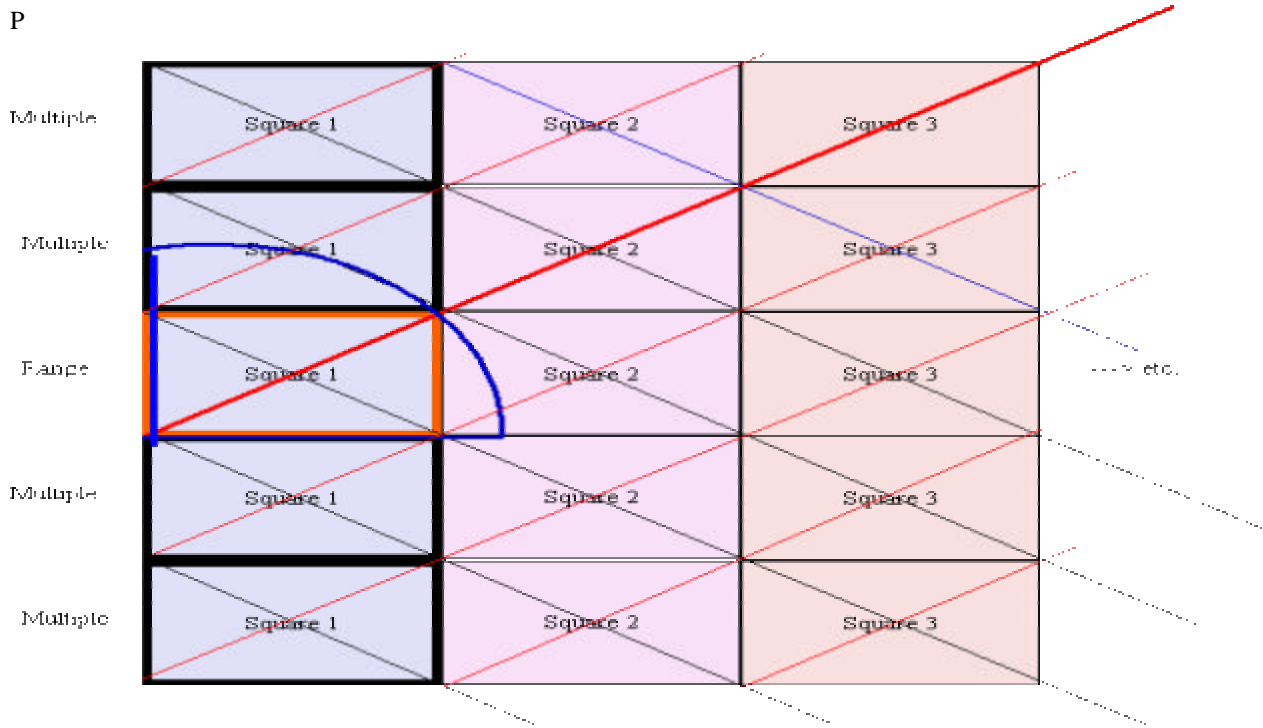


Figure 3. Pricetime "space" during the trading day showing multiples of initial range and the first formation of the "diagonal arc."

Figure 3 also illustrates the importance of the *diagonal* of the first pricetime square. Notice that as the diagonal is raised and lowered to a 90 degree angle (from 45 degrees), it creates *arc*. I will call this the *diagonal arc*. Recall the earlier suggestion that the diagonal of the pricetime square is equal to the range multiplied by the square root of 2. For example, if the opening range was 8.6, then the diagonal of the first pricetime square would be 12.16. This value, because it represents pricetime, will become an important indicator both in price and time throughout the day. When this distance is 90 degrees vertical it is a pure *price* measure. When it is 90 degrees horizontal it is a pure *time* measure. Whether in price or in time, we anticipate that this value will be important. Trends may find their limit at this value in price, or change direction (or amplify direction) at diagonal distance time points. Moreover, from important market structure highs and lows, we may anticipate that this diagonal value will be an important measure of those ranges, particularly as the diagonal of a pentagonal structure (more about that next time).

Figure 4 illustrates some of these ideas for the S&P futures on Friday, April 20, 2001.

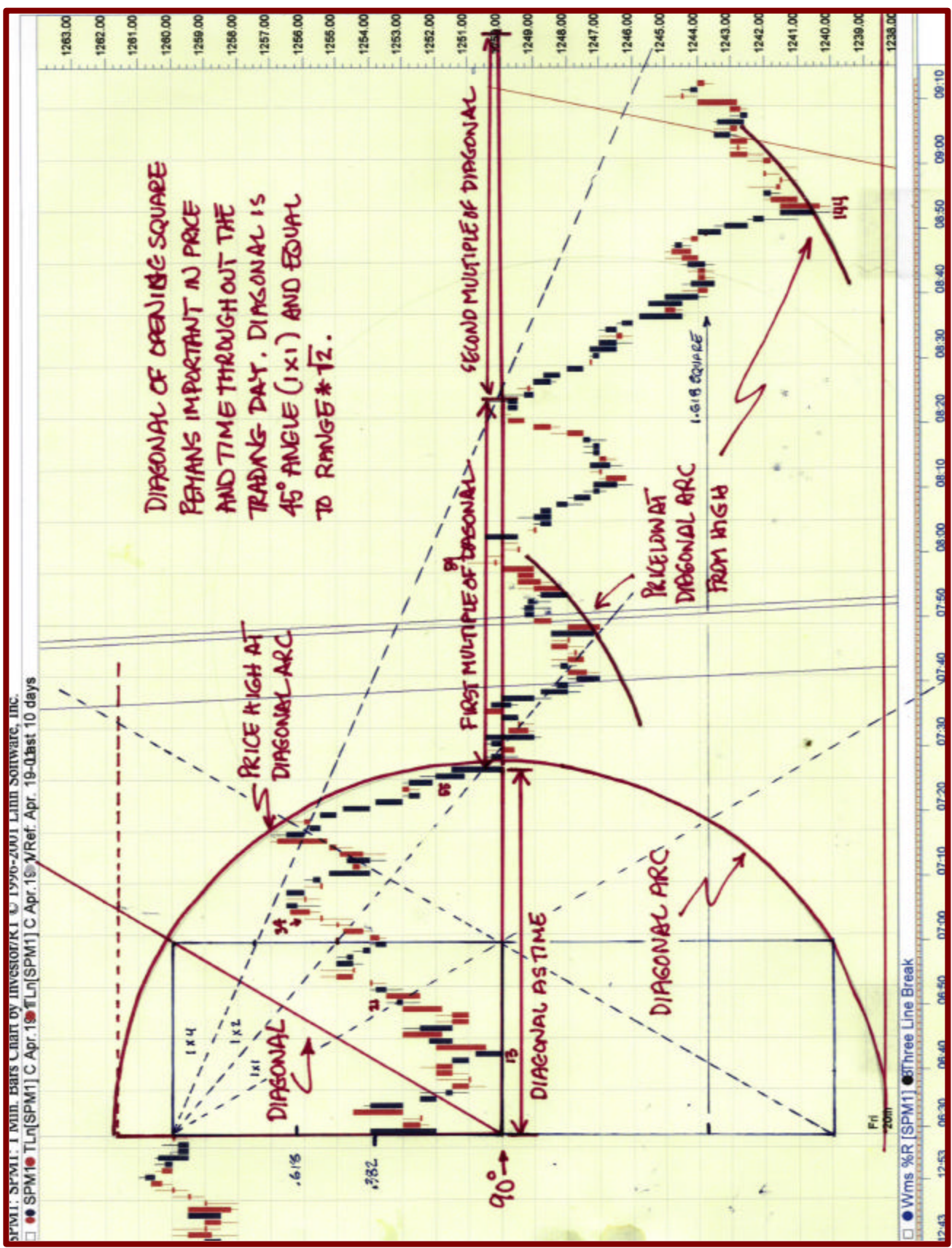
This is a complex figure and may be a bit overwhelming at first. I'll go through it step by step keeping in mind that this has only a few of several important items of interest that we would pay attention to in trading. First, locate the original pricetime square (the blue box). The diagonal is red. The extension of the diagonal to 90 degrees creates an "upper" diagonal line. An important concept to keep in mind is that when ever this diagonal line intersects an angle, a "time event" may be expected. This if prices are rising, it would not be surprising to see a reversal of trend at that intersection point. Note that time intersections project all the way up and down a chart—so prices do not need to be at the price level of the intersection to be affected by the intersection. Note where the upper horizontal diagonal line intersected with the original diagonal line, the market reached a high (just following the 34th Fibonacci minute) and just below the declining 1x4 angle from the pricetime square. The

convergence of multiple time and price indicators increases the likelihood of a "time" event. Note the large red *arc*. This is the *diagonal arc* and will become an important measuring tool in future work. Note that the high of the day touches this arc before falling precipitously to the 90 degree lower opening line. Notice how the fall in prices stays within the arc until prices hit the lower line at which time the arc "moves into the past." Prices touching "arc points" are especially important points in time and may produce exactly what we see here... quite sudden and inexplicable reversals. Notice too that the down trend hit simultaneously the diagonal as a *time* distance. Now, if one takes a compass, and from the market structure high of the day draws an arc the distance of the diagonal, we find the price lows at 7:50 *touching* this arc in conjunction with the 1x2 angle down from the upper origin of the pricetime square. As mentioned earlier, touching of the arc often "reverses" the trend as we see here. Note also that the high of this trend was reached at the 89th minute, a Fibonacci point of potential reversal. Note how price was sent lower from that point and returned to a high precisely at the end of the first multiple of the diagonal in time and its conjunction with the 1x4 line. Here we see that when price support on the 1x2 line, they are likely to rise to the next higher angle (1x2) as they did here. This point is also another arc point (not drawn) and price touches the arc and drops precipitously. From that high, I have drawn in the next lower arc point, and you can see that prices touched the arc, achieving a price low at the 144th time point (a potential Fibonacci reversal point) and beginning a move up toward the second multiple of the diagonal in time.

I have not done so, but you may wish to test out the first arc from the high of the day, treating it as the diagonal of a pentagon and constructing the pentagonal clock and see how it relates to the unfolding of prices.

My purpose here is not to illustrate these ideas completely, but to show you the beginnings an approach to the wealth of information carried in the opening pricetime square, its dimension, its diagonal, its multiples and its angles. The endogenous cyclical nature of prices during the trading day is importantly related to the features of the opening pricetime square, as if the opening were fractally reiterating itself throughout the day.

What the opening does *not* tell us, of course, is *why* the market gapped down from the prior close. Some times this *seems* evident from pre-opening news, or overnight events. Why the market opens the way it does is undoubtedly due to exogenous factors, and many of these factors are *cyclical* in nature such as planetary harmonics, price harmonics (the hundredth trading day since trading at 100, etc.), and other cyclical factors. In Figure 4, we see that once prices are set in motion in the opening square, the cycles generated there become very potent in the trading day. [To be continued...]





THE OWL and all contents of THE MANUAL PROJECT are educational material only and not intended as financial advice. Any use of the methods, techniques or strategies described herein is solely at your own discretion and risk. There is risk of loss in the trading of any market and there is no guarantee that past results will be duplicated in the future.

The Owl's Forum . . . Dadcat on Covered Calls

Dadcat on Covered Calls

Before I describe my strategy for covered call investing, readers should know that I do this primarily in an IRA account. Remember, that IRAs are cash accounts, and options are restricted to covered calls, and long calls and long puts. I am retired, and write calls for monthly income. I also keep a pre-determined level of cash in that account to trade stocks intra-day. I use CyberTrader because I can trade both stocks and options in an IRA with their platform. I also maintain a small margin account with Interactive Brokers.

I started developing my covered call portfolio in July 2000, with an initial investment of 325K. Since then I have received over 128K of premiums, much of which I reinvested in my portfolio. Currently, I hold the following Stocks in 1000 + share lots: ADCT, C, CNXT (3000), GE, INTC, KLAC (1500), NEWP, ORCL, SUNW (2000), VSH, and WCOM.

In this "Bear Market" period my CC premiums have totally compensated for the loss in stock price, allowed me to add to

my positions, and provided supplemental income. I can't imagine why any investor would not use this strategy.

Here are the guidelines that I use:

1. I try to select good companies that have real products and services and generate income. I am not tempted by the high premiums that many stocks seem to offer. There are plenty of good stocks that have sufficient volatility to pay you a nice premium, (AMAT, CHKP, KLAC, NEWP, CIEN, HGSI, for example). I am generally looking to write a position that will pay 4% - 7% return if called out. If the first strike considered pays a larger return, I may lower the strike price to gain more downside protection. I pay attention to the "daily charts" in order to decide on my acquisition strategy and strike price, especially those studies that would indicate an overbought or oversold condition. Also look at the general market trend.
2. For overbought conditions and down-trending markets I sell calls either "at the money" or "in the money".

In these situations, I want downside protection. Just because a stock may decrease in price doesn't necessarily mean it is a poor choice for a covered call.

3. For oversold conditions and up-trending markets, I sell calls "at the money" or "out of the money" one strike up. In these conditions I can take a little more risk and maybe benefit from the increase in stock price.
4. I don't worry about getting "called-out". This provides an opportunity to re-balance my portfolio, or to select a stock with a better premium. Sometimes I just buy the same stock back on the following Monday. I don't worry about missing a "potential" profit; there is always another stock. I do, however, take a second look at my positions on the last hour of each expiration date. Sometimes, because of the lapse of time value in the option, and my assessment on the market trend, I will buy the call back.
5. After I have selected the stock, and decided on a strike price strategy, I begin to look at the intra-day charts to see if I can determine a daily price

pattern. Ideally, I want to buy the stock near the daily low and sell the call when the stock is higher. This is easier said than done. In all cases, when entering a new position, I will buy the stock and sell the call the same day. For existing positions, where I have not been called out, I may wait a few days to sell the next call only if the market and stock is in an up-trend.

6. I usually enter a new position with 300 - 500 shares, depending on the stock price. Over time I will try to accumulate 1000+ shares.
7. In most cases, I do not "stop-out" if a stock falls below my net cost. I use the lower price to add to my position. Although I have stopped out of a few "bad choices" in the past (CMGI, HSAC, WSTL).
8. When a stock price has deteriorated so far that the premium, at the purchase strike price, is not worthwhile, I calculate the "net cost" (original cost (-) the premiums received, and consider a strike price "one strike up" from the net cost. I also study the largest historic % of gains that the stock has advanced in the past year, and consider a strike price that would be one above that price if the stock were to equal this % of gain. Finally, I may go out two months. These strategies have allowed me to continually receive cash income with minimal risk of being called out at a loss.

What to do in a bear market? The first thing that comes to mind is that a disciplined covered call strategy can make a bear market much more "bearable" (no pun intended). But even for me, this has been an anxious time. There are three

simple things you can do to get downside protection: sell primarily in "the money calls"; buy a "put" to protect your downside; close out your position and get back to cash.

I primarily write "at the money" or "in the money" calls, I am conservative about my CC positions. This has given me more downside protection in this recent market downturn. But I didn't do this because I forecasted the market, I did it because it is my investment and trading style, conservative. I am quite pleased with a monthly 5% return on my money. This type of consistent return (60% / Year) puts most mutual funds to shame.

For research I use three web sites:

www.coveredcalls.com, www.winninginvestments.com (\$30.00/month), and www.askresearch.com.

I particularly like Ask Research's site for a quick screen of several stocks, they have a setup where you can view daily charts with studies. You can fix the display with a "cookie" so that your chart settings are saved. They also show option chains.

I hope this short article is helpful. This is a simple, straightforward strategy that any investor can replicate. If you have an investment portfolio and do not use covered calls, just think what your portfolio would look like now if you had been able to add 4% - 7% monthly since July 2000.

For members who have questions, I can be reached at jhmoore@bluetruck.net or just open a "private window" at the Pit. I will be vacation April 22-27.

Dadcat

Next time...

The next issue of THE OWL (May 27) will focus again on the issue of *cycles*. In particular, I will describe the relation between moving average oscillators and cycles and illustrate some novel uses of these devices in trading. I will also discuss the longer-term cycles and how to make use of them in your trading. Good trading all...