

## CHAPTER 9

# TRADING WITH THE BIG BOYS

There is a nagging question emanating from the halls of Wall Street’s lesser-known firms, which is this . . . how the hell do the top firms (especially Goldman Sachs) consistently earn such spectacular returns on their investments??? For example, in 2006 the five largest U.S. investment banks—Morgan Stanley, Goldman Sachs, Merrill Lynch, Lehman Brothers, and Bear Stearns—generated a whopping \$61 billion in profits from proprietary trading (about half their total revenue)—a 54% increase over 2005. What is it that they know that no one else seems to know? . . . Well, I have the answer . . . .

But before I tell you, I’m going to clue you in on a little secret . . . most of Wall Street’s biggest brokerages and investment banks that spend millions of advert dollars touting the value of the classic “buy and hold” investment strategy for their mutual funds are, in fact, themselves making their millions *not* by buying and holding, but with *short-term trading techniques* which accounts for that 61 billion mentioned earlier.

However, this growing contradiction between what is defined as long-term investing versus trading is putting many mutual fund managers in a quarterly performance evaluation trap, forcing them to become more active traders just to compete with the real traders, just to keep their jobs. They must now compete quarterly, contrary to being the long-term investors that they were originally trained to be. *But the firms will never come out and admit that.*

## INDEX VERSUS EQUITY MANAGERS

Managing an index fund is a basis-point game. Unlike active equity managers who hope their fund's performance will consistently rank high relative to their benchmark and peers, index fund managers are usually indifferent about the absolute performance of the index itself; whether the benchmark index appreciates or depreciates is of little consequence.

Of significantly more importance is by how many basis points their fund underperforms or outperforms its benchmark. This is known as tracking error. Index fund managers routinely analyze their tracking error, and take corrective action as often as necessary to mirror the benchmark as closely as possible. Because the success of an index fund is measured by its correlation to the performance of the benchmark, successful index fund management requires a detail-oriented, micro-managing, perfectionist-type personality.

## ONE-TWO PUNCH

If you're already a subscriber to our trade alert service, [HedgeFundTradeAlert.com](http://HedgeFundTradeAlert.com), you know that we enter trades based on these institutional trading firms' actions as reported by Thomson Financial's incredible

global, pre-trade execution and communications network called [AutEx](#), which provides us with an in-depth view of the moves being made by over 800 institutional traders (representing member broker firms, exchanges, ECNs and ATs) who rely on it for their executions.

Combined with the LogiCast quantitative analysis program, (mentioned earlier), we have a pretty accurate one-two predictor of future price movement which allows us to generate substantial returns for our fund and trade alert clients.

When I was working with Jim at the “command center,” I learned what makes stock prices move—and more importantly, what doesn’t—and it’s not what you think . . . . It really has nothing to do with earnings, P/E ratios, relative strength, “overvaluedness,” “undervaluedness,” corporate news releases . . . that’s exactly what the big boys want you to think, but no . . . it’s the **prior knowledge of all of the above!** These institutions’ massively deep pockets (banks, hedge and mutual funds, insurance companies, pension funds, investment pools, etc.) give them several major advantages over everyone else. Ever since the Buttonwood Agreement created the NYSE in 1792, Wall Street has always been able to control the markets and manipulate investors to its advantage. It’s been a one-way street for a long time. They use their financial wherewithal to hire the best researchers, brokers, traders, analysts, etc.—all with huge monetary incentives (and the protection of friendly legislators and regulators), which can provide them with crucial inside information about a company’s prospects in which they’re interested in trading **before anyone else has a clue**. They also have direct access to the CEOs, VPs and CFOs of every listed company, which they can get information from directly since they are usually their biggest shareholders (and management must appease shareholders . . . ).

Many of these giant firms are also members of private “intelligence networks” that share their inside knowledge with industry friends and associates. Some will even go as far as to hire private investigators to obtain information which they think will give them prior market-moving “inside information,” if they want it that bad. Remember the Eddie Murphy movie *Trading Places* where the Dukes were trying to corner the orange juice market? Well, believe it or not it was actually loosely based and inspired by the “Silver Thursday” market crash of March 27, 1980, when the Hunt brothers of Texas tried to corner the silver market, and subsequently failed to meet a \$100 million margin call; they were subsequently arrested . . . . So, yes . . . dirty tricks are sometimes used to get key market-moving data before it hits the street (as you’ll learn more about later on).

The benefit of having “inside” information regarding beforehand (which subsequently affects the company’s stock price) enables institutional traders to act well before the public, sometimes straddling the line of illegal insider trading activity (they call it being a “genius”).

In so many instances this is why the stock price actually goes UP when a company releases bad news, and goes DOWN on good news . . . because the pros (who’ve had information beforehand) are taking their profits from that news right out of the pockets of retail traders who think they’re on to something when they read some news in yesterday’s paper and act erroneously.

This is why the saying, **“Buy on the rumor, sell on the news”** carries so much validity. **Institutional traders always know “the rumor” before you, and are greatly rewarded with massive trading profits from “the news” . . . .**

Therefore, all the fundamental and technical analysis of a company and its stock will have little bearing on its price movement if the big institutions are not the ones driving the stock price with their tremendous buying power whatever their reasons may be—do you understand that? **Repeat: The price simply will not make a sustained move without the power of institutional buying or selling.**

Because **amateurs theoretically influence the opening because of overnight orders (and professionals the close)**, this is one reason why opening price gaps occur, because the amateurs reacting to news released after the previous day's close are late to the party.

Another reason to be wary of the big boys is that institutional traders are compensated on their ability to meet or beat the all-important VWAP (volume-weighted average price) which is the average of the price of every print weighted by the size of the print. Most institutions grade their traders by comparing the trader's performance to the VWAP, which determines their year-end bonuses . . . so traders do everything they can to juice their profits all year long. Guess who's paying their bonuses? That's right—YOU!!! And have you heard about the SIZE of these guys bonuses????? Some are bigger than many countries' GDP. **ASTRONOMICAL!!!!!!!**

So, let me now ask you this: Do you have a comparable network of inside information providers to compete with the big boys? Of course not—that's why **trading *with* the big boys is really the only fool-proof method of racking up enormous profits in the market.** With the help of AutEx, LogiCast and other important tools of the trade, I learned how and where the “smart money” crowd was taking action with their *money*—not their *words*—and more importantly, *at*

*what price they are willing to pay.* (Remember the word ***pre-trade*** mentioned earlier? What do you think having that inside institutional demand knowledge would do for *your* bankroll?) By having this information at our disposal and using it effectively, **trading became easy and our profits skyrocketed . . . so will yours!** HedgeFundTradeAlert.com subscribers share in this exact same information—in real time! Welcome to the *Great Game* . . . .

### **THE TRUTH: HOW IT ALL WORKS—JIM MELLANCAMP, GENIE ONE**

“So, how *does* the market really work? The truth is, it’s just one big sporting event. Retail traders, and the media, focus only on the game itself: earnings, the products, and management, and not on the actual players—the traders—who, on behalf of their team (the funds), come up to bat, continuously hitting doubles, triples and (of course) home runs, while the other team (retail traders) is barely on the field, looking around and wondering what just happened.

“I know how the big institutional money managers think because I was one of them, and have been predicting their behavior and buying stocks accordingly for almost as long as I’ve been in the game. The truth is that the people who control most of the money that moves the market all tend to think the same way. They were all trained at the same funds or investment banks, they all know and talk to each other, and they all buy and sell the same stocks.

“So . . . the way the market really works is however these big-time players play it. They make the rules. Stocks don’t move to a specific level by themselves, where they are suddenly correctly priced and sit there. No; they go where the institutional managers’ send them for whatever their reasons may be, regardless of underlying fundamental value. The market is not a democracy. The big institutional money managers *are* the market.

As the Equivolume diagram above shows, Equivolume combines price and volume in a two-dimensional box. The top line of the box is the high for the period, and the bottom line is the low for the period. The width of the box is the unique feature of Equivolume—it represents the volume for the period.

The shape of each Equivolume bar provides an indication of the supply and demand for the security in whatever time period you are looking at. Short and wide boxes (heavy volume accompanied with small changes in price) tend to occur at turning points, while tall and narrow boxes (light volume accompanied with large changes in price) are more likely to occur in established trends.

However, as good as this information is, **we prefer to use the Candlevolume** derivative which is a unique hybrid of Equivolume and candlestick charts. It represents that same information in our preferred candlestick form, showing the open/close/high/low and trend. And just like Equivolume, the candlesticks widen or narrow, indicating the volume for that particular period.

This candlestick/volume information combination gives you the ability to study both candlestick and volume attributes in one candle. Now admittedly, because of the information we receive from MarketLogicData Corp. we usually don't pay too much attention to volume indicators (since most institutions find many ways to hide their buying/selling activity as was described previously), but Candlevolume charts are still a great visual tool for seeing possible institutional demand.

The shape of each candle is very useful in finding potential breakouts, which will depict a jump in volume that often precedes a nice move, whether it's on an intra-day, daily or weekly chart.

Here are a few examples:



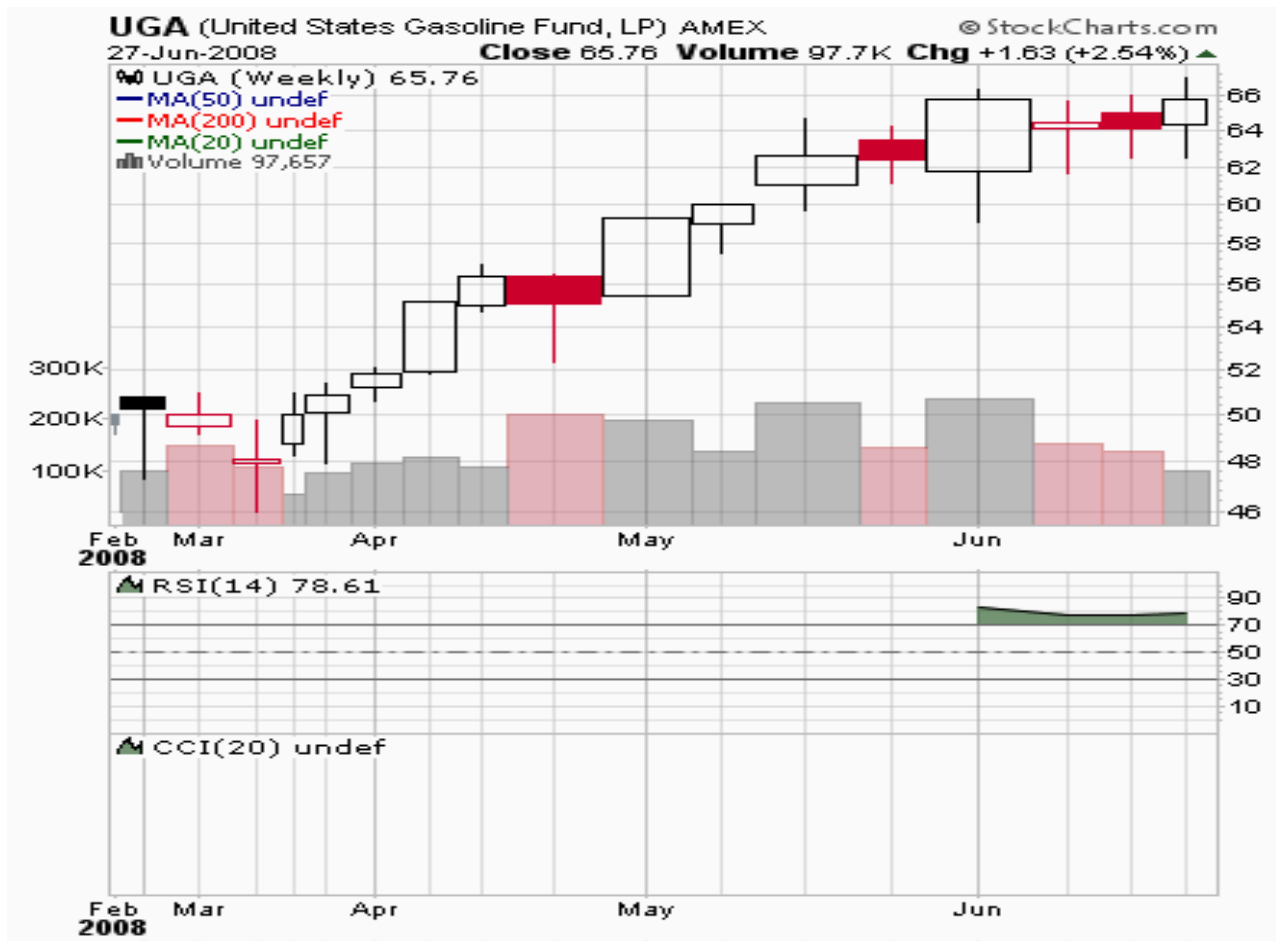
Notice how November's wide candle and increased volume preceded the decline.



Notice how November's wide candle and increased volume preceded that nice move up.



Notice how January's wide box and increased volume followed a Doji, and moved higher on increased volume.



Notice the Doji in March and subsequent wide candles, as the price moves ever so higher.



Notice April's wide candle and subsequent move higher on increased volume.