Some Stock Trading Skills

by *Guy R. Fleury*

In playing the stock market game, maybe the very first question should be: How much trading skills do you really need? To which I would venture, in many cases, practically none or very little. The game is simply too simple. Common sense might be your best asset ever.

What you might need however is sufficient capital, time, and some sustainable long-term method of play. You could even outsource the whole process should you not have the time to do it yourself. But that too has its limitations.

For some reason or other, you buy stocks, one or many at a time, at the prevailing market price and then try to resell them or hold them, hopefully for a higher price. You repeat the process as many times as you want. But, it is more something like as often as you can, within your capital constraints, available time, and trading methods.

You will win some and lose some. You simply will not win them all, but you will not lose on all of them either. Also, you might not know the outcome of your various bets until you close them out.

Unrealized profits or losses are just that, unrealized. For your trading account, what matters is the bottom line. You are in it for the money. Whatever you do, the objective is to make some, the more, the better.

Nature Of The Game

That is the nature of the beast. You would have to be really awful at this game to make 100 bad trades in a row... Probability of such a thing is in the order of 10^{-30} even if you had a slight edge. This should not be happening to anyone anytime soon. Yet, a lot, and I mean a lot of people manage to lose it all anyway. You are not in that game just to play a few shares at a time either, trades need to be of substance, or their number relatively large.

Your holding period for any of those trades could be anywhere from a few seconds to years and years. For a non-leveraged portfolio, the sum of weights is usually maintained at less than 1.00, as in: $\sum_1^j w_j \leq 1.0$ where j is the number of held positions at any one time. Going for a sum of weights above 1.0 implies leverage, while negative weights will account for short positions.

You will be the one (or your program) to determine which stocks you will trade on, when to get in, and at what price. Determine the size of each of those positions, and then plan their exits if need be.

The whole process can be automated or performed in a discretionary fashion, both ways can work. You can make it big, or small. It really is up to you, your trading skills, and mostly your available resources.

Regardless, you will have to address other problems. Three of which are: how much capital will you have available, how much time will you have, and what is the long-term expected return from your trading methods? Very basic questions. Two of which can be answered even before you start.

The Future Value Formula

The outcome of whatever you will do can be expressed in a simple future value formula:

$$F(t) = F_0 \cdot (1 + \hat{g})^t$$

where F_0 is the initial capital, t the number of years, and $\hat{g}$ the expected average growth rate over the period. Your growth rate is composed of: $\bar{g} = \bar{r}_m + \alpha$ where α represents the excess return above market average $\bar{r}_m$.

The alpha is an expression for the value of the trading skills you bring to the game. No skills are required to gain $\bar{r}_m$ (i.e. $\alpha \simeq 0$). You can get it simply by buying a low-cost index fund which will tend, over the long term, to $\bar{r}_m$, almost by definition.

Nothing complicated there, and technically quite boring. People understand the concept of compounding returns, yet, they still want instant gratification when time, and maybe, a lot of it might be required. Should your expected growth rate be relatively low, it will indeed take a lot of time to make it worthwhile.

You are planning for the future. Try using your own numbers in the above equation to estimate how long it might take to achieve your long-term objectives based on the expected growth rate you think you might generate. You might find that your most expected outcome is within the single-digit range, or something close to some historical average. It will still be money, but it might not be that much money after all. You could find out right now that you needed more, much more.

Inflation

Say, you are presently 30 years old and want to build your retirement fund for when you retire at age 60. Hoping to have up to 40 years of financial independence after retiring. You expect to have, on average, a 3 to 5% inflation rate or more over the next 30 years (could be higher or lower). You do not really know, but based on

historical numbers, it sounds reasonable. To compensate for this phenomenon, we would need, based on the future value formula:

$$F(t) = F_0 \cdot (1 + 0.03)^{30} = 2.427 \cdot F_0, \text{ or}$$

$$F(t) = F_0 \cdot (1 + 0.05)^{30} = 4.322 \cdot F_0, \text{ or}$$

$$F(t) = F_0 \cdot (1 + 0.08)^{30} = 10.063 \cdot F_0 \text{ (using current US inflation rate)}$$

This would be just to maintain your buying power, meaning that the dollar you have today could buy the same things in 30 years. Your portfolio would have to grow by 2.4, 4.3, or even over 10 times its original value over the period just to compensate for inflation.

You could in effect multiply by 4 (even up to by 10) your initial stake and still not have earned a single penny in real buying power. Your stock trading portfolio might maintain its original purchasing power, but then, there are no guarantees to that either. This also means that everything you will buy in some 30 years from now will be priced 2.4, 4.3, and maybe even as high as 10 times today's prices.

For example, your \$50,000 car could cost you in the neighborhood of \$500,000 by the time you retire. The \$100,000 car would then cost close to \$1,000,000. The point is: it will change the financial dynamics of how you will live your retirement. If your mortgage payment was some \$2,000 per month, it would then be \$20,000 per month. Everything would have increased following the ongoing inflation rate.

Not Playing The Game

Nonetheless, it is better than having kept your money under the mattress since that would have in fact reduced your buying power:

$$F(t) = F_0 \cdot (1 - 0.03)^{30} = 0.40101 \cdot F_0, \text{ for the 3\% inflation scenario.}$$

While at a 5% rate, your initial stake would have been reduced to: $F(t) = F_0 \cdot (1 - 0.05)^{30} = 0.21464 \cdot F_0$.

At the 8% rate, would be left: $F(t) = F_0 \cdot (1 - 0.08)^{30} = 0.08197 \cdot F_0$. Even less should the average inflation rate be higher.

This says that whatever you do, you are better off investing, even if your rate of return is 5% or less. However, do note that it is not that productive. You might just end up with the same buying power as you started with, or even less. How far do you think you will be able to go once you reach age 60?

You are almost not offered a choice. You have to invest in something just to maintain

your buying power, even if you know it will not be sufficient. The above numbers applied to whatever amount you started with.

Hope that the above, at the very least, made the point that you should invest in your future. It does not say how, or in which assets you should invest. Only that you might be forced to do so not only to preserve your buying power but to also try to reach some higher retirement goals.

After all, you might need to develop some trading skills. Since, with no trading skills, you might need to adjust to the following formula where I_r is the inflation rate: $F(t) = F_0 \cdot (1 + \bar{r}_m + \alpha - I_r)^t = F_0 \cdot (1 + 0.10 + 0.00 - 0.08)^{30} = 1.81136 \cdot F_0,$ and then see if it could buy that $500,000 car in 30 years from now.

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