The Official Advocate for Personal Investing
Originally published March 2009. SFO magazine.

Trading FX Like Jesse Livermore Traded Stocks

By Jamie Saettele

Jesse Livermore is widely considered to be one of the greatest stock traders of all time. On more than a few occasions, he traded a shoestring into at least a $1 million fortune. It is said that the 1929 stock market crash was the pinnacle of his career, when he shorted stocks and made more than $100 million. Somehow though, he ended up broke and committing suicide in 1940.

His demise is most likely because he did not follow his own trading rules. Still, when Livermore followed those rules, his trading success was unparalleled.

The keys to his trading are not limited to the stock market. Foreign exchange traders can apply Livermore's techniques to gain an edge in their trading as well.

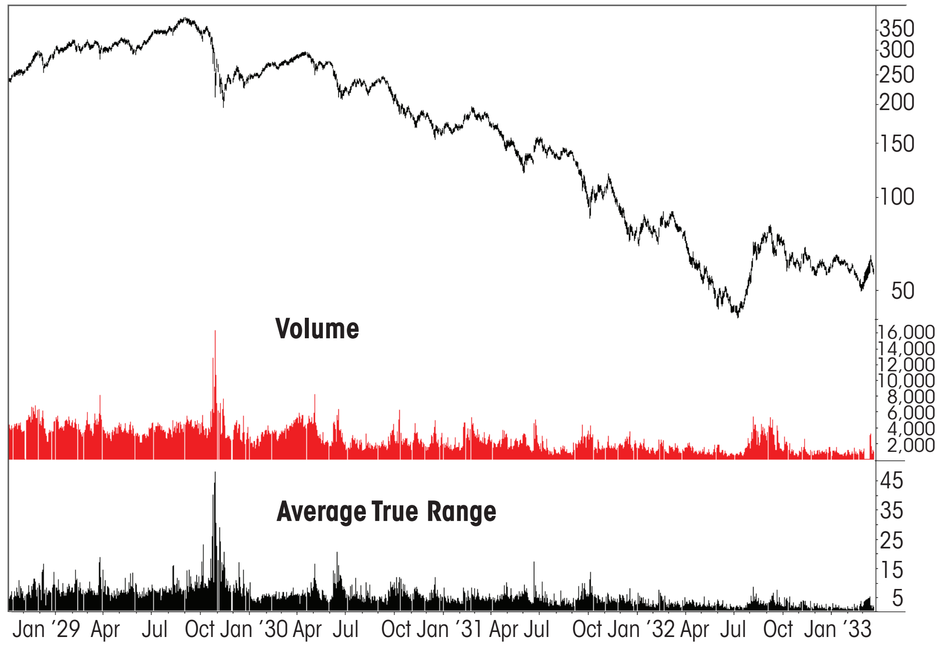
SOME BACKGROUND

In modern trading jargon, Livermore would be classified as a swing or position trader. In Edwin Lefevre's 1923 classic trading book Reminiscences of a Stock Operator, Livermore explains that the common thought of the day is "you never grow poor taking profits. No, you don't. But neither do you grow rich taking a four-point profit in a bull market." He would build his position gradually, putting himself in place to catch the meat of the trend.

Livermore was a speculator who would pick his battles more than a trader jumping in and out of the market everyday. He thought that trying to pick tops and bottoms was for fools, but he often found himself buying close to bottoms and selling close to tops as a result of his trading strategy.

In Jesse Livermore: World's Greatest Stock Trader, author Richard Smitten writes in the guise of Livermore that "I always wanted to trade along the line of least resistance, so I was generally moving along with the crowd, the herd, most of the time … I was always hunting

FIGURE 1: Daily DJIA Chart



A strong relationship exists between volume (red) and a one-day average true range (lower black).

Source: TradeStation

for the clues to the change. So I was always ready to separate myself from the popular thinking, the group thinking, and go the opposite way. These major changes in trends were hard to catch, but I did not want to ride the sled downhill with the crowd, unless I had sold stocks short."

PIVOTAL POINTS

Livermore's strategy was based on what he termed "pivotal points." Most traders today are aware of pivot points, and many traders use some form of pivot points (of which there are too many to count) in order to identify support and resistance, which aids in entering and exiting trades. To my knowledge, Livermore was the first trader to refer to a pivot concept. If he was not the first, then he certainly was one of the first.

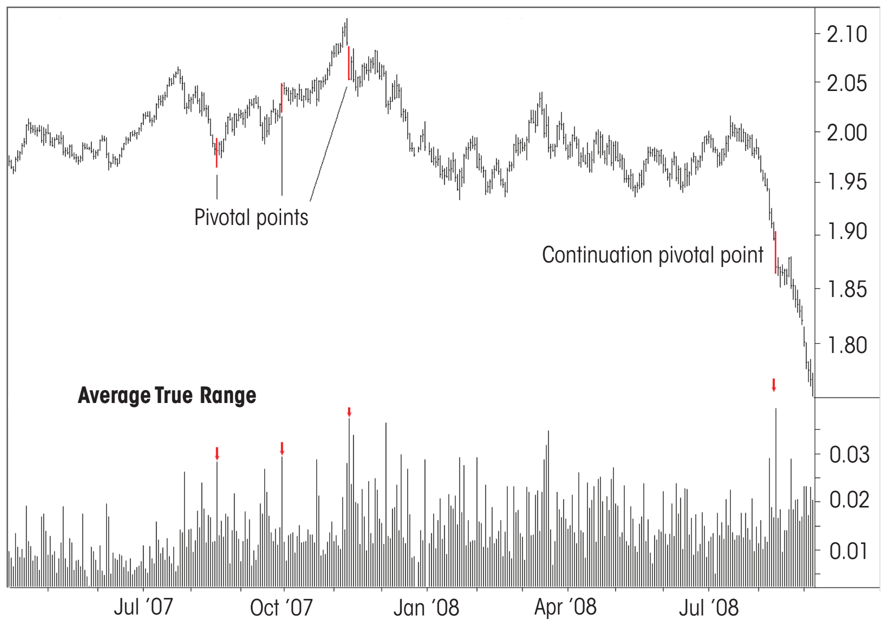
Livermore defined pivotal points as days that contained heavy volume. After a prolonged move, significantly increased volume was a key signal to him that the market was at the end of its major move. Rather than exit his position instantly, he would wait for the market to roll over and confirm that what he saw was what he referred to as a reversal pivotal point. At the end of a trend, a reversal pivotal point may be referred to today as a blow-off top or a panic bottom.

However, not all pivotal points lead to reversals. Heavy volume is often present not just at the end of a major move but also toward the middle of a trend. Take a look at a stock chart to see for yourself. If, for example, heavy volume occurs and the market in question does not roll over right away (or bounce right away), then a continuation pivot point may have occurred. When a continuation pivot point occurred, Livermore added to or even initiated his position.

ADAPTING TO THE FX MARKET

You are probably wondering how it is possible to apply Livermore's trading tactics, pivotal points, to the FX market. Volume is required in order to identify pivotal points in the way that Livermore did. Because the FX market

FIGURE 2: Daily Sterling/U.S. Dollar Daily Chart with Pivotal Points



Source: TradeStation

does not trade through a centralized exchange, no indication of volume is available. It is, therefore, impossible to trade FX in the way that Livermore traded stocks, right?

STRATEGY IN ACTION

Figure 1 reveals the Dow Jones Industrial Average (DJIA) from 1929 to 1933. The top indicator (red) is volume, and the bottom indicator (black) is the one-day range (this is simply a one-day average true range, or ATR). To the naked eye, a strong relationship exists between the two indicators.

Of course, the naked eye can be deceiving. As humans, we often see what we want to see. Statistics are required to back up our assumption. If you export the DJIA price and volume data into Microsoft Excel and perform a correlation (correl) test with daily volume and one-day ATR as the two arrays, you will find that the correlation coefficient is 79 percent—a high correlation. I ran this test with daily data from 1920 until November 2008.

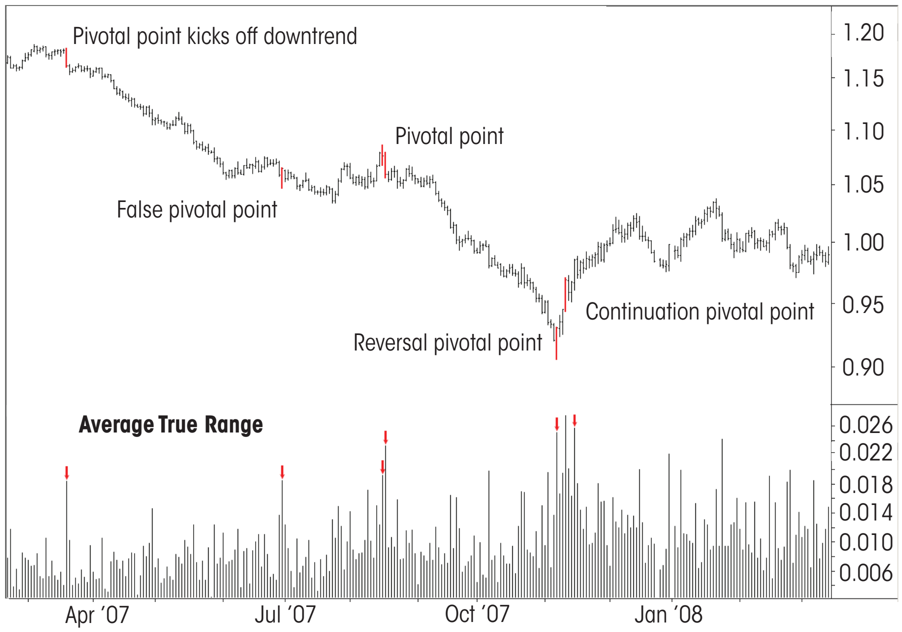
Intuitively, it makes sense that the day's volume and range would exhibit a strong relationship. If more prices are being hit, then more orders should be executed. A strong enough relationship exists in order for FX traders to use one-day ATR in order to approximate the appearance of a volume indicator. Simply plot a one-period ATR on your chart and identify the "spikes" in it. These are essentially equivalent to volume spikes (see sidebar online with this article).

In Figure 2, I have plotted the sterling/dollar (GBP/USD) daily chart and one-day ATR. I have also plotted the function that paints the bar red when one-day ATR reaches a 200-day high. (The input can be changed, of course. A smaller number will produce more pivotal points.) A pivotal point (200-day high) was made Aug. 17, 2007. If price would have dropped below that day's low, then that day would have been defined as a bearish pivotal point. However, the day's low was never breached and the Aug. 17 high was broken a few days later, confirming the bullish trend.

Another pivotal point occurs Sept. 28, and the GBP/USD shoots higher after breaking that day's high a few weeks later.

A pivotal point is made Nov. 12, but price breaks to the downside this time, confirming

FIGURE 3: U.S Dollar/Canadian Dollar Daily Chart with Pivital Points



Source: TradeStation

that it is time to trade from the downside going forward. As long as price is below the high of that pivotal point, the trend is considered down. The high of that pivotal point was never breached.

A continuation pivotal point is made Aug. 13, 2008, at about the halfway point of the 2.0156 to 1.7442 decline (not shown is the reversal pivotal point that occurred in September and led to a more than 1,000-pip rally in less than a month).

Figure 3 shows the U.S. dollar/Canadian dollar (USD/CAD) daily chart with pivotal points. The rules are applied just as they were with the GBP/USD. The largest one-day ATR during the past 200 days is identified. Whichever way price breaks confirms the pivotal point as either bullish or bearish (and sometimes specifically reversal or continuation).

A false pivotal point shows up, however. On June 29, 2007, the USD/CAD appeared to have made a continuation pivotal point (bearish in this case). After falling below the low a week later, price continues to fall but reverses July 25. The high of the July 29 pivotal point is exceeded, rendering that point useless. The next opportunity presents itself less than a month later, though.

PIVOTAL POINT REVIEW

1. Identify the largest one-period ATR over X number of periods
2. If price exceeds the high of the pivotal point, then trade long. If price exceeds the low of the pivotal point, then trade short.
3. If both the high and low of the pivotal point are broken, then the point in question is no longer a pivotal point.

Experiment with different timeframes and look-back periods. Ideas include a 52-period look back on a weekly chart, and a 24-period look back on an hourly chart.

TIMING AND MONEY MANAGEMENT

One of the more famous quotes from Reminiscences of a Stock Operator: "It never was my thinking that made the big money for me. It always was my sitting." Many read this quote and assume that Livermore meant that he lets the position ride in order to catch the big move. This is true, but there is a more important interpretation from the same book:

"No man can always have adequate reasons for buying and selling." In other words, there are times when the correct trade is no trade.

Nothing is wrong with sitting in cash. Many otherwise profitable traders fail due to overtrading. In this sense, the pivotal point is not just a timing technique. Waiting for a pivotal point to form also serves as a money management device by discouraging overtrading.

During Livermore's success as a speculator, margins for stocks were no more than 10 percent. In other words, a trader need only put up one-tenth of the value of the investment (10-to-1 leverage). The low margin requirement was probably one of the reasons that Livermore focused so much on timing. In this respect, the stock market that Livermore traded in the early 20th century is similar to the FX market today (where margins are significantly lower than even 10 percent).

Smitten wrote in his book from the perspective of Livermore that "timing was everything to a speculator. It was never if a stock was going to move; it was when a stock was going to move up or down." This seems quite obvious, but many traders I see pay little attention to when the market might move. It seems to be common practice to enter, long or short, and wait for the move to play out. The market may move sideways for some time before moving in the expected direction. By the time the break occurs, conditions may have changed and the break may be in the opposite direction.

Besides, it is not sensible always to be exposed to market risk. Rather, wait for a pivotal point to form before risking capital.

USING THESE TOOLS

A quote from Lefevre's book wraps it up: "But in actual practice a man has to guard against many things, and most of all against himself—that is, against human nature."

Trading in the way that Jesse Livermore did offers many benefits. Among the most important is the way in which pivotal points discourage overtrading. Overtrading is a detriment often overlooked by traders wondering where they went wrong.

Another benefit of trading with pivotal points as I've described here is that you always know where you are wrong. A stop is always placed on the other side of the pivotal point. Not overtrading and always knowing where the stop should be placed help immensely in controlling the human impulses that so often result in mistakes.

Not controlling his human impulses is what ultimately did in Livermore. When he was able to follow his rules and stay objective about the market, he was one of the greatest stock (and commodity) speculators of all time. I hope that this look into his trading tactics help you improve your FX trading.

Jamie Saettele is senior currency strategist at Forex Capital Markets LLC in New York and author of Sentiment in the Forex Market. His technical strategy is published daily at DailyFX.com. Saettele is an active currency trader employing a discretionary approach to the FX market.Sure enough, the former support level turned into new resistance, and the EUR/USD moved downward and resumed its new downtrend.