

INTERVIEW

Exploring Commodities With

Alan Knuckman Of GlobalTec

Alan Knuckman currently serves as the president and developer of GlobalTec's Commodity Explorer product line. In this capacity, he oversees all aspects of the decision support software, direct-access trading platform, educational training, and support. He is the expert on the daily Future Focus and Market Wrap programs on WizeTrade TV. Knuckman also is a frequent guest during CommoditiesTalk Live training broadcasts, where he answers in-the-market questions for traders. As an instructor, he also travels around the country training software users.

Technical Analysis of STOCKS & COMMODITIES Editor Jayanthi Gopalakrishnan conducted a phone interview with Alan Knuckman on January 8, 2007.

Alan, how did you get interested in trading?

I was always interested in the financial markets — I traded stocks as a teenager in high school and then college. After school I moved to Chicago and while I was trying to find a real job, I would wander down to the Chicago Mercantile Exchange and hang around the viewing galleries because I was interested in finance and watching the dynamics of capitalism at its finest and all that. I was “discovered” because I was down there one day when someone came off the floor and asked me if I wanted a job. I didn't realize until later that you started at \$2.85 an hour and you had to work your way up. There was no formal education for trading, and I also realized I was immediately hired because I'm tall. That's an advantage in the pits, which I also didn't realize until later. But it worked out.

So did you start with commodities?

Yeah, I started on the trading floor in Chicago. I worked in the grain room and moved up and started trading in the bond room and eventually traded for myself and eventually got involved in the software. I realized that trading is trading and there aren't that many tools for the individual trader. Now with electronic trading, everyone has tools to take advantage of what the big boys have always done.

When you were on the floor, it was pretty much open outcry, right?

Yes, it was, and there was a bit of a transition from open outcry to electronic. The electronic revolution in the last three to five years have really achieved more market change than we saw in the last 30 or 50 years. Electronic trading has changed everything so much. When I was down in the pits, it was a matter of who you stood next to, what order flow you could see — buying at the bid, selling at the ask — that's how guys made their money. Now, everyone has to trade on their own merits and do more analysis so they can take advantage of the markets and not just because they're standing at the right place.

So what are some of the differences between the two that you've come across?

The main difference is in the volume increases. The volumes have increased exponentially. You can see every year at the Chicago Board of Trade (CBOT) and the Merc that new volume records are hit, and this benefits the trader. The guy on the floor used to be there to provide liquidity to buy the bid and sell the ask, but now, with volume the way it is, they don't need that market mechanism. Orders are matched electronically, so volume becomes a huge advantage. You can execute your trading plan and get in when you want and get out when you want because there are so many participants. More important, this increases the opportunities for everyone. Now everyone has opportunities to access the markets and everyone has tools to take advantage of it.

Since the retail trader has no experience in the floor, aren't they at a disadvantage playing against the bigger players in the commodities market?

The bigger players in the futures markets are going to be the speculator and the hedger. There are hedgers in the institution who are going to protect their positions, and there are going to be those in the market who are there to make money. You're not up against a “someone,” so to speak.

But now, with electronic trading, you have the tools to be able to access the markets. There are direct-access software programs that allow traders to send their orders to be executed instantaneously. This is something only the professionals used to have. Live data is a significant revolution as well, since you don't have to wait for the pricing. This levels the playing field. Unlike open outcry, with electronic matching, the computer doesn't know who you are. If you place an order, your order's the same as Warren Buffett's or George Soros'. The computer doesn't care about giving everyone a role to play. These

markets offer huge opportunities.

So when you say “tools,” do you mean the technology?

Yes. Technology has enabled us to create the tools to help take traders to the next level. We have developed “discipline tools” so traders can be more successful and have an approach to the markets that provides more consistent results. But the technology is what's enabled us to create these tools.

In your opinion, what are some of the advantages that trading commodities have over equities now that everyone has access to these markets?

As a trader, it doesn't matter what I trade. I want to trade whatever provides me with the best opportunity. There are some limitations with equities, but with the emini futures contracts, which are the fastest-growing financial products in the world, you don't have individual stock risks, you can trade in any market direction, you can trade short term and long term, and you can trade in bullish markets and bearish markets, which is not as easy to trade with equities. These markets are open nearly 24 hours, so with all-electronic trading the advantage is that you can execute your trading plan. You can quantify your risk, put in a stop-loss, and know what your exposure is, regardless of what happens in the world marketplace because they're open nearly 24 hours a day.

What else?

Another advantage of electronic trading is that with equal access to live data, with the liquidity and transparency, you can execute your plan with immediate execution. It always comes back to commodities. No matter what you're investing in, it all comes back to the drivers of all economic activity, which means interest rates or inflation, which is reflected in the metals, the stock indexes, energies, and so on — the drivers of all investment activities. So now you have the ability to trade them electronically at any time.

With all these different commodities markets I would assume each one is unique. How important is it to understand every market before you place a trade?

That's nearly impossible, so I try to make it as easy as I can. Out of the hundreds of different commodities markets, I boil it down to 25 or 30 with good liquidity and that trade electronically. And of those markets there are maybe five or six different segments I focus on. So I just learn how to trade regardless of what the fundamentals are

because I don't trade off fundamentals. I can't trade with that information, because I don't find it helpful.

Why not?

The fundamentals are already built in and reflected in the price. Once you know how to trade technically, it doesn't matter what the underlying is. So I'll trade any market so long as I see the technical setup I'm looking for and I have the right situation. It's impossible for me to keep track of the weather or the news reports or government reports because that type of information is constantly coming into the market. And that just causes emotional trading and that's what we're trying to factor out.

What are some of the technical setups that you look at?

Our Commodity Explorer™ software has its own algorithm built in. It helps identify trends, and what we're trying to do is help give decision-assistance software. One of its key components is the money management side, taking into account all the things that people may think are confusing when you trade commodities — the face values, the times they trade, where they trade, the contract sizes. It simplifies all that so the trader can concentrate on what's important like the trends and different time frames, so they can make disciplined trading decisions.

Let's talk about money management. What kind of money management strategies do you use?

I mainly use stop-losses, and that's the first technique I teach anyone who is trading, regardless of what their trading vehicle is. You've got to be able to analyze and identify trading candidates.

The second most important part of any trading process is the money management, and the stop-loss is key. For whatever reason not everyone believes you should place a stop-loss, but that's rule no. 1. I don't care if you're daytrading or position trading, you should always have a stop-loss in place so that you know what your maximum exposure is.

And that's the difference between a professional and a nonprofessional. A professional is always going to look at the situation and know what the worst-case scenario is. They are going to know if it's something they can live with. A nonprofessional, on the other hand, is looking at how much money they can make. It's all about probability, and as long as you're using a small percentage of your account on any one trade, you're going to do fine in the long run if you're using that approach.

That sounds reasonable.

So a stop-loss is absolutely, positively necessary. That's the top mistake that people make. They don't place a stop-loss, then they get emotional about a trade and hope it comes back. One trade is not your whole account or your investment portfolio. It's just a small component, but if that trade isn't managed properly, that small component can have a huge effect on the value of your entire portfolio. You can choose how you want to manage your money, but it's key that you must have a plan so you can be successful and repeat your success.

Suppose someone trades the emini contracts and they place their stop-losses. The market is trending the way they want it to, or they think it's going to, and they enter that trade, and everything goes in the direction they anticipated. When is a good time to exit?

That's going to vary from trader to trader. It depends on your personality, your account size, and your risk tolerance. That's the million-dollar question that each trader needs to consider. You can paper-trade and realistically simulate your trading so that you can build those skills and then transfer them into real money when you feel ready for it. The market is always going to be here.

There's a quote from JP Morgan on my wall that I have taped up, and I try to remind myself of it from time to time as well because people are always asking about the money management aspect. The quote says, "I made all my money selling too soon." So you're *never* going to be able to buy the low and sell the high. The objective is to maximize the trend, but it's important to remember that you can always become a better trader down the road. What you need to learn is how to take bits out of the market. And you can build on that as time goes on.

Do you mostly daytrade?

It depends on my schedule. I traded bonds on the floor, so I prefer to trade the emini stock indexes for short periods of time. But if you look at the emini S&P, it's moved up \$7,500 in the last three months. You can either trade it long term, or you can trade it short term. It just depends on your lifestyle. And that's the beauty of these markets now. Whatever personality you have, these markets can offer you that sort of opportunity. You just have to find it.

So how long did it take you to really grasp trading? Did you experience a lot of losses at the beginning?

Things have changed. I've been doing this for

more than 15 years. Initially, the markets were very different from what they are now. And in the last three years, things have changed dramatically with electronic trading. The only markets left that are all open outcry are the meats, and those will be electronic soon.

The introduction of electronic trading has changed a lot of the dynamics. Previously, you weren't getting out when you wanted. You weren't able to execute your trading plan. Now, with electronic trading, you don't have to worry about your slippage, your entry, or your execution. You can concentrate on what is important or on what the trends are. So this evolution has helped create success, but you also have to be careful. Now, with such easy access to the markets, people tend to overtrade.

Do you see that as a big problem?

Overtrading can be a problem, but the way the futures markets work is that the software will only let you trade as many contracts as you can afford from a margin standpoint. It will never let you put your stop-loss farther than the money you have in your account. So the way the exchanges have quantified those deposit requirements is based upon volatility. There are some good mathematics behind that, so you're not going to get caught by any one market as long as you have good discipline.

You mentioned trends. Does that include short-term intraday trends as well as the long term?

Sure, because in trading, the time frame doesn't really matter. You apply the same process in a smaller time frame. It's just more condensed. It's still the same decision-making process: Identify, execute, manage, and maximize. Since you're looking at a smaller time frame you have to make your decisions more quickly, and that's where emotion sometimes comes into play. So the trends are available to be identified, short term or long term.

Do you look at multiple time frames to determine the trend?

Our software is constructed so that you're looking for trends in agreement. You're looking to trade with market flow. When I was younger I experimented with identifying tops and bottoms, but as I've become more mature I've realized that it's easier to go with the flow of the market. It's also easier to identify new strong and stable trends and jump onboard with things working together. If the trends aren't working together, you should find another market. There will be other opportunities.

So you focus on 25 markets or so.

We focus on 27 commodities and I've chosen them based on the fact that they have a certain degree of liquidity. I want my customers to be able to get in and out smoothly. Recently, we added the electronic grains. That was a huge evolution in the markets, because the grain traders have been fighting electronic trading for a long time. In Chicago you'll see that a lot of the grain trading has finally turned to electronic markets because it's more advantageous for the reasons I've mentioned, for people to trade electronic corn versus the open outcry corn.

So you don't look at any fundamentals like weather when you trade these markets?

No. My thinking is that by the time you read something or hear something fundamentally, someone had to come up with the story, research it, write it, and edit it before it was broadcast or printed. So by that time, it's already built into the market.

But the technicals would have reflected that a lot sooner.

Exactly.

But it's a matter of being at the right place at the right time, isn't it? If you see it, then you see it. If you don't see it, then there's no point in chasing it.

Right. You can't ignore fundamentals, but you can't trade them, either. You have to be aware of specific situations. For example, I know we're unfortunately one step away from crude oil having a dramatic move just because of world dynamics such as war and devastation. I can't ignore those fundamentals, but we've seen some significant dollar movements to the downside in crude. So here's an instance of how we've been able to see it technically, but fundamentally we have to be cautious because there's always that underlying that could shake things up. That's why electronic markets with the ability to put in a stop-loss let you sleep easy at night.

What are your thoughts on the currency markets?

Currencies we trade on interest rates and that's my background, so I have a natural inclination to trade more of the interest rate products. The dynamics of interest rates are going to change the currency values, so my thinking is I'd rather trade personally, I'd rather trade bonds and notes, and they're going to give us a view of where we think interest rates are going and how that's going to affect the currencies that way.

Currency trading has become popular among

retail traders, mainly because of 24-hour operations and so forth. Tell us about your television shows.

In those shows I try to teach people about technical analysis. We've got a couple shows a day on Wizetrade TV where people can call in. It's interactive so I can show them some technical analysis through the television. I've got two shows a day, one called *Future Focus* and one called *Market Wrap*. I can answer their questions and show them what the software is telling them and how to evaluate things. The ability to show them having the software in their hands is a big step forward.

Are these indicators you teach pretty much proprietary or do you have some public domain ones?

The indicators are built into the software. It's an algorithm that drives the software. It identifies the trends on different time frames for different markets. What we're looking for is a certain setup in these time frames that identify new strong and stable trends and participate for intermediate trades, swing trades, or daytrades. People have that misconception that most trading is active trading.

The reality is that a lot of these markets can be traded long term. You can trade any market long term. If you become an advanced trader and you get to be a daytrader that's great, but I just tell folks that you can trade the futures markets long term. You can check in on them every couple days and if you're looking for slow, steady trends, there are markets like gold, corn, wheat, or crude oil. It's not something that requires a lot of time and energy. Once you know what you're looking for, the opportunities are there. It's just like any other investment.

How important is liquidity, volume, or open interest when it comes to trading some of these contracts?

The most important thing is how tight the spread is. I want to trade markets with a very tight bid/ask spread so if you look at the S&P it's going to be a quarter of a point, which works out to be \$12.50 between the price you can buy and the price you can sell. Corn is going to be a quarter-cent. So I pick markets that have tight, one-tick spreads because you need to be able to execute your plan. If you're wrong, you need to be able to get out, and that's the important part of trading.

Some of these commodities markets have changed so much. When I started in the business, commodities weren't respected the way they are now.

They weren't?

No, and if you watch CNBC or read any financial newspaper, what are they talking about? Commodities. So it's interesting to see the guys on all the financial channels jump on the commodities markets and appreciate what they have to offer. Five, 10, 15 years ago they were a bit hands-off. But now, they understand electronic trading, and how the dynamics have changed.

I see a big growth in the interest in currencies.

That's true, but one thing I'm trying to educate people about is to trade the emini stock indexes because those indexes are actually more efficient or a better way to trade than trading, say, the exchange traded funds (ETFs). They'd be better off trading the mini contracts since these markets don't gap. They don't close like the equities do.

Why don't they gap? Is it because you're not trading an individual stock so one news item or bad earnings report won't create havoc?

Well, that's a key attribute. That's really one of their best attributes. But what I mean by not gapping is that they close at 3:15 in the afternoon CST but they reopen at 3:30. So they're only closed for 15 minutes a day.

I see.

So they're not going to gap. And the best thing about trading the indexes, just like trading an ETF, is if a company has a bad report like Apple did a few weeks ago, your investment won't be as badly affected as if you owned the stock of that particular company. But if you're trading the index you've got all those other stocks to smooth it out, so you have less individual stock risk with the indexes.

So the indexes are open 24 hours: You've got leverage, and you've got less individual stock risk. Most people don't appreciate it now, but if the stock market's getting crushed, it's a lot easier to short the stock indexes than it is to short stocks. And most people don't go short the stock market.

That's very true. Thank you, Alan.