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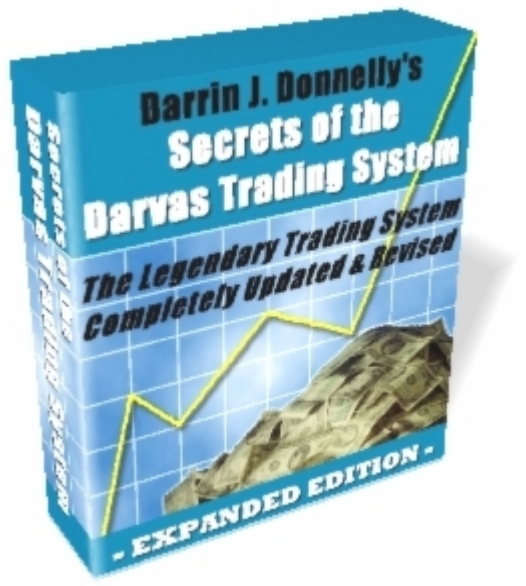
Secrets of the Darvas Trading System

The Legendary Trading System

Completely Updated & Revised

by Darrin J. Donnelly

- EXPANDED EDITION -



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Introduction:
Why the Darvas Trading System?

The purpose of this book is to show you exactly how to follow one of the most powerful trading systems ever developed. This system isn't for everyone, but those that have mastered it have made fortunes with it.

As they say, "there are a million ways to make a million dollars," and on Wall Street, there is certainly no *one* way to make a lot of money. The Darvas Trading System may not be ideal for you due to any number of reasons. But for me and many other traders, I've yet to find a *better* way to make a great living.

Traders vs. Investors

Primarily, there are two major camps on Wall Street: the buy-and-hold investors and the fast-money traders.

Neither strategy is inherently superior to the other as each side can claim historic market heroes who have made millions, if not billions. But, it's important for each individual to find the *primary* style that suits him best and then follow that style.

The Darvas System is a *trading* strategy and I believe that a trading approach has two major advantages over a long-term investing approach, especially if you're looking to make a full-time career out of this.

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First, my goal in the market is to make money and if I have a choice between making money quickly and making money slowly, I prefer to make it quickly. Holding a stock for years or decades and hoping for an eventual profit simply doesn't appeal to me as a primary income source.

All my research has shown me that successful traders consistently build their fortunes at a much *faster* rate than successful long-term investors.

Secondly, I like to be hands-on with my investments. I don't have the stomach to "ride out a storm" and watch my stocks fall lower and lower while I hope for a rebound. A trader, unlike an investor, gets out of a position at the first sign of real trouble. He doesn't sit through a bearish trend and wonder how much more money he'll lose. Instead, he gests out of the market with his cash intact or he goes short.

Now, there are thousands of different ways to trade, but my exhaustive search for the right trading system brought me to the Darvas Trading System.

[*Author's Note*: Before we end this discussion on trading versus investing, I'd like to point out that while I'm a Darvas trader first and foremost, I also like to implement a buy-and-hold, long-term investing strategy in a separate account. I think of this long-term account as something similar to a real estate portfolio, something I rarely make changes to. The point is that you don't have to adopt *one single* investment strategy and completely disregard another. In fact, I think everyone should experiment with and learn from different strategies in order to become the very best trader they can be. For more on my long-term approach, please refer to another book I wrote called *The Buffett System for Darvas Traders*.]

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The 4 Requirements for the Perfect Trading System

I was looking for a trading system that met four specific requirements and I found that the Darvas Trading System passed the test of those four requirements.

No. 1

I was looking for a strategy that had been proven to work in the past. The Darvas System carried a successful track record of more than 50 years and the proof wasn't based on hypothetical, back-tested results, it was based on *real people* who mastered the strategy and turned small accounts into huge fortunes.

I'm much more interested in a system developed by and followed by people who have actually *made real money* with it as opposed to a system that a computer programmer or author claims *would* have worked in the past.

In this book, you will learn Nicolas Darvas' amazing success story and the success stories of several other Darvas Millionaires who learned from him.

No. 2

I wanted a trading system that allowed me to have all the freedom I desired. I wanted the freedom to travel and relax and enjoy my family. I didn't want a trading system that forced me to live in front of a computer at all times.

I'd seen traders who, while they may have made a lot of money, had become ghosts to the rest of their world due to their 14-hour days glued to eight different monitors. That wasn't the life that I wanted. To me, a huge fortune was worthless if I had to sacrifice my quality of life in order to get it.

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The Darvas Trading System met this requirement as well. Not only did it *not* require a person to live his life at a trading desk, but it actually worked best when you were nowhere near your desk!

Nicolas Darvas traveled the world while he was amassing his multi-million dollar trading fortune. Needless to say, he bucked the stereotype of a rapid-fire trader who had no life outside of Wall Street.

Today, I've found that to be a successful Darvas System trader, you should spend just 15-30 minutes per day implementing the system. That's 15-30 minutes *TOTAL* and includes research time and actual trade execution.

No. 3

Another requirement for my trading strategy was that I wanted a true, systematic approach. I didn't want any emotions, hunches, or feelings to be involved with my trades. I wanted set-in-stone rules that could be followed at all times.

I understood that great traders needed to always apply *some* discretion, but I wanted this discretion to be minimal.

In the past, I'd always had a very difficult time checking my emotions at the door and I didn't want to go down that path again, especially with all the psychological turmoil that comes with "trusting your gut" on critical trading decisions.

The Darvas Trading System had what I was looking for here. It was actually very simple: follow the rules laid out and you'll be executing it perfectly – it will take care of you *if* you let it.

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Of course, this is easier said than done. It is human nature to let our emotions get involved and second guess our decisions, especially when money is involved. However, I knew from experience that I hadn't been very successful when I traded in this manner. Therefore, I needed a system that would force me to be disciplined and follow the set rules.

As great traders will tell you, "Rule No. 1 is: Follow your rules!"

No. 4

Finally, I wanted a trading system that limited my losses. I wasn't interested in a high-risk strategy that could potentially wipe out everything I had.

Finding a low-risk trading strategy wasn't easy.

Many trading systems that I came across involved high-leverage futures and options or "just trust the system" trend following strategies that forced traders to sit through drawdowns of 50% or more.

These were not for me. I just didn't have the stomach for them.

I knew that many fortunes had been lost by traders who "held on and hoped" instead of cutting their losses and moving on.

The Darvas Trading System limits risk. In fact, it's specifically designed to limit losses first and make money second.

Darvas himself said, "The best part of the system which I had so painstakingly devised was not that it had made my fortune. What was infinitely more important – it had enabled me to *keep* it!"

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The Holy Grail of Trading

Finding the Darvas System was like finding my "holy grail" of trading. It met all of my criteria with flying colors:

- It had been proven to work for actual, real-life traders and wasn't based on computer back-testing. It had been creating millionaires from very different backgrounds and in very different market conditions for 50 years.

- It allowed me to implement the strategy without giving up my freedom and the things I love in life. I could fully execute the system in just 15-30 minutes per day.

- It had hard, set-in-stone rules that prohibited one from letting his or her emotions get involved. You would never be asked to *rely* on gut feelings. The system would take care of you as long as you followed the rules.

- And most importantly, it cut losses and limited my risk!

Too Good to Be True?

When you really look at the Darvas Trading System, it sounds almost too good to be true. And in a way, it is.

You see, even though this book will show you *everything* you need to know in order to execute this amazing strategy in just 15-30 minutes a day, I know that the vast majority of people out there won't be able to follow it simply because *they lack the discipline to do so*.

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It's simply far too common to second-guess yourself and to not trust the rules of the system, to become impatient with the system, and to start making drastic changes. That is precisely why some people have become multi-millionaires with the Darvas Trading System while most others have scrapped the strategy and claimed that *it* didn't work.

The major difference is discipline.

If you want to succeed with the Darvas Trading System, you must have the discipline to trust it and follow *ALL* of its rules.

What This Book Will Show You

You'll notice that this book is short and to-the-point. I'm not going to waste your time with stories and theories. I'm not here to "sell" you on the Darvas System and explain why it is better than any other trading system I know of (although it undoubtedly is).

Instead, this book will simply and succinctly give you everything you need to implement the Darvas Trading System.

In the chapters that follow, I will explain to you the origins of the Darvas System. You'll learn Nicolas Darvas' amazing story and how he developed his strategy. You'll learn the incredible success stories of Darvas' most famous students. You'll learn how the Darvas Trading System has evolved to work better in modern market conditions and how today's technologies make it easier and more efficient than ever before to apply this phenomenal system.

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In this book, I'll show you where and how to find Darvas stocks. I'll show you exactly how the Darvas System has changed through the years. I'll show you when and why to buy and sell your Darvas stocks.
I'll do all this, but you've got to do your part as well.

If you want to succeed, you've got to stay disciplined and follow the system's rules. This may mean staying completely out of the market for weeks or even months. This may mean cutting losses so quickly that you're out of a trade just moments after you enter it. This also may mean holding a stock for six months, nine months, maybe even 12 months while you're tempted every day to cash in on your 300%+ profit.

Discipline is *the biggest* key to succeeding with the Darvas Trading System and by having such discipline, wealth beyond your wildest dreams can be a reality.

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Chapter 1:
Who Was Nicolas Darvas?

Nicolas Darvas lived a diverse and success-filled life.

Before he discovered the stock market, Darvas made his living as a world-touring ballroom dancer. After making his initial multimillion-dollar fortune as a trader, he became a bestselling author, a successful real estate speculator, and a partner in numerous business ventures.

His interests were quite diverse as he achieved success in the fashion industry, theatre production, and even the crossword puzzle business (I had no idea there *was* such a business).

But what Darvas was best known for – and what he seemed most passionate about – was his astounding success in the stock market. He created a stock trading system that amassed a $2 million fortune in just 18 months and he continued trading and evolving his system until his final days.

In May of 1959, *Time Magazine* ran a story on Darvas and shared his amazing story with the world. In the 50-plus years since his story went public, a lot has been said about Nicolas Darvas. Some of it true, some of it fabricated.

The point of this chapter – of this brief history of Darvas' life – is to separate the fact from the fiction and to provide you, the trader, with a sound foundation and understanding for why Darvas and his trading methods are held in such high regard by so many of the world's top traders.

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This is the true – and amazing – story of Nicolas Darvas.

Early Years

Nicolas Darvas was born in 1920 and raised in Hungary. At the age of 23, he fled the country with a forged exit visa to escape the Nazis and the Soviets, who were both trying to take control of his homeland.


Nicolas Darvas in the 1950s

Darvas would eventually team up with his half-sister, Julia, to form the highly-successful ballroom dance team known as "Darvas and Julia." The two took their act around the world in the 1950s and made several major television appearances on shows such as *Toast of the Town* (which would eventually become *The Ed Sullivan Show*).

While on tour in 1952, instead of a normal cash payment, a Toronto nightclub offered Darvas $3,000 worth of stock in Brilund, a Canadian mining company. Darvas accepted the offer and incredibly, the stock took off over the next two months and gave Darvas a quick $8,000 profit.

Needless to say, Darvas became very interested in the stock market.

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Darvas' First Crisis

It didn't take Darvas long to realize just how much pure luck was involved in that first "trade."

Over the 14 months after cashing in a huge gain on Brilund, Darvas played the stock market and slowly gave back more than 60% of the profits he'd gained on that initial Brilund transaction.

At this point, Darvas was extremely frustrated, but he didn't give up. Instead, he became committed to conquering Wall Street.

For nearly three years, Darvas read as much as he possibly could about the stock market. He devoured more than 200 books on the stock market. He meticulously analyzed company balance sheets, he studied analyst forecasts, and he read dozens of investment newsletters. He left no stone unturned in his quest to beat the Street.

Darvas' "Value" Disaster

At one point, Darvas' exhaustive study led him to what he believed was a hidden treasure in the stock market. He found a company called Jones & Laughlin that met every conceivable valuation measure. He was absolutely certain, based on his extensive research, that this company was priced well below its fair value.

Darvas bet big on his analysis. He mortgaged some property he owned to free up money for this stock and also became heavily margined in the investment.

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Less than one month later, Darvas had lost nearly 25% on this investment and he couldn't take it anymore. He sold at a huge loss.

This was a crisis moment for Darvas. He was now falling into debt and his confidence was shattered.

Darvas could not fathom how this loss occurred. He had done everything conventional Wall Street wisdom had told him he should. He had focused on "value" and he had been meticulous and extensive in his research. But yet, he'd lost so much so fast on this investment that he was forced to sell his position for a substantial loss.

This crisis would turn out to be a blessing for Darvas as it would lead him to the discovery of his own powerful investment strategy. The strategy that would eventually become known to successful traders around the world simply as, "The Darvas System."

Darvas Finds Trend Trading

After his disheartening investment with Jones & Laughlin, Darvas dusted himself off and started looking for a better strategy. He discovered what is now commonly known as "trend trading" (also sometimes called "momentum trading").

Trend trading is a strategy very different from the more common and more popular value investing method, which tries to buy low and sell high.

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Instead, the objective of trend trading is to find the most powerful growth stocks that are already moving higher; stocks that are already on an upward trend. These are the stocks big institutional investors (mutual funds, hedge funds, pension funds, etc.) are buying in bulk. Once you recognize these stocks, you simply climb aboard to ride the trend as their stock prices rise. The intention is not to buy low and sell high, but rather, to buy high and sell *higher*.

Darvas read and re-read books like *The Battle for Investment Survival* by Gerald Loeb and *Tape Reading and Market Tactics* by Humphrey Bancroft Neill nearly every week. He spent a minimum of *eight hours per day* studying stock price movements.

When Darvas wanted to master a skill, he threw himself into it with a relentless focus on succeeding. He was extremely passionate about achieving his goals (in any endeavor that interested him).

Darvas put in eight hours a day nearly *every single day* for three years in an effort to conquer Wall Street. Is it really any wonder that he devised a system that achieved his goal?

Those who brush off Darvas' amazing achievements as a random stroke of luck fail to appreciate the time, effort, enthusiasm, and study he put into his trading strategy. His success in the stock market came as a result of what it takes to succeed in any other field: hard work, long hours, passion, and the relentless determination to succeed.

Everything Darvas learned went into developing the Darvas Trading System.

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Honing His System

Darvas focused his attention on high-growth stocks that were hitting new highs and breaking out of price ranges on increased volume. Basically, he wanted to find stocks that had already been trending higher, but then went sideways, resting for awhile. When the stocks broke out of this "resting" price range, Darvas saw that as a sign that the upward trend was poised to go much higher.

However, Darvas didn't rely on price movement and volume alone. Darvas described himself as a "techno-fundamentalist," focusing on *both* technical and fundamental analysis.

Darvas' new objective was *not* to rapidly trade in and out of stocks he didn't have any knowledge of. He had tried this and failed miserably. He found that with such a method, not only did the commissions deplete his account, but he struggled with his timing on these "swing" trades as his travels made him unable to follow price movements all day as they happened.

Darvas had also stopped trying to find low-priced stocks that were undervalued; the value investing method. He had tried and failed with value investing, as seen with the Jones & Laughlin debacle, and he wasn't about to repeat his mistakes.

No longer interested in holding a stock for a few years or more, Darvas also recognized that he wasn't interested in a system that tried to hold a stock for only a few days. Instead, Darvas shifted his focus to looking for stocks with the potential to double, triple, or quadruple over an *ideal* timeframe of 3-12 months.

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All the pieces finally fell into place for Darvas. He developed his personal system for finding fundamentally-strong growth stocks and buying them when they were likely to continue their trend higher. The results of his trading system would change his life dramatically.

Notice a point of emphasis here. Darvas was undoubtedly aware that fortunes were being made by value investors, swing traders, and day traders – just as they are today. But, Darvas recognized that those particular systems were not best for him.

There is no *one way* to make good money in the stock market, but a successful trader needs to find the system that works best for his or her personality, financial goals, ideal timeframe, and overall flexibility.

$2 Million in Less than 2 Years

During an 18-month period beginning in November 1957, Darvas put his new system to the test. The results were nothing short of phenomenal as he took his $30,000 account and turned it into a fortune of more than $2.25 million! (To put this figure in perspective, it would be equal to $16.8 million in today's dollars.)

It's no wonder that Darvas was able to afford a life that most people dream of, traveling the world as he pleased. He had homes in London, Paris, and the South of France. When in the U.S., he made his home at the luxurious Plaza Hotel in New York City.

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Darvas' unbelievable stock market success sparked national attention. He was featured in *Time Magazine* and he would author several bestselling books including the Wall Street classic, *How I Made $2,000,000 in the Stock Market*.

As is the case with most extremely successful people, Darvas' success also made him a target for critics.

Many claimed that Darvas was a product of freak luck. Some brokerages allegedly claimed that Darvas was hurting their business because clients felt they no longer needed to rely on the advice of their brokers. The American Stock Exchange went so far as to change its rules and temporarily ban the use of automatic stop-loss orders because so many such orders flooded the market after Darvas' story was publicized.

Yet, Darvas continued to trade successfully until his final days. He also continued to teach his ever-evolving system by writing books and speaking at universities.

The Darvas Legacy

Nicolas Darvas died in 1977, but his legacy undoubtedly lives on.

What's incredible about Darvas and his trading system is that it was not a one-time occurrence of success. He succeeded with the strategy until the end of his days, always evolving to new market conditions. He made big money when the market went up and his system took him out of stocks when the market went down.

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But perhaps much more significant than Darvas' personal success in the stock market was the success of those who learned from his teachings and mastered his trading strategy.


Nicolas Darvas in 1965

There have been numerous "Darvas Millionaires" who credit Darvas with their success and I've featured a few of these success stories in the next chapter.

Nicolas Darvas lived a truly amazing life and has been an inspiration to several generations of traders. He's sure to be an inspiration for future generations as well.

Today's professional Darvas traders, in particular, will always be extremely grateful to Darvas for his willingness to share his system and help others succeed with it.

This book will show you how to implement the Darvas System as it now works and I sincerely hope that you too are able to achieve the incredible success that Darvas and his students have achieved.

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Chapter 2:
Darvas Millionaires

Nicolas Darvas created a strategy that turned his personal account of $30,000 into $2.25 million in just 18 months and inspired a generation of traders with his success. But Darvas went beyond merely inspiring others. He would also teach others his system and the result is a strategy that has produced 50 years of phenomenal results for those who put in the time and discipline to master it.

Perhaps much more significant than Darvas' personal success in the market was the success of those who learned from his teachings and mastered his strategy.

There have been numerous "Darvas Millionaires" who credit Nicolas Darvas and his system with their success. The purpose of this quick chapter is to give you a snapshot of just a few of the more famous Darvas-influenced people who have traded their way to millions and recommended Darvas' teachings to others who wish to do the same.

William O'Neil

William O'Neil is probably the most famous name on this list of Darvas Millionaires.

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From 1962-1963, O'Neil took a $5,000 account and turned it into $200,000. He used his winnings to buy a seat on the NYSE and never looked back. He would later become the founder of the highly-respected financial newspaper, *Investors Business Daily*, and the powerful investment website, *Investors.com*.

O'Neil lists Nicolas Darvas as one of his trading strategy's primary influences and recommends that all traders learn from his teachings.

Dan Zanger

Beginning in 1999, over a period of less than two years, Dan Zanger turned his $10,000 account into $42 million. His amazing story garnered national attention, but what wasn't surprising was the method he used to produce such phenomenal returns.

Zanger quickly become somewhat of a celebrity in trading circles and his advice was highly sought after. He recommended Darvas' strategy and told traders that the Darvas System is, "widely used and followed today by the best traders in the world, and still this breakout method is little understood by most…"

His statement could not have been more accurate.

Zanger is still a big advocate of Darvas' teachings and he tells traders that applying the Darvas method will "yield fortunes beyond the reader's wildest dreams."

Zanger was listed by *Trader Monthly* magazine as one of the top 100 traders in the world with an annual income of $25 million!

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David Ryan

David Ryan got started with a $20,000 account in 1982. He more than doubled this account in less than one year.

This quick success gave Ryan the confidence to enter the prestigious U.S. Investing Championship in 1985. He won the event with a return of 161%. To prove that his performance was not a one-hit wonder, he entered the competition again in 1986 and, despite finishing in second place, achieved a gain of 160%.

Ryan ended up winning the event twice and from 1985-1987, he produced a compounded return of 1,379%!

Not surprisingly, Ryan credits Darvas as being a major influence on his trading method.

Gary Smith

In 1985, a nearly bankrupt Gary Smith took a meager $2,200 and turned it into an account that now produces annual profits of more than $190,000.

How did he get started? He credits Nicolas Darvas for having the most impact on his career as a fulltime trader.

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Gil Morales

In 1999, Gil Morales wowed investment circles with a one-year return of 971%! But how did he do in the bear market that followed? In the period ending from 1998 through 2005, Morales achieved a total return of 10,904.25%!

Today, Morales is a sought-after fund manager and publicly recommends that investors learn from Nicolas Darvas' teachings.

Ced Moses

Ced Moses made a big name for himself when he entered and won the 1991 U.S. Investing Championship with a record-setting return of 379%! He would go on to start his own hedge fund where triple-digit returns became the norm and he was named to Nelson's list of *The World's Best Money Managers*.

Who does he credit as a major influence on his trading strategy? You guessed it, Nicolas Darvas.

Timothy Sykes

When Timothy Sykes was 18, he took his Bar Mitzvah gift of $12,415 and started trading with it. In just three years, at the age of 21, Sykes had traded that small account into a $1.65 million fortune. He would go on to start his own hedge fund, which quickly became one of the top-rated funds in the Barclays Fund Rankings.

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Sykes lists Nicolas Darvas as a key influence on his trading approach and states succinctly that Darvas' system is "timeless" and that despite the fact that Darvas created his system in the late 1950s, "his technique still works to this day."

What They All Have in Common

These prolific traders all became well-known for achieving seemingly impossible returns in a very short period of time. They all started with relatively small accounts and turned them into fortunes. And they all have one thing in common: their tremendous respect for the Darvas Trading System.

Perhaps there is something to this system after all?

It should also be noted that each of the above-mentioned traders chose to make their stories public by entering contests, writing newsletters or books, starting hedge funds, and so on. One must wonder just how many Darvas millionaires are out there who prefer to stay out of the public eye.

Don't Listen to the Naysayers

I included this chapter in the book for two reasons.

First, I wanted to show how the Darvas System has achieved phenomenal results for many different individuals in many different market conditions over the past 50 years.

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I also wanted to include this as a motivator for traders to read and re-read. The world is full of naysayers and complainers who will assure you that the success achieved by these Darvas traders is impossible. Remember the individuals included in this chapter when someone tells you "it can't be done." They are living proof that it can be done again and again.

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Chapter 3:
The D.A.R.V.A.S. System – An Overview

What is the Darvas System and how has it evolved since being introduced 50 years ago?

For starters, let's be clear on what it is not.

The Darvas System is *NOT* just a technical "boxing" system. People have become so enamored with the famous "Darvas Boxes" that they fail to understand what these boxes were intended to be and, more importantly, they disregard the main components of the Darvas System.

The Darvas System is also *NOT* a day trading strategy. While a Darvas trader will always cut his losses quickly, most winning trades are held for a period of several weeks or months.

Nicolas Darvas was only interested in stocks with the potential to double, triple, or quadruple over the next six to 12 months. He developed a list of criteria which he found to be most indicative of the potential he was looking for. Without a doubt, Darvas' criteria worked as he turned $30,000 into more than $2 million in less than two years of applying his strategy.

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The Darvas Trading System in Darvas' Own Words

In his last book, *You Can Still Make It in the Market*, Darvas tried to clarify what his system entailed. The following characteristics are presented in their order of importance according to Darvas:

1- Only buy companies "whose growth and earnings prospects look highly promising."

2- Avoid companies that are "already so big that the prospect of any further substantial growth is highly unlikely."

3- "Check the overall market trend to ascertain whether stocks in general are in an uptrend."

4- "Check whether the stock belongs to a strong industry group, i.e., a group that is performing well in the market relative to other groups."

5- Consider the stock only "if it is rising in price on high volume."

Then, and only after passing these first five requirements, would Darvas evaluate a stock in light of his "Box Theory."

The Darvas Box Theory

How does Darvas describe his Box Theory? Simply stated, Darvas writes that stock price movements are not erratic and random, but rather, "a series of price ranges or boxes."

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Notice here that Darvas explains his theory as a series of price ranges *OR* boxes, thus implying that the Darvas Boxes shouldn't be applied too rigidly.

We'll take a closer look at how these Darvas Boxes are defined in the next chapter. But for now, simply understand that Darvas was looking for stocks that developed recognizable price ranges – areas of support and resistance. And, he wanted to see these price ranges trending higher and higher – in other words, he wanted to see higher highs and higher lows.

That is the Darvas System in its simplest terms.

Wall Street likes to call this style "trend trading" because you buy high-growth stocks as they move up in price (trending higher) and only sell them when the stock falls below previous support levels (breaking a trend).

Big institutions – mutual funds, hedge funds, pension funds, trust funds, etc. – have the ability to drive stock prices quickly and as a Darvas System trend trader, you're basically following the trend created by these institutional moves.

The Individual Trader's Advantage

This is why an individual trader has a huge advantage over a large institutional fund manager. Because of their size, institutions are unable to get in and out of positions quickly, but an individual trader has this capability.

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An individual can ride the trend on the way up and easily get out before the institutions have time to unload their huge positions. This is also why it can be difficult to achieve huge returns with the Darvas System once you're dealing with an account of more than $50 million. (Of course, having an account that large would be a good problem to have for most individual traders.)

Some of you may be noticing the many similarities between the Darvas System and William J. O'Neil's popular CAN SLIM system. O'Neil was heavily influenced by Darvas' teachings, so this is no accident.

However, while O'Neil is a brilliant trader who has helped thousands make better investment decisions, I feel that there are some aspects of the CAN SLIM system that, frankly, aren't all that important in picking winning stocks.

Therefore, we offer a new, easy-to-remember acronym for the Darvas System:

D – Direction of the Market
A – Accelerated Earnings and Sales
R – Relative Price Strength (and Return on Equity)
V – Volume Increasing
A – Aggressive Growth Group
S – Sound Base Pattern

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To further explain:

D – Direction of the Market

Is the market, as a whole, in an uptrend? It is highly unlikely that a stock will have huge gains when the overall market is in a downtrend, so make sure the direction of the market is moving upward.

A – Accelerated Earnings and Sales

Is the company seeing increases in earnings and sales this quarter compared to the same quarter last year?

You want to see stocks with *at least* 40% increases in earning *AND* sales in the most recent quarter compared to the same quarter last year. And remember, the higher the increase in earnings and sales, the better. If you have a choice between a stock with a 50% increase and one with a 90% increase, definitely go with the 90% increase stock.

R – Relative Price Strength (and Return on Equity)

Is the stock outperforming most other stocks in terms of its price increase?

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Darvas wanted to see stocks that had at least doubled over the past year *before* he'd consider buying. If a stock has already increased a great deal over the past year, most investors are fearful of a steep decline, but many studies have shown that Darvas was right in his assessment; if a stock had already made a powerful move, it proved that it had the ability to move in such a fashion and therefore, was likely to do it again.

Another important characteristic of ideal Darvas stocks is a high Return on Equity. Fund managers love to see a high ROE. Some put a higher value on ROE than they do earnings and sales.

William O'Neil conducted a 50-year study on top performing stocks. This study's findings were published in his classic book *How to Make Money in Stocks*. O'Neil found that almost all of what he labeled "the greatest growth stocks of the past years" began their runs with a Return on Equity of 17% or higher. And just like when it comes to earnings and sales, the higher the ROE is, the better outlook for the stock.

Therefore, with the exception of rare cases when earnings or other conditions are extremely attractive, we should primarily buy stocks with a ROE of 17% of higher.

V – Volume Increasing

Is volume increasing on up days, particularly on the day when the stock breaks into new highs?

Volume can tell you so much about a stock. Ideally, you want to see much higher-than-normal volume when a stock breaks into new highs and lower volume when the stock declines.

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A – Aggressive Growth Group

Is the stock a member of an industry group that has been increasing in price more rapidly than most other groups?

At any given time in the market, there are certain groups and sectors that are very hot. It's always been this way and always will be this way. Make sure your stocks are members of these hot groups.

S – Sound Base Pattern

Is the stock breaking out of a sound base pattern?

You want to buy stocks that are breaking out of old price ranges and into new, higher price ranges. You also want to sell stocks that are falling down into lower price ranges. These price ranges may be strictly applied Darvas Boxes or one of the other proven base patterns explained in later in this book.

If a stock meets all of the above criteria, it is potentially a huge winner.

Remember, as Darvas said, the only reason to buy a stock is if this price of that stock is going up. He was only interested in stocks that could double, triple, or quadruple over the next six to 12 months.

If you concentrate your stock selections to these types of stocks, you too may soon join the ever-growing list of Darvas Millionaires.

Unfortunately, most traders lack the discipline to stick with these strict requirements.

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Chapter 4:
An Introduction to "Darvas Boxes"

Before we get into this explanation of what "Darvas Boxes" are, I want to reiterate that one of the biggest mistakes Darvas followers make is relying too much on these technical Darvas Boxes and disregarding the main components of the Darvas System. While the Darvas Boxes are easily the most talked about aspect of the Darvas System, you will not succeed without understanding the *entire* system.

Having said all that, it *is* vitally important when implementing the Darvas System that you understand the concept of Darvas Boxes.

After a stock first met all the Darvas System fundamental requirements, Nicolas Darvas would then apply his technical "Box Theory." He found that stock price movements were not erratic and random, but rather, "a series of price ranges." Darvas Boxes were simply Darvas' method of identifying these price ranges.

Support and Resistance

Darvas wanted to identify key points of support and resistance in the price range of a stock. The top of the box would identify the stock's resistance level – the price point at which, at least temporarily, there are no more buyers to be found. The bottom of the box would identify the stock's support level – the price point at which there are no more sellers to be found.

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Darvas was looking for stocks that developed these definable price ranges – areas of support and resistance – and he wanted to see these price ranges going higher and higher; that is, higher highs and higher lows.

Based on these boxes, Darvas would buy a stock as it propelled up through a box top and he would often sell a stock if it dropped below a box bottom. In other words, he would buy a stock if it broke through previous resistance levels and sell a stock if it fell through previous support levels.

For example, if a stock was spending days or weeks moving up and down between 30 and 35, Darvas would define the Darvas Box as a 30-35 box. The top of the box, 35, would be the resistance level where the price stopped moving up. The bottom of the box, 30, would be the support level where the stock stopped moving down.

If the stock moved above 35, it was time to purchase. Once Darvas owned the stock at, say, $35.10, he would then wait to see where the new price range was established. If the stock moved up and down between 38 and 42 for several days or weeks, the stock was now in a 38-42 box and would be held as long as it stayed in this price range or moved higher.

If the stock broke out above 42, the stock would be establishing a new, higher box and may be considered for an additional buy. If the stock fell below 38, the stock would be sold.

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The following chart is of ICE in November and December of 2006. I've identified the support and resistance levels to make it clear. As you can see, these levels aren't all that difficult to establish:



Identifying Darvas Boxes

There has been plenty of debate about how exactly Darvas identified the top and bottom of his boxes. In his writings, Darvas' most specific answer came in the revised 1971 edition of *How I Made $2,000,000 in the Stock Market*. In a Q&A segment new for the revised edition, Darvas explains his box tops and bottoms as follows:

"The top of the box is established when the stock does not touch or penetrate a previously set new high for three consecutive days. This is true – in reverse – for the bottom of the box."

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In analyzing these comments, we understand that the box top takes a *minimum* of four days be identified.

For example, let's say that on Day 1, a stock hits a high of $61. On Day 2, the high is $59, Day 3's high is $60, and Day 4's high is $60.50. At this point, we can see that the previously set high of $61 was not touched or penetrated for three consecutive days. Thus, the top of the box is $61.

While there is some debate about whether the top of the box could be established in just three days (that is, including the day the high is made as one of the three consecutive days required for the top to be established), Darvas makes it quite clear in the above statement that the high had to be set prior to the three consecutive days of not being penetrated.

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Darvas Boxes in Action

Let's take a look at a real example of traditional "Darvas Boxes" in action. In the following six-month chart of ISRG in 2005-2006, we see that seven traditional Darvas Boxes were formed. The Darvas Boxes are shaded blue.



Darvas would normally base his buy and sell signals on how the stock price moved in accordance with these boxes. In the ISRG example above, Darvas would likely have bought as the stock gapped out of Box B.

By strictly following the traditional Darvas Boxes and their corresponding rules, one would have held the stock until the stock price fell below the bottom of Box E because the bottom of each box served as the stop-loss.

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(A stop-loss is a tool where the trader sets an automatic sell stop. This means that when the price of the stock hits the price set by the trader for his sell stop, the stock is automatically sold, even if the trader was nowhere near his computer or a phone to manually sell the stock. This tool is a key component to the Darvas Trading System as it makes sure that your risk is always limited – because a stock will always be sold if it falls to a certain price point – and it allows you to implement the system without being glued to a computer at all times.)

As you can see in the ISRG example, the Darvas System would have resulted in a substantial profit in roughly three months holding time.

Understanding the Purpose of Darvas Boxes

While these traditional Darvas Box rules are extremely helpful and they can be very profitable, it's important to understand that they should *not* be relied on fully for your technical buy and sell signals, especially in today's more volatile market. After all, Darvas himself acknowledged that while these boxes were a good basic strategy, he didn't strictly adhere to the Box Theory.

Darvas sometimes decided to let his stocks fall below the box bottom without selling or he'd sell a stock while it stood in the middle of a box. He made exceptions to his strict Box Theory based on the particular price action of the stock he was holding.

As you can see in the above ISRG example, there is a long stretch between Box B and Box C with no boxes being formed. This could be a real problem for many traders who would prefer to identify new support levels for a sell point as the stock climbs.

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Also, why did Darvas decide to make four days the minimum for establishing a box? Why not five or six or just two?

The fact is, in some market environments, using six or seven days would be much more profitable in establishing boxes. In other environments, the two- or three-day rule is much more appropriate.

These specifics can be argued endlessly, but what is most important is to understand the *PURPOSE* of the Box Theory: identifying support and resistance levels.

Darvas' rules for establishing the Darvas Boxes made sure that he would be much less likely to sell a stock that was still moving up. He wanted to ride the trend for as long as he could.

Most novice traders have a tendency to sell a stock too quickly because they "don't want to be too greedy." Darvas himself ran into this problem and realized that he would often sell a stock for a small profit, only to watch the stock go on to establish huge gains that he missed out on. By defining support and resistance levels, he helped ensure that the stock itself would let him know if it was running out of momentum and breaking the upward trend.

Darvas knew he couldn't *predict* whether or not the stock was done moving up and ready to retreat, so he relied on his technical analysis to tell him what to do. Of course, even using the rules Darvas created, you will often sell a stock only to watch it go on to make further gains, but these rules drastically cut down on the number of instances you will see this occur.

The key with Darvas Boxes is not getting so enamored with what is actually identified as a strict Darvas Box to the point that you fail to understand the principles behind support, resistance, and following the trend.

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Don’t get so caught up in the specifics of how many days are required to establish a box. Nicolas Darvas himself didn’t.

Instead, just make sure you understand the concept of identifying new areas of support and resistance. Strict Darvas Boxes or Flat Bases aren’t always the best way to do this. There are a handful of other extremely powerful base patterns you should be aware of and a few specific base characteristics that will drastically increase your rate of success in technical analysis.

Further discussion on these patterns and characteristics can be found in the next chapter.

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Chapter 5:
Beyond the Boxes, Part I:
Identifying Sound Bases

It's very important that you understand the *concept* of Darvas' famous "Boxes." That is, you need to be able to identify points of support and resistance in a stock's price range.

Once you understand how to do so, you'll be able to recognize what a *sound* base is. And once you're able to recognize a sound base, you will know how to buy and sell at the best time possible – making your trades extremely profitable. The purpose of this chapter is to help you do just that.

As pointed out in the previous chapter, the point of recognizing support and resistance levels is to identify buy and sell points in a trade. If a stock breaks through a resistance level, it's time to buy that stock. Conversely, if a stock breaks below a support level, it's time to sell. When a stock shows a clear resistance point and support point, a base has been formed.

When a stock breaks out of a sound base, Darvas System traders know it's time to buy. When a stock pulls back and falls through the bottom of a base, it's time to get out of the stock because more often than not, it's done advancing for the near future.

What do these bases look like and what characteristics does a *SOUND* base have?

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Recognizing *Sound* Bases

First and foremost, Darvas System traders are only interested in bases which are forming on an already advancing stock. We're looking for stocks that have already climbed a great deal and are now forming their bases near new price highs. Often times, this means that a stock is forming a new base after it has already climbed 100% or more during the past year.

Another factor to consider is the time it takes for a base to form. Numerous extensive studies have confirmed that the most reliable bases to make an *initial* buy from take – *AT THE VERY LEAST* – four weeks to form and most take longer. Short bases formed in only a week or two have a much higher failure rate, especially when making an *initial* purchase.

There are times, such as during an extremely exuberant bull market like the one in 1999, when the market environment may dictate an exception to this rule. However, these environments are very, *very* rare.

As a rule, you should only pay attention to bases that have formed over the course of at least four weeks.

Volume also tells us a lot about a base. A sound base will see volume dry up while it's forming. This tells us that there are fewer and fewer sellers to be found.

It's also extremely important to remember that you should *ONLY* buy a stock breaking out of its base if the volume is much higher than normal on the day of the breakout (*at least* 50% above its average level, but preferably 100% or more above its average level).

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There are five, and only five, sound base patterns that you need to be aware of.

Flat Base

Sound bases can take a few different shapes. They don't have to actually look like a box or rectangle. However, Darvas Boxes, in general, identify the very solid base pattern known as the Flat Base. These Flat Bases do, in fact, look similar to a box or rectangle.

The Flat Base, like all sound bases, is formed after an uptrend. The stock then trades back and forth within a fairly tight trading range over several weeks. Usually, the support and resistance levels of this tight base will not be further than 10-15% apart.

Here's an example of a Flat Base:



Notice how the stock was moving up and then it built its tight base between $66 (support level) and $70 (resistance level). As soon as the stock breaks through its resistance level at $70, we see that it's off to the races.

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Bull Flag

A variation of the Flat Base is the extremely powerful base known as the Bull Flag. A study of Darvas' actual trades shows that Bull Flags were definitely his pattern of choice.

A Bull Flag occurs after a stock has advanced extremely fast – often doubling in a month or two. The stock then forms a new Flat Base that is normally rather short. When the stock breaks through this Bull Flag base, it usually picks up right where it left off, once again taking off for a rapid advance.

Here's an example:



As you can see, the ideal time to buy would be when the stock hits new highs as it crosses the top blue line. The Bull Flag is probably the most powerful base pattern. This is where huge, fast gains can often come from. It's no wonder why this was one of Nicolas Darvas' most coveted patterns.

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Rounded Base

Some base patterns don't actually form a box or rectangle-shaped pattern of price movement. In fact, bases that form a rounded bottom are often some of the most powerful you will find.

This rounded look forms when the sellers dry up and the buyers start coming back into the stock. Like all sound bases, you want to see volume decrease, for the most part, as this pattern forms.

Here's an example of a Rounded Base:



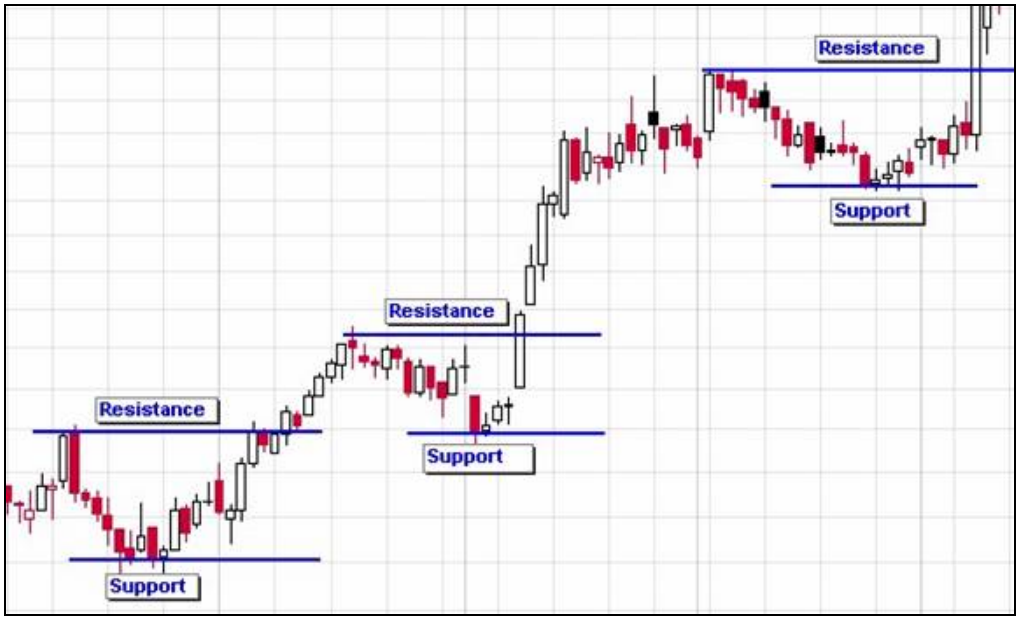
As noted in the chart, you'd buy as the stock hits new highs breaking out of the base – right as it penetrates the top blue line.

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In the following example, we see a series of several Rounded Bases as this stock climbs, giving us several buying opportunities if we missed a previous buy point:



The support and resistance levels would be identified as follows:



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Cup With Handle Base

A Cup With Handle Base was brought to national attention by the Darvas-influenced founder of *Investors Business Daily*, William O'Neil. This extremely powerful base pattern is a variation of the Rounded Base. Instead of rounding out and then climbing to new highs without much of a pullback, the stock hesitates just before it reaches new highs and sells off a bit, getting rid of a final few weak sellers and forming what looks like a "handle" on a cup (the "cup" being the normal Rounded Base).

This base pattern rarely forms in less than eight to 12 weeks and will sometimes take many months to form.

In the example below, please note that I am using a weekly chart and not a daily chart as used in our other examples:



As you can see, you would buy the stock as it cleared the top of its *HANDLE* in the Cup With Handle Base. This is a case where you wouldn't have to wait for new highs to buy the stock.

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Double Bottom Base

Our final sound base pattern is known as the Double Bottom Base. Unlike the Flat Base, this pattern forms when a sell-off occurs a bit more sharply. And unlike the Rounded Base, where a nice rounded bottom is formed before advancing, the stock starts to climb, but then pulls back once again to form a "W"-like base bottom.

The buy point on this pattern doesn't need to be at new highs. Instead, the buy point occurs when the stock climbs above the midpoint of the "W" in the pattern:



And of course, as with all base patterns, volume must increase a great deal on the day the stock breaks through its buy point.

Those are the five sound base patterns that you need to be able to recognize. Some technical analysts will rattle off hundreds of other patterns that you must know, but if you're looking for sound base patterns that have proven to be the most reliable precursors to huge winners, these are the only five patterns you need to master.

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A Reminder

Make sure you understand that in our *initial* search for solid bases, we're looking for buy points as a stock breaks through a resistance level. However, it's just as important to *continue* to recognize bases formed on the stocks you're holding so that you can sell if the stock falls through a support level.

Identifying support levels is the subject of Chapter 7, but before we get into that, let's look at how we identify *market* trends.

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Chapter 6:
Identifying Market Trends

The market must be in an uptrend before you should enter a position, but how do you know when the market is in an uptrend?

The best way I know is to look at a market chart and evaluate the market in terms of Stan Weinstein's market stage analysis, as he described in his excellent book *Secrets for Profiting in Bull and Bear Markets*.

Stage analysis is very simple.

When the market is in Stage 1, it's coming off a clear downtrend and it flattening out.

In Stage 2, the market is clearly heading higher.

In Stage 3, the market is flattening out after a considerable uptrend.

And in Stage 4, the market is in a clear downtrend.

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Here's an example of market stages on a weekly chart of the S&P 500:



In looking at the above example, two factors may jump out at you.

1) Stage 4s can happen extremely fast.

2) It can be rather difficult to identify a Stage 1 or Stage 3. After all, a Stage 1 could easily be a quick flattening out zone before Stage 4 continues. On the other hand, a Stage 3 could easily be a flattening out zone before Stage 2 continues.

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The most important thing to remember is that *you should never buy stocks during a Stage 4 market*. In the example above, the Stage 4 was over and done with quickly, but that is rarely the case. Often times, a Stage 4 can last several months.

My suggestion is to trade cautiously in a Stage 1 or Stage 3, perhaps taking positions half the size that you normally would. Then, when the market is in a *clear* Stage 2, take full positions.

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Chapter 7:
Beyond the Boxes, Part II:
Identifying New Support Levels

Knowing when to sell is perhaps the most difficult skill to master in trading. When we exit a trade, two bad things can happen.

1- *We can sell too early* and miss out on a lot of profit. For example, if we sell a stock for a 10% gain, we may *initially* be satisfied with the result. But if that stock goes on to make a 100% gain over the subsequent few months, we will be anything but satisfied. We will have left 90% of our profit on the table!

2- *We can sell too late* and give back a lot of our profit. For example, if a stock goes up 100% for us in a very short period of time, we may be thrilled. But if that stock suddenly takes a 25% dive on us and we sell with a 50% gain, we will be anything but thrilled. We will have left 50% of our profit on the table!

In looking at the two bad things that can happen when we sell a stock, one thing all successful Darvas traders recognize is that it's better to hold too long than to sell too quickly (unless a stock falls on us from the start, in which case you should *ALWAYS* sell your stock at a predetermined stop-loss below your purchase price – more on this in Chapter 9).

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In the above hypothetical trade, a 50% gain is obviously better than a 10% gain. However, that doesn't mean we would be happy with letting a 100% gain turn into a 50% gain. Our goal is to sell a stock before we give back too much of our profits while also making sure that we don't sell too quickly and miss out on future profits.

Here's where I'm going to save you some unneeded heartache: *You're NEVER going to sell right at the top*.

Get rid of the idea that selling a stock that has fallen from its top is somehow a bad thing. Amateur traders stress about this. They can't get over that extra 10% they could have cashed in. Professional traders recognize that doing so is simply part of the game and catching the bulk of a trend.

In most cases, using the Darvas Trading System, you're going to sell a good 10% below the top of a major price move.

But don't stress about this.

The goal is not to cash out at the very top of a stock's run. If that is your goal (as it is for most amateurs), you'll find yourself holding on to a stock for too long as you wait for it to "rebound" back to its previous highs. This is a losing battle.

Our goal is to sell a stock before we give back too much of our profits while making sure that we don't sell too quickly and miss out on future profits. I don't have a problem giving back 10% for a 90% profit, but I *do* have a problem with giving back 50% for a 50% profit.

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The Best Time to Sell

To accomplish our goal, the best rule I know of is to sell a stock when it falls below a previous support level.

So how do we identify new support levels?

As discussed previously, many have misunderstood the Darvas System and rely way too much on the number of days the stock behaves the way it does to identify support and resistance levels.

This is a mistake. I've seen way too many stocks establish a three- or four-day low, start to move higher for a few days, fall back below their four-day low, and then take off rapidly.

There is a much better way to establish reliable support levels.

Support levels are not complicated. We simply want to identify the point at which a stock is unlikely to fall further unless a trend is breaking. Therefore, it's important to give our stocks the breathing room they need to establish *dependable* support levels.

I have found that the best way to do this is to allow a stock to hit new highs *before* identifying new support levels.

Look at any stock chart and you will see that rarely does a stock shoot straight up for any considerable amount of time. Instead, a stock that rises 50% or more will often experience minor dips along the way. These dips are support levels. Each time a stock dips and then establishes a new high, the bottom of that dip becomes the new support level.

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This raises a logical question: what constitutes a “dip?”

The answer isn’t exactly black and white and varies for each stock based on the stock’s normal movement.

However, a good rule of thumb is that if a stock dips 7% or more from its high and then turns around and hits a *new* high, that low point of the dip will be your new support level.

For example, let’s say we buy a stock at $50.00 and it climbs to $57.00 before it starts to pull back. The stock spends a week or so trading near $55.00. This means nothing to us because the $55.00 point is a perfectly safe trading range. However, let’s say that the stock then falls to $52.75. At this point, we are alert and watching the stock closely because it has fallen below $53.01, which is 7% below our high of $57.00.

We’re now waiting to see what our stock does next. We don’t want to set a new stop until *after* it reaches a new high. Sure enough, the stock soon rushes past the $57.00 mark and we now set a new sell-stop at the low point of the dip, the support level we saw established at $52.75.

And that’s all there is too it.

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Support Levels in Action

Let's take a look at a real world example. Remember the chart of ICE from November/December 2006 that we looked at in Chapter 4? Well, here is a bigger picture of that chart, this time stretching from October 2006 to March 2007.

In the chart below, I have marked each of the support levels established (red lines) until we were stopped out (red arrow):



As you can see, the result of this trade was a 58% profit in three and a half months. Notice how new support levels were established. Every time the stock dipped 7% or more and then hit new highs, we set new sell stops at the low point of the dip between new highs. It's really not at all complicated.

And remember, once new highs have been hit and you've established new support levels, all you do is raise your sell-stop to those new support levels. If your stock ever falls through your support level, you automatically sell out of your position.

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Why 7%?

In establishing new support levels, is there something special about a 7% drop as opposed to, say, a 5% drop?

Not necessarily.

However, it has been my experience as a trader that most of the Darvas stocks we trade tend to be more volatile than most other stocks. These are high-growth stocks that are receiving a lot of heat (or Wall Street attention) and are therefore moving rapidly. A 4% or 5% drop may mean something significant to your typical Dow Jones Industrial Average heavyweight, but for a Darvas stock, it's not uncommon to see such swings in a single day.

The 7% mark is simply a pretty reliable rule of thumb for setting new support levels. A 10% drop, even for highly-volatile Darvas stocks, is usually a fairly significant move and waiting for such a big move to establish a support level is simply too high of a percentage.

Because 5% is usually not quite significant enough for our typical Darvas stocks and 10% is too extreme, 7% becomes our magic number. Something in between a drastic price movement and a normal price movement.

An Important Note

Allow me to clarify something here.

Identifying support levels and selling when a stock breaks a support level is the best rule I know of for selling a stock that is making a profit for us. However, it is not the *ONLY* rule you should follow.

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There are times, for instance, when you'll want to use price targets to exit a trade with at least a portion of your investment.

There are times when extreme price action occurs with your stock (or the general market) that tells us to head for the exits immediately, even if our stock hasn't slashed a support level.

We'll discuss all of our selling rules in Chapter 9.

The most important thing to remember on stops is this: once you've made your decision to sell at a certain point, whether the bottom of a base, a moving average line, or a percentage-based trailing stop, *make sure you stick to this stop and get out when your stock hits the stop*. Don't over-think and over-analyze it while you hope it turns around and goes higher.

It's emotionally difficult to sell a stock because we're always hoping for higher highs. Having the discipline to stick to your sell rules is what separates the rich traders from the poor traders.

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Chapter 8:
The 7 Rules of Buying

Now that you have a firm understanding of how to identify sound bases and new support levels, it's time to put the Darvas Trading System into action. To do this, all you need to do is follow the simple buying and selling rules.

Buying Rule No. 1: Only buy stocks that meet *ALL* the criteria of the D.A.R.V.A.S. System.

To review the most important factors:

- Make sure the market is in a Stage 2 uptrend. Looking at a long-term chart of the market will tell you whether we're currently in an uptrend or downtrend.

- With rare exceptions, only consider stocks with at least 40% increases in earnings *and* sales in the most recent quarter compared to the same quarter the previous year.

- Make sure the stock has already doubled during the past 52 weeks. This tells us that this stock has the ability to really move when it wants to.

- Focus on stocks with a Return on Equity of 17% or more.

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- Make sure the stock is in a strong industry group. When preparing to buy a stock, you want to see several other stocks in the same industry group or sector performing well. If the stock appears to be the only one in a group that is performing well, it should be avoided.

- Make sure the stock is coming out of one of the five sound base patterns detailed in Chapter 5.

Buying Rule No. 2: Buy right as the stock breaks out of a sound base, as close to the predetermined buy point as possible.

If the buy point is $50.00, you want to buy as soon as the stock hits $50.10 (assuming the volume is there, see Buying Rule No. 3).

You should rarely chase a stock that is more than 5% higher than its buy point. If that occurs, you missed the move and will have to wait for a new base or new buy point to be identified. Therefore, as a rule of thumb, if the buy point is $50.00, the most we'd pay for the stock is $52.50 (5% above $50.00).

The exception to this "never chase a stock 5% above the buy point" rule is when the stock has shot up in an explosive gap-up. That is, if the stock opened the trading day much higher than its closing price from the previous day.

An explosive gap-up breakout is often a sign of tremendous strength and therefore warrants a purchase even if it means getting in more than 5% above your previously determined buy point.

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When a stock jumps too far past its buy point, you may also want to take a wait-and-see approach and buy into a stock if it falls *back* into your buying range. While this is riskier because it means we're buying a stock that is falling and therefore could be losing its momentum, there are times when a stock breaks out, runs up 10% or so, cools off by falling back into our 5% buying range, and then takes off to higher highs.

I recommend watching how other stocks are behaving in current market conditions before attempting this "pull back" buying method. If you see a few other stocks act this way first, you'll know it's safer to attempt buying on a pull back.

Buying Rule No. 3: Make sure that volume is well above average on the day the stock is breaking past its buy point.

Only consider a purchase if the volume is *at least* 50% higher than its 50-day average daily volume. If the volume isn't there, avoid it. This rule will greatly increase your success rate.

Remember that it takes massive volume to make big moves. I can't tell you how often people disregard this rule and buy a stock that hits its buy point without strong volume only to watch the stock fall 10-20% in the next week or two.

Volume must be watched closely when a stock breaks out of its base.

Often times, a stock will experience a huge rush of volume, equal to or much greater than its average daily volume, as soon as the market opens. At this time, we can obviously assume that volume will be much higher than normal for the day as a whole.

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However, it can sometimes be difficult to gauge the day's expected volume when the early volume is not so dramatic. If a breakout occurs before we've seen a lot of volume, compared to the stock's average daily volume, then you may want to avoid the stock until you see a surge of volume come in.

Or, perhaps you may want to buy a small position and then add to the position if and when high volume does pour in. If, by the end of the trading session, the volume did *not* reach our required minimum of 50% or more above its 50-day average, then you should sell the small position you took.

You might ask, what happens when a stock breaks out of its base, but the volume doesn't meet our requirements, do we remove it from our watchlist? The answer depends.

If the stock hits the buy point without the required volume and keeps going higher and higher, then go ahead and forget about it until it forms a new sound base. As per Buying Rule No. 2, you don't want to chase a stock.

On the other hand, if the stock hits the buy point without the required volume and then promptly falls *back* into its original base, then you should keep a close eye on it. If a couple days later it again breaks out and this time has the required volume, go ahead and buy it.

In this situation, it's normally a good idea to make sure the stock actually hits new highs before buying. For example, if the original buy point was $50.00 and the stock tried to break out with weak volume and climbed as high as $50.75 before declining, then the *new* buy point would be $51.00.

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Buying Rule No. 4: Focus on stocks at or very close to new highs.

When a stock hits a new 52-week high, the sky is the limit. There is no resistance level above it, which means the stock is free to take off. You want to make sure most of your buys points are at a point where the stock hits a new 52-week high.

The only exception is when the stock is coming out of a sound Cup With Handle Base or Double Bottom Base. With these two patterns, the buy point may not quite be at a new high, but is very close to one.

Buying Rule No. 5: Don't risk too much on an initial buy. (aka "The 2% Rule")

When you're making your initial buy, make sure to limit your "worst case scenario" loss to no more than 2% of your trading account.

Your "worst case scenario" loss is the amount you would lose if the stock's breakout fails and you get stopped out (we'll be discussing initial stops and trailing stops in the next chapter).

For example, let's say you have $100,000 in your trading account. Following our 2% rule, you would not allow yourself to lose more than $2,000 on your initial buy. If your "worst case scenario" stop loss is placed $5 below your buy point, that means you would buy no more than 400 shares of this stock (400 shares multiplied by $5 equals $2,000).

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This 2% keeps you out of trouble even if you hit a major losing streak because each subsequent loss will be less than the previous loss in total dollars (obviously, as your account shrinks, so would what 2% of the account represents). All traders will hit losing streaks from time to time and staying alive is the name of the game for professional traders.

Buying Rule No. 6: Learn to pyramid your buys.

You're probably going to see 50% or more of all the trades you make with this system end with a small loss like that discussed in Buying Rule No. 5. What makes this system so successful is that you cut your losses quick and let you winners ride on huge trends. Therefore, "pyramiding" your buys is a very smart way to enter a position.

This means that you should purchase your initial position right as the stock hits its buy point and then add *smaller* amounts to the position as it climbs above the buy point.

There is no set-in-stone rule as far as exactly *when* to add to a position. A good rule of thumb is to add as the stock crosses potential resistance points, such as a nearby round dollar amount (like $50.00 or $55.00).

Another good rule is to wait a few days, watch how the stock is acting, and if it's holding above your buy point, go ahead and add to your position.

Yet another good time to add is when the stock breaks through new resistance points that it establishes with new Sound Bases or simply new highs after establishing a higher support level.

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There *IS* one set-in-stone rule regarding how *much* you should add to your pyramiding position. That rule is this: don't ever allow yourself to lose more than 2% should your stock drop and hit your trailing stop. This means that you can never add to a trade without first raising your trailing stop to the point that it will keep our 2% rule intact.

Winning trades turn into losing trades all the time. It's part of the game. A stock will take off and everything will look great before suddenly, the stock reverses and stops you out.

When you're pyramiding, you're adding to a winning trade. But with each additional dollar you invest in the trade, you're risking more of your account's capital. To make sure that you don't get into serious trouble or have too much capital in one stock, simply raise your trailing stops before pyramiding.

You should then *never* add so much capital to one trade that it would result in a loss of more than 2% of your account should the trade reverse and hit your trailing stop.

Of course, the higher your stock rises, the more money you can invest without worrying about losing 2% of your account on the trade.

In these cases, is there a limit to how much you should have invested in any one trade?

This varies with each trader's tolerance for risk. Some traders will risk as much as 50% of their trading account on one stock. This is extremely risky, of course, because there are times when the unthinkable happens and extremely bad news forces a stock to gap down, well below your trailing stops.

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For this reason, I think a good rule is to never allow one single trade account for more than 25% of your trading account.

Which brings us to the final Darvas System buying rule…

Buying Rule No. 7: Focus your buys to a small selection of stocks.

Darvas traders should always focus on a small number of stocks.

In most circumstances, depending on the size of your trading account, you'll only want to be holding four to 10 stocks at any given time. The more money you have in your trading account, the more stocks you should allow yourself to trade. The reason for this expansion is that the more money you have invested in any single stock, the more difficult it becomes to get out of the stock quickly and at the price you desire.

The following is a good basic rule for how many stocks you should be holding:

- If your trading account is less than $20,000, allow for a total of four positions.

- If your trading account is between $20,000 and $100,000, allow for a total of five positions.

- If your trading account is between $100,000 and $200,000, allow for a total of six positions.

- If your trading account is between $200,000 and $500,000, allow for a total of seven positions.

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- If your trading account is between $500,000 and $2 million, allow for a total of eight positions.

- If your trading account is $2 million or more, take a total of 10 positions.

These figures are intended for your "total" trading account. So, if you have $20,000 in an account, but you decide to use 100% margin, your "total" trading account is obviously $40,000. If you decide to use 50% margin, your "total" trading account would equal $30,000, etc.

(*PLEASE NOTE*: You should *NEVER* go on margin until you've gained a great deal of trading experience. I tell traders they should prove they can double their trading account without using margin before even considering the use of margin.)

An important thing to remember when managing your money and the number of positions you have is that you need to know the total *potential* dollar amount you're working with before deciding how many stocks you're buying.

Obviously, you will rarely buy all four or five (or whatever number) of your positions at the same time, so you have to know in advance how much you will be allocating to each trade. If you've got a $30,000 "total" trading account, you'll be taking five positions *at the most* and that means that you should allow for each position to end up costing you no more than $6,000.

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Chapter 9:
The 7 Rules of Selling

Knowing when to sell, I believe, is the hardest part of trading. To make better sell decisions, you need to take the emotions out of it. You need to rely on strict rules.

Following the seven rules in this chapter will make your sell decisions for you.

This is a point worth repeating: *You have to follow your rules*!

Don't let your ego get in the way. Don't let fear and greed and other instinctual emotions mess with your decisions. Your number one priority is to protect the money you already have and you don't want to ride a loser lower and lower. You also don't want to watch a big winner turn into a small winner or even…a loser.

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Selling Rule No. 1: Always sell your entire position if the stock falls below a *predetermined* amount from your initial buy point.

Don't feel bad about "losing" on a trade. I'm going to save you the suspense and let you know that you will probably "lose" on at least half of your trades following this system. But, the key here is that if you follow the Darvas System's rules and cut your losses as advised in this book, you will make a lot more on your "wins" than you will lose on your "losses."

And that – in a nutshell – is what makes any trend trading system so profitable. *Especially* the Darvas System.

Before you purchase a stock, you need to set your "worst case scenario" stop-loss. This is the price that you will sell at if your stock doesn't rise as you hope and instead fails its breakout attempt.

This can be a tricky situation because some stocks can break out, fall below the breakout point, and then turn around and take off on a huge run. If you give too little room for the stock to pull back, you could be stopped out prematurely and miss out on a hugely successful trade.

However, if you allow too much room for the stock to fall, you could take a much larger loss than you should have on a stock that fails its breakout and never succeeds.

So how much room should you give your stock on a breakout attempt?

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Many traders recommend a certain percentage. Nicolas Darvas himself advised setting an initial stop-loss 10% under the buy point. William O'Neil advises traders to use an 8% stop loss (he advised 7% for many years, but increased it to 8% more recently). A lot of very successful traders advise using a simple 5% stop-loss.

And still, other professionals use a dollar amount for a stop-loss. The Darvas-influenced multimillionaire trader Dan Zanger recommends selling if a stock ever falls $1 below your buy point – a little more if it's an expensive stock, but never more than $2 below your buy point.

I feel setting an initial stop based on a certain percentage or dollar amount is a bit arbitrary because each stock behaves differently. For some stocks, $3 swings are quite natural, as are 5% falls followed by 10% bursts. (Please note that we're talking about *initial* stop-losses here and not trailing stops that are added at points of support during a stocks upward trend. In other words, don't confuse this with the 7% rule for establishing new support levels that we talked about in Chapter 7.)

Instead, I recommend that initial stops be determined in a more logical fashion. I base stops on the actual base the stock has already formed.

I simply place initial stops halfway between the top of the base (the resistance level, which is also the target buy point) and the bottom of the base (the support level).

For instance, if a stock forms a Darvas Box/Flat Base where the top is $50.00 and the bottom is $45.00, I place my initial stop-loss right in the middle, at $47.50.

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The exact spot you allow a stock to fall can sometimes change depending on your particular risk assessment or even the current conditions of the market. But regardless of the method you use to set an initial stop, here's the key: as soon as you buy the stock, *decide where the exact stop- loss will be placed and stick with it!*

Whatever you do, don't initially plan on getting out after a 5% loss and then decide that you're going to change it to 10% because you have a "feeling" this stock will turn. Decide initially what your stop will be and *don't change it!*

Selling Rule No. 2: As a stock rises, learn to identify new points of support.

Review Chapter 8 and make sure you know how to identify new support levels. If these support levels are ever broken, it's time to sell. This is the most successful way I know of to sell and keep your profits.

Selling Rule No. 3: Take some of your profits at a price target.

As traders, we're all looking for that homerun, but a lot of doubles can go a long way as well.

When you buy into a stock, plan on cashing in 20-25% (perhaps even 50%, if you choose) of your position when the stock reaches a predetermined price target.

There's nothing like ringing the register by cashing in on profits and by limiting the portion you cash in, you still allow yourself to benefit big if the trade does in fact become a homerun.

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How do you set your price target? Take the price range of the base, add it to your buy point, and then cash out when it gets there.

For example, let's say you have a base with a $50 top and a $40 bottom. That's a $10 base. Add that $10 range to the $50 top and you've got a price target of $60.

The nice thing about this method is that if you use the base midpoint as your initial stop loss (as discussed in Selling Rule No. 1), you basically enter every trade with a 2-to-1 profit-to-loss expectation. You would have to have twice as many losing trades as winning trades to *NOT* make money in the long run. Winning 50% of your trades, on the other hand, would obviously make you an extremely successful trader.

[Side Note: If you've pyramided into your position prior to this price target being reached, I advise cashing in 20-25% of your *total* position at that point.]

Selling Rule No. 4: Sell at least some of your position prior to an earnings announcement.

Holding a full position during an earnings announcement is way too risky. If the news is bad, the stock can gap down 10%, 20%, even 30% or more. There's nothing worse than waking up in the morning, checking on your positions, and seeing that you've been stopped out 20% *below* your stop-loss. This is simply too much risk to take on.

For this reason, you must always be aware of when your company will be announcing earnings and you should sell half your position before the announcement.

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If the news is good and the stock jumps higher on the announcement, you can buy back into a full position immediately. Sure, you'll miss some of the gain this way, but a stock is more than likely to continue higher after good news.

Remember this: you can always buy the stock back and ride the new move if the news is good, but you can't get back the money you lost if the news is disappointing.

If a stock doesn't move excessively one way or the other after an earnings announcement, I recommend buying back into a full position assuming the stock still meets all our D.A.R.V.A.S. criteria, including having at least 40% increases in earnings *and* sales in the most recent quarter compared to the same quarter last year.

Selling Rule No. 5: If a stock falls below the 50-day moving average and stays there for 1-2 weeks or more, it's time to sell.

The 50-day moving average is a line you must pay close attention to. When a stock starts trading below this line, it almost always signals the end of a run.

Sometimes, a stock will briefly fall below this line and bounce back quickly as traders and funds come into buy what they believe is a bargain. For this reason, we don't want to blindly sell if our stock touches the 50-day line. Instead, give your stock a week or even two to try and climb out of it. If the stock stays below the 50-day line for more than a week or two, go ahead and sell.

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[*Side Note*: Why does the 50-day line hold any greater significance than, say, the 40-day line or 55-day line? The only significance is that fund managers decided long ago that 50-day lines mattered. They made a habit of letting some stocks pull back to the 50-day line before adding to their positions, which would then create a "bouncing" effect when you looked at a stock chart in relation to the 50-day line. If a stock falls below the 50-day line without any kind of bounce, then it's usually a sign the big institutional funds are losing interest in the stock.]

Selling Rule No. 6: If a stock declines on *VERY* high volume, it's time to sell.

Volume tells us so much about a stock's strength or weakness. When a stock climbs on very high volume, it tells us that a lot of buyers are coming in. Conversely, if a stock falls on heavy volume, it tells us that a lot of sellers are dumping their positions.

If you see three or more days of high-volume price declines without any high-volume price increases in-between, it's time to sell your stock.

And by "high volume" I mean at least 25% above the 50-day average volume or volume that is much, much higher than the previous day's volume.

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Selling Rule No. 7: If a stock becomes sluggish and you see a better opportunity, sell Stock A to buy Stock B.

A stock has become "sluggish" if it hasn't made new highs for the past 10 days. Now this can usually be very normal behavior as a stock rests up and gets ready for another run. However, if your portfolio is full and you see another stock with better earnings and sales breaking out of sound base, go ahead and sell the "sluggish" stock to make room in your portfolio for the new breakout.

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Chapter 10:
The 7 Most Common Mistakes Traders Make

This is the *MOST IMPORTANT* chapter in this book. If you take nothing else away from this book, please, *PLEASE* make sure you're aware of the seven most common mistakes traders make.

Making these errors can bankrupt a trading account faster than anything I know.

Mistake No. 1: Not having rules.

The first and most common error wannabe traders make is not having set-in-stone rules, not having a system to follow. Too many traders think they can "get a feel" for their stocks and rely on their gut instincts to make trading decisions. This is a fatal mistake.

Make sure that you have a system to follow. Needless to say, the Darvas Trading System is the best trading system I know of.

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Mistake No. 2: Not *following* your rules.

Want to know what really separates the successful traders from the bankrupt traders? It's not how many hours they put in. It's not the software programs they have. It's not how many college degrees they have. It comes down to one thing: discipline.

It's one thing to have a proven system, a set of rules that you *say* you're going to follow no matter what, and quite another to *actually* follow those rules.

Letting your emotions get involved will ruin any trading strategy and it destroys 99% of all wannabe traders.

Amateur traders are often tempted to "do something" even though the Darvas System says to hold tight – after all, this seems too easy and surely a great trader must work extremely hard at what he does and must always stay active in the market. These traders are gamblers, chasing the excitement and action of the trade instead of following a proven system.

Darvas taught us that once you have a system that works, stick with it and don't second-guess it. He told us it was always better to have set rules to follow than to rely on intuition or instincts when trading. The money involved clouds our judgment and making strategy adjustments on the fly will cost you a lot of money.

To be a successful trader, you've got to be disciplined and you've got to follow your rules with *NO* exceptions. Don't start second-guessing your rules. Find a system you believe in and follow it.

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Mistake No. 3: Taking too much risk with margin.

Some traders get into options, futures, and the Forex market where you're able to get ridiculously high leverage of 10 times the cash in your account and higher! If you don't know what you're doing in these markets, it's an easy way to land in the poorhouse quickly.

Obviously, with the Darvas Trading System, we're only trading stocks so the most margin we can typically get is 100% (two times the cash in your account). However, borrowing this much money can get you into trouble fast if you're not extremely careful.

Yes, leverage can be an excellent tool to increase wealth. Obviously, if we're fully margined on a stock that goes up 20%, our gain is actually 40%. But on that same note, if our position goes down 10%, we lose 20%. It doesn't take too many 20% losses to wipe you out.

I stated it previously and I'll state it again: If you're a beginning trader, *stay away from margin*! It can wipe you out very fast. Prove you can trade without margin before trying to use margin. I recommend to all traders that they should at least double their account *without* margin before attempting to use it.

And always remember, if you do decide to use margin, you don't always have to be 100% margined to the max. I personally don't like to use more than 50% margin, meaning that if I have $100,000 of my cash in an account, I'll only borrow $50,000 on margin for a total trading account of $150,000.

Regardless of if you use margin and how much of it you decide to use, make sure you *always* follow the 2% rule I showed you in Chapter 8.

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Mistake No. 4: Not cutting your losses quickly.

Most people are tempted to hold their stock just a little while longer, even though the Darvas System says to sell it. They don't want to "lose" or "be wrong" on a trade, so they hold a falling stock, hoping that it will turn around.

Or worse yet, they add to their position with the hopes that when it turns, they'll make back their money faster. This is a terrible strategy and it whittles away at the overwhelming majority of people's trading accounts.

You've got to remember that we don't care about "winning" or "losing" on one single trade. In fact, we fully expect to "lose" on 50% of our trades or more. Our only concern is making sure that our "losses" are very small and our "wins" are very large. It's that simple.

Cut your losses and never second-guess your initial stop-loss.

Mistake No. 5: Not having the courage to hit the sidelines in a bad market environment.

You've got to trust the Darvas Trading System and that means hitting the sidelines and waiting when the market is in a downtrend. This is very hard to do for many people. The result is that they do very well in a bull market, but then give it all back – and more! – in a bear market.

So many hopeful traders think they have to be active everyday, that even with 90% of all stocks falling, there must be a few out there they *could* be making money on. This thinking is a recipe for disaster. The odds of hitting a winner in a bad market are way too long and if you are lucky enough to catch one, it's highly likely that it will quickly turn into a loser.

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There is a way to make good money in bad markets by going short with a Darvas-based strategy. But that's a more advanced topic and we're not going to discuss it in this book.

For now, simply master the Darvas Trading System as it's laid out in this book and have the courage and discipline to get out of the market when things look ugly.

Remember that some of the most successful traders in the world refuse to mess with going short because it's simply not worth the effort. They use a bad market to go on vacation and recharge their batteries.

It takes a lot of discipline (there's that word again) to wait out the storm in a bad market. The good news is that history has taught us that the market is in bull mode much more often than it is in bear mode.

Mistake No. 6: Disregarding volume.

You must follow the volume requirements laid out in this book.

Reading a stock's volume is the key to reading a stock's strength. Too many technical traders only pay attention to price movements and this is a fatal error.

Volume will tell you everything you need to know about the strength of your stock and by following the rules in this book – especially those dealing with volume – you'll greatly increase your potential for success.

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Mistake No. 7: Relying on unproven chart patterns.

Traders often make the mistake of relying on dozens of different chart patterns that have never been proven to work. As this book has shown, it is extremely important that a trader be able to identify *sound* technical chart patterns, but the five in this book (Chapter 5) are the only five you need to know.

Think about this for a moment; you could look at any stock chart from any moment in history and identify *some* kind of supposed pattern that the stock has made. However, does this mean that the pattern tells us anything reliable about future expectations for the stock? Of course not.

There's no sense in trying to learn 50 different inconsistent chart patterns when there are only five that are necessary to make real money with our trades.

I think a lot of traders obsess about finding new patterns because they're looking for a false sense of security when entering a trade. They can "blame the pattern" if the trade doesn't work out for them. Don't fall into this trap.

Stick with the five *reliable* base patterns you really need to know. Study them and become a master at identifying them. Disregard all the rest.

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Chapter 11:
Vital Resources

The purpose of this final chapter is to give you all the resources you need to fully implement the Darvas Trading System. Here, I'll be showing you exactly how to screen for Darvas Stocks and where you need to go to find the charts for evaluating Darvas stocks.

I'll also offer you a few must-read books that you would be wise to study regularly. Darvas himself never stopped learning.

First and Foremost

Make it a habit to visit ***DarvasTrader.com***. Visit every day and sign up for the newsletter. It's all FREE!

I run ***DarvasTrader.com*** and comment several times a week on actual trades, the latest updates on the Darvas System, and any number of other things dealing with the world of trading. I also love interacting with a community of like-minded traders.

So before you do anything else, check out ***DarvasTrader.com*** and bookmark it now.

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How to Screen for Darvas Stocks

To begin your search for Darvas stocks, you'll want to screen for the fundamentals discussed in this book.

I've never understood traders who do this backwards – they go through the charts first and if they see a chart they like, they *then* check out the fundamentals. This seems like a complete waste of time to me. It means going through hundreds of charts each day even though you know fully well you won't buy a stock if the fundamental requirements aren't there.

Instead, I screen for the fundamentals first and *then* go to the charts.

When you screen for the fundamentals, you'll find that the number of stocks that meet the Darvas System criteria will vary widely based on current economic conditions. This number can range anywhere from a few stocks in tough economic times to 30 stocks or more in great economic times.

Once I have these stocks, I can quickly run through their charts to see if they're forming a sound base. On average, in a good market, about 5-10 will either be currently held by me or working on a sound base.

Where do you find these stocks? The easiest place to go would be ***DarvasTrader.com***, where we're talking about the latest Darvas stocks every day.

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Another great resource is *Investors Business Daily*, the newspaper founded by the Darvas-influenced trader, William O'Neil. Grab a copy of the Monday edition, which showcases their IBD 100 and scan through all 100 while circling the stocks that meet your criteria. You can do the same thing throughout other editions of the newspaper as they typically showcase the hottest Darvas-type stocks.

You could also use an online stock screener that you're comfortable with. There are several free stock screeners available online from sites such as *Yahoo! Finance* and *MSN Money*.

As far as online screeners go, I personally prefer to screen for Darvas Stocks through *Investors.com*, the website for *Investors Business Daily*. The tool I use is called the Custom Screen Wizard. The only bummer about this stock screener is that it isn't free. It's a part of the Daily Graphs Complete Equity Research Package, which runs $112.00 per month as of this writing. I use it because it's what I've become most comfortable with over the years.

However, I'm not sure how necessary such an expensive screener is when you can easily scan *Investors Business Daily* or visit ***DarvasTrader.com*** to find the latest Darvas-type stocks. It's really a matter of personal preference.

When we begin a screen, we're looking for stocks that meet all the Darvas Trading System fundamental requirements that have been laid out for you in this book.

Let's take a look at the seven fundamental requirements.

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1. We want stocks that have earnings per share up at least 40% this quarter over the earnings per share for last year's same quarter. Make sure that you're not comparing consecutive quarters. For example, if you're using 2009's 3rd Quarter results, don't compare these with 2009's 2nd Quarter results. Instead, you'd want to compare them with 2008's 3rd Quarter results. We want 3rd Quarter 2009 earnings per share up at least 40% compared to 3rd Quarter 2008 earnings per share.

2. We want stocks that have sales per share up at least 40% this quarter over the sales per share for last year's same quarter.

3. We want the stock's relative strength to be in the top 15%. If you're using *Investors.com*, that means you only want stocks with a relative strength rating of 85 or better. Most online screeners have some sort of relative strength screen. If they don't, just make sure you stick with stocks that have already *doubled* in the last year and you'll be fine.

4. We want stocks with a Return On Equity of 17% or higher. As mentioned earlier in this book, funds love ROE and a high ROE is an investment bullseye almost as big as high earnings and sales.

5. We want the stock to be a member of a top industry group or sector. This means a top 50 industry group or a top 10 sector according to the *Investors.com* rankings of industry groups and sectors, which divides the stock universe into nearly 200 total industry groups and 33 sectors. In other words, we're looking for stocks that are in the top quarter or so of all industry groups or sectors.

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If your stock screener doesn't rank groups by performance, just make sure that you can find two or three other stocks within your stock's industry group that are also performing well, usually trading near new highs.

6. We want stocks that are priced at $15.00 or higher. Cheap stocks are way too volatile and are usually cheap for a good reason.

If you buy a stock at $2.00 and it falls $.50, you will have lost one-fourth of your investment! On the other hand, a $50.00 stock must fall $5.00 before you lose 10% of your investment.

The more expensive the stock, the better. Not only are more expensive stocks easier to deal with as far as price fluctuations go, but they are also the ones that have already shown the ability to move higher. I rarely touch a stock under $15.00 and prefer to deal only with stocks $50.00 or higher.

7. And finally, we want stocks that have average daily volume of at least 100,000 shares per day. Anything less than 100,000 shares per day and the stock is probably too volatile for what we're looking for.

And that's it for the fundamental screens. Now it's time to go to the charts.

Where to Do Your Chart Work

The chart service I use is free to all. It's *StockCharts.com* and all the charts included in this book and included on ***DarvasTrader.com*** are from that wonderful service.

When you're using their charts, there are a couple things you should be aware of.

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First, you can have their charts define the 50-day moving average line as well as the 50-day average *volume* line – two factors that are very important in the Darvas Trading System.

The 50-day moving average line is included in their default SharpCharts, but if you don't notice it, you can turn it on manually. Scroll down below your chart and under "Overlays" select "Simple Mov. Avg.". Under "Parameters" enter "50".

You can include the 50-day average *volume* line on your charts by scrolling down to "Indicators" and selecting "Volume." Under "Parameters," enter "50". You can then choose whether you want this indicator displayed above or below your chart.

Once you have the chart set up the way you want, you can click on "Annotate" right below the displayed chart. This will open up a new window for you where you can draw lines and bases, make notes, and add pretty much anything else you'd like included on your charts.

It's a good idea to get in the habit of drawing your bases on charts, noting your buy points, sell points, and support levels, and then printing off the charts to save for future reference. Keep them in a trade journal to look back on and study.

Implementing the System

Once you've gone through the fundamental screen and picked out the stocks currently trading in sound base patterns, you've got your watchlist. This most likely consists of just a handful of stocks.

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What you'll want to do with this watchlist is note the stock symbol, the stock's 50-day average volume, and the stock's buy point. Then, either manually check on your stocks a couple times a day or simply tell your broker (or set up an automatic trade command with your online brokerage account) to buy the stock if/when it hits your buy point and meets your volume requirement as determined by the rules outlined in this book.

Once you're holding a stock, set an automatic stop sell (either by telling your broker or setting it up yourself with your online brokerage account) to sell your stock if it ever hits your sell point. Sell points, of course, are determined by the rules outlined in this book.

And that's all there is to it. You can see now why this system takes just 15-30 minutes per day *AT THE MOST* to implement. Almost everything is automatic based on the rules in this book.

Recommended Reading

Darvas never stopped trying to learn more about the Wall Street game. You should learn by his example and continuously read new articles and books dealing with the world of trading.

Read ***DarvasTrader.com*** every day.

Investors Business Daily and/or its sister-site *Investors.com* is also essential reading for Darvas traders.

Below I've included a list of indispensable books to read:

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How I Made $2,000,000 in the Stock Market

by Nicolas Darvas

The Wall Street classic that gave traders their first glimpse of the Darvas System. You should read this book at least a dozen times. Not only does it explain the concept and general method behind the Darvas System, but it also takes the trader through the psychological battles we all face. You should read all of Darvas' books (if you can find them), but this one definitely tops the list. It is the bible of Darvas System trading.

How to Make Money in Stocks

by William J. O'Neil

The Darvas-influenced William O'Neil wrote this excellent momentum trading manual. You will be hard-pressed to find a Darvas System trader who hasn't also read this book at least a dozen times. Included in the book are excellent explanations on what to look for in growth stocks and how to properly read the charts for momentum trading success.

Reminiscences of a Stock Operator

by Edwin Lefevre

A timeless Wall Street classic, this book is basically the autobiography of the legendary momentum trader, Jesse Livermore. (Edwin Lefevre wrote the book after spending days interviewing Livermore about his career and his methods.) Just about every successful trader out there has a copy of this classic nearby at all times.

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The Battle for Investment Survival

by Gerald Loeb

Another Wall Street classic, this is the book that opened Darvas' eyes and set him on the path to creating the Darvas System. It's an excellent overall description of how the market works and why momentum trading is the best strategy to use. Darvas himself made a point to read this book every week to stay sharp on the lessons it taught.

Secrets for Profiting in Bull and Bear Markets

by Stan Weinstein

This book probably does the best job of explaining the central concepts of how momentum trading and technical analysis work in very simple language. Weinstein's explanations of stage analysis and market cycles is essential reading.

Market Wizards

by Jack D. Schwager

This book features interview after interview with some of the best traders out there, including Darvas-influenced successes David Ryan and William O'Neil. While many of the traders featured in this book have varying strategies, you can learn essential lessons from each and every one of them.

How Legendary Traders Made Millions

by John Boik

This book takes us through more than a century of Wall Street history while showcasing the great traders of each era, including Livermore, Loeb, Darvas, and O'Neil. When you read this book, you clearly see how momentum trading has always worked – through many different market environments – and continues to work today.

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A Final Word

I hope that this book will help you achieve trading success beyond your wildest dreams. Certainly it can be done and you should review Chapter 2 whenever you hit a losing streak and need a little kick-start of motivation.

My only request to you is that as you accomplish your goals and achieve your success, please remember to share with those around you. Find charities and good causes to contribute to. Inspire others by doing what you love and encouraging them to chase their dreams. Always put your family's needs first. Help those around you to learn from you and the lessons you've learned.

Nicolas Darvas could have squandered his millions and the world would never have known the difference. But instead, he chose to share his knowledge with all who care to seek it by writing several books on his trading methods and speaking at universities.

Just as we follow his trading system, I think we should also follow his example of sharing with those around us.

In conclusion, never forget these two rules:

1. Be disciplined and follow your trading system's rules.

2. Never trade with any money you can't afford to lose.

Thank you for reading this book and I wish you nothing but incredible success in your market (and life) pursuits. And don't forget to visit me and other Darvas traders from around the world at ***DarvasTrader.com***.

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