TSR TRADING GUIDES

THE RISK MANAGER

GALEN WOODS

The Risk Manager

TSR Trading Guides

Galen Woods

Contents

Notices & Disclaimers

First Edition, July 2015.

Published by Galen Woods (Singapore Business Registration No. 53269377M).

Contact Information

Galen Woods can be reached at:

- Website: http://www.tradingsetupsreview.com
- Email: galenwoods@tradingsetupsreview.com

Financial Disclaimer

Trading is risky. Please consult with your financial adviser before making any trading or investment decision.

The information contained within this book including e-mail transmissions, faxes, recorded voice messages, and any other associated content (hereinafter collectively referred to as “Information”) is provided for informational and educational purposes only. The Information should not be construed as investment/trading advice and is not meant to be a solicitation or recommendation to buy, sell, or hold any securities mentioned.

Neither Trading Setups Review nor Galen Woods (including all content contributors) is licensed by or registered with any regulating body that allows us to give financial and investment advice.

Trading Setups Review and Galen Woods makes no claim regarding past or future performance. While there is always a risk a loss when considering potential for profits. Losses connected with trading futures contracts or other leveraged instruments can be significant. Hence, you should consider if such trading is suitable for you in light of you financial circumstances bearing in mind that all speculative trading is risky and you should only speculate if you have sufficient risk capital.

Trading Setups Review and Galen Woods does not manage client assets in any way. Trading Setups Review is an educational service, not an advisory or stock recommendation service. All examples are provided for educational purposes.

You agree that Trading Setups Review, Galen Woods, its parent company, subsidiaries, affiliates, officers and employees, shall not be liable for any direct, indirect, incidental, special or consequential damages. All trades and investment decisions in your account are at your own risk. There is no guaranteed trading performance.

Members and readers agree to indemnify and hold Trading Setups Review, Galen Woods, subsidiaries, affiliates, officers and employees harmless from any claim or demand, including reasonable attorneys' fees, made by the member or any third party due to or arising out of a member's use of the service.

Company names, products, services and branding cited maybe trademarks or registered trademarks of their respective owners and the owners retain all legal rights. The use of trademarks or service marks of another is not a representation that the other is affiliated with, sponsors, is sponsored by, endorses, or is endorsed by Trading Setups Review or Galen Woods.

Trading is risky. Please consult with your financial adviser before making any trading or investment decision.

Affiliate Disclaimer

Trading Setups Review seeks to provide you with the best trading resources. As a result, we have included useful links in our articles.

Some of these links are affiliate links. It means that we might receive a commission from your purchases made through those links. But you do not pay more.

For transparency, you can view an up-to-date list of our affiliates here.

However, we include links (affiliate or otherwise) in our articles only if we feel that they provide value to you.

Please don't hesitate to contact us if you need any clarification.

About TSR Trading Guides

The articles in this series of trading guides were first published on Trading Setups Review, where they are available for free reading.

In this series of guides, we have organized selected articles into common trading topics with an exclusive introduction from Galen Woods. The objective is to present a better learning experience for serious readers.

You can find out more about Galen Woods by clicking here.

1. Introduction

The job of a trader is never about profits. It is about risk. The real job of a trader is to find the right risk to assume.

What is the right risk?

The right risk is one that offers you, on average, a net positive return. The right risk is the one that you can afford to lose. The right risk is the one you take for a reason, not out of your emotional whims.

Taking the right risk is difficult. This is because even the right risks cause losses in the short run. It is tough to recognize something as "right" when you lose money because of it. But if you want any chance of making it in trading, you must learn to accept losses that stem from taking the right risk.

You need to view losses as costs of doing business. For a profitable trading business, each trade loss is just a business expense like your internet connection fee. You cannot trade without an internet connection. Similarly, you cannot trade without losses.

A trader also faces risks beyond the financial market. There are business risks. What happens when your broker goes down? What happens if your computer fails? What happens if you lose your trading records?

The best way to deal with risk is to keep things simple. Complicated strategies, systems, and processes multiply risks.

Very often, the consistent and profitable trader is the one who has the right attitude towards risk - the trader who see himself as a risk manager wins.

2. How to Create a Price Action Day Trading Plan

The market is a wild creature that no trader can control. For the intraday trader, the market is even more uncontrollable. Trying to control the market is impossible.

In this wilderness where we face overwhelming market forces, how can a trader achieve consistent performance?

The trick lies with controlling the only thing a trader can control. And that is the trader himself or herself.

If we cannot control the market, the best option we have is to control our response to the market. To do so, we need to define our own playing field. Instead of allowing the market to overrun us, we demand what we want to see from the market before taking any action. If the market fails to show us what we want to see, we will not enter the game. Make the market prove itself to you, and not the other way round.

The first and essential step to defining our playing field is to create a trading plan. A trading plan is specific to your trading style and strategy. In this article, we will show how to create a price action day trading plan.

In theory, the perfect trading plan anticipates every situation and prescribes what to do. The perfect price action day trading plan has the response to every intraday market behaviour.

But we know that it is not workable to anticipate every possible situation down to the finest detail. This is because market price action has infinite possibilities. Thus, the practical approach is to build a set of trading rules and guidelines.

2.1 Trading Rules & Guidelines

Instead of anticipating every scenario, we should rely on trading rules and guidelines.

Trading rules are rigid. They cannot be broken under any circumstances. Trading rules guarantee a consistent playing field for the price action intraday trader.

Trading rules typically define the markets, time-frames, and price patterns you can trade. If you follow these rules, your trades are consistent and the Day Trading Evaluation Cycle (covered later) is meaningful.

Trading guidelines are flexible. You can break them for the right reasons. Trading guidelines empower the price action day trader to deal with an ever-changing market.

A trading guideline might state that we need a bullish bar as a long setup bar and a bearish bar as a short setup bar. But when the market bias is clearly bearish, we can choose to take bullish bars as our setup bars.

Having both trading rules and guidelines is the key to building a sensible trading plan. Instead of having fixed rules in a market of flux, we have guidelines, which are “rules on breaking rules”.

As most price action day traders are discretionary traders, this distinction is extremely helpful. Many traders break their trading rules under the guise of "exercising discretion", leading to inconsistent trading.

With defined trading rules and guidelines, they can no longer break their trading rules. They can only exercise their discretion with regards to trading guidelines. Trading rules cannot be bent.

A vital trading rule pertains to your trading size which is the product of a position sizing system.

2.2 Position Sizing System

A position sizing system tells you how much to trade with your trading capital and given your trading performance. Your position size is arguably the most important part of a price action day trading plan.

Regardless of your trading edge, if you trade a position size that is too large, you will go bust. If you trade a position size that is too small, you are not maximizing your profit potential.

(Learn more about position sizing with Van Tharp's Definitive Guide to Position Sizing.)

A comprehensive day trading plan does not only help us find profitable risks in the market. It also includes actions to mitigate risks beyond the market.

2.3 Risk Management

There are many risks in our intraday trading process that lies beyond the market price action. These are risks related to factors that do not add to our trading edge, but can definitely damage our trading edge if left unmanaged.

Examples include:

- Risk of computer failure
- Internet connection problems
- Psychological problems like overtrading

Our trading rules should manage these risks. For instance, our price action day trading plan might include:

- Do not use your trading computer for downloading files from the Internet. (computer failure)
- Scan your trading computer for malware every week. (computer failure)
- Always have a back-up mobile Internet connection. (internet failure)
- Take only three trades per session. (overtrading)

2.4 Principles of a Solid Price Action Day Trading Plan

To build a solid price action day trading plan, bear these principles in mind.

Know why something is in your trading plan. What does it add to your trading process?

Many traders start with a trading plan template from other traders. While there is nothing wrong with that, you need to understand the trading plan. This is because a trading plan is not static. It changes according to your progress as a trader. To know how and when to change it, you must understand the underlying reasons for every part of your trading plan.

Focus on creating an actionable plan. An effective trading plan must lead to actions.

When you write your trading plan, use verbs. Be clear. A well-written trading plan that focuses on specific actions is far more likely to lead to compliance.

Price action trading demands years of learning, observation, and practice. Learn from various sources and be open-minded. Eventually, you will find a trading perspective that you understand and can identify with. Regardless of your eventual perspective, you will need a trading plan.

Remember that a price action day trading plan is an individual masterpiece.

You craft it with your understanding of the market price action and your trading experience. You are the only one that can realise its benefits. A trading plan is not about the market. It is about you.

3. Why You Must Have An Initial Stop-Loss?

A stop-loss order is a trading order placed to close your position when it moves against you.

There are traders who don't believe in having a stop-loss order. These traders have been stopped out right before watching the price move in their favor again. They remember such painful experience. They remember them too well. As a result, they believe that having their stop-loss order in the market makes them vulnerable to "stop hunters".

Some traders do not have a stop-loss because they just do not want to lose. Most of these traders are no longer trading.

You must have a working stop-loss order in the market. Here's why.

3.1 There must be a price at which your perceived trading edge is gone.

This is true for technical traders.

If you believe that stop hunters are chasing you, simply place the stop-loss order further away. Just place it somewhere.

For instance, if you buy a stock at $45 and was aiming to sell it at $50 because of a perfect Hikkake pattern, what reasons do you have to keep the stock if it has fallen to $20?

Is the trading edge you perceived from the Hikkake pattern is still valid?

(Fundamental traders might be better off with a mental stop-loss. This is because their perceived edge is not based on price.)

3.2 A stop-loss protects you from your worst enemy.

Your worst enemy is yourself. Because you don't want to lose.

A stop-loss order forces you to take losses.

We don't like to take losses, but taking losses is part of profitable trading. It is a game of probability, and not certainty.

Having a stop-loss order working in the market enhances your discipline to take good losses.

(If you taking too many bad losses, you might be over-trading. Learn how to stop over-trading.)

3.3 You cannot put in a stop-loss order by blinking.

This is especially true for day traders. If you do not have a working stop-loss order in the market, when the market gets volatile, you will not be able to send the stop-loss order from your brain to your broker by blinking at the falling prices.

Mental stop loss orders will not do.

3.4 Exceptions

If you are a technical price action trader, you must have a stop-loss order.

As with everything in trading, there are exceptions.

- Die-hard buy and hold investors probably won't need a stop loss order. Technically, these traders have a stop-loss at zero dollars.
- Some options strategies limit the risk to the initial outlay. Hence, options traders may not need a stop-loss order.
- Traders who know the fundamental conditions that erase their trading edge, but they are unable to relate a specific price point. For them, they could exit at the market once they recognize the circumstances.

In sum it up, a stop loss order reminds us that we, as traders, are fallible.

4. Five Ways To Exit Your Trade

When I review trade setups, I always state the rules for entering the trade. However, most of the time, I leave out the exit strategies.

It is not because exit strategies are not important. Instead, they are so crucial and deserve so much attention that I'm unable to include them in a concise review.

In this article, let's take a look at fives ways to exit your trades.

Passive Management of Trade Exit

If you prefer to "set and forget", pay attention here.

4.1 Initial stop-loss hit and exit.

I'm assuming that you always have an initial stop-loss order. If you don't, you need to re-read the previous chapter.

In this case, your initial stop-loss is hit and you suffer a loss. Although it is the worst possible outcome for your trade, be glad, as you have followed your trading rules with the discipline required for trading success.

4.2 Target price hit and exit.

Again, I'm assuming that you have a target price with a limit order set to bank your profits. If you want to let your profits run, it's okay to omit a target limit order.

However, some traders don't feel that great having their targets hit. Why?

Because the fact that their targets were hit meant that they could have set it higher. (Except in situations when the price hits your target to the exact tick. Not likely.)

4.3 Time stop hit and exit.

Time is money. Thus, some traders have a time stop.

Having your capital tied up in a sluggish position while missing many other great opportunities is hardly ideal. If your trade is not going anywhere within a certain time period, exit at the market and look for other opportunities.

How long do we wait before exiting?

Observe all your trades to find out. Most of the best trades move quickly towards your favour.

Check out these trading strategies with a time stop: Opening Range Scalp Trade & Quick Trade with Linear Regression Channel

---

Active Management of Trade Exit

If you can keep your cool while in an active position, then you may attempt to manage each trade actively.

4.4 Trailing stop hit and exit.

If you prefer to lock-in profits when possible, trailing stops are your best tool. Trailing stops are stop orders moved in your favor to lock-in profits.

There are 1001 methods to trail your stops but the principle is the same: to balance between locking in profits versus suffocating the trade to a premature death.

4.5 Conditions have changed, exit at market.

We enter each trade with a reason. (At least, I hope you do.) If that reason is no longer valid, we should simply exit at the market price.

For instance, you entered a trade based on the Holy Grail which finds opportunities in strong trends. Then, you saw that prices were moving sideways for a prolonged period. The strong trend you wanted to capitalise on was missing. Thus, we should exit.

This is the most logical way to exit a trade, but the most subjective. A trader must understand his edge extremely well to use this exit strategy. Most new traders are too excited when they are in a trade, with eyes glued to the P/L movements, to reassess their edge constantly.

Regardless which method appeals to you, you must have an exit plan in mind before entering any trade.

5. The Logical Trader's Guide To Setting Stop-Losses

A stop-loss order limits the risk of a trade. It is the best friend of a trader who wants to survive and realise his long-term potential profits. Most traders find comfort in having stop-losses to protect them. But often, they do not give much thought to how they set their stop-losses.

To truly realise the benefit of having stop-losses, you must adopt a logical mindset. Before we discuss how to set stop-losses, let's take a look at *how not to set stop-losses.*

5.1 The Wrong Way to Set Stop-Losses

The two questions below summarise the wrong thought process for setting stop-losses.

Step One - How much do I want to lose?

Let's say I want to limit my risk to $200.

Step Two - What is the implied stop-loss price?

I am buying 100 shares of stock ABC at $50. To limit my risk to $200, I must place my stop-loss at $48.

$50 - ($200 / 100 shares) = $48 stop-loss point

Thus, I will place my stop-loss at the $48 price level.

What is wrong with this thought process?

It disregards market price action completely. We determined the stop-loss level purely based on our risk preference. To the market, that stop-loss point is arbitrary and meaningless.

5.2 The Logical Way to Set Stop-Losses

A logical trader thinks through the following questions in sequence.

Step One - What is a logical stop-loss price?

A logical stop-loss point is not implied by our risk appetite. It is highlighted by market price action. Stop-loss levels based on price action allows us to limit our risk while giving breathing space for our trades to wiggle.

There are two primary methods for finding stop-loss points using price action.

Support/Resistance as Stop-Losses

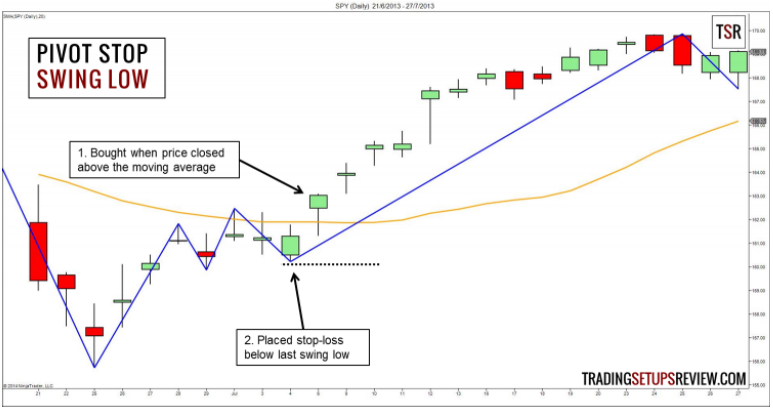
Ideally, we want the market to stay away from our stop-loss point. Hence, for long trading setups, using support levels as stop-losses is logical. The same goes for using resistance levels to set stop-losses for short trading setups.

Candlestick patterns and bar patterns offer minor support/resistance. When trading with price patterns, place your stop-loss below (or above) them.

In the example above, we placed a stop-loss order below the long Hikkake pattern.

1. This long Hikkake pattern bounced off the moving average, and we went long.
2. The natural pattern stop was slightly below the low of the Hikkake pattern.

Swing pivots are also natural support and resistance suitable for placing stop-losses.



In the chart above, we marked the market swings with blue lines.

1. Here, we entered the market without a specific price pattern. Instead, our trade trigger was the market closing above the moving average (orange).
2. We placed our stop-loss slightly below the last swing low, which acted as market support.

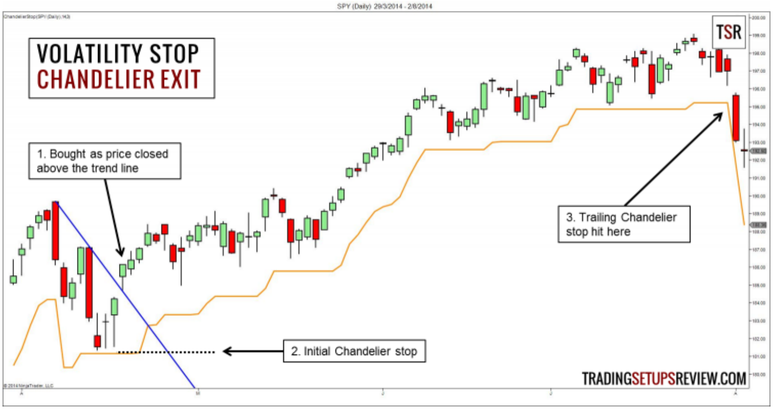
Volatility Stop-Losses

The ideal stop-loss is one that offers enough space for a trade to wiggle. How much space (price range) is enough?

The answer depends on the market's volatility. Hence, another logical method for setting stop-losses considers the volatility of market price action.

The classic example of a volatility stop-loss is the Chandelier Stop. It uses the Average True Range (ATR) as a measure of market volatility. Then, it places a stop-loss based on a multiple of the ATR.

In the example below, we used the 14-period ATR multiplied by three for our Chandelier Stop (in orange).



1. We bought after the market broke and closed above a minor bear trend line.

2. Based on the Chandelier Stop, we placed our initial stop-loss here.
3. The Chandelier Stop is often used as a trailing stop-loss. In this case, it performed well. We were able to trail the market upwards for a nice bullish run.

Step Two - How much do I need to risk based on the logical stop-loss point?

For instance, a pattern stop implies a stop-loss level at $40. We intend to enter at $50 with 100 shares. We will need to risk $1,000.

($50-$40) x 100 shares = $1,000 trade risk

Step Three - Can I afford to risk that amount?

Scenario One

I have $2,000 in my trading account. That is all I can use for my trading activities. If I lose it, I can no longer trade.

If I lose $1,000 as implied by the pattern stop, I run the risk of suffering a 50% drawdown. I cannot afford to take the risk.

In this case, regardless of the trading setup's quality, this trade is too expensive for me. I must pass the trade or scale down my position size to lower the trade risk to an acceptable level.

Scenario Two

I have $500,000 in my trading account. $1,000 is only 2% of my risk capital. A loss of 2% will not ruin my ability to continue trading. I can well afford to take this risk.

Hence, I will take the trade.

5.3 A Logical Stop-Loss Places Price Action First

The misguided trader starts with his personal risk preference and proceeds to place a stop-loss in the market. He has already decided that he wants to enter the market before evaluating his risk.

On the other hand, the logical trader considers the market risk before deciding if he wants to enter the market. He starts with an analysis of the market for potential stop-losses. Then, he considers his risk preference. Ultimately, he enters the market only if he is able to bear the risk.

Stop-losses limits risk and are critical to a trader's survival. However, if you do not set your stop-losses logically by placing the market first, they are pointless.

Remember, market first. And do not trade when you cannot afford to lose.

6. Position Sizing - The Most Important Trading Rule

Imagine a trading setup with 99% chance of winning $100 per contract, and 1% chance of losing $100 per contract. I'm sure you agree that it is an excellent trading opportunity by any standard.

The Importance of Position Sizing Rule

I'm not sure about you. But I'm tempted to borrow as much money as I can from my family, extended family, friends, friends of friends, and my banker. Not to mention selling off my retirement portfolio and using the highest leverage my broker offers. I'm tempted to enter the market with as many contracts as I can.

Yet, this is a temptation that I MUST resist.

This is because there is a 1% chance of losing everything. If this loss occurs, it is one that I can never recover from. Not only will my broker and banker be after me, I will find creditors instead of friends. It is a catastrophic loss.

This is why your position sizing rule is the most important trading rule. It determines the size of your position. It tells you how many shares, lots, or contracts, to buy or sell for each trade that you put on.

6.1 Purpose of a Position Sizing Model

Position sizing has two aims.

The first is to preserve our capital and avoid any catastrophic loss. Catastrophic losses are those that we will never recover from. This aim takes priority, and we must never risk ruining our trading account.

However, if our sole purpose is to preserve our capital, the best solution is not to trade at all. Hence, position sizing has a second aim, which is to maximise our profits.

If we trade a size that is too big, we risk going broke. If we trade a size that is too small, we are limiting our potential profits. Thus, we want to find the sweet spot that maximises our profit while protecting our trading capital.

What we want to achieve with position sizing is easy to understand. How we do it is the difficult part.

Let's take a look at three position sizing models that try to maximise profit while preventing risk of ruin.

6.2 Position Sizing Models

Model 1 - Fixed Percentage Position Sizing Model

The idea is to risk a fixed percentage of your trading capital (for e.g. 2%) for each trade.

For instance, based on your stop-loss, the largest loss per contract is $100. You have $50,000 in your trading account.

Limit your risk per trade to 2% of your trading capital.

Fixed Percentage x Trading Capital = Risk Per Trade

- 2% x $50,000 = $1,000

Calculate your position size according to the amount you can risk.

Position Size (No. of contracts) = Risk Per Trade / Risk Per Contract

- $1,000 / $100 = 10

Hence, trade 10 contracts.

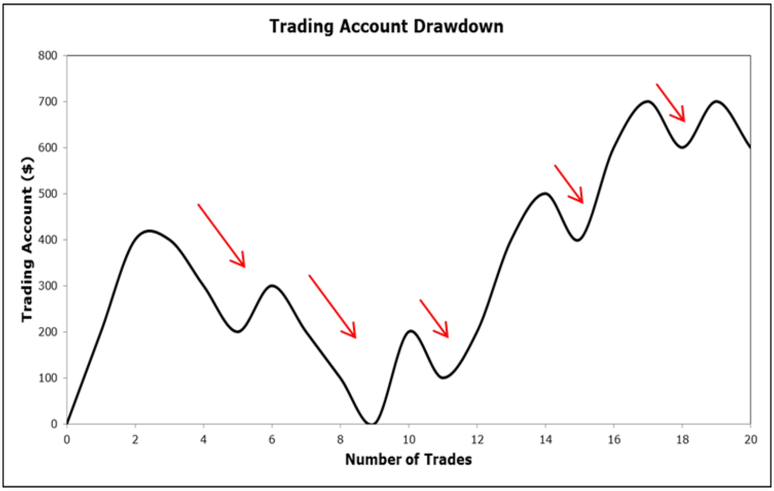
This is a popular position sizing model because it is easy to understand and simple to put in place. It is also friendly to new traders as it does not need a trading track record (unlike the other two models below).

Furthermore, it increases your position size (in absolute terms) as your account grows. Assuming that your trading account is increasing due to your trading skill, your position size depends on how well you trade. This is a logical link that allows us to earn more as we become better traders.

Model 2 - Maximum Draw-Down Position Sizing Model

If you look at your trading account equity curve, you see peaks and valleys. The difference between each peak and valley is the draw-down.

Draw-downs ruin trading accounts. Hence, this position sizing model uses the maximum draw-down to determine how much to risk.



Trading Account Drawdown

The basic idea goes like this. If your largest draw-down per contract is $2,000, you can trade one contract for every $2,000 in your trading account.

Position Size (No. of contracts) = Trading Capital / Maximum Draw-down Per Contract

The key input in this approach is the maximum draw-down per contract. However, the largest draw-down per contract based from your trading records might be underestimated.

Hence, there is a need to adjust the maximum draw-down figure. A simple way to do that is to use a multiplier. A large multiplier implies a more conservative approach.

As an example, consider the maximum draw-down per contract of $2,000 and a multiplier of 2. In this case, we can trade one contract for every $4,000 (2 x $2,000) in our trading account. The multiplier has effectively halved our position size.

(Another great method to adjust the maximum draw-down is by Monte Carlo simulation. It simulates the potential largest draw-down based on your trading records.)

This position sizing model focuses on the draw-downs of our trading strategy. Hence, given a reliable maximum draw-down input, it is effective for preventing risk of ruin.

Model 3 - Kelly Criterion for Position Sizing

John Kelly, a smart guy, described this criterion more than 60 years ago. The Kelly Criterion computes the optimal size for a series of bets. Both bets and trading positions deal with probabilities. Thus, the Kelly Criterion is a natural candidate for position sizing.

Kelly Percentage = W – [(1 – W) / R]

- W - Winning probability
- R - Win/loss ratio

With your trading records, you can calculate your winning probability and win/loss ratio easily. Then, plug them into the equation.

For instance, you win 40% of the time and your win/loss ratio is 2.

Kelly Percentage = 0.4 – [(1 – 0.4) / 2] = 0.1 (10%)

Kelly tells you to limit your position size to 10% of your trading equity for each trade.

On paper, the Kelly Criterion sounds great.

But there is a caveat. The Kelly Criterion is reliable only if the inputs correctly represent the future. We know that the probability and ratio based on our trading records are estimates. Hence, we might have over-estimated them. The consequences of doing so are dire as the resultant Kelly trade size can easily ruin our trading account.

Hence, the fractional Kelly is strongly recommended. It refers to taking a fraction of the Kelly trade size. For instance, the half-Kelly sizing model dictates committing 5% (and not 10%) of your equity to one position.

6.3 Employing A Position Sizing Model

Other than the three position sizing models above, there are dozens more options. However, regardless of which one you select, pay attention to the following.

First, ensure consistency to avoid "garbage in, garbage out". Most position sizing models need inputs derived from your trading records. (For e.g. the winning probability and maximum draw-down.) For reliable inputs, use trading records of the same market, time-frame, and trading approach.

Next, use common sense when choosing your position sizing model and its inputs. Make sure that it stands a reasonable chance at achieving the dual-aim. Ask yourself these questions.

- How does this position sizing model prevent risk of ruin?
- How does this position sizing model maximises my trading profit?
- Are the inputs realistic?

If you use a fixed percentage model risking 50% of your equity each time, your account will be down 75% after two consecutive losses. This is suicidal.

Finally, a position sizing model is like a trading strategy, there is no perfection. Seeking the perfect position sizing model is not realistic as we do not know the exact market probabilities. The exact position sizing model you use is less important than simply having one that makes sense.

Regardless of your choice, you must follow the most important rule in your trading - the position sizing rule.

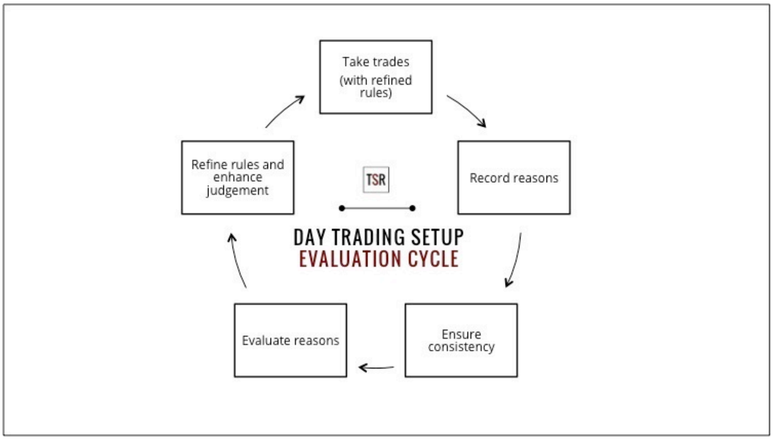
To learn more about various position sizing models, start with these books.

- Van Tharp's Definitive Guide To Position Sizing
- Money Management Strategies for Futures Traders
- A Trader's Money Management System: How to Ensure Profit and Avoid the Risk of Ruin

7. Day Trading Setup Evaluation Cycle

For day traders, evaluating trading setups in real-time is a fast and almost subconscious process. Hence, day traders must focus on **post-trade evaluation** to improve their day trading performance.

However, day traders often neglect to evaluate their trades ex-post. Day traders tend to think that their job is over after the trading session closes. As a result, they overlook the critical day trading setup evaluation cycle.



Day Trading Setup Evaluation Cycle

7.1 Record Reasons For Your Trades

You must have your reasons for taking each trade. Having reasons is not enough. Write them down.

For instance, you took a 9/30 trading setup as prices found support at the daily pivot level. It is also a two-legged pullback from the day's high in what seemed like a strongly trending session. Pen down these reasons.

However, do not let this record-keeping affect your trade execution. Quickly scribble your reasons for taking the trade, and refocus on the ongoing trade.

Bear in mind that you should write down your reasons right after you decide to take the trade setup. You must record them before the trade is over. **We do not want the result of the trade to taint your original reasons for taking the trade**.

You may have good reasons for taking a losing trade, or ridiculous reasons for entering a winning trade. In any case, for our day trading setup evaluation, we need to know the real impetus for taking each trade. Hence, we must record our reasons as soon as possible.

7.2 Ensure Consistency in Your Trades

Before you analyze a trade setup, make sure that it is consistent with your day trading plan. A trade that is inconsistent with your trading plan is a rogue trade. **Rogue trades should not be evaluated**.

Admit that it was a mistake, and work on your discipline to follow your trading plan.

Need help? Take a look at The Disciplined Trader by Mark Douglas.

Think of why you took the rogue trade but DO NOT check it for price action nuances.

For effective day trading setup evaluation, we must compare apples to apples. If you planned to take 9/30 trades but ended up taking a setup based on a moving average channel, you have lost the basis for comparison.

Start comparing after you have picked out the apples.

7.3 Evaluate and Refine Trades

Examine the reasons you wrote down earlier. Good reasons generally lead to profitable trades.

Do trades that bounced off pivot levels really do better?

Are two-legged pullbacks really superior to one-legged pullbacks?

Keep probing your reasons for taking each trade. This is a crucial step to build your confidence as a discretionary day trader. This is also a chance to confirm your understanding of price action.

However, avoid hasty conclusions based on a few recent trades. You always need a decent sample size before coming to any conclusion.

Remember that we are not looking for the perfect setup. We are looking for factors to help us avoid bad trades, not to eliminate losing trades.

Bad trades are not losing trades. However, taking bad trades over time does make you a loser.

7.4 Complete The Day Trading Setup Evaluation Cycle

To complete the cycle, we must consider our analysis result as we look for future trading setups.

For instance, if your study concludes that two-legged pullbacks do better, then you should give more weight to setups with two-legged pullbacks.

For independent day traders, the ability to self-learn is essential. And the day trading setup evaluation cycle is the best self-learning process.

8. Five Day Trader’s Tricks to Control Your Emotions

Day traders must control their emotions. The slightest lapse in controlling your emotions will ruin your accumulated hard-earned profits overnight.

For instance, after having several losses in a trading session, you are afraid of having a losing day. This fear spurs you to over-leverage and blow up your trading account with a single trade.

How many times have you blown up your trading account because you lost control of your emotions?

Furthermore, having your emotions on a roller coaster everyday is not sustainable.

Most day traders understand that trading is a game of probabilities. We know that we should control our emotions and stay detached from the results of each trade. We have also read dozens of trading maxims that sound like these.

- Don’t marry your positions.
- Don’t be affected by fear and greed.
- Be in the zone.

While these straightforward statements are great reminders, they are of little practical value. This is because they do not show you the exact action to take when you are actually trading.

Day trading requires focus. Day trading setups are fleeting. Hence, it is crucial for day traders to know exactly what to do to control their emotions while trading. They do not have time to ponder on vague statements.

What can you do exactly to control your emotions?

Follow these five day trader's tricks if you have problems controlling your emotions.

8.1 Take a walk after each trade.

Even if it's just for a minute.

Given the fast and furious nature of day trading, it is too easy to get trapped in the sea of emotions.

Walking away from your trading screen is a deliberate break in your trading tempo. It is a physical action that you take to control your trading tempo. This simple act clears your mind and reminds you that you are in control.

The market does not drag you into a trade. Quite the opposite. You can walk away from the market any time you want. You are in control.

8.2 Find out the least volatile hour of the trading session.

Read a book during that hour.

Most day trading strategies work best when price action is volatile. Trying to trade when a congested market leads to frustration. Anger follows. Then, your emotional dam is pretty much broken.

The easiest solution is take a break when the markets are going nowhere.

Plus, you get to read the latest novel from your favourite author.

However, do not read anything to do with trading. Trading books give you trading ideas. You might be tempted to try those ideas immediately. Trading ideas, before becoming part of a consistent trading plan, are losing propositions.

(For forex traders, you can use the Forex Volatility Calculator mentioned in this article to find out when not to trade.)

8.3 Stop trading after three consecutive wins or losses.

Three consecutive wins make you feel like a super trader. You think that you cannot lose. You are invincible. You over-leverage and over-trade.

Three consecutive losses make you feel like a loser. You don't want to lose. Your emotions explode. You revenge trade.

When a certain event happens for three times in a row, it is tough not to get affected by it. Let's evade this problem altogether and stop trading after three consecutive wins or losses.

8.4 Don't look at your profit and loss while you are trading.

I can hardly think of a figure that causes a greater surge of emotions than your profit and loss figure. To many traders, the profit and loss figure is an expression of their self-worth. (Nope. You are greater than just your profit and loss.)

If you follow the most important trading rule discussed in chapter 5 and have a daily loss limit in place, you are already protected from severe losses. Hence, you do not need to check your profit and loss figure constantly.

Whenever you feel like peeping at your profit and loss for the session, read your trading rules.

8.5 Ask yourself: "Am I scared?"

Fear is an intense and destructive emotion that traders often encounter.

1. When you are watching your trades unfold, keep asking yourself: "Am I scared?"
2. At any point, if you answer "Yes". Exit immediately.
3. Review your trading rules.
4. Reduce your trading size.
5. Repeat.

8.6 Conclusion - Master Your Emotions for Long-Term Day Trading Success

Control over your emotions does not give you a trading edge. This is because your trading edge depends on your trading method. However, you need to master your emotions for long-term trading success.

With the five tricks above, your nerves will get a slow boat cruise instead of a roller coaster ride.

Learning to control your emotions requires persistence. Over time, you will start to perceive the benefits of keeping your emotions under control. These benefits serve as positive reinforcement to your brain to continue good emotional habits and responses.

It takes time. But if you persist, it does get easier.

9. What To Do When Your Day Trading Broker Fails?

Imagine that you just bought a few ES futures contracts. As you always do, you submitted your stop-loss order concurrently to limit your risk. All of a sudden, your connection to your broker dropped.

You could not check on your position. You could not see if your stop-loss order was working. You received an email from your broker stating that they have suspended all execution of orders. In trying to redeem themselves, they stated that traders with open positions should contact their 24-hour trade desk.

But guess what? You could not get through to the trade desk.

Great. What now?

As a day trader, every price tick counts. Screw-ups and delays are costly. You must learn how to protect your trading interest.

Are you ready to deal with such emergencies?

9.1 What can go wrong with your broker?

The specifics of what can go wrong depends on the market you are trading and the type of broker you are trading with. However, generally, when traders are unable to enter and exit positions according to their trading strategies, things are wrong.

Your broker's involvement in the execution of your orders varies. They might be routing the order to the exchange with their own systems or a trading engine provided by a separate entity. They might even be market makers who are the counter-party of your trades, especially in spot forex and CFDs trading.

In any case, regardless of what goes on behind the scenes, if you are unable to trade, you go after your broker. This is because the job of your broker is to put together a system for you to trade.

(Unless you are using a third-party vendor of your choice and it is clear that your broker has nothing to do with it. An example is a third-party market data feed.)

Essentially, our ability to trade is impeded if we are unable to:

- Monitor current price movement
- Monitor current trading positions
- Execute any trading orders

9.2 Getting Help From Your Day Trading Broker

When you experience technical problems with your trading, the first thing to do is to contact your broker. Tell them exactly what went wrong and request them to fix the problem as soon as possible.

We have listed the common ways of reaching your broker for help below in descending order of responsiveness.

1. Phone (all brokers should have a trade desk dealing with emergencies)
2. Live chat (some brokers offer live chat on their websites)
3. Email
4. Forum (some brokers have an online support forum)

Compile the contact information of your broker and keep them near for emergency. Place your broker's number on speed dial. Save their live chat and forum URLs as desktop shortcuts.

What if you cannot get hold of your broker or they are unable to assist you?

Do not waste time venting your frustration on the poor guy picking up your call. I can assure you that there are tons of traders waiting in line to scream at him. And if the problem is technical, it is unlikely that getting angry at the front-line staff helps.

Instead, let's see how we can help ourselves.

9.3 What can we do when our day trading broker is not helping?

Stop trading. This is the best option when your day trading broker fails. Why risk trading with an unreliable connection?

However, this is not an option for traders who have open positions in the market. Look at hedging your position with another broker as discussed below.

Activate a back-up market data feed. This will allow you to continue monitoring the market and call your broker's trade desk to execute your position. In such situations, I strongly recommend that you close existing positions but do not to start new trades.

For some forex traders, using a back-up market data feed is tricky because you trade with a dealing desk. Your broker quotes you the bid and ask prices you can trade at. External market data is not reflective of your broker's quotes. However, most of the time, the external market data is a reasonable proxy for monitoring your positions.

Trade with a back-up broker. If you are unable to trade with your primary broker, switch to using a back-up broker. Implement your trading strategies with the back-up broker. Reassess how your primary broker is doing before shifting your trading operations back to them.

Make sure that your back-up brokerage account has sufficient funds for trading.

Maintaining back-up data feeds and brokerage accounts increase your operating costs. However, if you want to manage the risk of your day trading broker failing, you should get them ready.

Hedge using a back-up broker. For traders with open positions and are unable to close them with your existing broker, you might want to hedge your position with your back-up broker.

Hedging is simple. If you have a long position with your primary broker, go short with your back-up broker to effectively exit from your bullish position. The reverse applies for exiting a short position.

However, before you start hedging, run through the following questions.

- Do you have a position to hedge? Your broker's systems are screwing up. Are you sure that you have an actual trading position on? Verify, verify, verify.
- Do you have live stop-loss and target-limit orders? If your stop-loss and target limit orders are live (effective), then you do not need to hedge your position.

To answer these questions, it helps to know where your orders are held. There are a few possibilities.

- Held locally on your trading platform
- Held on broker's servers or trading engine
- Held on exchange

Orders held locally are gone once your trading platform loses connection. Orders held on trading engine are effective as long as the trading engine is still executing orders. Orders held on exchange are live, until cancelled or until the end-of-day depending on the type of order.

Where your orders are held depends on many factors including your broker, trading platform, trading engine, and the exchange. Ask your broker to explain the order routing process. Having a clear picture of how the orders flow will help you react better to technical failures.

9.4 Should you change your day trading broker?

This is the question we have after every broker screw-up.

Do not be too quick to switch brokers. No broker is perfect. It takes time and effort to transit and there is not guarantee that the next broker will not screw up some day.

Instead, pay attention to how your broker handled the issue.

- Did they take reasonable effort to rectify the problems?
- Were they upfront about the problems?
- Did they offer compensation as necessary?

The answers to these questions will decide if you should change your day trading broker.

(Read: Choosing the Best Day Trading Broker)

When your broker fails, it is a stark reminder that **day trading is a business**. It has many aspects beyond just your trading strategies, and each aspect is critical to the success of your business.

10. Nine Ways to Simplify Day Trading

Day trading is not easy, but it can certainly be simple. Keeping things simple is a mark of professional traders.

Simplify day trading by following these nine steps.

10.1 De-clutter your trading desk

Day traders spend long hours at their trading desk. Having a clean and organized work space helps to simplify the trading environment.

A clean trading desk will also cut the risk of accidents like spilling coffee on your keyboard. Murphy's Law dictates that the best trade of the day will take place while you are cleaning your keyboard.

Designate 10 minutes after each trading session to tidy up your desk, so that you will start the next day with a simple trading environment.

10.2 Clean up your day trading computer

Other than physical clutter, digital clutter is also a problem. However, it is often overlooked because it doesn't really stand in our way. Well, until your computer starts to slow down and on some occasions stop responding to your click on the "Buy" button.

Prevention beats cure. If you can, dedicate a computer to day trading. Do not download or install any non-trading applications. That will lower the digital clutter in the first place.

You also should have a digital spring cleaning regularly. Every week, I clean my computer with CCleaner from Piriform, which has a free version that works well.

10.3 Remove one trading indicator

When it comes to trading indicators, "the more, the merrier" is not true. More indicators need more time to interpret and might very well lead to analysis paralysis.

Remove one trading indicator from your charts today to assess if you really need it. It could be the crutch that you do not need.

If you would like to simplify your trading and get used to trading without indicators, here are some resources to get you started.

- How to Trade with Price Action
- Top 10 Price Action Trading Books
- Day Trading with Price Action Trading Course

10.4 Remove the news feed when you are trading

Many day traders listen to the news feed when they trade. The news feed is essentially a trading indicator. If you do not know how to use it, you are definitely better off without it.

When the news is better than expected, but your technical analysis points down. What do you do? What weight do you put on news?

These questions complicate your trading thought process, and do not add value unless you have a system to trade news.

10.5 "All in, all out" Trade Management

Do you have a complicated scaling in and scaling out trading strategy?

Are you sure it is helping you to earn more? Have you conducted an analysis of your trades to confirm this?

If not, you are just complicating your trade execution unnecessarily.

Try "all in, all out".

10.6 Use only one day trading setup

Choose only one trading setup from this list. And learn to use it well.

It simplifies your trading and helps you to focus. You will find it easier to become as expert.

One sharp knife is better than a dozen blunt ones.

10.7 Trade only one instrument

Each instrument has different volatility and tick sizes. If you trade multiple markets, you need to size your positions differently each time to risk the same amount.

Every market has its own price tendencies at different times of the day. So you will also need to learn the quirks of each market.

Sticking to one instrument simplifies both your position sizing and learning process.

10.8 Stay in the same trading time-frame.

Like the choice of instrument, your trading time-frame has an impact on the level of trade risk. We need to keep it constant for simple position sizing.

In addition, keeping the time-frame ceteris paribus allows us to check what works in our day trading strategy.

10.9 Accept infrequent trades

If you follow the recommendations above, you will end up taking fewer trades. With only one time-frame, one instrument, and one trading strategy, you will have limited trading opportunities.

You must accept the fact that if you want simplicity as a day trader, you must think like a hunter that stalks its prey quietly over a long period before gunning it down.

Patience is a virtue and it belongs to the day trader with a simple approach.

10.10 The Simple Day Trader

These are 9 ways to simplify your day trading. But do not go on an extreme minimalist route.

The basic principle is to look at the value of each addition to your trading process. If it does not help you, remove it. If it does, keep it.

> Make things as simple as possible, but not simpler.
>
> -Albert Enstein

11. Five Checks Before You Start Day Trading For A Living

You have been day trading part-time and making some decent extra income. You are not day trading for a living, not yet. That is your dream. To work anywhere you want, with just an Internet connection and a computer.

Are you ready to make the leap and start day trading for a living? Day trading for a living is the same as becoming an entrepreneur and starting your own business. It is a huge commitment and a major step in life.

This 5-item checklist will help you decide if you are ready to day trade for a living.

11.1 Do you have a trading edge?

You have made some money from day trading part-time. Or you have made a killing from day trading simulation. But do you really have a trading edge?

To find out if you have the skills to start day trading for a living, consider the following:

Day Trading Profits

Based on your trading performance up to now, you are a profitable day trader.

Time Period of Day Trading

Count the number of trading days you traded.

Include days that you looked out for trading setups but was unable to find any. **On those days, you did not take any trades, but you traded the session**.

Not taking bad trades contribute to your trading edge, so we count those days in.

You should have traded around 60 trading sessions. The more, the better.

Number of Day Trades

At least 30 trades. The more, the better.

Quality of Day Trading Track Record

This is the most important factor. You might have made a fortune over a year of day trading with hundreds of trades under your pocket. But you might just be lucky.

Your track record's quality depends on the consistency of your trades with your trading plan. If you have planned the trade, and traded the plan, you are good to go.

11.2 Do you have enough capital?

To answer this question, work out the following numbers first.

Monthly income needed for a living

If you have kept track of your personal finances, you should know the answer.

If not, it's time to start keeping tabs on your expenses.

A day trader must master his or her personal finances. This is because we don't draw fixed salaries. Our income is volatile. Budgeting and cash flow planning is essential so that we can use our volatile income to meet relatively fixed expenses.

Kylie Ofiu wrote a great article on budgeting on variable income, which I think is very relevant to day traders.

Trading size

Based on your trading performance, calculate the size you need to trade to meet your income goal.

Capital based on money management model

Using your money management model, work out how much trading capital you need.

For instance, you need a monthly income of $1,000. You need to trade 3 futures contracts to make that amount, on average. For each contract, your average risk per trade is $250. For 3 contracts, that will be $750.

According to the simple money management model of risking no more than 2% of your trading capital, you will need $37,500 as your trading capital.

(These numbers are fictitious.)

If you have been day trading real money part-time and are conservative, use 150% of the required capital you calculated.

If you have been day trading fake money, use 200% of the calculated capital. You will realize that trading real money is very different, and a lot harder.

11.3 Do you have enough savings?

Before you start day trading, you should pay off all your debts. So we are referring to net savings.

After paying off all your debts, your savings should cater for a year of living expenses.

Having enough savings for your living expenses is critical to your day trading performance. If you feel the pressure to make a certain amount of money each month, you will feel tempted to take more trades than you should. You will start to see trading setups where there are none. Having immediate financial stress will definitely affect your day trading performance.

11.4 Are you ready to give up your current job?

For some people, a job is more than just a job. It forms an important part of their social life and gives them opportunities for self-actualization.

A day trading career has limited opportunities for socializing and recognition from your colleagues (not that you have any). Day trading for a living gives you freedom, and isolation.

Is this really what you want?

11.5 Do you have a fallback plan?

You must plan for failure. Have a stop-loss. Just like what you have for every trade.

To start day trading for a living is a courageous step. I applaud you for taking a step towards your dream.

But not everyone is cut out for day trading. You may deplete your trading capital and you cannot continue trading. But you still need to pay the bills.

Do you have a contingency plan? Are you able to find a job easily? Can you work as a freelancer for some income?

11.6 Conclusion - Day Trading For A Living

If you cannot pass the first two checks, don't even think about day trading for a living.

Item 3 helps you to maximize your chance of trading for a living successfully.

Item 4 wants you to reconsider.

Item 5 seeks to control damage. As traders, risk is part of the game. We need to deal with the risk of us not trading well.

If you pass all 5 checks, you are ready to starting day trading for a living, if that is really what you want.