Mastering The Trade

Author: John F.Carter

Preface

To everyone out there who is courageously facing the task of turning themselves into a professional trader

Other Books in the McGraw-Hill Trader's Edge Series

《The Complete Guide to Spread Trading》by Keith Scha

《Pattern Recognition and Trading Decisions》by Chris Satchwell Mastering Futures Trading by Bo Yoder

《One Shot, One Kill Trading》by John Netto

《Techniques of Tape Reading》by Vadym Graifer and Chris Schumacher

《Quantitative Trading Strategies》by Lars Kestner

《Understanding Hedged Scale Trading》by Thomas McCafferty Traders Systems That Work by Thomas Stridsman

《Trading Systems and Money Management》by Thomas Stridsman

《The Encyclopedia of Trading Strategies》by Jeffrey Owen Katz and Donna L. McCormick

《Technical Analysis for the Trading Professional》by Constance Brown Agricultural Futures and Options by Richard Duncan

《The Options Edge by William Gallacher The Art of the Trade》by R.E. McMaster

ACKNOWLEDGMENTS

Writing and trading have a lot in common in that they are essentially solitary professions that are made much more enjoyable by anyone who is willing to lend a helping hand. In regards to this project, I would like to first thank Hubert Senters and Priyanka Rajpal for holding down the fort while I was "working on the nightmare." Also thanks to your contributions to this project, which helped to keep me sane toward the end when things were getting crazy. Although the book deadline was firm, July Soybeans were moving and I couldn't just ignore them.

Thanks to Kira McCaffrey Brecht, Gail Osten, and everyone at SFO Magazine for help?ing me to realize that writing about trading could be a worthwhile thing to do. Larry Connors and Eddie Kwong at Trading Markets for advice along the way and for keeping me on track with this original project, making sure I didn't spend a lot of wasted time reinventing the wheel. Kelli Christiansen at McGraw-Hill for initially contacting me about this project and turning it from idea into reality, and to Executive Editor Stephen Isaacs at

McGraw Hill for helping to keep this project on track.

I thought I could rest easy once I completed the first draft, but little did I know that the real work was about to begin. Thanks to Bill Shugg, Tim Sambrano, Pamela Snelling, and Don Allen for reading early drafts and providing feedback. Also thanks to the staff at McGraw?Hill, who performed the herculean task of bringing this book to life: Scott Kurtz, Editing Supervisor; Maureen Harper, Production Supervisor; Roberta Mantus, copy editor, and Eric Lowenkron, proofreader. Thanks also to Mark Douglas for insightful feedback in the later stages of the project.

For help with my trading and trading related projects along the way, I'd like to thank Marcia Wieder, goddess of Maui, for kicking things off in regard to my leaving corporate America and trading full time. Scott Sether, who was truly in this from the beginning, for helping to redefine the term "market research." Tracy Alderman, Rosa Hernandez, and Michael Duwe, for helping to get things kicked off. Page Rossiter, for keeping me on track during the transition. Skip Klohn, as an early mentor in the process. Eric Corkhill ...

where do I start? Thanks for acting as a consultant on a multitude of topics, and thanks for giving me enough red wine so that I only remembered the good stuff the next morning.

Thanks to Barbara Schmidt-Bailey and Jeff Campbell at the Chicago Board of Trade, and Marty Doyle at One Chicago for good ideas and great feedback along the way. John Conolly, for a multitude of solid insights into the business. To the gang at Mirus, for continued support. To the gang at Newport, for clarifying what not to do and how not to do it. Cooper Bates, for keeping me on track on the meaning of it all. Steve Patrow and Becky Herman, for keeping things entertaining while I was in the beginning stages of this journey.

Of course, it makes sense to thank family members where appropriate. Thanks to my mom, Francie Cobb, for supporting me while I "did my thing" along the way, even if it was some?times scary to watch. Thanks to my step-father, Lance Cobb, for being a father and introducing me to the world of financial markets at an early age. To my brother, Jason Carter, for being a great sibling. It's nice to have another person in the world who understands. Maria Carter, my wife, for her

unflinching support in the face of it all, and also for becoming passionate about the Home Decorating Channel while her husband played "catch up on the book" over the weekends. Next time I swear we'll just go to Hawaii. I'm pretty sure I can write and drink Mai Tais at the same time.

Thanks also to the memory of my father, Bill Carter, who was taken away too soon, but in so doing passed along valuable lessons to his kids. And to the memory of Joanne Wolfram, a good friend, who reminds us all to live life while you have the chance.

FOREWORD

In early 2003, I was attending an online trading conference in an effort to educate active traders on a new class of products called Security Futures. I had joined OneChicago after having been in the managed money business for over 20 years because I believe these products will enhance equity trading in the cash, futures, and options markets. Having avoided these events for many years, I was surprised when I had the pleasure of listening to someone who was incred?ibly articulate and thoughtful. I said to myself, "He really gets it."

John Carter was not speaking about security futures, but rather he was presenting his intellectual framework and approach to trading. It is a method to which I relate strongly, so I introduced myself. We spoke at length on many subjects, including the idea that his method?ology could be applied to security futures and that successful trading is one long journey, not a destination. John became an early supporter and trader on OneChicago, another indication of his innovativeness. We have continued to exchange ideas, and therefore I was honored when John asked me to review Mastering the

Trade.

I judge a book on trading according to one simple criterion: Have I learned something new? Mastering the Trade not only introduces new concepts, but is insightful and easy to read. This is indeed a rare combination in the trading literature. In addition, John stresses that there is neither a single approach nor a single answer to successful trading. In fact, he emphasizes that before one can be a profitable trader, one must fully understand one's own personality. Every decision from the holding period of a trade to the amount of one's capital to risk per trade is a reflection of the inherent preference curves of the trader. In fact, Mastering the Trade begins by emphasizing the importance of the proper approach to trading prior to discussing methodology.

Once the book turns its attention to the process of trading, it sparkles once again.

Regardless of how long one has been in the markets, there are new approaches or enhance?ments to existing ones that I find quite beneficial. For example, as an active participant in the stock index futures markets, John's unique application of extreme tick readings is very insight?ful. I can then decide whether to apply it toward my own trading, test it further or ignore it entirely. The beauty of trading is that there is not one size that fits all and John does not try to force fit his ideas on anyone. They are presented, discussed and then demonstrated. Amazingly enough, every trade is not always a winner. The set-up is a probability outcome that iffollowed over time should lead to trading success. That is the essential message that John drills repeatedly. Bad trades happen all the time; it is how one reacts to them that determines future success.

Another point that Mastering the Trade makes is that there is no a single answer to the question: Should one be short or long a market? There are always valid reasons to be both ways. The markets provide some clues, but ones trading style needs to provide the rest. That is why John shows how to use everything from monthly charts to one-minute pivots. A full-time trader should have different volatility and risk parameters than one who can only examine the market before and after the close.

Trading is an emotionally debilitating business. One can always explain yesterday per?fectly. The weekly trader says "if I only followed the one-minute chart, I would not have gotten caught in that position." The one-minute, intraday trader says "if I had only leaned against that weekly pivot point, I wouldn't have gotten stopped out and had a huge winner." John doesn't play this game. He applies an intellectually honest process to trading, suggests risk-reward set-ups and then lets the markets do the rest. Remember the market is always right. It is the analysis or set-up that is wrong.

Mastering the Trade reinforces what successful traders intuitively do every time they place a position: Trade small, stay in the game and try and let time be your ally. Losing streaks are bound to occur and knowing that they will occur and living through them are two different things. Diversify across markets. Some set-ups will be working well in a market and then stop. The market hasn't changed nor the set-up failed; the more opportunities, the greater the chance of success. But if one is trading too large, then one may not be able to initiate the next trade after a series of losses. John is very helpful in outlining what unit sizes to trade.

I would suggest studying the list of markets recommended and being prepared to partici?pate in many of them. We all have a tendency to pick and choose the set-ups in those markets where we have a pre-defined bias. The message of Mastering the Trade is that the set-ups are objective and can help eliminate the emotional battles that are constantly being fought. Today a single stock future will look great on a chart, but the set-up will indicate that it is time to sell. If one is looking for excuses not to follow the signal, then don't buy Mastering the Trade. However, if one is tired of saying "I knew this would happen," but does not have anything to show for that knowledge, then John Carter's new book is an outstanding place to start a realistic, grounded approach to mastering the trade!

Peter Borish
Chairman, OneChicago
Former Head of Research for Paul Tudor Jones

INTRODUCTION

The best lesson I've ever learned about short-term trading happened while on a white water rafting trip. Eight of us were in the raft when it hit a rock and flipped, launching us into the air like a catapult, sending everyone headfirst into the icy water. Half of us remembered that, in the event of a spill, to stay calm and position ourselves on our back, feet facing downstream. We zipped around rocks and through cascades of water, eventually dragging ourselves safely ashore. An hour passed before we leamed what had happened to the rest of the group. For them, a rescue operation went into effect, and the end result was a gashed leg, a concussion, and a near drowning. Later, when speaking to the abused, I leamed that all of them had experienced a type of brain freeze. They could see the danger around them. They knew they were in trouble. They even knew they needed to act, to do something. But they literally could not make a decision about what action they should take. So, they took the one option left to them: They froze like the proverbial deer in the headlights and did nothing .. In the absence of a decisive path of action, the river grabbed them by their lapels and, like an angry pimp with bills to pay, slapped them senseless.

I remember one member of the group saying, "That river was out to get me!" Extreme paranoia and self-centeredness aside, the river was not out to get anyone. It did what it was supposed to do; move quickly and rapidly through a canyon in order to get to the ocean. The riders who understood the nature of the river were prepared and took the roller coaster journey in stride. The riders who were unprepared got thrashed.

The similarities between this event and a typical trading day are nearly identical. The unprepared trader (newbie) is in the same situation as the unprepared white water rafter. In the event of extreme conditions, both will freeze, and both will be lucky to survive the expe-rience. One bad trade can wipe out months or years of profits.

Professional traders make money not because they are right more often than not, but because they know how to take advantage of all the "fresh meat" that is sitting out there in the form of amateur, unprepared traders. "Fresh meat" refers to anyone who has been trading for less than 10 years. That said, many traders never make the leap, and remain in this victim?like state all of their trading lives. The minority who endure and join the ranks of consistent winning traders are the ones who have learned the following truths:

1.The financial markets are naturally set up to take advantage of and prey upon human nature. As a result, markets initiate major intraday and swing moves with as few traders participating as possible. A trader who does not understand how this works is destined to lose money.

2.Traders can know more about a market than anyone else in the world, but if they apply the wrong methodology to their trading setups, they will lose money.

3.Traders can know more about an indicator or group of indicators than anyone else in the world, but if they apply the wrong methodology to those indicators, they will lose money.

4.Traders can know exactly what they are doing, but if they are trading the wrong market for their personality, they will lose money.

5.Traders can know exactly what they are doing, but if they apply the same strategies they used to make themselves successful in other areas of their life, they will lose money.

Without this knowledge, a trader is like a wounded antelope in the center of a lion pride, where it is not a question of "if' the antelope is going to get tom to shreds and swallowed, but rather of"when." For a trader without this knowledge, the possibility of ruin it not a ques?tion of "if." It's only a matter of "when."

Nevertheless, even with the odds stacked against them, each year tens of thousands of unprepared traders flock to the markets like lemmings to the sea, their heads filled with visions of easy cash, first class tickets, and of telling their boss to go pound sand. By the time most of them sense that spark of an idea that would have allowed them to understand how trading really works, they have already flung themselves over the cliff and are plunging towards the rocks below. All they have to show for their hard work is ample amounts of frustration and despair, perhaps a furious spouse, and a trading account that has been ravished and ripped off by a professional.

Trading is not about everyone holding hands, belting out the lyrics to John Lennon's Imagine, and making money together. The financial markets are truly the most democratic places on earth. It doesn't matter if a trader is male or female, white or black, American or Iraqi, Republican or Democrat. It's all based on skill.

The only way to become a professional trader is to obtain that blunt edge of a weapon that separates you from the rest of the migrating sheep. That edge is gained by utilizing specific chart setups and trading methodologies that take into account the five key points listed above, as well as the psychology of the trader taking the other side of the trade. Otherwise, as you enter the revolving door to the financial markets, filled with excitement and anticipation, the predators are merely licking their lips, because what they see is a slab of freshly cured meat, ripe for the eating. And feast they will.

WHO SHOULD READ THIS BOOK?

This book discusses a unique approach to the markets that focuses on the underlying reasons that cause market prices to really move, and is applicable to trading stocks, options, futures, and forex. In reality, markets don't move because they want to, they move because the have to. Margin calls, stop runs, and psychological capitulation all force a series of rapid fire market orders in a very short period of time. These generate sharp intraday moves lasting a few min?utes to a few hours, and, on a bigger scale, swing moves that last a few days to a few weeks. These moves inflict pain on a lot of traders who do not understand how this process works. Yet, there is always a group of traders who profit from these moves. This book discusses specific

ways to get positioned "on the other side of the trade" in order to take advantage of these moves, relying on a unique interpretation of many classical technical analysis and chart patterns.

More specifically, the book discusses strategies with exact entry, exit, and stop loss levels for the intraday trading of stocks, options, ETFs, e-mini futures, 30-year bonds, and the forex currency markets. There are also swing trade setups discussed on stocks, options, single stock futures, and e-mini stock index futures.

It is my hope that traders at all levels of experience will welcome this book's broad mar?ket overview and specific trading strategies. Beginners will be treated to a no-hype reality check on how the markets really work, will be introduced to clear concepts and trade setups, and will come to understand why newer traders are destined to lose money until they grasp the basic market mechanics that are constantly happening behind the scenes. They will also understand how they are repeatedly taken advantage of.

It is my goal that intermediate traders will appreciate the knowledge included in this book, which is designed to take them to the next level of trading. In addition, I hope that pro?fessional traders and other market insiders will find this book is able to clarify some of the truths in which they have instinctively found to be true, in addition to providing fresh ideas to improve their bottom line. Stock traders who have never traded e-mini futures or forex will learn how these markets work and how to get enough information to decide whether the addi?tion of these markets would be appropriate for their own trading. They will learn how the futures markets affect specific stocks and thus better position themselves to profit from their stock trading.

Day traders will learn why relying on indicators alone is a losing game, discover specific strategies to get into a trade early, and learn the differences between knowing when to bail and knowing when to hang on for the ride. Swing traders and pure stock pickers will learn how to read the ebbs and flows of the market, and know whether they should be focusing on the long or the short side. Investors that are overlooking their retirement accounts will discover specific ideas for timing their investments on a monthly and quarterly basis in order to improve their returns. While this book is aimed at full-time traders, there are special sections throughout the book that focus on individuals who are working full time and are only able to trade part time. This does have advantages if done correctly.

While I feel this work will be a welcome edition to anyone who is interested in the finan?cial markets, it is important to realize this book assumes a working knowledge of the basics. There won't be a chapter discussing the nuances of support and resistance, or a chapter with 25 examples explaining the differences between an uptrend and a downtrend. While I'm going to spend a chapter on option plays, I'm not going to spend a chapter discussing how options work. In other words, if it has already been written about, or if it can be Googled, then it won't be rehashed here. This book focuses on new concepts that have not been written about before. That said, the work does provide an introductory chapter on futures and forex trading and the types of markets that are focused on in this book. If you're not sure what a bond tick is worth, or what 10 Euro pips mean to your P&L, then this section is for you. I will also discuss web?sites and other books that are great for getting up to speed.

In addition to specific trading setups, the book discusses practical aspects of trading such as the type of hardware and software to use, as well as money management allocation and developing a game plan that fits the trader's personality. Finally, there is a strong focus on spe?cific information that can be used the next trading day.

Let's get started.

Publish Information

PROVEN TECHNIOUES FOR PROFITING FROM INTRADAY AND SWING TRADING SETUPS

McGraw-Hill

New York Chicago San Francisco Lisbon London Madrid Mexico City Milan New Delhi San Juan Seoul Singapore Sydney Toronto

The McGraw Hill Companies

7890 DOCIDOC 0987

ISBN 0-07-145958-8

Trading the financial markets has large potential rewards, but also large potential risk. You must be aware of the risks and be willing to accept them in order to invest in the futures, currency and options markets. Don't trade with money you can't afford to lose. This material is neither a solicitation nor an offer to buy or sell futures, options, or currencies. No representation is being made that any account will or is likely to achieve profits or losses similar to those discussed in this book. The past performance of any trading system or methodology is not necessarily indicative of future results.

McGraw-Hill books are available at special discounts to use as premiums and sales promotions, or for use in corporate training programs. For more information, please write to the Director of Special Sales, Professional Publishing, McGraw-Hill, Two Penn Plaza, New York, NY 10121-2298. Or contact your local bookstore.

This book is printed on recycled, acid-free paper.

Library of Congress Cataloging-in-Publication Data

Carter, John F.

Mastering the trade : proven techniques for profiting from intraday and swing trading setups / by John F. Carter.

p. cm.

Includes bibliographical references and index.

ISBN 0-07-145958-8 (hardcover: alk. paper)

1. Investment analysis. 2. Portfolio management. 3. Day trading (Securities) 4.Electronic trading of securities. I. Title. HG4529.C3742006

332.63’228-dc22

Text

Part 1 Trader's Boot Camp

I don't want the cheese; I just want to get out of the trap.

SPANISH PROVERB

CHAPTER 1

MARKETS DON'T MOVE BECAUSE THEY WANT TO——THEY MOVE BECAUSE THEY HAVE TO

AVERAGE TRADER PROFILE: THE WRONG SKILLS IN THE WRONG PLACE AT THE WRONG TIME

Individual traders live in a state of constant flux, stuck between two worlds that combine both the best and the worst that trading has to offer. On the one hand, they can move in and out of markets with an ease and efficiency large funds can only dream of. Traders have the freedom to carve out specific niches for themselves that the manager of a pension plan could never achieve or duplicate, and in so doing have the opportunity to create an independent life, free from the hassles of the average Joe. These perks are extremely appealing and impossible to duplicate in any other profession.

Reasons for trading full or part time are many, and can range from wanting a career change, a wish to be more independent, the desire to escape the responsibilities of running a large corporate division or individual business, or choosing to be a stay-at-home parent. This is a “job” that provides the chance to make a very nice living, and it’s a lot more interesting and fun than any other profession———except being a rock star, of course. But if sharing the stage alongside U2 seems slightly out of reach, then trading is a good alternative.

It can be done from anywhere that has reliable Internet access. There are no bosses spewing forth inane, ever-changing contradictory orders as they struggle within a system that has promoted them right up to——and through——their level of competence. Employees are not necessary. Those of us who have survived the corporate world can find nothing on this earth that equates to the freedom and beauty that come from no longer having to manage a large group of dispassionate human beings. Start-up costs are minimal thanks to leasing programs from companies like Dell. Trading in your robe or nothing at all is perfectly fine. Best of all, a trader can choose his or her own working hours. Some examples of schedules from suc-cessful traders I work with include: trading actively October through April and then taking the remaining five months off; trading only the first two hours of the market open and taking the rest of the day off; trading until they make 50 percent on their capital and then taking the rest of the year off. The list goes on and on. With so much to offer, it is no wonder that tens of thousands of people toss their hats into the ring, trying to make a go at this most appealing of professions. It truly represents the proverbial American dream.

However, with so much freedom comes a cruel price. Simply put, the markets cannot protect a trader from himself or herself. Individual traders, unlike fund managers, are unsu?pervised and have the freedom to act unchecked in any way that they choose. And for some traders this means acting like a 7-year-old child who has just been dropped off at a Toys-R-Us after chugging two cans of Mountain Dew. Unfortunately, this kind of freedom reinforces bad habits, and the net result is a market that moves and thrives in such a way as to prevent as many people as possible from consistently making money. Why is this? It has to do with traders being the best salespeople in the world.

Although used-car salespeople are saddled with reputations as being pushy and dishon?est, they don't hold a candle when compared to the average trader. A trader, once in a position, can deceive himself or herself into believing anything that helps to reinforce the notion that he or she is right.

When faced with a loss, Joe Trader will look at a chart and tell whomever is within spitting distance, “The market is acting as if a reversal is about to happen.” Net result: he does not exit the position, and his losses mount. When faced with a profit, Joanne Trader hes?itates to pull the trigger, telling her cat, “The market is acting great. It would be premature to sell at these levels.” Net result: She does not exit the trade, and it turns into a loser. The mistake these traders are making is a common, yet fatal affliction most traders suffer from. They are unaware of how the market naturally programs their reactions so that they will lose. And they are unaware of the key factors that really move the markets I discuss in the intro?duction. The net result is a trader who “eats like a sparrow and defecates like an elephant.” This is a situation, of course, that no account can withstand. Worse, this cycle of emotional slavery will not end until it’s met head on. Unfortunately, professional traders understand this all too well, and they set up their trade parameters to take advantage of these situations, specifically preying on the traders who haven't figured out why they lose. One trader's dis?aster is another trader's bread and butter.

IT'S ALL ABOUT PAIN AND SUFFERING

The problem is simple and twofold. First, although traders certainly know that not all trades are going to work out-they do get a distinct feeling right after placing every trade that this trade is going to work out. A study done by a pair of Canadian psychologists documented this fascinating aspect of human behavior. Just after placing a bet at the racetrack, people are much more confident about their horse's chance of winning than they were immediately before laying down the bet. Obviously, there is nothing about the horse that changes, but in the minds of those bettors, its prospects improved significantly once they placed their bet and got their ticket. Without getting into a large psychological treatise on why humans behave like this, it has to do with a strong, underlying social influence to appear consistent with our choices. Once we make a choice, we respond to external and internal pressures in such a way as to justify our earlier decisions. If we made a good choice, then this process works out very well for us, and we will continue to build upon our good choice. However, if we made a bad choice, whether it is regarding a trade, a job, or a boyfriend, then this process will take this bad choice and make it emphatically worse. We will simply refuse to let go and move on, being more concerned about trying to act consistent regarding our earlier decision. People can waste an entire lifetime living within the justifications of a bad choice. What a waste.

Second, many traders feel they can rely on their judgment while in a trade. On paper, this makes a lot of sense. After all, before a trade is placed, traders are at their most objective. However, once the trade is on, the degree of objectivity diminishes immediately and in direct proportion to the number of shares or contracts being traded relative to the account size. Think of it this way: If one trader is long 10 Emini S&Ps in a $10,000 account, and another trader is long I Emini S&P in a $100,000 account, who is going to be sweating bullets over each tick? Not only does the first trader already have the feeling that "this trade is going to work out," but now he or she is trapped with the additional pressure of having to manage a position that causes huge equity percentage swings with every tick. Traders relying on their judgment while in a position that is churning their brain with extreme emotions is like trying to row a boat upstream with a piece of Swiss cheese-it simply does not work.

These factors perpetuate a vicious cycle, with the end result being traders who, like bad used-car salespeople, are consistently selling themselves a faulty collection of beliefs that set them up for slaughter. Instead of following a game plan with which to exit a position, traders in this situation spend their time justifying why they are right and will end up closing a posi?tion only for one of two reasons. First, the pain of holding becomes so great they cannot "take it" any longer. Once they reach this "uncle" point, they start frantically banging their key?board to sell (or cover) "at the market" in order to relieve the pain. Second, their broker politely offers to help them out by giving them a phone call, gently letting them know that they should exit their position. This is also called "getting a margin call." This trade is also placed "at the market." In these situations, there is no plan, no thought, and no objectivity. Just a batch of forced sell orders, or, in the case of someone who is short, a batch of forced buy orders, or cover-ing. This act of capitulation, traders exiting a position because they have to, not because they want to, is emotions-based trading at its finest, and this is what moves the market. Whether it is a sustained multimonth move to the downside because of continuous capitulation selling or a quick lO-minute rally because of shorts being forced to cover, these acts are responsible for the major moves in all markets, in all time frames. In the end, mar?kets don't move because they want to. They move because they have to.

The pressure of traders trying to act "consistent with their original choice" combined with traders who are trading way too big for their account, leads to more disasters in trading than anything else. Disasters for most people, that is. For every 10 to 20 traders who are blow?ing up their account, there are typically one or two traders who are making a mint. After all, the money doesn't just disappear. It simply flows into another account-an account that uti?lizes setups that specifically take advantage of human nature.

THE CASE STUDY YOU WON'T READ ABOUT AT HARVARD BUSINESS SCHOOL

Figure 1.1 is a chart of an actively traded stock with the name deliberately removed for now. During 2004 it was vigorously bought by one side of the trading community and energetically shorted by the other side. Both parties had plenty of opportunities to make money. On December 29,2004, this stock made a new 52-week high, hitting $33.45 the next trading day. Over the next five sessions it pulled back to support at point 3, at $27.62, which represented

FIGURE 1.1

1.jpg

a solid buying opportunity, replicating the buying opportunity that took place at point 1, with the same oversold stochastic reading as point 2.

This chart represents a classic case of an inflection point in which a group of traders has to make a decision. A trader who bought the stock as it broke out to new highs will be feel?ing pain, while the trader who shorted the highs will be feeling euphoria. Traders who are long the stock way back from $10.00 will feel excited and wonder if they should add to their position on this pullback. A trader who is flat the stock is anxious, not wanting to miss the next move, and will be looking to buy the stock here at this pullback to support. Take a moment to look at this chart. What would you do here? Do you short the stock or buy it? What would you be willing to risk? These are questions all traders need to know before they actu?ally place the trade.

Let's work with someone I will call Joe Trader. Joe has been trading for a while and has learned a lot about risk reward levels and about being patient and waiting for high-probabil?ity setups. He looks at this chart and sees a decent buying opportunity in this stock. He has a $100,000 account. Near the close he buys 2,000 shares at $27.80, using about half his cash buying power, not even getting close to using any margin. He places a stop limit order at $26.20 and also places a GTe (good till canceled) sell order at $32.60, which is just below the recent highs. He's risking $1.60 ($3,200) to make $4.80 ($9,600), a very comfortable 3:1 risk reward ratio.

If he's stopped out, he will lose 3.2 percent of his account's value, which he deems an acceptable risk against making a potential 9.6 percent return on the trade.

The next day, on January 7, 2005, the stock gaps lower, opening at $23.78, well below Joe's stop limit order. (See Fig. 1.2.) This leaves Joe in the stock, and his stop limit order won't fire unless the stock rallies back to $26.80.

Joe doesn't panic. He's been down this road before. He is negative on his trade but it's not terrible, just a dollar over his original stop. He understands that when stocks break down, they will almost always retrace a portion of the move before ultimately moving lower. Also, the daily stochastic is oversold, setting the stock up for a bounce, even if it is just a dead cat bounce. He decides to leave in his limit stop order for this eventual retrace, and he plans to see where the stock ends up near the close.

Fifteen minutes before the closing bell he checks the stock and notices it never reached his stop limit order, but it also bounced off its lows on the day. He thinks there is a good chance that the stock will start to retrace a portion of the move the next trading day. He is calm. He is objective. He decides to hang on. Unfortunately, the next trading day isn't until Monday, and he spends most of the weekend thinking about his stock, not really reacting to the environment around him. On Sunday his wife notices that he has been quiet all weekend, almost listless, and keeps staring at charts on his computer screen. She flips through her lat?est issue of Cosmopolitan magazine to see if she can get any insights into how to cheer him up, but by the time she is done reading the insightful articles, she wonders why she ever mar?ried this submissive little mouse of a man in the first place. The guys in the articles are so much more daring and fun! By the time she goes to bed Sunday night, she is angry.

Joe, oblivious, is still up looking at a chart.

Monday morning finally arrives. Joe jumps out of bed early after a restless sleep, just in time to see that the stock is trading lower premarket. It gaps down by almost $3.00 at the open of the regular session. (See Fig. 1.3.) Joe looks at this and shakes his head. How could this have happened?

FIGURE 1.2

2.jpg

As Joe numbly sips his coffee, he looks at the chart "objectively" and sees all the reasons why the stock should bounce. It's now down by over 40 percent from its all-time highs in only seven days. It's near major support on the daily charts. The daily stochastic is now deeply over?sold. He is realistic. He knows this stock is done for, but he also knows that at some point the stock will at least retrace, and he will be able to exit gracefully. He watches the stock all day, chewing his nails, slurping coffee, and getting nothing done. The stock closes at over $6.00 below his stop. Aghast, he decides to hang on for another day, as the stock is way overdue for a bounce.

It is not until he hears the garage door opening downstairs that he remembers he was supposed to drop off his wife's pile of clothes at the cleaners. He grabs them and races out the front door.

On Tuesday, January 11, the stock (okay, its TASR) gaps down yet another 3 points, open?ing at $17.01. (See Fig. 1.4.) Joe takes a deep breath and grits his teeth. He is dead tired from not being able to sleep last night, and to top it off, his wife has suddenly been acting downright

FIGURE 1.3

3.jpg

hostile. He wonders if she saw his P&L on the computer screen, but he's confident that he's kept that covered up really well, always minimizing his execution platform when he leaves the room. He knows he should talk to her, and he will, as soon as he exits this position and goes flat.

He focuses on the chart. He tells himself not to panic like a stupid newbie and to react like a professional trader. He knows he will never let himself get into a situation like this again, but, in the meantime, he has to keep a cool head and get out of this mess.

He reflects that, over the past four months, he has been able to generate an income aver?aging $5,000 per month from his trading account. If he closes out his TASR position here at $17.00, he will be down $21,600 just on this one trade. It would take him over four months just to rebuild his capital. He asks himself, "Okay, forget about your original order. Let's say you just entered the trade here. What would be a reasonable target?" He quickly sets up a series of Fibonacci retracement lines on his chart to see where the 50 percent retracement level is of the entire move down. That level is $22.79, well below his original stop, but if the

FIGURE 1.4

4.jpg

stock rallies up to that level, it means $11,580 in profits, leaving him with just a $10,020 loss to make back instead of $21,600. He places his new sell order, confident that this is going to work, and sits back to watch the action.

Amazingly, the stock continues to drift lower during the day. Joe stares at the chart, continually reminding himself to keep a cool head, that the stock is desperately oversold and that it will soon bounce. Be patient, wait for the retracement, don't be a chump and sell at the dead lows.

As the markets near the close, TASR breaks new intraday lows yet again, cracking $14.00 a share. Joe pushes back from his desk and yells in disgust. This is impossible. TASR is down by nearly 60 percent in eight days. About to explode with rage, he realizes he simply cannot deal with this any longer. His nervous system is a wreck, and his neck muscles feel like plywood. He sells near the close for $14.02, a loss of $27,560. He still cannot believe how far and how fast TASR has fallen. How much lower can it go? On impulse, he looks at the weekly

chart and notices there isn't any support until $10.00 a share. He immediately reverses and goes short 4,000 shares at $14.04, just before the closing bell. Although disgusted with him?self, he feels better now that he has taken action, and at least he won't miss out on the remain-ing down move for this stock. He is anxious to see where TASR opens the next day.

He decides not to tell his wife about any of this, but he does leave a Post-it note reminding himself to pick up the clothes from cleaners the next day.

TASR opens flat the next day, and then steadily starts to rally. (See Fig. 1.5.) Joe is con?fident the rally will be short-lived. However, he does place a stop just above yesterday's highs. This time he places a stop market order, as it was the stop limit order that got him in trouble in the first place. He feels very confident that this trade is going to work out. This is a good horse!

TASR closes near its highs on January 12, but it does not exceed the previous day's highs, so Joe's stop is not hit. He can't believe his bad luck, and he hopes the stock will gap down the next day. His wife calls to say she is going out with the girls. He grabs a six pack and turns on HBO to see how Tony Soprano is dealing with the problems in his life

FIGURE 1.5

5.jpg

Well, the next day comes around, and the stock gaps up by almost $4.00. Joe's stop order gets him out at the open, as this turns into a market order when the price is above his stop, which is $20.83. He lost $6.79 on the play. On 4,000 shares that is $27,160, nearly iden?tical to that of the loss on his first trade. His $100,000 trading account is now down to $45,280. He needs to make 121 percent just to get back to break even. He is so angry he doesn't know what to do, and eventually he picks up his keyboard and slams it against the wall. About an hour later his wife calls to say that they should seek counseling. Joe pours himself a large whiskey and contemplates the meaning of life.

Joe got the stock long. He used a low-risk entry point, had a great risk-to-reward ratio, and he was risking only 3 percent of his portfolio. He didn't even get a margin call like many traders did in this same situation. The bottom line, it was a great plan, but it turned into a disaster.

But for someone else it was a great trade.This chart of-TASR represents a different view. (See Fig. 1.6.) This is a common setup that is created when large funds want to get out of a stock. They push the stock to new highs, sucking in the retail crowd, and then they start unload-

FIGURE 1.6

6.jpg

ing. They know the retail crowd will buy the new highs, and they also know the retail crowd will also feel comfortable buying all the way down to support. This gives the institutions ample time to sell their holdings. I call this setup the "fake and break," and I use it as a fade play for swing trades on stocks. (To fade a market means to take a trade in the opposite direction of the move.) In other words, if a stock is rallying with this setup, then I'm looking to short it.

TRADING RULES FOR SELLS/SHORTS (BUYS ARE REVERSED)

These are the rules I use in trading the “fake and break” setup. This is a setup I use on indi?vidual stocks.

1.Look at stocks making new 52-week highs: On December 30, having made new 52-week highs the day before at point 1, TASR gapped up and hit a newall-time high of $33.45 (point 2).

2.For stocks making new highs, look for a bearish divergence using a seven period RSI (relative strength index): When TASR made new highs on December 30, the RSI hit 72.35 (point 4), well below the level it hit on November 15 when it made its last 52-week high (point 3). When prices make higher highs and, at the same time, the RSI makes lower highs, this is called a bearish divergence. The RSI measures the power of the move, and this is telling the trader that the stock is los?ing power.

3.For stocks making new highs, look for a significant decrease in volume: When TASR made new 52-week highs, it was on one-fourth of the volume of the last thrust to new highs. This is the equivalent of a car running out of gas. There is no sustained price movement without volume.

4.Short the stock the day after it closes below the previous 52-week high: On January 3, TASR closes back below $30.98, the previous 52-week high established on November 15. Utilizing this setup, the trader, let's call her Joanne, goes short 2,000 shares at the open on January 4, getting filled at $30.27. She places a stop 25 cents above the all-time highs. Since the all-time highs are $33.45, the stop is placed at $33.70. This is a stop market order, not a stop limit order as Joe used.

5.To exit, use a close backup above the high of the low day while above key sup?port. If key support is broken, stay in the trade until there is a close backup above the high of the low hour on a 6O-minute chart. We take a look at this briefly here, but this is a concept I talk about in much detail later in the book.

6.Don't trail stops. The exit is the price reversal signal.

After TASR is entered short, the stock never rallies enough to close above the previous day's highs. So Joanne is still in the stock short once it breaks key support on the daily charts in the form of the key uptrend line. Once it breaks this key support level, the selling gets ugly.

Figure 1.7 is a 60-minute chart that shows the increase in volume once TASR breaks key support on the daily charts, at point 1.

FIGURE 1.7

7.jpg

During the three large sell off days, at points 2, 3, and 4, at no time does the market rally enough to close above the high of the low 60-minute bar. The next day, at point 5, TASR ral?lies enough to close above the previous 6O-minute bar, which is the low bar of the entire move down. This close is the signal to cover, and once the next bar opens, Joanne covers her 2,000 shares ofTASR at $16.17, pocketing $28,200. She also reverses and goes long 4,000 shares at this same level, using the lows of the move as a stop.

She stays in the move until the 60-minute price action creates a close below the low of the high 6O-minute bar. This happens the next day at point 6, and Joanne closes out her long at $20.54 for a profit of $17,480. As Joe is berating himself for being such a stupid fool and sitting through his first day of counseling, Joanne is counting her profits totaling $45,680 and wiring a portion of them out of her account to pay for a one-week vacation to Maui. When a trader loses money, it isn't gone. It has just been moved into another trader's account.

TASR didn't lose 60 percent of its value in eight trading days because it wanted to. Desperate traders and mutual funds who loaded up on this stock to sell covered calls were the main vic?tims. Covered call writing was one of the most reliable forms of income generation for most of 2004. This is because the market was choppy and didn't go anywhere. Because this method was doing so well, Wall Street announced plans to start a couple of mutual funds that special?ized in covered calls. Although there are no guarantees in the markets, here is one "almost" guarantee: As soon as Wall Street announces a special vehicle for trading a particular market or strategy, then that market or strategy is done for. Once the covered call funds got started, the markets roared higher during the last two months of 2004, invalidating this strategy as the best way to take advantage of current market conditions. Another example? Wall Street's pushing of home-loan-backed CMOs (Collateralized Mortgage Obligations) is a clear signal that the housing market is about to go in the toilet. The moral of the story? When Wall Street decides to package it up, put a bow on it, and sell it to the public, that move is over. But I digress.

TASR lost 60 percent of its value because a lot of people were caught on the long side, like Joe Trader, and froze. Many of them didn't make a conscious decision to sell the stock. They held on until they couldn't take the pain any longer, or their brokers got them out because of margin calls. It's the margin calls that caused the worst of the selling when TASR closed near $14.00 a share. These forced market orders caused riplike movements in the stock that resulted in even worse fills for traders like Joe who were trying to use their skills to finesse their way out of the trade.

Disgusted with themselves and red in the face, the victims of these trades stalked off to contemplate the insanity of the universe. Meanwhile, as we saw, another group of traders took the opposite side of this "capitulation trade" and made great profits. How does a trader get on the winning side of these trades? To fully understand how to do this, we must first step back and understand how the markets really work, and why traders continually and instinctively sabotage themselves in the first place.

Well, the first part is easy. The markets are not that complex, and they work very sim?ply. Markets rise on a day-to-day basis because current demand exceeds current supply?period. It has nothing to do with being in a secular bear market, a cyclical bull market, high price/earnings ratios (PIE), or Maria Bartiromo's choice of a necklace. (For anyone who actively traded during the dot.com bubble, traders would look for a rally when Maria wore pearls. Very rational, of course.) This has everything to do with what traders are willing to pay for a particular market or individual stock today.

It doesn't matter if the demand is falsely created by a hedge fund "taking the street" (buying large amounts of a single stock to drain a market maker of its inventory, forcing it to buy the stock back at a higher price). Or a squeeze that whacks shorts and forces them to cover, or a rumor that a biotech stock is being cornered by Martha Stewart. Demand is demand, and that is what drives markets higher. The inverse is equally true: If there is too much supply in the market, prices will fall. The best source of "too much supply" hitting the markets is generally in the form of margin calls and other means of forced selling, such as the Joe Traders of the world throwing in the towel and dumping their position. This is why mar?kets can erase gains so quickly; they take the stairs up, but ride the elevator down. It is very important for a trader to remember this. Yes, the stock may be acting great and its prospects are bright, but if there are 1.5 million shares being offered for sale all at the same instant and there are only 50,000 shares being sought by buyers, then that stock is going to crash. It isn't rocket science. It's supply and demand at its finest.

Trading the long or the short side is very easy, once a trader learns to ignore his or her own personal opinions. This means pushing aside any and all prejudices about the market and focusing on the current supply and demand situation. Once traders understand this, the next thing to work on is their own mental trading outlook and how they process this information, and to fully understand how the human brain naturally and emphatically causes traders to do things that make them lose money in the markets. It could be a whopper of a bad trade like Joe Trader's, or a series of smaller bad trades that grind down an account. Either way, it's the human brain that's letting it happen.

And that is what we discuss in the next chapter.

CHAPTER 2

PSYCHOLOGY 101: WHAT THEY DIDN'T TEACH ABOUT TRADING IN SCHOOL

Only a fool tests the depth of the water with both feet.

AFRICAN PROVERB

–EMOTIONS ARE FINE AT WEDDINGS AND FUNERALS

Trading is the most deceptive profession in the world. Do you know anyone who has recently walked into an airport, jumped into the cockpit of a jumbo jet loaded with passengers, and taken off down the runway without any prior training? Yet people will routinely open an account and start trading without any guidance whatsoever. And that is equally insane. Little do they know that their emotions and the natural functions of their brain are against them right from the opening bell.

Just as a chatty masseur is the enemy of a relaxing spa treatment, emotion is the enemy of successful trading. Remember, the markets are set up to naturally take advantage of and prey upon human nature, moving sharply only when enough people get trapped on the wrong side of a trade. This sweeps a burst of fear, frustration, and rage into the markets-and creates fabulous trading opportunities for the prepared trader. To head into this adventure called trading without having a firm grasp of how human emotions move markets, and how human emotions sabotage your own trading, is like trying to hail a taxi in Manhattan during a thunder shower. In other words, the overwhelming odds are against you.

The whole idea of this chapter is to lay the groundwork for the setups we discuss later in the book. With this foundation, traders will be able to understand how to control their "inner demon" with respect to trading. This is the creature that mentally blocks traders from following the parameters of a particular setup once they are in the trade. This is very similar to the brain freeze that occurred during the river rafting incident discussed in the introduction. It is also important to remember that every trader has different dominant personality traits that they use to absorb information and relate to the world around them. Some traders are more visual, others more auditory, and still others are more kinesthetic-they relate to the world based on how events make them feel on the inside. These three traits can have a big impact on a person's trading. Traders who are dominantly kinesthetic are doomed from the outset?until they realize that is how they relate to the world and what impact that has on their trad?ing. Near the end of the book there is a chapter on tips for when trading "isn't working for you." In this chapter there is a personality test that helps to determine what type of personal?ity you are and the pros and cons for each personality trait. The cons will work against a trader without their even knowing it-until they learn about it and realize what's going on.

In addition, the trader will realize the importance of utilizing a specific methodology for each setup, because each setup takes advantage of a different aspect of human emotions. A trader cannot apply the same trading rules to all setups across the board. This is one of the biggest mis?takes I see newer traders make. A two-point stop in the E-mini S&Ps can work well with one setup but cause nearly every trade to get stopped out in another. Trading five lots per $50,000 can work well with one setup but be devastating with another. By understanding the psychology behind the trade, the individual will also then understand the right parameters and the right allo?cation to use for each setup. Each setup really is unique, and it has to be treated that way.

The end result of this chapter is for you to develop what I call a professional trading mindset. Although we discuss setups for most of this book, traders have got to have the trad?ing psychology nailed down or their trading experience will be short-lived and painful.

SHOW ME A GUY WITH A SYSTEM, AND I'LL SHOW YOU A GUY WHO IS WELCOME IN MY CASINO

This is an old Las Vegas saying that applies equally well to the financial markets. Having a system gives people a sense of security-nothing can go wrong. Every time I walk into Mandalay Bay or Bellagio in Las Vegas, I am reminded that all these fabulous structures were paid for by people who thought they could beat the blackjack tables. The owners of the Luxor borrowed $550 million over 20 years to build their place. They were able to pay it off in less than three. Tell them at the front desk that you have a strategy, and you'll most likely get a presidential suite and a private table.

Why don't the strategies work in Vegas? The reason for this is twofold: The house has an edge with percentages, and as soon as the system falters a couple of times, the human mind gets to work trying to tweak it to make it perfect. This eventually screws up the entire process. In the casinos, as in trading, it takes only one stupid bet to blow the whole wad. Casino own?ers know this, and this is why they sell the strategy books right there on the property, promi-nently displayed in their own gift shops. This elevates the concept of the fox guarding the hen house to a whole new level.

It's the same process with the markets. The odds are against the trader surviving because the market has an edge:

It doesn't have any emotions. Like the river making its way to the ocean, the markets ebb and flow with total disregard for the objectives of the people hanging on for the ride. Humans have a tendency to try to imprint their will on the markets. This is like trying to get a tornado to shift course by yelling at it.

–THE RIGHT MENTAL OUTLOOK FOR THE MARKETS: DON'T TURN ON YOUR COMPUTER WITHOUT IT

He who conceals his disease cannot expect to be cured.

ETHIOPIAN PROVERB

First traders must understand the psychology, and then they can learn about the setup. It's like two pieces of a puzzle, and these two pieces have to snap together snugly in place before the trader can expect to trade for a living without repeating the same mistakes over and over again.

I've spent a lot of my career focused on trader psychology-not only working on myself, but working with hundreds of other traders. I've spent a lot of time in large trading rooms with hedge funds and prop traders, executing orders right alongside hundreds of other traders. I've watched the fear and the elation and the greed permeate a room and a group of traders like a disease. I've literally seen money from accounts on one side of a room flow into the accounts on the other side of the room, as each group of traders focused on different setups and parameters. In addition, I've worked with over 100 traders who have come up to my office to sit beside me and watch me trade, and to have me look over their shoulder while they trade. I'm the first to say that I'm not a shrink,but let's just say my experiences have left me with a clear road map of the process most traders go through when they first start to trade. Every person is unique, but when it comes to money, the differences are quickly stripped away. A herd of thirsty cattle will quickly drop all pretenses and stampede to get to water.

In addition to my experiences in working with other traders it shouldn't be surprising to hear that I learned a lot of this first hand through the best teacher that the market has to offer: extensive pain and suffering. My stepfather, Lance, a broker with Morgan Stanley, got me started trading options when I was a sophomore in high school. Of course, I'm not sure if he was introducing me to a great career or just trying to generate enough extra commissions to pay the mortgage-but it all worked out in the end.

He noticed that while I was at the mall slinging cookie dough and sodas, I had built up a decent-sized coin collection, had my own mail order business, and was actively engaged in buying and selling rare coins from dealers and individual collectors. This was a small opera?tion to be sure, but the entrepreneurial spirit was alive and well. He said that I could do essen?tially the same thing with household name stocks, but instead of trading the actual stocks, I could leverage my positions by trading options. I thought about it for about eight seconds and decided to give it a shot. On my first trade I bought 10 out of the money call options on INTC for 50 cents, and I sold them a week later for $1.35, pocketing $850 less the commissions that were going to help pay our mortgage. My monthly expenses as a sophomore in high school amounted to about $150. It didn't take me long to figure out that a person could make a liv?ing doing this. My capital became, in a sense, an employee working for me. And it beat work?ing at the mall. My senior year in high school happened to be 1987, which was quite a year for trading. By blind luck, I owned puts during the crash on October 19, when the Dow lost over 22 percent in one day, so I had some money to play with as I headed to college.

I continued to trade actively through college, where I started out studying business in California, used my trading stake to finance a year abroad studying history in Cambridge, England, and eventually graduated from the University of Texas at Austin. During this time, I quickly developed a very consistent approach to my trading: I would routinely tum a $10,000 account into the high 5 or low 6 figures over the course of a year. I would then buy myself a piece of rental property and a couple of nice gizmos. Then I would sit back and decide what other big?ger and better things I wanted to buy. Once I figured that out, I would go back to trading. Armed with these visions of "bigger and better things," I would dive back into the markets-and promptly give back the rest of my trading account in less than a month. This happened not once but three times. The most memorable trade happened right out of college, when I was able to give back a $150,000 trading account in less than a week. (That's what happens when you buy 200 OEX puts at $7.20 and sell them a week later for 75 cents). Luckily I did have enough real estate at this point to be able to sell one of the properties to raise a new trading stake.

At this point, of course, I had to sit down and figure out what I was doing wrong. I knew I could make money trading-why couldn't I keep it? My studies in history had a huge impact here. I could clearly see that since the beginning of modem civilization, the world had gone through a repetition of similar events all driven by human decisions. This insight really changed my focus and how I looked for opportunities in the markets. I stopped looking for the next great indicator and started looking for repeatable market patterns based on human nature.

During this time I also came across a book by Mark Douglas called, The Disciplined Trader. This book was a real eye opener in that Mark showed how to tum everyday stressful trading situations into "normal" successful trading behavior. His follow-up book, Trading in the Zone, is also excellent. His books have had a huge impact on me, and they are required reading for anyone I'm working with. Mark's insights, as well as my long discovery period, finally gave me the answer: Whenever I focused on the setups and not the results, I did fine. But whenever I focused on the results and not the setups, I got killed. Why is this? Once I got my hands on a decent-sized trading account, I would start to think of things like, "I want to tum this account into a million dollars." Instead of focusing on the setups, I would focus on making a million dollars. This caused me to jump into the trading habits that ruin all traders: betting it all on one trade, not using a stop because the trade "had to work out," and focusing on making a million bucks instead of waiting for a high-probability trade setup. Sure, it would have been easier to just blame it on my mother for hitting me with a wooden spoon once when I was a kid, but at some point we have to step up and take responsibility for our own actions.

Once this revelation sank in, I started to do two things differently: First, I started wiring any profits out of my trading account at the end of each week. This kept me focused on pro?ducing a steady income, as opposed to making a grand killing. I also discovered it was a great way to protect profits-the market can't have them if they are safely tucked away out of reach. Second, I started a competition among the various setups I used. This way I could mea?sure the performance of everyone of my setups at the end of each month. The setups that made money I kept using. The setups that lost money, I dumped. This was incredibly impor?tant to my trading. The only way I could keep my competition going was to execute my trade setups the same way each and every time. Anytime I deviated from a standard setup, I would mark this down in my trading journal as an "impulse trade." I kept track of the performance on these too. After about six months of tracking my impulse trades (wow, this market is going higher, I have to get in), I realized that they were not making me any money and were in fact preventing me from making a living as a trader.

In working with other traders, I see impulse trading as one of the most common rea?sons for people getting their heads handed to them. They don't have a plan. They just get long when that feels right, and they get short when that feels right. I've literally had traders in my office who have come up to work specifically on their impulse trades-only to sneak in orders when I wasn't looking. It's that powerful an urge to jump in and be a part of the action. It's like a drug addition, and like most addictions, it never works in the long run. My method for dealing with them is to simply sit next to them and watch them trade-and to do exactly the opposite of what they're doing. At the end of the day, or week, we compare our profit and loss statements, and that usually tells the story. This is a win/win situation because it is a great lesson for the impulse traders-there are actually people out there doing the exact opposite of what they are doing and making money-and it is a profitable exercise for me. The cure for impulse trading is patience. Patience is such an important quality for a trader-both in learning what setups best work for you, and in waiting for those setups to occur. Impulse traders who cannot own up to this bad habit need to stop trading and go to Vegas. The end result will be identical-they will lose all their money. But at least in Vegas the drinks are free.

If people are stuck in a relationship with an individual who berates their best efforts and undermines their dreams, then it is time to leave this individual and move on. It is in this vein that I "broke up" with my impulse trade. I liked my impulse trade. It was fun. It made me feel good. It was exciting. But the bottom line is that my impulse trading undermined my poten?tial and prevented me from realizing my dreams of being a full-time trader. Once this real?ization took hold, I took immediate steps to cut that cancer out of my life. This included a reward and punishment system that I discuss later in this book, in the chapter on formulating a business plan.

In the end, I stuck with my friends who believed in me-my setups that worked when I gave them half a chance. Once I was able to follow my setups consistently, exactly the same way each and every time, I was able to make the transition to trading full time. A large part of my transition was mental and developing what I call a "professional state of mind."

Before this could happen, however, I went through three very distinct phases in my trad?ing career. I've found that most traders go through these same phases in one fashion or another. Unfortunately, by the time they get through Phase III, they are typically out of money. The three phases are as follows:

1.Phase I: Destined to Lose-six months to a year

2.Phase II: Fear-Based Trading-two to six months

3.Phase III: Search for the Holy Grail-six months to death

4.Phase IV, of course, represents the time that a trader has become consistently profitable.

It is critical that traders understand this process and recognize from which phase they are cur?rently operating. This is obviously important for a trader's own development, but there is a more subtle reason why it's essential to grasp this concept-so a trader can understand how to crush other traders who are still stuck in one of these phases. This is the biggest poker game on the planet, and the money flowing into your account isn't appearing as if by magic. It's coming from someone who is still learning how the markets work, and who most likely fol?lowed his or her gut and got suckered into taking the wrong side of the trade.

PHASE I TRADING: DESTINED TO LOSE - - TRAITS THAT MAKE PEOPLE A SUCCESS IN LIFE GETS THEM KILLED IN THE MARKETS

He that lives on hope will die fasting.

BENJAMIN FRANKLIN

It has been said that the path to hell is paved with good intentions, and nowhere is this more apparent than in the world of trading. I have yet to meet one individual who went into trad?ing with the goal of losing money. Everybody's intentions are quite the opposite, and the first thing people do when they enter the world of trading is tap into what has worked for them successfully in the past. The problem is that the tactics an individual uses to achieve his or her goals in everyday life do not work in trading, and in fact are one of the main reasons for fail?ure. While good judgment is critical to an individual who wants to climb the corporate ladder or start a business, we have already seen why "good judgment" didn't work in the middle of the TASR trade. This leads us to what has to be the most painful lesson ever inflicted on the optimistic nature of the human species: The tactics an individual uses to achieve goals in everyday life do not work in trading, and in fact are one of the main reasons for a trader's failure. The determination, positive thinking, and stubbornness that made people a success in one area of their life simply sets them up for slaughter in the markets. It is these types of traders who obstinately hold on to a losing position, adding to it on the way down, using pos?itive thinking techniques to visualize this fiasco eventually turning into a winning trade. I don't care how many Tony Robbins tapes the employees of Enron listen to; it's not going to get their stock back up to $90 a share. The trader who is unaware of this phenomenon is set up for failure from the very beginning. This doesn't mean that a person shouldn't be positive about their ability to eventually become a successful trader. Far from it. However, a trader will be much better off assuming that every trade they take is going to fail. This way they learn to focus on protecting their downside. The upside can take care of itself. Be positive on life, but pessimistic on your next trade.

Traders who "play the markets" with a mental framework oriented toward how external society rewards and punishes "good" and "bad" behavior are set up to lose from day one. For example, "cutting losses short" is difficult when there is the possibility of the market coming back to the breakeven point. At breakeven, the trader is not a "loser." Thus, according to the benchmarks of society, if traders can exit a position with a gain, they are "successful." This leads to the removal of stops "once in a while" in the hopes of getting out at breakeven-in order to be a winner in the eyes of society (sigh). This can work 10 times in a row, but it is the one time it doesn't work that knocks traders flat on their back. On this particular day, these traders will be among the many who cause a "riplike movement" in the markets as they pound their keys in disgust to get out of a trade that is killing their account. This habit of removing stops, even if it is only once in a while, is reinforced by the societal belief of what defines a winner versus a loser. This habit will destroy a trader's account faster than anything else. By using hard stops and sticking to them, a trader at least has a fighting chance in being able to do this for a living. If they can't at least do that, they will not make it as a trader. Period.

What happens to traders in the beginning is that they naturally end up on a cycle in which they label themselves as a good trader on days that they make money and a bad trader on days that they lose money. This is an ordinary reaction instilled into them based on the principles that apply to general society. After all, straight A's mean a student is a success, while F's mean they are a failure, right? If there is anything I can emphasize in this book, it would be this: Trading has nothing to do with general society. In fact, the markets are set up in such a way as to take what most people hold near and dear to their hearts as a means of taking advantage of them.The markets thrive on taking the rules and ideals that govern gen?eral society, wadding them up into a ball, lighting them on fire, and then shoving them down a new trader's throat. Any trader who is unaware of this phenomenon is being played like a fish right from the opening bell.

General society tells us that losing money equates with failure and making money equates with success. The trader, after a losing day, unconsciously thinks, "I've lost money. I can't do this. If I would've just removed my stop, the market would have come back and got me out at breakeven, and then I'd still be a contender." So what happens is that the trader starts looking for opportunities to remove his or her stop in order to not end up with a losing trade. Not on every trade, of course. Just on some trades. And how do traders determine when to do this? Easily enough, they just use their "judgment" while in a trade. And this is exactly when professional traders step in for the kill.

This society focus on money traps traders into the very habits that cause their ruination.

Removing a stop in the hopes of getting out at breakeven is one of the worst habits a trader can develop. Sure, it will work some of the time, but it has to tum into a disaster only once to wipe out half an account or more. While the rest of the world views losing as a bad thing, in trading, small losses are the best sign of success. Nobody outside of trading will ever under?stand this, so don't waste a lot of time telling your in-laws how losing only $2,000 yesterday is part of your success plan. Yes, this means you are doing your job, but as long as the sun continues to rise in the east, other people will never get it. The only people who understand traders are other traders. Personally, when I'm at a cocktail party and people ask me what I do for a living, I've found it's just easier to say that I'm a leper. People at least understand that and can empathize.

The biggest issue for newer traders is to reprogram their brains into realizing that, in trading, losing is winning. A professional trader's job is to take small losses. Period. Most traders don't realize that there are only a few days each month where big profits can be made. The rest of the time traders are doing their job if they are keeping their head above water. The idea is to keep the trading account intact for when the big moves come along. If on Monday some traders take three small losses in a row and end up down on the day, they are doing their job and have the chance to be successful professional traders, because they will have main?tained the bulk of their account to use on one of the few days when the markets really move. That is what trading is about. It's about traders sticking to the parameters that they have set for themselves and sticking to the setups that they've decided to follow. It's not about gut reactions and chasing the latest sound bite mentioned on CNBC. That is the path to trading annihilation.

I remember getting a call from a guy in mid-2003 who was running a $10 million hedge fund for his family. It was never made clear to me how he qualified for this role, though I think he mentioned something about knowing how to use the Internet. He sent me an e-mail about YHOO, asking me for my thoughts. I looked at the chart. The stock was trending higher on nice volume, and I told him about a couple of different setups I would use to get long the stock. Apparently that wasn't the answer he was looking for, because he called me the next day telling me I was reading the chart wrong. As I listened to him rant on about page views and price earnings (PIE) ratios, a light went on. I interrupted him and asked, "Where did you short this stock?" After a moment of silence followed by a cough, the story emerged. He had shorted it at $12.00 based on a newsletter recommendation. As the stock rallied, the newslet?ter shorted more, and so did he. By the time I talked to him, he had shorted 400,000 shares at an average price of $16.25 for a total outlay of $6.5 million.

I asked if the newsletter was still short, and he said no. I checked my quote screen and saw that YHOO was trading at $22.50 and had just cracked out new 52-week highs. He asked me if he should short some more to raise his average cost, "so it won't have to go down as much for me to get back to breakeven."

Here he was down $2.5 million on the trade, his family hadn't seen the statements, and he was trying to salvage his career as the family financial guru. There was zero rationality in his thinking. I told him he needed to get out of the trade, or at least buy call options for a hedge. I even said that YHOO was going to keep on rallying until all the people who were short cried uncle and covered. Apparently that wasn't the advice he was looking for either. He ended up shorting another 100,000 shares, and finally caved when YHOO hit $30 for a loss of $6.25 million. It's an excruciating story, but this happens all the time with all types of dif?ferent account sizes.

This guy didn't want to take a small loss because he didn't want to look like a loser to his family. His motto became, "As long as I hold onto this position, it's not really a loss." This is like having blood pour out of your bowels and you choose not to go to the doctor. "As long as I don't go to the doctor, no one will know I'm dying." Trust me, once you are dead, people will figure it out.

Averaging down on a losing position is like a sinking ship taking in more water. When the family fund manager kept shorting YHOO as it made new highs, he may as well have been dri?ving nails into the Mona Lisa. Both are deliberate acts of destruction. Financial planners always talk about dollar cost averaging. I call it dollar loss averaging. Adding to a winning trade is okay, but adding to a losing trade is insane. If you caught some of your employees stealing from you, would you give them a raise or fire them and find somebody else? This guy trading YHOO would have given them a raise, a housing allowance, and a comfortable pension.

As traders approach the end of Phase I, assuming they still have any capital left, they have some solid experience under their belt. They haven't quite figured out why they are get?ting hammered by the markets. It's not like they have lost money on every trade. In fact, they've had some great trades. Unfortunately, they've also been knocked down pretty hard on a number of occasions, and their account is under water. They started off optimistically, but now they just want to be a little more careful. And the bottom line is that they don't want to lose any more money. Welcome to Phase II.

PHASE II TRADING: FEAR-BASED TRADING OR, "EVERYTHING I TOUCH TURNS TO CRAP"

Many traders think that once they become more cautious, their trading will improve. They would be wrong.

When traders decide they don't want to lose any more money, they unwittingly tum themselves into the "late entry" champions of the trading world. They wait and they wait and they make doubly sure that a trade looks good before they take it. In this scenario, the mar-kets start to rally, and by the time the trader is absolutely convinced that this rally is for real, he or she is jumping in near the dead highs of the move. He or she and the rest of the traders who did this just gave the markets the fuel needed to start moving down. Why? Because sud?denly the market has a lot of stops being placed beneath it, and like wind on a forest fire, these stops will ignite a sell off. This safe, cautionary entry quickly turns into a loss. The difference this time is that prudent traders religiously stick to their stops. The problem is that this over?cautious behavior gives them terrible entries, and their odds of getting stopped out are extremely high. Yes, small losses are good, but if nearly every trade results in a small loss, the account will eventually wear itself down.

Phase II usually doesn't last very long. Traders in this phase generally don't lose a lot of money, but they lose enough. Once traders figure out that they can stick to their stops, but that their entries are suffering, they reach what alcoholics refer to as a "moment of clarity." If the traders' entries are bad, then obviously their indicators are bad. So they go looking for some better ones. And thus begins the search for the Holy

Grail.

PHASE III TRADING: THE SEARCH FOR THE HOLY GRAIL-HOLDING YOUR BREATH IS NOT ADVISED.

The search for that fail-safe indicator that's going to work nearly every time takes a trader down a path littered with corpses, broken dreams, and stuttering fools. Many traders stay on this search for the rest of their lives. The irony is that individuals in this phase think they are developing as traders, when in reality their development as traders is dead in the water, hav?ing been stopped faster and with greater intensity than Monica Lewinsky's future in govern?ment. Traders in Phase III are stuck in quicksand, entrenched in a losing game that can last years, decades, or longer. The end result is a trader who spends this time repeating the same mistakes over and over again or happily discovering new ones.

The cycle that takes place is one of always looking for the next best thing. It's the search for that oh-so-special indicator or system that is going to give the traders their lodestone reward.

In a typical scenario, this means diving headlong into a couple of different trading programs or ideas and endlessly tweaking them until they reveal their magic. One typical scenario relates to traders who develop a simple set of mechanical rules, which are kept secret, of course, that will help them attain a substantial profit each year with virtually no risk and using only a small amount of capital. They get especially excited when they see that these methods, when carefully applied to select historical data, work amazingly well. The ones that didn't work out could eas?ily have been "filtered out." This type of trader typically dies with a one-page summary of how well the trade works, and a stack of 68 pages that explain when not to take the trade.

Other traders stuck in Phase III will go to seminars and learn about trends, and learn the importance of never fighting the trend. They discover the magic of moving averages and how they cross over when the trend changes. Oh, the power! When the market is trending, they work beautifully. Eventually, though, they get discouraged when they figure out that 75 per?cent of the time markets are trading sideways, as professionals chop the Holy Grail seekers into mincemeat.

This may lead traders to the world of options and they start looking at spreads to con?tain risk and writing premium to generate monthly income. This works great when the mar?ke are chopping around, but then when the markets start trending again, these positions can, and often do, get killed.

The list goes on and on. At various stages throughout this journey, after traders have studied a number of systems, strategies, and indicators, one day they sit down and create what they think is the perfect chart with the perfect indicators. Then they start to use it. It may work well during the first couple of days, or even the first couple of weeks, but then the traders gets burned on what they thought was a perfect setup. So, instead of using an MACD (Moving Average Convergence Divergence) with a setting of 12, 26,9, they read somewhere that a set?ting of 12, 17, 10 is faster. They go in and reformat all their charts with the new setting and eagerly await the next trading day. Their setups work for a couple of days or a couple of weeks, and then a couple of trade setups don't work out. Back into cyberspace the traders go. They are determined. They are focused. They neglect their family, miss the daughter's soft?ball game, and lose track of time. But it's all worth it, because seven days later, at 3:45 in the morning, they discover what they've been looking for. On their stochastic, they've been using the settings of 14, 3, 3 when they should have been using 15,3, I! They put it on a chart and apply it to historical data. It works much better! The traders once again reformat all their charts, and, once again, eagerly await the next trading day.

And when this doesn't work, they go from a IS-minute chart to a 13-minute chart.

And when that doesn't work, they switch from trading the E-mini S&P to the E-mini Nasdaq. And when that doesn't work, they learn that the euro is the place to be. And when that doesn't work, they become a gold bug, because, don't you know, it's the only real money? It's always, always, always the next best thing. This cycle repeats itself forever until the trader gets sick of this roller coaster and jumps off at the next stop. Most never fig?ure this out and remain stuck here for the rest of their trading lives. The kids go from dia?pers to dormitories, and they barely notice because they're still lost, tweaking the next best thing, never realizing they're the chump with the strategy who would be welcomed with open arms in any casino. Like Duluth, Minnesota, in February, it's a terrible place to be.

This whole situation is summed up succinctly by one of the hedge fund characters in Ben Mezrich's entertaining book, Ugly Americans: The True Story of the Ivy League Cowboys

Who Raided the Asian Markets for Millions. "The whole game of arbitrage is spotting who the ass hole is. If you can't spot the asshole-well, then you're the asshole,"

SIGNS THAT A TRADER IS STUCK IN PHASES I, II, OR III

Here are a few additional anecdotes and situations that let traders know they are still stuck in these beginning stages of trading.

Good Till Close

A popular order type for swing traders is called a GTC order, or "good till canceled." This means just what it says: "Keep my order in place until my target is hit or until I cancel the order." My partners and I, as well as many brokers, refer to GTC orders as "good till close." This is because many traders will keep their "good till cancelled" order in place right up until price action gets "close" to their order. What happens is that the stock they are in is rallying hard and approaching their GTC sell order. They start looking at the stock and think, "Wow, this stock is acting great! I don't want to get out of it because it's going to keep heading higher." So they call their broker and cancel their GTC sell order. The stock rallies, pushes up through that order level, and then eventually starts to sell off. The trader has no exit strategy, and the stock continues to fall and turns into a losing trade. This starts off as a greed play and turns into a fear play. When enough of these happen to traders, they start to get really fearful about losing money.

Size Really Does Matter

When traders get scared and start to put most of their focus on not being wrong, a variety of bad things start to happen. The most common is that the traders get into a new position, and as soon as they see a small profit, they take it. They buy the minisized Dow at 10100, and it goes to 10 104. Even though there are screaming buy signals in place and there are zero sell signals, they, miracle of miracles, have a profit, and they'll be damned if they are going to let the market take it away from them. So they pocket the four Dow points, which amount to $20 per contract, or about $14.00 after commissions. Never mind that the Dow goes on to rally another 40 points, and then and only then, does it give an exit signal.

What happens is that traders are taking a four-point profit, a three-point profit, a six?point profit, and then on the last trade of the day it goes 30 points against them. So the traders have three winners out of four but they are down on the day. And it's kind of a typical thing that'll happen for traders who are in this frame of mind of not wanting to have to go through the pain of watching a profitable position go all the way back into the red.

Many brokers actually analyze their client's accounts in order to predict when they are going to blow up. This way they can hedge the traders before the losses actually occur, essen?tially trading against them. The number one indicator that a trading account is going to blow up is an increase in the frequency of trading combined with the increased use of market orders instead of limit orders. Firms that hedge see this situation develop, begin to lick their chops, and fade their customer's account, taking the opposite side of every trade. In general, traders who suddenly start taking smaller profits are also trading much more frequently than they used to. It is important to realize that some firms will see this activity and take specific action, because 90 percent of the time this means a trader is about to blow up their account. Don't be the trader that comes up on the broker's radar screen as a hedging candidate.

Yes, size does matter. Bigger losses are a lot worse than smaller profits. However, a trader who takes small profits because of fear is not following a plan. A trader who is not fol?lowing a plan, who is only reacting to internal emotions, is going to get beat. Not maybe. Not probably. Going to.

Greed Is Bad Nourishment for the Brain

There are limitless ways for traders to sabotage their account, but this is a particularly good one. What happens is that traders get into a comfortable routine. Maybe they are averaging $250 a day trading the mini-sized Dow on a $50,000 account. This, for them, is a reasonable goal on the capital they are trading. One night they are at dinner with their spouse who asks how the trading is going. The traders respond that all is going great. The spouse is pleased and says something like, "Well, since your trading is going so well, I've been thinking that I'd really like to get a BMW. Can we go ahead and get one?"

And so the next day the traders wake up and think, "Okay, if I'm going to get this BMW, I've got to step up my trading and start making $750 a day. This way I can set aside a large down payment, and I can get the car in the next six to eight weeks." The very second traders utter those words, a trigger clicks in the remote recesses of their mind, and they have unknowingly entered a period where they will not be able to do anything right. Instead of sticking to their original parameters, they're going to start reaching for more. What used to look like a perfectly good 20-point profit in the mini-sized Dow now looks puny-it cer?tainly won't have much of an impact on the BMW purchase. So the position doesn't get sold as the traders sit back and wait for the market to give them more money. The market inevitably turns and the traders end up getting stopped out for a loss. In this mindset, what once used to look like a reasonable profit becomes too small, and this throws the entire trad?ing plan out the window.

I remember working with one trader who was in almost exactly this same situation. He was a good trader, but had recently entered a losing streak, and he couldn't figure out why. I asked him if he suddenly was trying to trade his way into any big, specific purchases. Yes. Aha. Something for his wife. We talked about this phenomenon for a while, including the story about the fur coat, which is described in Reminiscences of a Stock Operator by Edwin Lefevre, a book that is a must read for all traders. My friend paused for a moment, rubbed his chin. "Well, I think I know how to fix this problem," he said. "I'll just divorce my wife."

This is the home run mentality, and it's a downfall to all traders. It's important for the trader to remember that the market is not going anywhere. Like an all-you-can-eat-buffet in Vegas, it's going to be there all the time. There is no reason to try to load up your plate to the max on your first trip through the buffet line. People can grab their plate, mosey on over to the buffet, pick up a couple of pieces of shrimp, and saunter back over to their table and enjoy them. Then, when that's done, they can go back and pick out a few slices of brie. There is no need to be a hog and load up the plate. The buffet is always going to be there. A person can sit there all day and take little nibbles from the buffet all day long. Remember, in the markets, bulls can win and bears can win, but pigs get slaughtered.

Speaking of Jesse Livermore

Many traders know that Reminiscences of a Stock Operator by Edwin Lefevre is a book about Jesse Livermore, the famed trader who made approximately $100 million in 1929 dollars in the stock market crash (about a billion in today's dollars). What many people do not know is that on March 5, 1934, he filed for bankruptcy, and on November 28, 1940, he blew his brains out in the bathroom stall of a hotel. Although this may not sound like a strong endorsement for the book, it is a must read for any serious trader. While this book talks about the trading strategies that made him his fortune, the book Jesse Livermore, World's Greatest Stock Trader by Richard Smitten also goes into detail about the years and days leading up to his suicide.

I majored in history and was trained to take pieces of historical data and form an opin?ion, based on facts, about what really happened in the past. From what I've read of Jesse Livermore's life and eventual demise, my opinion is that he suffered a bout of euphoria after the 1929 crash. This euphoria caused him to trade recklessly and with huge size, and this caused him to lose his fortune in less than five years. Although he had gone broke and made a fortune three times before, the size of this loss did permanent psychological damage, and the pressing weight of "trying to make it all back" is what eventually did him in. Let's take a look at what euphoria can do to a trader.

Euphoria: Redefining Stupid

Euphoria is the worst emotion for a trader to succumb to, even worse than greed. What hap?pens with euphoria is that traders have such a great day in the markets that they proclaim themselves king of the trading world. Normally let's say they trade 10 contacts. Well now, since they are "king," they are going to start off with 50 contracts, and go up from there if they feel like it. After all, they are now "the world's greatest trader" and can do no wrong.

This happens to traders frequently, and the resulting act of insanity is just like doubling each bet on a roulette wheel. People can sit on red and keep doubling up on each bet until they win. This works great right up until the time that they have maxed out their capital on red, and the color comes up black. Doubling and tripling up on positions just because a trader is feel?ing confident is yet another sucker's game. What's worse is that this strategy always leads to traders giving back all the fantastic gains that made them euphoric in the first place. This places added pressure on traders-now they have to trade in order to get back to where they were. This, of course, causes a multitude of bad habits.

Increasing trading size just because you are feeling awesome about your trading is like being in a marriage that is going fantastically well. The conversations are sparkling, the mutual adulation adoring, and life under the covers is grand. Happiness abounds in spades.

How can you make this better? Double up! Have an affair. A good idea in theory, but this is only going to tum out one way-very, very badly.

PAPER TRADING-WHY IT'S MORE WORTHLESS THAN AN IRAQI DINAR

There are a few good reasons for people to paper trade. Paper trading will help a trader learn a new execution platform. This way they can figure out how to use the software through a demo account and save themselves costly errors that arise when they try to place orders on an unfamiliar system. Also, paper trading is good for forward testing a system or strategy to see how it works before committing real money. However, paper trading does have one distinct disadvantage-it can be worthless in a way because it does not take into account how a trader will act when there is real money on the line. That is what makes or breaks a trader. It's ok to trade a smaller size, but without real money on the line, a trader won't understand how they hold up under pressure. This is also a good way for a trader to test how far apart they are men?tally from "paper trading vs. real trading." A trader should feel the same trading paper as they do real money. To the extent that they feel extreme emotions when really trading vs. paper trading, it will give them a clue where they are on the psychological trading scale. In other words, how screwed up they are psychologically when they are actually trading real money. When a trader freaks out on a real trade, it is a red flag that they are trading too big for their account size. In this case, a trader should keep trading smaller size until they feel the same emotionally as when they are in a paper trade.

The most dramatic instance I've seen with this is in working with traders in Asia, specif?ically in Taipei, Hong Kong, Tokyo, and Shanghai. Asians are fantastic gamblers, willing to risk huge sums. This can be a problem with trading and it only takes one bad trade to ruin an account. One guy I worked with was trading 100 lots at a time in a $100,000 account. Each 1 point move in the S&Ps represented $5,000. The first day he made 5 points ($25,000), and the next day he lost 7 points ($35,000). These were normal fluctuations for him, and it showed. He'd get so excited and animated that I thought he was going to implode. I had him cut his size down to 10 lots. At first he was bored, but then a strange thing happened. He wasn't excited, so he traded objectively … and he made money. We got him to trade in the same fashion as if he were paper trading, and it made all of the difference. Being able to work with traders over?seas is a great win/win for me as I get to learn how other people view the U.S. markets, as well as see how U.S. news is filtered through their local news channels. Being able to put yourself in another person's shoes brings more understanding of how the world really works. That may not help you decide whether or not to take the next trading setup that comes your way, but it does help form a macro view of the world-and it does make life more interesting.

Good Ideas to Keep in Mind

A trader's relationship with the market is really like a dance, and it's best to let the market lead. It's important not to come into the market with an overly bullish or overly bearish outlook. The stronger a trader believes in an idea, the easier it will be to get suckered into taking the wrong side of a trade. In an upcoming chapter I talk about how to read market internals, and this is a great way to get a read on what's happening in the markets. Instead of coming into the day a raging bull or a roaring bear, I just come in as an interested observer. The "radar screen" that I watch keeps me in the loop and gives me odds on the path of least resistance. As long as we're dancing together, I'd like to know when my partner is going to try to dip me.

And there's a little saying that I always like to remember; it's called "discipline before vision," which is something I first heard from Peter Borish, the former head of research for Paul Tudor Jones. I might think the market is going to crash today, but I'm still going to have a stop in place in case I'm wrong. The vision of being short during a crash is a pleasant one, and the thought of a big move gets traders to do stupid things, like doubling up and adding to losing positions. Disciplined traders live to fight another day. Through most of 2004 and 2005, I've heard many traders who are "staying positioned for the next, inevitable terrorist attack." After the events of September 11, they saw how that impacted on the market, and they want to get positioned for the next attack. (Yes, this is a terrible way to look at a disaster, but this is how traders think. If there is a hurricane in Florida, then it's time to go long lumber because they will have to rebuild a lot of houses). The funny thing is, this vision of being posi?tioned for a crash totally clouds their judgment. The only thing the market hates is uncertainty. The events of September 11 were unexpected, and the market got crushed. However, terror?ist activity is now a certainty. It is no longer an unexpected event, and therefore the market has already priced in future terrorist attacks. Sound insane? On July 7, 2005, America woke up to the news of the London bombings. The Dow at one point was down over 200 points pre?market open. All of these people got heavily short. The markets rallied and closed positive on the day, and these "waiting for the next disaster traders" got crushed. Discipline before vision.

It is also important to remember that there is no need to spend wasted years looking for complicated setups or the next Holy Grail. There are very simple setups out there to use. Some of the best traders I know have been trading the same setup, on the same time frame, on the same market for 20 years. They don't care about anything else, and they don't want to learn about anything else. This works for them, and they are the masters of this setup. They have nothing else coming in to interfere with their focus. If a setup doesn't happen that day, then they don't take a trade.

Other successful traders I know have learned to celebrate their losses. When they get into a trade and get stopped out, they jump up and clap their hands. When they get into a trade and it hits their target, they do nothing. They're doing the exact opposite of everyone else, and they're making money. When Jesse Livermore was in the process of making his fortune, one of his favorite quotes was, "If I bought a stock and it went against me, I would sell it imme?diately. You can't stop and try to figure out why a stock is going in the wrong direction. The fact is that it is going in the wrong direction, and that is enough evidence for an experienced speculator to close the trade." Small losses make all the difference, and traders must learn to reward themselves for doing their job in this regard.

It is important to remember that a trader is not trading stocks, or futures, or options.

Traders are trading other traders. There is another person or system out there taking the oppo?site side of the trade. One side is going to be right, and the other side is going to be wrong. Whoever has the better setup on this trade is going to win. Is the trader on the other side of the trade an amateur or a professional? That trader should be wondering the same thing about you. The next time you succumb to greed and chase a trade, remember that there is a profes?sional somewhere else in the world who has been waiting patiently for this setup and is doing just the opposite.

I have found that the most important step to becoming a successful trader is just learn?ing how to accept a loss without any anger or frustration or shame. It's just part of trading. It's not a big deal. I take losses every day, and I do it live in front of people all of the time. It's just part of the process. Okay, this trade just hit its stop. Next. It's like Tom Hanks's char?acter in the movie A League of Their Own, who screams at his female player and makes her cry. "Are you crying?" he asks, shocked. "There's no crying in baseball!"

And there's no crying in trading and no throwing your coffee cup against the wall or screaming at your monitor. Losses and missed trades are just part of the deal. On some days things are just not going to come together. If I'm using a setup and I'm stopped out two times in a row, then I just stop using that setup for the rest of the day. For whatever reasons, it is out of sync with the markets on that particular day. No big deal. There is no need to reformat the MACD. It's just part of trading.

The key is to have two specific sets of rules. First there needs to be a trading method?ology. For this setup, do the traders go all in or scale in? Do they scale out or get all out at a specific target? Do they trail a stop or leave it? Where is the stop placement in relation to the target? These are all things that have to be set in stone before the trade is placed. Once the trade is placed, there is no room for rational thought. The setup has to be followed the same way each and every time, or the traders will never be able to gauge if the setup is going to help them or hurt them in their trading. Otherwise they are just making impulse trades, and those are the sucker trades. Second, there has to be a money management rule. How many shares or contracts does a trader allocate toward this setup? How much equity is a trader will?ing to risk on this setup over the course of a day, a week, a month, or a year? After traders do this for a while, what happens is that they develop the habit of following their rules and they eventually learn to trust themselves.

Once traders learn to trust themselves, they can then free their mind to focus on market opportunities that present themselves, instead of being wrapped up tight in a ball of fear, frus?tration, and doubt. This is where traders make the transition out of the first three phases and begin to really have an opportunity to do this for a living. The transition involves focusing on developing their own trading skills instead of focusing on the money. And the skills are easy-keep the emotions in check and have the discipline to follow the setups. Don't focus on making $1,000. That is what the amateurs do. Focus on developing your skills and exe?cuting the setups the same way each and every time. It sounds simple enough, but I've worked with enough traders to know that most of them can't do it over the long haul. They get impa?tient and don't want to miss out on the action, so they jump in and chase without a clear setup. Once they do this, they go back into the barrel with all the amateurs.

Most of trading involves waiting. First, it involves waiting for a setup. Once the setup occurs, then the professional trader takes it without hesitation. The skill comes in waiting for it to set up and not succumbing to an impulse trade. Then, once in a setup, a trader has to have the discipline to wait for the exit parameters to be hit and not cave and bailout too early. Waiting is the hardest thing for many traders to do, but it's the waiting that separates the win?ners from the losers. Even for a day trade, it can be hours before a setup happens or a parameter is hit. And that's the whole key. Just being patient and waiting. The person who chases four rabbits catches none.

Also, it is so important to realize that professional traders are not in every move. It is okay to have the market leave the station without you. Catching every move is impossible, but chasing every move is the mark of an amateur. This is why it is imperative for traders to have a set of rules to follow for both entries and exits, as opposed to relying on their own gut feel?ings to manage a position. Develop a set of rules and have the discipline to follow them; they exist for your protection.

For me, the biggest difference in my trading occurred when I learned to ignore my brain. and just focus on a handful of good setups. Once I learned the setups, the next challenge was to have the discipline to follow them the same way each and every time. No thinking, no hem?ming, no hawing. I did this by recording my trading activity and grading myself on how well I executed each setup, instead of how much money I was making or losing. Whereas focus?ing on the P&L automatically encourages the bad habits that plague many traders, a setup?based approach encourages habits that can push a trader into the realm of consistent profitability.

In the end, professional traders focus on limiting risk and protecting capital. Amateur traders focus on how much money they can make on each trade. Professional traders always take money away from amateurs. Amateur traders start to tum into professional traders once they stop looking for the next great technical indicator, and they start controlling their risk on each trade.

You cannot be disciplined in great things and undisciplined in small things.

Brave undisciplined men have no chance against the discipline and valor of other men.

Have you ever seen a few policemen handle a crowd?

GENERAL GEORGE S. PATTON

CHAPTER 3

HARDWARE AND SOFTWARE-TOP TOOLS FOR TRA

Dress a goat in silk and it's still a goat.

CELTIC PROVERB

HARDWARE-IT'S ALL ABOUT THE RAM

This chapter is about creating a level playing field for all traders with respect to the equip?ment and software they are using to tackle the markets. If traders can get this part right, they are at least going to have a fighting chance to compete on a level playing field with everybody else. If traders are behind the technology curve, they are going to be trading at a distinct dis?advantage. In trading, people without an edge in terms of equipment, mental outlook, and methodology are like young wildebeest trying to snatch a drink at the edge of a crocodile pond-they're simply not going to make it. Why would people deliberately create a weakness in their trading plan by having trading software or technology that is outdated? It would be like entering the Daytona 500 with a Winnebago. This is the easiest part of a solid trading plan, and it is 100 percent under a person's control.

The amount and type of trading equipment that traders have is going to depend a little on their own financial resources, and a lot based on the type of trading they are doing. Top of the line systems with three or four monitors are available from companies like Dell on a leas?ing program for less than $150 per month, so cost isn't a huge issue. If traders have a com?puter that is more than three years old, they need to upgrade some of its components or just get a new one.

The most important component of a trader's computer is the RAM. This is the amount of memory available while the computer is running applications in real time. Traders with an older computer will definitely need a boost here, as this has a major impact on how fast they will be receiving their quotes and other live data. This is also the most expensive part of the computer, though prices continue to drop. As I'm writing this on February 7, 2005, there are three ads on the Internet that boast top-of-the-line computers for $399. These are equipped with a nice 2.4 gigahertz processor, a fat 40 Gigabyte hard drive-and a puny 256 megabytes worth of RAM. This is inadequate for a trader. The RAM on a trader's computer should be at least 2 gigabytes, and nearly all basic systems come with much less than that. Realistically a trader is going to spend about $2,500 for a high-performance computer with at least 2 gigabytes of RAM, multiple flat screen monitors, and a solid multi-monitor-ready graphics card. There are companies out there that market "trader computers" for a lot more money, but exactly the same computer is available at Dell for much less. Dell also has the best customer service I've ever encountered. I've had monitors go out that have been replaced for free by Dell within 24 hours. The same thing happened with another popular manufacturer and the tum-around time was six weeks. The main thing to keep in mind is that a trading computer should be specifically set up for trading and have a minimum of other stuff going on. If there are kids in the house, make sure they have their own computer for Internet surfing and computer games, and tell them not to touch the trading computer under pain of death.

One question I receive a lot from traders is, "How many monitors do I need?" This really depends on what you are trading. I personally utilize 10 monitors for viewing charts, and 2 additional monitors for other tasks such as e-mail, instant messaging, and Internet surf?ing. These are all set up on four different computers. Most traders do not need this many mon?itors, and I know of many traders who make a great living with just two. For me, I keep my day trading and swing trading separate, and for these trades I use different accounts, different monitors, and different execution platforms.

Figure 3.1 shows a snapshot of my day-trading execution platform. This keeps a run?ning tally of how I'm doing on the day, for each market and with a grand total. On the day shown in Figure 3.1 the DAX and S&Ps generated a nice upside, while I kept getting stopped out in the euro. The dots on the chart show my entries and exits. All my swing trades are set up on a different execution platform.

This strategy of having distinct accounts for day trading and swing trading helps me to keep the different trade setups separate, because I could be short the mini-sized Dow futures in my swing account, but long the same contract in my day-trading account. These are in dif-ferent time frames and require different parameters. By keeping them in separate accounts, there isn't any confusion, and the performance for both types of setups is easier to track. Also, because I'm writing newsletters and updates during the trading day, I need access to more data than most traders.

FIGURE 3.1

There is a danger for traders in setting themselves up with information overload. I vis?ited one trader who had 25 monitors shooting data at him from all directions. Shockingly, he could never decide when to pull the trigger to get into a trade. It is important to remember that traders don't need to know everything that is going on in the markets. They just need enough information to be able to decide whether or not to take their setup. All of the suc?cessful traders I know focus on just a handful of setups. They don't need a confirming move in crude oil in order to take their buy signal on the S&Ps. If traders have found one or two setups that really work for them, then they can, and should, ignore a lot of the data out there. Laserlike focus on a small part of the markets brings expertise and a better understanding of when to take a trade.

FIGURE 3.2

Figure 3.2 shows the computer setup I use for my trading. I do like to have one com?puter that I use specifically for e-mails, instant messaging, and Internet surfing. This is the computer that is going to get attacked by viruses, so I want to keep it separate from the oth?ers. In addition, I also keep a backup laptop in place that is attached to a dial-up modem. Thankfully I rarely have to use it, but whenever the power goes out or my broadband con?nection goes down, I can still have access to my accounts and current quotes.

Monitors, Graphics Cards, and Other Gizmos?What to Get and Where to Get Them

The graphics cards that I like the best are the Matrox G200 Multi Monitor Series (MMS) cards. These are available right off their Web site, www.matrox.com, for about $400. They are also available on eBay (www.ebay.com) for about $120. The dirty little secret in the hardware busi?ness is that most hardware is available on eBay for half price or less. This used to be where people could buy products at a discount because of inventory clearance or merchandise that falls under the semi-legal arena of being redistributed without manufacturer's approval or war?ranty.These days, the company itself typically sets up an alias and sells its own products right on eBay in order to tap into the "auction crowd." I've always purchased things like graphics cards right off of eBay, and I've never had a problem with getting ripped off or getting a faulty product. The most important thing to remember when buying something from eBay is to make sure the sellers have great feedback. If they have low ratings, or worse, no ratings, then don't touch them. I'm not a computer guy, but it was really easy to take out my old graphics card and slip in the new one. A trader who is unsure how to do this can look in the yellow pages and find a consultant to do this for a reasonable cost. Have them come to your house or office. Whatever you do, don't take your computer and drop it off at some mass-market, nonspecial?ist dealer, whose employees often have a lesser degree of computer-specific expertise.

For the actual monitors, one of the best deals out there for big flat screens is (as I'm writing this on March 13, 2005) the Dell UltraSharp 2001FP 20.1 inch Flat Panel LCD Monitor available for $679 each. The LCDs are much lighter in weight than the CRTs, by a factor of more than three to one. Although LCDs cost more than CRTs, the gap is narrow?ing. Also, for multimonitor setups, LCDs have a thinner "bezel" or rim around the screen which lessens the gap between adjacent monitors. By going down just a little bit in size, a person can save a lot of money. The same models in 19 inches are $269 each and in 17 inches are $169 each. The 19s are a great size for traders, and if resources permit, the larger ones are awesome. The Samsung models are also nice, but they are a little pricier than the Dells. I have both, and I like them both the same. Samsung has a very new 20.1 inch LCD, the model 204T, that is selling only at a few dealers as of this writing for just under $600. This model will be widely available by the time you are reading this. If you like to shop around, then check them both out. If you just want to get a trading computer as quickly as possible, then stick with Dell.

Two great places to find deals on monitors, or anything on hardware for that matter, is www.slickdeals.net and www.tec These sites search the Internet for deals and coupons on anything related to technology, including monitors, hard drives, DVD players, and so on. There is always somebody having a sale. Also, public companies like Dell will issue special coupons during the last few days before they close a quarter to boost sales. These always show up on these two Web sites. A few weeks ago I was able to pick up a lap?top from Dell using a $750 off coupon code I got from www.slickdeals.net. There is no rea?son to pay full retail price for anything. This is a good first test for a trader. Don't panic and buy the top.

Another area of interest for traders is setting up multi-monitors in such a way that they fit comfortably on a desk, don't take up a lot of space, and are easy to access. One site I like for this is www.lcdarms.com. Here traders can get different wall and desk mounting solutions for their monitors. In terms of desks and chairs, this is really wide open. A door across two file cabinets works really well as a desk. There are desks available from medical supply com?panies that are interesting in terms of how they are set up. The desk isn't that big of a deal, however. Traders just need a place to put their computer equipment. The chair is a different story. Traders are going to be spending many quality hours with their posterior region planted firmly in a chair. Getting a good one is worth the money. My favorites are the Aeron chairs from Herman Miller.

TAMING THE TECHNOLOGICAL BEAST: KEY THINGS ALL TRADERS SHOULD KNOW TO KEEP THEIR COMPUTERS ALIVE AND WELL

Once traders have their hardware in place, it is time for them to tum their attention to the soft?ware. There are a lot of software choices available for traders, but what this boils down to for most people is a charting program and an execution package. While this is important, there is another category of software that is vital to the trader, and this is software aimed at keeping

a computer in top working order. This is by far the most neglected area for traders. Let's take a look at this first, and then we will delve into the trading software. Don't worry, I'm not a techie so this will be easy to follow, and I'll make it quick.

Trading in and of itself can be one of the most stressful occupations on the planet. One day's worth of market activity can determine whether a trader's kids are going to study abroad in Oxford, all expenses paid, or are stuck at the local community college making telemarket?ing calls part time to pay for their books. Technological problems or disruptions increase the stress factor and cause drains of both real and mental capital. Traders who are stuck behind the technology curve are at more of a disadvantage than those who are up to speed. From soft?ware that is outdated to specific tactics used by companies to dump process-clogging spyware on the user's computer, traders who choose technological ignorance are setting themselves up for disaster. Having a trade go wrong because of technological issues is inexcusable for the serious trader who is trying to make a living at this profession.

The bottom line is that traders who want to maintain a competitive edge in this business must first be aware of the technological dangers facing them in today's world. Once aware of the hurdles, determined traders must then take a proactive approach and take the time to attack these issues head on. The three main technological problems for traders today are as follows:

1.Computer invaders: The PCs are traders' most important trading tool. Being con?nected to the Internet, the traders' computer is being abused without their knowl?edge. This causes most malfunctions on computers today, and traders must be aware of how to first remove the "crud" and then block it so it won't happen again.

2.Process cloggers: Use these steps to maximize computer effectiveness and prevent crashing.

3.General technology problems: What to do when the technology around the trader fails to deliver-because it will.

Ignoring these preventable issues is like trading without a stop loss. Take the time to take care of this right now and get on the path to smooth trading.

Strip Away the Crud That Is Slowing Down Your Computer

Traders can have the best software available for trading, but if their computer isn't properly cared for, protected, and maintained, then the greatest trading software in the world becomes worthless. Each day the trader's computer is bombarded and invaded with hidden crud, and it is truly shocking how dangerous some of this stuff is to the trader's PC. For the trader who is serious about making this business a full-time job, neglecting these next steps is the same as a professional football player drinking a 12-pack of beer the night before he is supposed to play in the Super Bowl. That would deliberately put his team at a disadvantage. Why give the other guys out there an edge? In trading, the other guys are trying to take your money. There is no reason to make it any easier for them.

The biggest technical problem facing traders today is one of which most are completely unaware: staying "spyware-free,' It is one of the most important things traders can do to keep their PC running smoothly and safely. Spyware will crash traders' computers, ruin their Internet connection, and make Internet surfing unsafe. Spyware is not a cookie, which I talk more about shortly. In a nutshell, spyware is software that companies place on users' PCs without their permission. Sometimes it is unknowingly with the users' permission, if the users don't read the fine print in the agreement they accept before downloading a software program. This spyware software takes over the traders' Internet browser, and collects data on their surf?ing habits, generates pop-up ads when the traders visit certain Web sites, and generally slows down their computer. In addition, a lot of spyware is poorly written and can cause incompat?ibility issues, corrupt important system functions, and threaten the stability of the trader's computer. Traders who want to keep their computer running smoothly, and keep it from freez?ing up and crashing, must attack back and get all the spyware off their computer-and then prevent it from coming back.

The first time I learned how to do a search for this malicious software, I found over 50 spyware programs on my computer. After they were removed, my computer operated faster and stopped freezing up on me. This stuff is downloaded "behind the scenes," so it is invisi?ble to the computer user. Before I did this, I was certain that I didn't have any spyware on my computer, as I don't do much in the way of Internet surfing. Needless to say I was surprised.

There are two excellent spyware removal applications available, and they are both free, so there is no reason not to use them regularly. The two best applications there are for remov?ing spy ware are SpyBot Search & Destroy and Ad Aware. It is important that the trader use both of these applications, since each one finds what the other misses. Computers are not safe using just one of them. To find out where to download these, just type them into the search field on Google (www.google.com). which will provide a list of sites from which they can be downloaded for free.

Once traders have installed these two "must have" applications, they then need to keep them up to date. I would recommend checking for updates weekly. Similar to antivirus soft?ware, the trader needs to stay protected from the latest spyware out there. To update SpyBot, just open the application from the start menu (use the advanced mode option) and select "search for updates." It will then show what updates are available for download. Always install all the updates. Another feature that SpyBot has is called "Immunize." Select this icon and under "Permanent Internet Explorer Immunity" select "Immunize." This works in block?ing new spyware. It also gives the trader the option of locking the trader host's file against hijackers, a feature I highly recommend using. To update Ad Aware, just open it and select "Check for updates now."

Anything these applications find is spyware and should be removed. Traders who choose not to remove them have no one to blame but themselves when their computer crashes because of spyware. On a more malicious level, these programs can potentially invade traders' privacy by recording where they buy items online along with their billing and credit card information. I recommend doing weekly scans, and, as I have already said, always remove anything these programs find to keep your PC safe.

Another easy way to block spyware is to stop using Internet Explorer. All spyware pro?grams are written for this browser, since this is what 95 percent of the population uses. There is a newer Internet browser available called Firefox, which is made by Mozilla (www.mozzilla.org). It has more advanced features than Internet Explorer, is faster, and is a lot safer to use.

Cookies and Spam-It's a Bad Idea for Lunch, and It's a Bad Idea for Your Computer

Another device companies use to track information on the trader's PC is called a cookie. This is a small text file that can be good or bad. It's good for visiting a favorite Web site, such as Amazon.com. With a cookie installed, Amazon will remember who the users are, so they don't have to always log in when they visit the site. However, there are also bad cookies placed by companies such as Doubleclick that track site usage, coordinate pop-up ads, and generally invade the trader's privacy. The best thing to do here is to start from scratch and delete all the cookies on the computer. To do this, go to Start, Settings, Control Panel, Internet Options. Under Temporary Internet Files, there is a button that says, "Delete Cookies." Click this. After the cookies are deleted, go to Privacy, Advanced. Once there, check the box that says "Override automatic cookie handling." Below that I check "Prompt" for First Party Cookies and "Block" for Third-Party Cookies. This way when the trader goes to Amazon, a message pops up asking if the trader wants to accept the cookie. I say yes because that is a site I visit often. Any third party cookies like "doubleclick" will automatically be blocked. This will prevent pop-up ads and keep the trader's computer running in top form. If I am asked to accept a cookie from a site I rarely visit, I will say no and the cookie will not be planted on my computer.

Spam is typically a big problem for everyone. Mail Washer Pro (www.mailwasher.net) and Cloud Mark (www.cloudmark.c used together are the best solution I've ever seen for spam protection. Mail Washer Pro stops spam before it ever hits your mailbox. For stuff that does get through, identify those to Cloud Mark, and they won't get through again. Both these programs together will cost about $80. I use Microsoft's Outlook program to handle all my e-mail, and these programs can work directly with it. I used to routinely get 100 spam e-mails a day. Once I installed Cloud Mark, they all disappeared. It was truly a miracle.

Finally, it is critical that everyone have virus protection software. Norton Antivirus is good, but it takes up a lot of resources. Another one that is good is Trend Micros PC-cillin

(www.trendmicro.com)InternetSecurity.Formiscellaneoussoftw
Copernic (www.copernic.com)desktopsearch.This free software provides a great, easy way to search for e-mails and files on a computer. This saves time in trying to find that missing e-mail or file. All a person has to do is type in a word or the name of the file and the software will find it in seconds. This is instead of sifting through e-mails in Outlook or trying to search with the windows function, which takes forever. During market hours, a trader does not have a lot of time to spend on little things like searching for a missing file. This speeds it up.

These are the basics for the general computer software. Let's take a look at how to keep a computer running smoothly, and then we'll start looking at specific trading software.

TURBO CHARGING THE TRADING COMPUTER

There are three things traders should be doing on a weekly basis to ensure that their computer is running at maximum efficiency. The first two of these involve deleting files on the com?puter that are unnecessary. To do this, first go to the Recycle Bin, which is an icon located on the desktop. Right click, select “empty recycle bin,” and delete the files. Every file the com?puter user deletes is not really deleted-it is just moved to the Recycle Bin. To really get it out of the computer and free up memory, the trader needs to empty the Recycle Bin.

The second place where memory is gobbled up is in what is called the cache. This “catches” all the Web sites the trader visits for faster downloading of the site next time it is visited. With the advent of broadband, this is an unnecessary feature. To “clean the cache” go to Start, Settings, Control Panel, Internet Options. Under “temporary Internet files” click “delete files.” A pop-up box will appear asking if the user wants to delete all offline content. This is important to do, so the trader should click the box to indicate yes. Hit “ok” and sit back. If the computer user has never done this, it can take five to ten minutes to delete all the garbage on the computer-or longer. It may appear that the computer is frozen. It’s not. Walk away and come back later. The serious trader should do this at least once a week.

Finally, once these two things are completed, the serious trader will want to defrag his or her hard drive. Disk fragmentation slows the computer down and is often the cause of a variety of other problems such as hangs, crashes, and errors. Fragmentation accumulates rapidly through normal computer use, and program access time continues to increase, prob?lems worsen, and the productive life of a computer will be shortened by years. Defragging the hard drive puts all the pieces back together again, making the computer run much more effi?ciently. Traders should do this weekly, if not daily. Go to Start, Programs, Accessories, System Tools, Disk Defragmenter. Make sure the hard drive is highlighted (usually this is drive C) and click "Defragment." This can take 20-30 minutes if this has never been done before. There is also a program called Diskeeper that eliminates fragmentation automatically so it is never an issue.

Strip Away the Crud That Is Slowing Down Your Computer

THE BACKUP PLAN:

WHAT TO DO WHEN YOUR COMPUTER CRA OR THE POWER GOES OUT-BECAUSE THEY WILL

Once a trader's computer is in top working form, there are still other technical problems that can occur. In my experience, there are four main problems that all traders should be prepared for:

1. Black- or brownouts that cut off all electricity.
2. Cable or DSL goes down.
3. Difficulty in contacting a broker.
4. Data feed goes down or the trading platform goes down.

These are problems that can happen at any time. Serious traders can prepare themselves for all these eventualities.

A black- or brownout will occur when it is least expected. The last one happened to me when three other traders had booked appointments to spend the week trading next to me at my office. That is hard to do when there isn't any power. The point is that the timing is never good. I've personally been involved in half a dozen of these through the last two years for a variety of reasons. This can relate to the weather, a power grid going out, or a car accident involving a telephone pole. It can happen out of nowhere, and traders will suddenly find them?selves without power, losing their ability to view the market and execute trades. To combat this situation, the serious trader must have the following in place:

1.Battery backups on the computer: These are available at any major office supply shop. In the event of a loss of electricity, these will give the trader around 30 min?utes of power, which is plenty of time to close out positions or reset parameters in case the power is going to be down for a long time. This also gives the trader time to manually shut down the computer, which is much safer than having it go out suddenly because of a power loss.

2.Noncordless phone: These are the old-fashioned phones that have a cord attached to the headset. When the electricity goes out, so does the cordless phone. With the old-fashioned corded phones, a trader will still be able to make a phone call to his or her broker. Obviously a cell phone would work in this situation-but those things run out of juice at the worst possible moments. Corded phones can be pur?chased for less than $20 at any department or electronics store.

3.Dial-up backup: Cable or DSL can go out even when the electricity is still on.

This usually happens at the absolute worst time, so the astute trader will want to be prepared. The best way to combat this is to have a fully charged laptop connected to a phone line. This way the trader has Internet connectivity if the DSL or cable goes down-and the trader will also have a backup in case the electricity goes out. By having a laptop that is fully charged and ready to go, attached to a phone line, a few hours of valuable time can be gained.

Another technological trend in the industry is for brokers to let computers do all the work. Although this provides for efficiencies and cuts costs, the bottom line is that if I have a problem, I had better be able to get hold of my brokers right away. If I call my brokers and can't get hold of them, I start foaming at the mouth-a signal that it is time for me to switch brokers. If I want to be on hold, I will call the airlines, not my brokers. My suggestion here is to take advantage of technology and get the broker or brokers hooked up on an instant mes?saging program. This is an incredibly efficient way to stay in touch throughout the day. If my data feed goes down, I can 1M (instant message) my broker for a quote. My expectations for my brokers are that I can contact them via phone or instant message right away. If they are not available, then I have the number and instant message as a backup. In trading, there is no excuse for not being able to get a live person to help out with an order or question right away. What else do we pay them all the commissions for?

If the trader's data feed goes down, much of what already has been discussed will help.

Being able to contact a broker to get a quote or place a trade in this situation is imperative. Yahoo Finance is also a great site to get free quotes on stocks, options, and futures.

Finally, the most neglected aspect of any computer user's life is the backing up of data.

I recommend getting a Maxtor One Touch drive. These are available at places like Best Buy, or online at www.maxtor.c Once it is hooked up, all a trader has to do is touch a button and the entire hard drive will be backed up. It seems like a pain to set up until that one day when the computer finally does crash.

Trading successfully requires an edge. Traders who choos to remain in ignorance about what is really going on with their computer, or are "outta luck" when the power goes out, are leaving themselves at a decided disadvantage with traders who are prepared. By staying up to date on the technological front, the trader has an advantage over those who don't. And having an advantage over other traders is the only thing that will make the trader a winner in this business.

NOT All QUOTES ARE CREATED EQUAL

Now that we've beaten the nontrading technical issues to death, let's look at issues geared specifically for trading. This typically comes down to three areas:

1. Quote software
2. Trade execution software
3. Market-related subscriptions and services

Let's look at quote software first. Much of the decision to use a specific charting software package typically comes down to "whatever a person has stumbled across" as he or she began the trading journey. For most traders, this is not a good thing. I remember when I first started trading online in the late 1980s, and I had to hit "refresh" every time I needed a new quote. I was charged a fee each time I hit "refresh" if! didn't trade enough. I stayed with that brokerage for about three weeks, and that was three weeks too long. It is important for the trader to have a quote system that is robust, is in real time, and has the flexibility to easily add a variety of indi?cators and tools. The ultimate goal of traders is to develop a trading style that best fits their own personality. A flexible quote system gives people the ability to try different things until they find the setups and techniques that work best for them. There are only a few quote vendors who fit this bill, and there are many who do not. The bottom line is that good quotes are not free and can easily run a few hundred dollars a month. Skimp on the desk, not on the quotes.

The two main quote systems I use are TradeStation (www.t and eSignal (www.esignal.com). TradeStation makes it possible for me to easily add my own indi?cators and studies, and I like its chart functionality and ability to back-test specific setups and data. I like eSignal because it has fast reloading time and is robust and easy to use. Although I like having two quote vendors in case one is having problems, for my own trading it is a must. For example, I follow the German DAX market, and I rely on real-time put/call ratios throughout the trading day. As of this writing, eSignal carries data on the German DAX, while TradeStation does not. And, to top it off, Tradestation carries data on the put/call ratio, while eSignal does not. It's important to find out everything a quote vendor offers before signing up. Obviously, if all a trader follows is the DAX, then TradeStation is not going to be a big help. At some point TradeStation will cave in and add it, and who knows, it may have already added it by the time this book hits the shelves. I'll also continue to bug eSignal about adding the put/call ratio, because at some point it will have to bow to pressure from the trading com?munity and offer it up. Interestingly enough, most quote vendors do not offer the put/call ratio, which is a hugely important reading of current market sentiment.

Another good source I use for quotes is the market data available at the Chicago Board of Trade's (CBOT) Web site, www.cbot.com. There are of course other good quote systems available. The key is to utilize a robust and flexible version that best fits a trader's needs. For the most part, traders will get what they pay for in this area. The best way to find a good quote system is to first and foremost ignore any marketing material that is put out by the company itself. This is like believing that a can of soda is good for you because it says "diet" on the label. One of the biggest marketing gimmicks in trading is "free level II data." Level II data are worthless and shouldn't be watched in the first place. Larger traders use Level II to trick and fool smaller traders by putting up fake size and using every method at their disposal to hide what they are really doing. It also causes traders to overtrade, which is the number one way to get out of this business in a hurry. Traders will save themselves a lot of frustration sim?ply by turning this off. In sum, ignore the marketing and ask other traders who have been actively slinging stocks and futures for at least five years.

A BAD EXECUTION PLATFORM CAN INFLIC CAPITAL PUNISHMENT ON YOUR ACCOUN

In the late 1990s and early 2000s, it was all about faster executions. A trader who had an exe?cution platform that was faster than the others had an edge. Online Web-based brokers caught on and started out offering "60-second guarantees" on fills. Those of us who were using direct access laughed in their face. Sixty seconds might as well have been a week. Today, nearly every broker has adapted and everybody has lightning fast executions. So what platforms have the edge?

Think back to what I say about trader psychology in Chapter 2. Most of the mistakes

traders make are emotional. I've watched traders get flustered, especially in futures trading, and make mistakes with their orders. They go long five contracts of the mini-sized Dow and then make an error in trying to place their stop that ends up liquidating their position. Other times they put a target in place and end up doubling up on their position because of a mechan?ical error. Or, worse, they don't feel like going through the entire process of placing a stop, then placing a target, and then remembering to cancel the remaining open order once either the stop or the target is hit-so they don't place a stop or a target. These are the traders who "rely on their judgment while in a trade" and create great opportunities for the rest of us when they inevitably freak out. Manual order submission and trade management is a tedious, error prone process. Coupled with heightened emotions, it is a recipe for trader blowout. Maybe not today, and maybe not tomorrow, but that day is always lurking on the horizon.

In addition, some traders simply are not computer savvy. They are not comfortable on computers, and it is easy for them to fumble an order. The best computer users are kids, and it's because they have grown up playing video games on their PCs. Some traders I know have deliberately learned to play "one person shooter" games on their PCs in order to improve their speed on the keyboard. The most popular of these is called "Call of Duty." This game places you in various battles during World War II, and it is literally act fast or die-kind of like trad-ing. By the time people get through this adventure, their eye-hand-mouse-keyboard coordi?nation will have improved exponentially. My trading partners and I have all gone through the game, and it improved our hand-eye coordination considerably. This game is available at stores like Best Buy for $30.

Trading execution software today has evolved to help traders protect themselves from ... themselves. Think of a typical trade. Let's say I go long 10 contracts of the mini-sized Dow futures at 10814. I place a 20-point stop, and I want to exit half my position on a 10?point move to 10824, and for the rest of my position I will trail my stop—every time the Dow moves 10 points, I will move my stop up 10 points. This requires active trade management, with the pressing of a lot of keys and many mouse clicks. One mistake and I can tum this win?ning trade into a loser.

What if, each time I bought the mini-sized Dow, my trading execution platform knew I would be using a 20-point stop and a 1 O-point target on the first half of my position? If it knew that, then it could place the orders for me automatically, and I wouldn't have to do a thing. What if it also knew that when my first target was hit, I wanted to bring my stop up to breakeven? And it also knew to change the number of contracts in my stop from 10 to 5 when the first target was hit? What if it also knew to then trail the stop? What if I had a target, and it knew to cancel my stop order once my target was hit? All automatically? So all I had to do was get into the trade, and after that I could essentially walk away because the software was managing the trade for me according to my specifications? The purpose of my day would be to sit back, relax, and focus on finding high probability entries, instead of having to scramble around once I'm in the trade and actively manage it-a process that can be mentally strain?ing and cause many emotional fluctuations.

That is the kind of software that is available today. All traders have to do is wait and be patient for an appropriate entry level, take the entry, and then the software can man?age the trade for them according to their own specifications. This process removes a lot of the mental stress involved in trading and helps to prevent traders from making the common mistakes that ruin many of them. This type of functionality is not readily avail?able with many brokers, but I'm sure they will catch on and the improvements in this field will continue to roll along. Today this type of software is available through third-party vendors who create the code, and then brokers elect, or not elect, to offer this platform to their customers.

I've tried many platforms that are available today and there are a few standouts from the crowd. However, it doesn't take long for a new version to emerge and triumph over all its rivals. There are some that are great but add too many fees. Others work fine but they are memory intensive and really slow down a computer. The perfect one is fast, doesn't take up much memory, and doesn't tag on a lot of extra fees. If you are interested in the list of plat?forms I am currently using, send an email to rosa@tradethemarkets.com or call our office. Let's take a look at a more or less generic example of what I'm talking about.

Figure 3.3 illustrates a shot of the "Strategy Manager" window, where traders can enter in their predetermined trade entry and exit points. The Strategy Manager is open and the Position Strategies tab is selected. The strategy that is highlighted is called TradeTheMarkets, which is a strategy I created. In the position type box (Pos Type), I have selected the bottom choice (Stop/3T). This means that this strategy will have three profit targets and one stop order. In other words, I can buy six lots of the E-mini S&Ps and scale sell out of my position two lots at a time, at predetermined exit points. The details are entered in the middle of the screen. For this trade, when I get in long or short, the software will automatically place a 2?point stop, and it will automatically place orders so that I can scale out of two contracts when I'm up one point, another two contracts when I'm up two points, and the final two contracts when I'm up three points. In addition, once I am out of my trade, the open stop order is auto?matically canceled.

FIGURE 3.3

This screen focuses on my "target exit strategy." My "stop exit strategy" is different, and you can see that a stop strategy called "JohnCarter" is selected. (See Fig. 3.4.)

The "Stop Strategies" tab allows the trader to create a single stop or a trailing stop. The trailing stop will automatically move based on the parameters put into this screen. As the var?ious profit targets are hit, the stop loss will move up a specified amount, ensuring that an increasing portion of any profits are protected.

Traders may have just one setup that they use, or they may have half a dozen or more that they have created over the years. Each setup that a trader uses should have a different set of rules for exiting the trade. Some of the setups may utilize a

3: 1 risk reward ratio (risking 1 point to make 3) while others utilize a 1:2 risk reward ratio (risking 2 points to make 1). Some

FIGURE 3.4

of the setups may use trailing stops and multiple targets, and some may have stationary stops and single targets. All the various exit and stop strategies can be created for each setup, on each market in which it is going to be utilized, and matched together. Once these are all cre?ated, all traders have to do is tell the software which setup they are about to take, on which market, and then focus on the entry level. Once they enter the trade, the software does the rest of the often very tedious and error-prone work. What is also nice is that a trader can have a couple of plays running simultaneously in different markets and not get frazzled watching after all of them. This type of technology automatically brings discipline and focus into the trader's life and generally makes the trading day smoother and more deliberate, leaving a trader refreshed at the end of the day instead of worn out.

FIGURE 3.5

What is also nice is that, once the trade is placed, all these orders are easy to follow and are marked visually on a screen of the market being traded.

In Figure 3.5 the screen shows that an order was filled for six contracts on the E-mini S&Ps at 867.75. The total number of contracts being traded is displayed at the top of the col?umn. On the left side of the column there are the three profit target orders, two contracts each, placed at one, two, and three points above the entry price (868.75,869.75, and 870.75, respec?tively). Down below the entry price is a stop order for six contracts at 865.75, which is two points below the entry price. A single mouse click was used to place the market buy order at 867.75. All these other orders were simultaneously and automatically placed by the software as specified in the selected strategy. In addition, since these are OCO orders (one cancels the other), as each profit target is reached, the stop loss is reduced by the appropriate number of contracts and trailed accordingly.

This represents the new generation of trading software, and all traders should seriously consider such a system. Many brokers do not offer these features. For example, I love TradeStation's charting ability, but its order execution is a little behind the curve in regards to this type of trading technology. They are working on it, to be sure, and they may have caught up by the time this book is released. For now, it is software programs like this one that are leading the pack.

OPINIONS ARE LIKE BELLYBUTTONS; EVERYBODY HAS ONE

This section isn't about recommending good financial market subscription services that are available. It's about how to treat them. There are many market-related services, newsletters, and Internet chat rooms that are operating today. These services typically offer opinions on the markets, and they usually charge a fee for accessing their information. They offer thoughts on market direction and, sometimes, specific market picks. I used to be a newsletter junkie, and still am to some extent. These days I'm much less interested in individual opinions and am more interested in Web sites that offer a quick synopsis of the current state of the markets through a variety of technical data. To that end, one of the best sites on the Internet is Decision Point, run by Carl Swenlin (www.decisionpoi site allows traders to get a quick feel for the markets and offers an endless amount of drill down detail, which I like to peruse on Sundays. In addition to getting quick readings on key numbers such as NYSE (New York Stock Exchange) Member Net Buy/Sells, Investor Sentiment, and key put/call readings, traders can sort sectors and markets by relative strength and quickly see where the next ral?lies and declines will emerge. I find this tool priceless for gauging market direction and for seeing first hand where the big money is flowing. It's the best $20 a month ever spent. I also like to read comments by John Mauldin in his weekly newsletter, Thoughts from the Frontline (www.2000wave.com). His writing is lucid, far reaching, and entertaining.

I also find it useful to read and balance the views of the people who think the Dow is going to 3,000 versus the views of the people who think the Dow is going to 30,000. There are both rational and ridiculous arguments for both cases. I personally don't have an opinion where the stock market is going to be by March 27, 2023. I'm more focused on where it is going to be by the end of next week. Also, it is important to take these views with a grain of salt. With Wall Street, if everyone is expecting the same thing to happen, then it's not going to happen. It is certainly important to stay on top of the major trends affecting the world today, namely, an aging population, rising crude oil prices, and the explosive economic growth of China and India. These are real trends that affect nearly everything in our lives. Where there are trends, there are opportunities to make money.

The main thing to keep in mind is that everyone is offering an opinion, especially if it's regarding a specific trade recommendation. The writer may sound absolutely convinced it is the best trade on the planet, and this conviction can easily pass into the brain of the reader. The bottom line is this: If traders take a recommendation from a subscription service, they still have to set appropriate risk parameters and decide how much they are willing to lose on the pick. Just because a guru thinks the market is going to crash doesn't mean that it is going to. I've heard more stories about people blowing out their accounts because "they put it all on a newsletter rec?ommendation." There is a tendency for traders to feel more confident in a trade because it is being recommended by somebody else. A tip! In reality, it's just a trade setup like any other, and it is important that a trader not get lured in with a false sense of security that this particular trade is going to work out exactly as planned. Whether traders found a setup for themselves or whether they are following a trade setup recommended in a newsletter, the ultimate responsi?bility is on the trader. Don't get overconfident just because you read about something online.

ESTABLISHING PRIORITIES: IF YOU ARE GETTING INTERRUPTED DURING THE FIRST TWO HOURS OF THE TRADING DAY, IT IS YOUR FAULT

I talk more about this at the end of the book when I discuss the business plan, but it does touch a little on technology here. The bottom line is that a trader needs focus and concentration in order to be successful in this business. The most critical hours in the stock market are gener?ally the first two hours of the trading day. This is where most of the setups occur. It is up to the traders to communicate to colleagues, or, if they are trading from home, to their spouse and children, that they cannot be disturbed. When I am trading, I am not checking e-mail, I am not answering the phone, and I am not accepting uninvited visitors. If my wife wants to be dropped off at the gym before the trading day starts, she knows the deadline. If she lets me know after the deadline, my answer is always the same, "Honey, you know I love you. The trade is on." Click. (I usually remember flowers on those days.)

It can be hard to communicate things like this directly. You'll find it is helpful to write out a fully developed trading plan and then share it with the people in your life. Once they understand that this is important to you and that you are serious, they will generally respect any boundaries that are clearly outlined in what they are reading.

In terms of communicating with people throughout the day, for anyone who doesn't uti?lize instant messaging software, this is an incredibly efficient way to stay in touch. People can call at exactly the wrong moments during a trade. With instant messaging, people can type in a question and the traders can get back to them at their leisure. Instant messaging was built for traders. This is free software, and I utilize the three most popular programs: MSN, Yahoo, and AOL. I also utilize a software program called Trillian (www.ceruleanstudios that ties all three of these together into one application. The key with instant messaging software, however, is to block everybody except for people traders have specifically permitted to their list. If everyone knows you are online, then everyone will bug you. Instant messaging for traders is appropriate between their brokers and other traders. It is inappropriate for anyone else who could interrupt a trader's workday, and this includes family members and clients. There are very few people who are on my list, but they are all important to my trading day. My wife did make the cut, however, and it has proved to be a useful way to stay in touch when the markets are moving.

WHY WATCHING HARRY POTTER ON DVD AFTER 12 NOON EASTERN IS BETTER THAN WATCHING CNBC

I am bringing this up because I've seen too many traders who quit their jobs and follow what I call the "CNBC setup." They are excited because they are able to finally trade full-time. They feel they've been at a disadvantage all these years, getting quotes from the Internet, sneaking trades onto their computers in between meetings, and hearing about key news events only after the markets have already closed. So what do they do? They plop a TV down right next to their computers, turn on CNBC, and glue themselves to the screen, looking for trading opportunities.

CNBC has a very specific job: to provide enough entertainment to viewers so they tune in and watch. With a lot of people watching, the network makes more money from the com?mercials. It's as simple as that. CNBC is fun to watch, and when things get serious, it does a great job of reporting. I found out about 9/11 as it unfolded live before my eyes from

Mark Haines. I flipped to some of the other channels, but ended up parking it on CNBC that day because it did, hands down, the best job reporting about it. Who can forget Maria Bartiromo reporting about the event, covered in ash and soot just after the first building collapsed? It was a gut-wrenching experience to watch, and the reporters and the network did a great job.

That said, traders must realize that they cannot make a living "trading the news" off any financial news channel. By the time it appears on television, it is way too late to react. Trading floors have already heard the news, and by the time it makes it to the public, the floor traders are closing their positions, ideally to suckers who just saw the headlines. If anything, CNBC can be used as a fading tool-taking the opposite side of the news. Once it runs out of stories and starts repeating the same things over and over, I turn down the volume and either turn on a commercial-free music radio station or, once in a while, plop in a DVD. Who can get tired of watching Gladiator?

Traders who do this for a living spend their days waiting for specific setups to take shape. Yet one of the biggest weaknesses for most traders is a need to be in every move. If the markets start running away, many traders just can't help but jump in, fearing they may be missing something big. This is a fatal flaw that will ruin any traders who can't control this habit. If there is anything I can hammer into your brain as you are reading this book, it is this:

It is okay to miss moves. Professional traders miss moves; amateur traders try to chase every move. By listening to music or keeping a DVD on in the background, traders have something to pass the time while they wait for their specific setup to take shape. This makes them less prone to impulsively jump into trades just because they are bored or because they can't stand missing out on a move. The goal is not to catch every move in the market. The goal is to take the specific setups that a trader has outlined as a part of their business plan. Otherwise he or she is just a gunslinger, and sooner or later all gunslingers get killed.

chapter001N004

chapter001N005

chapter001N006

chapter001N007

chapter001N008

chapter001N009

chapter001N010

chapter001N004