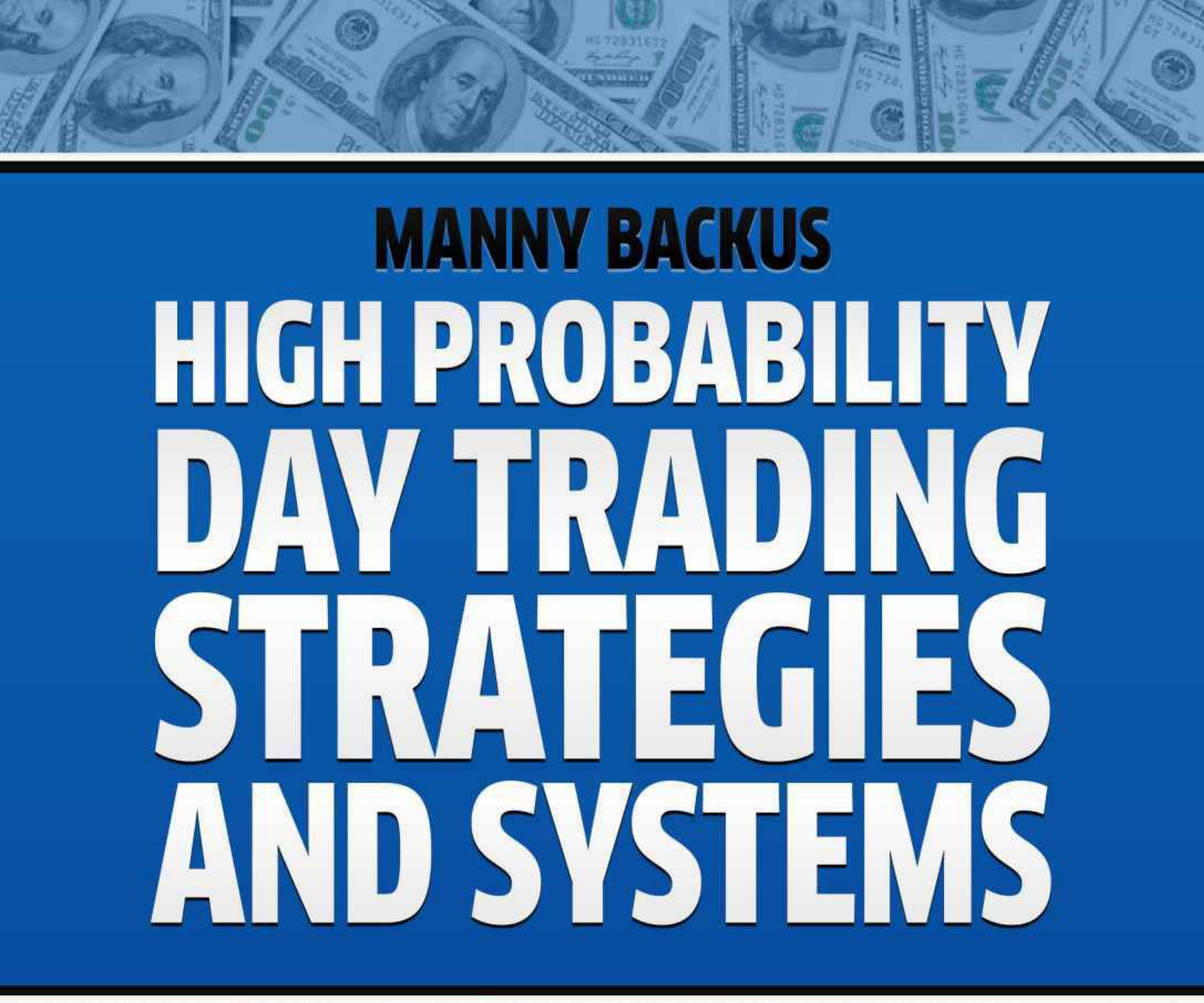


MANNY BACKUS

HIGH PROBABILITY DAY TRADING STRATEGIES AND SYSTEMS

High Probability Day Trading Strategies and Systems

by

Manny Backus

This book is divided into the following sections:

Acknowledgement and gratitude: the charts used in this book are taken from Worden's suite of chart services. TC2000 is their

award winning premier product available at www.worden.com. Worden also has free charts available at www.freestockcharts.com.

Introduction

Welcome to the world of day trading!

First, I want to thank you for taking the time to download and read this book. Believe it or not, this one act sets you apart from the average person. The average person, you see, doesn't believe they have the power and the intellect to take on the challenge of trading stocks. It takes an unusual person to stand up and say "I believe I can do this". So, congratulations on taking this first step. If this is the first book you've ever read about trading stocks, or even if it's the 10th book you've read about trading stocks, my plan is to make you a smarter and more informed trader by the end of this book.

Second, I want to encourage you to read this book as it was written...page by page, from beginning to end. The reason I say this is because we'll be building on concepts as we progress together. If you jump ahead, then you might miss key concepts and ideas that were presented earlier in the book. So, take it page by page. If you find that some areas are more difficult than others, then take the time to go back and read those sections again before moving forward. If you find that certain words are foreign to you, then you can always "Google" those terms for online definitions.

The purpose of this book is to introduce you to the world of day

trading. But we'll go deeper than that. We're going to get at key concepts as well as a philosophy of trading stocks that many traders fail to realize when they start out on their own. The concepts and ideas presented in this book can end up saving you thousands of dollars if you will simply listen to someone who has gone before you.

You see, I've been trading stocks for a very long time. I've had the good fortune to help thousands of students learn how to profit from the trading of stocks. From their letters and emails, and by talking with them at national trader conferences, I know how

difficult it is for new traders to get started on the right foot. And I want to shorten your learning curve. There is no need for you to repeat the same mistakes that thousands of other traders have made before you. So part of the goal of this book is to tell you where other traders have made mistakes so you don't have to repeat them. There is no secret society here where only a small handful of traders really know how to do this thing called day trading. Instead, you'll find the world of stock trading to be filled with generous people who are willing to share their time, ideas, and support with you. So, if you are new to the world of day trading, then this could be your first step toward a whole new universe.

Qualifications of a Day Trader

You may be wondering “Am I qualified to day trade?” It’s a good question. After working with thousands of other traders, I can tell you that day traders come in all sizes and shapes. But there are certain attributes that may be common to all of them. Perhaps the best way to start is by asking you a series of questions. I cannot answer these for you. But the answers will provide you with a starting point for discerning whether you have what it takes to become a successful day trader.

1. Can you fit a couple hours of time into your schedule each day? The U.S. markets open for regular trading at 9:30 AM, Eastern, and close at 4:00 PM, Eastern. If you live on the west coast in the U.S., then you could possibly become a day trader even if you have a full-time job. As I said earlier, day traders come from all walks of life. Some are retirees who are looking for a way to supplement their income. Some are downsized employees who are still looking for work. Some are full-time students who are able to carve out a few hours each day for trading. Some are stay-at-home parents. But you will need a few hours for trading each day. As you’ll see later, the best part of the day for trading is the morning session. Much of the day’s action occurs by noon each day. So it’s helpful to have those early hours available each day.

2. Do you have enough money to day trade? Let's get some definitions on the table. A day trade is the entry and exit of the same stock in the same day. For example, if you buy AAPL (the ticker symbol for Apple stock) at 10:00 in the morning and then sell it at 11:00, then that is one day trade. You entered and exited the trade on the same day, what some people call a "round trip trade". A day trader is the person who executes these trades. A "pattern day trader" is someone who does this more than three times in any five consecutive day period that the stock market is open. So, for example, if you execute two round trip trades on Tuesday and two on Thursday, then you are considered a pattern day trader. A pattern day trader is required to have at least $25,000 in their account in order to qualify to trade as a pattern day trader.

This minimum account balance is not my rule. It is the rule of the FTC (Federal Trade Commission) and it is enforced by brokers. So, even though you can day trade without that minimum account balance, you cannot do it more than three times in a five consecutive day period in which the market is open. Check with your broker to find their specific wording on this FTC rule.

3. Do you have the proper equipment? You've probably seen pictures of traders who are surrounded by six or ten computer monitors. Don't worry, that's not required. You can get started with one computer, one screen, and a fast internet connection. But you will need those basics to get started. You'll also need charts. But I'll tell you how to get those for free in just a few

minutes.

You'll need some space at home that is somewhat private. You don't want to distracted by phone calls and the like. But that doesn't mean you need to rent office space. You can get started sitting at home on your back porch!

4. What is your relationship with money and risk? This may seem like an odd question at first and your first response might be "I like money". But some people are better at dealing with money than others. And it's not just the ability to do basic math. Some people approach the stock market like it's a giant online casino. Wrong move. The trading of stocks involves substantial risk. Every trade is not going to work out. This fact means you are going to have some trades in which you lose money. And you'll lose money on purpose. What I mean is that you will have trades that don't work out and it is better to lose a little bit of money than a whole lot of money. But in order to lose a little bit of money, you have to decide to do it. And some people never get this simple fact. They are so scared of losing money in the stock market that they (a) don't ever trade at all, (b) take profits too quickly when the trade could offer them more profit, or (c) hang on to losing trades too long because they just can't bear the thought of getting out of a trade and taking the loss. For this last group, the pain of the financial loss has to get very large before they finally exit the trade and take their loss. And their loss at that point is always much larger than it would have been earlier.

So, part of your relationship with money has to do with your

ability to handle financial loss. Can you afford to lose any money? How much are you willing to lose? Let me describe it to you in another way. This book is about "high probability trading strategies", so lets do a little math. For starters, let's assume you have a day trading strategy that is 80% accurate. Translation: if you execute this strategy accurately, then you will make money on 8 out of 10 trades. But this also means that you will lose on 2 out of 10 trades. And guess what? You might have 10 losing trades in a row before you have the 50 winning trades. So, if you are willing to lose $400 on a single trade, you could lose $4000 before you make a dime of profit? How are you going to feel if this happens to you?

Now, I'm not trying to scare you away from trading. But I am trying to point out that you have a relationship with money and risk. And this relationship is complicated with a mixture of emotions and a cloud of how you've dealt with money in the past. You may have had some hardships along the way and these experiences have caused you to be risk averse. You may be so scared of losing money that you cannot make money. Or, you may be a gambler at heart and your approach is on the other extreme of recklessness. Obviously, neither extreme is going to work when it comes to trading stocks with real money. Fear and recklessness are both signs of a troubled relationship with money. And those troubles are going to spill over into your trading whether you like it or not.

So, back to my original question, "what is your relationship with money and risk?" It needs to be a healthy relationship if

you are going to make money as a trader of stocks.

5. Do you have an entrepreneurial spirit? This is somewhat difficult to define, but trading stocks is a business. As with any other business, it must be taken seriously on the one hand but also approached as an adventure. I believe that people should really enjoy whatever they do for a living. And the same thing goes for day traders. You may be just getting started in your day trading career, but the successful traders are those who are passionate about it and who enjoy it. I'm not saying it's all fun and games. No one likes to lose money. No one likes to have a bad day. I don't care what you do for a living, you're going to have those kind of days. But, when you wake up in the morning and you're excited about the opportunities in front you, you're eager to turn on the computer and begin your study of charts, then that sort of entrepreneurial spirit will take you a long ways.

Part of this entrepreneurial spirit is also the ability to make independent business decisions. Part of trading is decision making. You must be quick. You must be decisive. You cannot sit there and debate your next action for very long because the opportunities for day traders can be very quick at times. So, if you're a person who likes to debate every angle of a situation before reaching a conclusion, and then you continue to fret about the decision after you've made it, then you might find day trading to a challenge for you.

I hope these five questions have helped you make your own assessment about whether you are qualified to be a day trader. There are many other questions that could be asked, but these

five questions cover some essential areas that need to be considered.

How Do I Get Started?

I've already mentioned the capitalization requirements for day trading. The next thing you have to do is deposit that money with a broker so you can begin trading. Or is it? This is what most traders do. They get excited about the prospect of making money while sitting at home and trading stocks. So they immediately find a broker, deposit their money, and jump right into it. Sure, they may read a book or two first. They may look at some trading videos online. But once you get the trading bug, it's difficult to stop the urge to just start trading.

The fact is that this is the worst possible thing you could do. I've heard it likened to giving a scalpel to a pre-med student and asking them to go do brain surgery. You wouldn't do that, right?

The trading of stocks involves substantial risk. I've mentioned this already. But the fact is that many well-intentioned and eager traders have lost millions of dollars in the stock market because they were totally unprepared. Their eagerness to get started jumped ahead of their preparedness. And they lost a lot of money.

At a recent trader conference we held in Los Angeles, California, one of the speakers asked this simple question to those in attendance: "If you could change one thing about what you did when you first started trading, then what would that be?" Approximately 80% of the attendants answered "paper trade longer".

Now, you may have never heard the phrase "paper trading", so let me explain it. Paper trading is trading but without using real money. It is going through all of the motions involved with trading stocks with one key ingredient missing and that is the fact that real money is not involved in the activity. You see, even though you don't know it yet, trading can be difficult. You've heard "buy low and sell high" and you might be thinking "what's so hard about that?" But here's the problem. How do you know when the low is really the lowest low? How do you know when you should sell for the most profit potential?

The reason you start with paper trading, or what some people call a "sim account" (for simulated trading) is that there are many variables involved when you decide to buy and sell stocks. You'll be introduced to some of those variables in this book. But it takes more than just a little bit of knowledge to become good at trading stocks. It takes practice. And I mean lots of practice. So, if you thought you could just read this book in one weekend and you'd be ready to start trading on Monday morning, then I hate to be the one to break it to you but let me say it loudly "You're not ready!"

You can go ahead and set up an account with a broker. A

broker is a sort of intermediary between you and the stock market. They allow you to enter and exit trades through their "trading platform". A trading platform is the online configuration of windows that shows you stock prices, order entry forms, etc. The reason I mention this here is that many brokers will allow you to set up a simulated trading account so you can test their trading platform and become more comfortable with them. They will give you a fake account of say $50,000 and you can go and start trading with that fake money.

How long should you trade with fake money? As long as it takes. Once again, the over-eager trader gets a few good paper trades under his belt and he rushes into trading with real money thinking "this is easy". But a few good trades does not mean you are ready to begin using real money. You want to see consistency. And a lot of it.

Think about this for a minute. You've saved up your money and deposited $26,000 into your account. (You gave yourself an extra $1000 to be "safe".) Your first few trades go great and your account now says you have $26,500. Wonderful. But, on your next trade, price makes a sudden move against you. You hold on, thinking "it's got to come back up". Only, it doesn't. It goes down further. At 3:55, just before the market closes, you make a hasty decision to hold the trade overnight. "It really looks like it's ready to turn around." The next morning, after a listless sleep, you wake up and find that some economic report came out and the market is tanking because the news isn't good. The trade that you decided to hold overnight, because you knew

it was going to go up, has fallen even further. In fact, it's fallen so far that your account is now below $25,000. Not only have you lost the money you gained on the previous day's trades, but you've sunk below the pattern day trading requirement mentioned in the last chapter.

If you think this scenario hasn't happened, then guess again. It's happened over and over again by traders who jumped the gun and started trading with real money before they were ready.

Here's my simple rule. Keep paper trading until you have proven to yourself that you are consistently profitable over a long period of time. Keep paper trading until you learn how to limit your losses. It takes more than one good day or even one good month.

Part of the reason for paper trading is that each day in the market is unique. What happens with the market today probably will be different from what happens tomorrow. The easy trading days will happen and make you think you are ready to use real money before you really are ready. The tough trading days that happen will try your patience and your resolve and they will test your ability to limit your losses. You don't have to win on every trade. You don't have to make a gain on every trading day. But, over the course of a week, you want to see proof that you have limited your losses and made a good profit. Over the course of a month, you want to be able to look back and be proud of how far you've come. If you look back at the previous month of paper trading and you see that you are still struggling, then it doesn't mean you give up. It just means you're not ready to trade with

real money yet. And that's okay.

As you'll learn in this book, you need to use a simulated trading account with every new strategy you develop. Experienced traders know this already. But you may stumble upon a great strategy one day. You may look back at some charts and it looks like the pattern repeats itself over and over again. Even so, if it's a new strategy then you should use a simulated account until you see consistent and profitable results before using real money. Just because you know how to trade doesn't mean you know how to trade this new strategy. So go back to a simulated trading account and practice, practice, practice.

Part of the reason for doing simulated trading is that it helps you respect the money you have and the seriousness of this business. You may think, "well I have plenty of money, so I don't need to worry about losing a few thousand dollars". Well, I can tell you right now that you will lose more than a few thousand dollars if you have that attitude. You need to respect the value of the money you are using for trading. Once it's gone, then it's gone. And you need to respect this business.

Another reason for paper trading is that real money triggers all sorts of emotions in people. Whether you are winning or losing, there are all sorts of emotional responses to money. And as long as you are paper trading, then these emotions will be somewhat in check. If you're not using real money in the beginning, then you're able to concentrate on all of the other things involved. You're able to concentrate on making good trade decisions, following your written strategy (don't worry, we'll get to that),

managing the trade, studying the charts, etc. Once you start using real money, then you'll find that you will be more emotional about your trading. You will get upset if you're losing money. You'll get more excited if you're making money. But you may start to make decisions based on those emotions and on the adrenaline rush of trading rather than trading based on your strategies and being disciplined in your trading.

Once you start using real money, you want to start with small amounts of money to get your emotions trained as well. You don't want to jump from paper trading to using $20,000 on every trade. You want to make that transition slowly, testing yourself and making sure you're ready to start with the real money. If you find your emotions getting out of hand, then you simply go back to paper trading until you're ready to make that transition again. As you make progress using real money, then you can gradually increase the amount of money on each trade until you reach a comfortable equity level.

I've think I've drilled this idea long enough. I think you get the idea how I feel about this. But you don't have to take my word for it. Just listen to the attendees at the national trader's conference I mentioned. Remember, 80% of them said this is the main thing they would change about how they got stated trading. So, listen to those who've gone before you and learn from them.

Choosing a Broker

Let's go back to a discussion of brokers for a minute. Which

broker should you choose? There are many variables among brokers and I'm not going to make the choice for you by recommending just one. For now, I'll just list some of the considerations.

1. Fees. Brokers charge a variety of fees related to trading. There are fees associated with entering and exiting the trade. Some brokers will charge a flat rate regardless of the number of shares traded. Others will charge based on number of shares. Some brokers will charge extra for charts, extra for news services, etc.

2. Simulated accounts. Based on our earlier discussion, you want to make sure the selected broker allows a simulated trading account. But you also want to see if they offer any online training about how to use their platform.

3. Charts. As you'll learn in this book, you'll be using charts to examine price movement on stocks. You need good charts. Some traders prefer to purchase a monthly chart service rather than relying on their broker's charts. This is because many brokers' charts lack the slate of technical indicators that you may want. Or, if they offer good charts, then their fees may be higher to compensate for this fact.

4. Trading platform. As I mentioned, one of the reasons that brokers allow simulated accounts is that they want you to try out their trading platform. Since the platform is your trading work station, then you want to feel comfortable with it. If the trading platform feels bulky or awkward, then you'll know it. Listen to

your own frustrations and decide if your frustrations are due to the newness of the platform or the inherent awkwardness of the system. The ideal platform is one where you feel comfortable and unhindered as you go about your trading activity. Accept the fact that you may have to test several broker platforms before you find the one you like. And the one you prefer may cost you more than others. Then you will have to weight what's most important to you based on the amount of trading you hope to do.

5. Customer service. It should go without saying that you want a broker who is readily available for customer support should you need it. One way you can test this is by simply calling them up. Test their response time. Test their attitude. Which one do you like the best? Although you probably won't need to call them very often, it's nice to work with a broker who is responsive to your needs. After all, you're going to let them hold a significant amount of your money!

6. Reports. A good question for your customer service representative is "How to you report trades for taxes?" Like it or not, your trading activity is reported to the government by your broker and your annual taxes must reflect your gains or losses for each year. Some brokers make this an easy process and others are not so easy. Some brokers have software available to help you with this at tax time. So it's good to find out what your preferred broker has before you get too involved.

7. Online training. Some brokers offer online course to help you understand how to trade. While these resources are not going to provide you with necessary strategies, they can help you

understand the basic terminology of trading. So, if you are brand new to trading and you are still trying to understand the language of trading (i.e. bid, ask, spreads, open, close, etc.), then having a broker who offers basic trader education might be something worth considering.

If you have a broker and a simulated trading account, then what more do you need? Well, you need a strategy for trading. A strategy helps you decide which stocks to look at, which price patterns to look for, as well as the rules you'll follow for making high probability trades. Throughout this book, you'll see that I talk about high probability trading. The reason I emphasize this is that we want to stack the deck in our favor as much as possible. So a large part of this book will be devoted to helping you understand the ingredients of a high probability strategy.

You want to win at trading, correct? That means you need to win more than you lose and your winning trades need to make more than your losing trades. We'll get into all of that shortly. But, for now, it's enough to say that your simulated trading will not be just pressing a few keys and learning how the trading platform works. You want to be actually following a pre-written strategy that tells you exactly what to do and when to do it. Then it's just a matter of following your strategy. And from having helped thousands of traders, I can tell you that trading without a high probability trading strategy is one of the biggest weaknesses of beginning traders. Lacking a clear strategy, you are at the mercy of every your emotions and you will lack the subjectivity required for making profitable trading decisions.

Before you begin building a trading strategy though, we need to understand price movement.

Understanding Price Movement

The stock market is constantly moving. Prices go up and they go down. The same is true of individual stocks. Their prices go up and down as well. You might think that if the stock market overall is going up, then any stock you look at will be going up as well. But this simply isn't true. The stock market is made up of thousands of individual stocks. So, when you hear "the market is up", then it means that the average of all stocks in that aggregate are moving up. But there will be many exceptions. The market may favor financial stocks for a while and then favor retail stocks. And even when the market likes retail stocks overall, it will like some more than others. Some of those retail stocks will be falling while others are rising. So, in this chapter we'll look at price movement. You need to understand why prices change because those ever-changing prices are the foundation for everything you'll be doing.

So, what creates price movement in individual stocks? There are many reasons of course. But first, let's talk about the overall market. All stocks trade within the environment of the overall stock market. You can trade an individual stock without knowing this context, but your results will improve if you are

aware of this market environment. The overall stock market can be higher or lower on any given day due to investor concerns about employment, China manufacturing, the debate in Washington over the debt ceiling, military involvement in another country, etc. There are many things that can influence market sentiment. So you always want to be aware of the news and economic reports that might influence investor sentiment.

But let's talk about individual stocks. What can make them go up or down?

1. The overall market sentiment can have an impact. If the whole market is going up, then we say the market sentiment is bullish because prices are going up. If the whole market is going down, then we say the market sentiment is bearish. So, the price of an individual stock can go higher simply because the overall sentiment among investors is bullish and this causes investors to buy stocks. If you were already thinking about buying Apple stock (ticker symbol AAPL), and the overall market sentiment is bullish, then you might be inclined to go ahead and make that buy today. Bulls rush in, as they say.

2. Quarterly reports are issued by all companies listed on the major U.S. stock exchanges. These reports are required in order to be listed on these exchanges so that investors can know the health of the companies in which they invest. Earnings, sales growth, and profit are some of the items mentioned in these reports. So, if a company reports good news, then what do you think is going to happen to their share price? It's going to go up, right?

Let's look at an example. Zales is a jewelry store that has been struggling for years. Well, on August 28, 2013, this company filed their quarterly report and showed that they had their first profitable year since 2008. Did investors like this? Look at the chart below.

On the above chart, you can see that the closing price for Zale Corporation was around $9.00 on the day prior to the report. But after the report, price jumped by more than 10% and it kept going up from there. By the end of the day, the price had reached over $11.50 per share. Now that's a big price move.

So let's think about this for a minute. If you had bought ZLC stock on the 27th, would you have sold it when the market opened and taken your 10% profit? You might have done this. I'm sure some people did. But many other investors decided this was a big deal and they decided they wanted to buy this stock

even though the price was over 10% higher than the previous day.

Some investors bought the stock and sold it on the same day as a day trade, taking their profit on the same day of the trade. Other investors bought the stock in order to hold it overnight, figuring the price would continue even higher in the near future. This later group of traders are called swing traders because they want to catch the bigger swings in stock price and they are not going to sell it on the same day they bought it.

The quarterly reports for companies are not always good news however. For example, on the same day that ZLC made a jump higher, Joy Manufacturing made a drop lower.

On the above chart, you can see where JOY dropped when the market opened on August 28th. It moved a little higher, but it

stayed below the previous day's closing price (shown by the yellow line) because investors didn't like the report.

3. Another reason that a stock price can change is that a change occurs in the C-suite. The sudden departure of a CEO or CFO can usually cause price to plummet because it shows the possibility of instability and higher risk for investors. But, on August 23rd, Steve Ballmer announced he was leaving within the next year as CEO of Microsoft. Now, it may not have made him feel too good, but share price of the stock rose dramatically after the announcement though price has been fading since that point. On the chart below, you can see what how price moved.

4. The price of a stock may move because another stock in the same sector raised or lowered their guidance for the coming year. An example of this might be a retail stock that lowered

their guidance for the year ahead due to sluggish sales. Well, another retailer's investors might also be spooked by this report and therefore the share price could fall.

5. A biotechnology stock might go up or down suddenly based on drug trials and FDA approvals.

The above chart of Astex Pharmaceuticals jumped on August 28th when they announced a successful Phase II trial of a new drug. Price jumped over 20% on the news in one day!

There are many reasons why price can change. But the five examples just mentioned provide you some sense of price movement.

Let me show you one more chart and then we'll talk about probabilities.

The above chart is of the S&P-500 for August 28th, 2013. This was the date for several of the individual stock charts I just showed you. The S&P-500 is an index of 500 stocks listed on the exchanges that is often looked to as representative of the broader market. You can also look at the DJ-30 and the NASDAQ Composite, among others. The reason I show this chart is that all stocks move within the environment of the larger market as I've already mentioned.

So let's talk about some probabilities. If the market environment for this day of trading is bullish and Zale Corporation announces positive earnings, then do you think there is high probability that price will go higher for ZLC? The answer is yes.

If JOY announces poor earnings, do you think there's a high probability that price will go down? Yes, but if the market environment is bullish then it may cause investors to buy on the dip lower in price because they think it is now a bargain. That

may be part of what happened on the chart of JOY. Price moved lower initially, but then price moved higher. Would price have moved up if the market environment was negative? Maybe not, but at least it would not have been a high probability situation.

So this is part of the daily assessment you have to make as a day trader who is wanting to make high probability trades. You have to think about market sentiment, market psychology, and market probabilities. The good thing for us is that we don't have to really guess about these things. That is because all price changes show up on the charts in front of us. We don't have to try and predict these things. We just have to learn how to read the charts and the movement of price on those charts.

There are two basic approaches to stock market analysis. One approach is called fundamental analysis. This sort of analysis looks at the quarterly reports, company management, dividends, sector strength, etc. and makes an assessment about the future value and price of the company's stock. The second approach is called technical analysis. This sort of analysis believes that everything about the value of a stock is wrapped up in the current price of the stock. These two types of analysis are not exclusive of each other. But investors often lean one way or the other. For day trading, our emphasis will be upon technical analysis. While we may be influenced by the laws of probability given the set of circumstance mentioned in this chapter, we look to the movement of price as shown on the charts to help us with our decisions about when to buy and when to sell.

So, in our next chapter, we'll dig deeper into technical analysis

and begin to examine price movement on individual stocks in greater detail. After all, when we are day trading, we do not have the benefit of hindsight. The movement of price is happening minute by minute, right on the chart in front of us. Of course it's easy to look back at the price of ZLC and see that price continued higher. But when price is changing every minute, we need some tools to help us navigate our trading decisions. So let's dig a little deeper.

Technical Indicators

If you're going to use technical indicators to trade the stock market, then you have to get a bit...shall we say, technical. There's no way around the fact that some of this stuff is dry and boring...until you begin to see how it works. And when technical analysis begins to help you make money in the stock market, then it gets even more interesting.

The thing to remember about technical indicators is that they are all derivatives of price. They are all ways of measuring how price is acting on the chart in front of us. And there are hundreds of technical indicators. Don't worry, I'm not about to teach you a hundred technical indicators. You don't need that many and using too many can actually distort the fact that they all are derivatives of price. So, whenever we use technical indicators,

we must constantly remind ourselves of this. Price action is primary. It is possible to trade a stock just based on how price is moving without any indicators at all. But, ideally, the indicators will help you make high probability trades. Your objective is to make a profit by discerning the answer to this question: "What is price likely to do next?"

Yes, you are trying to be a predictor of price movement. Most people won't tell you this. They'll say you cannot do it. But that same person will buy a stock at one price with the expectation that _____ (see if you can guess the answer)...with the expectation that price will go higher. Why else would they be buying it here? So, while they may say it is impossible, they also must have some reason for believing that price will go higher or they would never have bought it. So, yes, we are in the business of predicting the future movement of price.

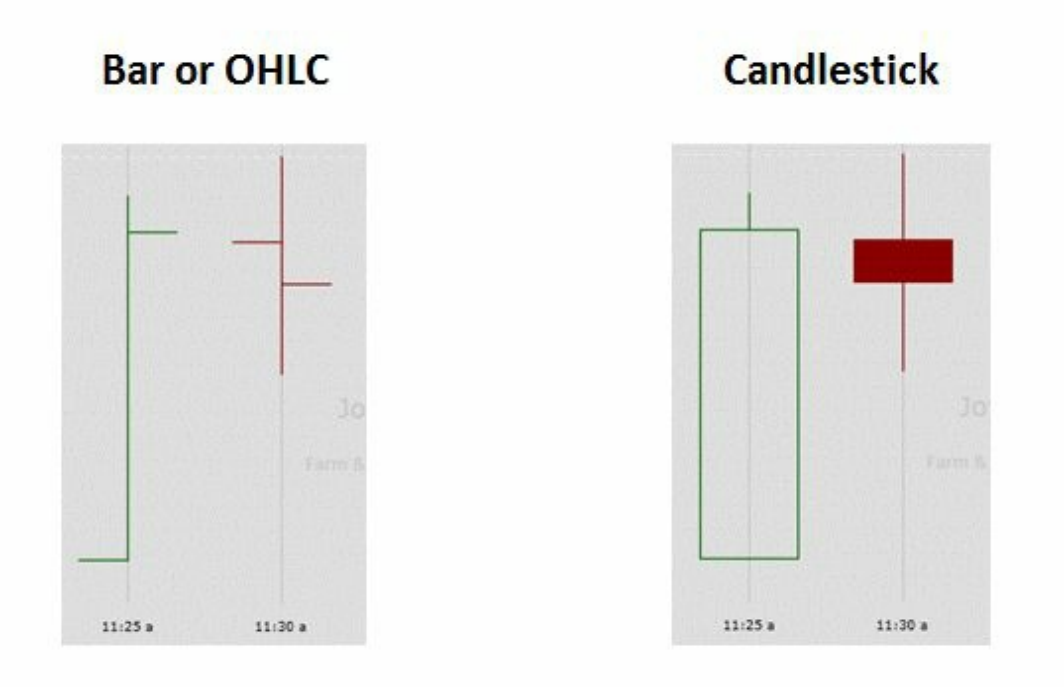
Will be right all of the time? No. Do we need to be right all of the time? No. You see, this is the whole idea behind high probability trading. We accept the fact that we will not always correctly identify which way price is going to go. But, through the use of good technical analysis, we can give ourselves an edge. We can increase the odds so the cards are stacked in our favor. If we consistently apply this edge to each trading decision we make while also limiting our risk when we're wrong, then we can create a high probability trading system. Is this possible? Yes. Is it easy? No. It takes time to develop a high probability system and it takes even longer to master the application of it. We tend to get in the way of our own successful systems. That

gets into the psychology of trading, and we'll get to that later in the book. But, for now, let's focus on technical analysis.

If you have already been trading some, then I encourage you to read this chapter even if you think you already know a lot about technical analysis. I'll provide a slightly different slant on technical indicators, a slant that can give you an edge with your high probability system. So don't skip this section.

Candles

No, I'm not talking about the kind you light with a match. Most day traders use price candles on their charts. As I said earlier, all indicators derive from price. But price can be represented on the chart in several ways. The two primary methods are bar charts and candle charts (also called candlesticks).



If we are going to look at price action, then we want to know

the answers to four questions:

1. What was the opening price?
2. What was the closing price?
3. What was the high?
4. What was the low?

The answers to these questions will be determined by the time frame we are studying. The above charts show a period of 10 minutes in the life of a stock and those 10 minutes are divided into two prints of five minutes each. (There are two five-minute bars/candles on each chart.)

Let's look at the left bar chart first. The opening price for that 5-minute period is the horizontal line that sticks out to the left of the vertical line. The closing price is the horizontal line that sticks out to the right of the vertical line. The high is shown by the highest point on the vertical line. The low is shown by the lowest point on the vertical line. Since the opening line is below the closing line, then we know that price closed higher during those five minutes and therefore the bar is colored green to show a net gain for those five minutes.

On the next bar, we see that the opening price is above the closing price and the line is colored red. This is because price closed lower during that five minute period.

Now let's look at the candlestick. Some candlesticks use simple black and white colors, but this chart shows green for up

and red for down, just as the bar chart. Instead of lines, however, we see the bodies of candles. The first body is hollow and green and shows that price moved up during that period. The tiny vertical line above the body shows that price moved higher during that period and this little line is called a wick. We know that price opened at the base of that body because there is no line beneath it. So, for this candle, the opening is the same as the base of the candle. The top of the body shows us the closing price.

On the next candlestick, we see that the body of the candle is red and filled. This tells us that price closed lower during that period. The wick on top shows us that price went higher during that period and the vertical line below the body shows us that price went lower during that period. (The line below the body is sometimes called the wick and sometimes it is called the shadow. I like the term shadow since we normally think of a wick as being on the top of the candle.)

Now that we've gotten this basic information on the table, we have to ask "Why is this important?" Each bar or candle tells us the story of price and gives us insight into what "the market" thinks about this price at this time. "The market" is actually just the other traders who are trading this stock at this point in time. Some of those traders are live traders sitting in homes or offices just like you. Some of those traders are institutional traders who are making trades on behalf of a pool of other investors. Some of those traders are computers who are trading price based on programs written by quantitative analysts ("quants"). But,

regardless of who is making the trade, it still tells us what all of these people think about price at this moment in time.

Throughout this book, I'll be using candlestick charts because they are the ones used by most traders and they give us more of a visual story. Don't worry if they seem a bit strange at first. You'll get used to them the more you see them.

Let's look at the candlesticks again and see what they tell us. The first candle shows us that investors rushed in to buy this stock. They were very bullish. We know this because the body of the candle is relatively tall (compared to surrounding candles), it is green, and it has no shadow beneath the body. The second candle shows us that investors are having second thoughts about that big run up in price. Perhaps the reason is that some investors who bought before the big run up are taking their profit since the gain was so much and so fast. This fact could be combined with the fact that few investors wanted to get into the trade after such a big run up. Perhaps they are waiting to see price pull back a bit before they buy the stock.

The net result on the second candle though is that price went lower. And that is all we have to know. We don't have to interview all of the people involved in this trade at this point in time and ask them what they were thinking. The candle tell us everything we need to know. It is telling us that run up was too much for this stock at this time. If investors thought it was still a great deal, then the next candle would be tall and green as well. But it's not. It's down. Do you think this is a great time to buy this stock long? Do you think it has a high probability of going

higher?

Looking at one candle tells us some information. Looking at several candles in a row tells us more however. As it turns out, these five minutes candles are part of the chart I showed you earlier for JOY manufacturing. That earlier chart of JOY showed the story using 10-minute candles. On the following chart, I'm showing the 5-minute chart and the two candles we just discussed have blue arrow pointing to them.

As you can see on the above chart, those two candles were actually the high points for JOY on that day of trading. When price pushed back down and resisted those new highs, then price continued to fall lower for the rest of the day. So, candles tell us a story and they reveal to us a lot about investor sentiment.

Without taking a poll or a survey, and without talking to one other trader, we can listen to the story being told in these candles and we can become better traders.

Moving Averages

While we focus on price movement, there are tools that traders use which are derivatives of price. In other words, traders use various technical indicators that offer various ways of analyzing price movement. The simplest of these is the moving average. Moving averages come in several flavors and the simplest one is called a "simple moving average". You may have heard people in the media talk about the 200-day moving average of the Dow. The math behind this idea is this: take the closing price of the DJ-30 over the past 200 trading days, add them up, and divide by 200. That gives us a 200 SMA (simple moving average) of the Dow.

There are other moving averages as well and the concept of a moving average can be applied to many technical indicators besides price. For day traders, the most important moving average is the 20 EMA (exponential moving average). I won't go into the math behind all of these various technical indicators, but an exponential moving average simply places more emphasis upon the more recent prices whereas a simple moving average gives equal weight to all prices. When I say 20 EMA, we also have to specify the time frame we're looking at. A 20 EMA of a 5-minute chart will be very different from a 20 EMA of a 60-minute chart. The first will be looking at 100 minutes of data and the second will be looking at 1200 minutes of data. In day

trading, our primary focus will be on the smaller time frames. So, we can use 20 X 1-minute charts, 20 X 5-minutes charts, etc.

Let's keep looking at the JOY chart for a minute. Let's add a 20 EMA to the 5-minute chart and see how it looks.

The blue line on the above chart shows the 20 EMA. This means that the blue line represents an exponential moving average of the previous 20 5-minute candles. It is called a moving average because as each new 5-minute candle is added to the chart then the earliest of the previous 20 candles falls out of the averaged formula and another candle is added.

Now, why is this important? Why should we be interested in the 20 EMA? Let me ask you a question. When did we get the big price spike higher on this chart? Answer: when price crossed above the 20 EMA. Is that coincidence? Probably not. You see, there are some indicators that many traders use. The 20

EMA is one of them. And it acts as a sort of self-filling prophecy. If everyone believes that price crossing the 20 EMA on a 5-minute chart is a big deal, then two things are going to happen. First, traders are going to buy the stock long because it has shown evidence of price strength. Second, some traders were short on this stock (I'll explain that in a second), so they bought the stock to cover their shorts. When all of this buying pressure happens at the same time, then it causes more traders to jump into the trade because they see price going up. Price will continue to go up until traders take their profit on the quick run up in price and fewer traders are buying the stock long at these higher prices. Price retreats to the 20 EMA line and it finds some support there before it falls back below it later in the afternoon. So, do you think it's important to have the 20 EMA on your charts? I think so.

I mentioned "shorting stocks", so let me explain that to you. Most people know that you can make money trading stocks by buying stocks long. That means you buy a stock at a low price with the expectation that price will continue higher so you can eventually sell it and make a profit at that higher price. Short selling is the opposite of this. I'll stick to a simple explanation here, but shorting a stock means you are selling it at a high price with the expectations that price will fall lower so you can eventually "cover your short" (buy the stock long to equal out the transaction) and make a profit.

It usually takes traders a little bit of time to get used to this idea of shorting stocks. They may think they're doing some wrong by

making money on a stock as price goes lower. But it is all part of the game of trading and it means you can make money in the market whether stocks are going up or stocks are going down.

For example, let's say you shorted JOY the day before it gapped down on the 28th. Let's say you shorted it at $51.25. Well, the next morning price falls down and hits $48.25. This means that if you cover your shorts at $48.25, then you'll make $3 per share on this trade. If you had shorted 500 shares, then it would have cost you $25,625 (500 shares X $51.25 per share) plus brokers fees (we'll use $10 to make this easy). If you covered those shorts at $48.25 then 500 shares X $48.25 equals $24,125.

25,625
- 24,125
- 10

1490 profit

You would make $1490.00 profit on the trade.

Another way to analyze your profits is by using ROI (Return on Investment). The way we figure this is to take the $1490 in net profit and divide it by the original amount of $25,625. You get an ROI of 5.8%. (You could also divide the $3 per share profit by the original $51.25 price to get 5.8% ROI).

I include these new terms such as "shorting" and "ROI" because they are terms you need to know as a day trader. But let's get back to our technical indicators and see what else we can find.

Many traders use multiple moving averages on their charts. For

example, we can add a 5 SMA to the JOY chart and it looks like this:

On the above chart, do you see a certain pattern?

When the 5 SMA (the red line) crossed above the 20 EMA, then buyers of the stock drove the price higher. When the 5 SMA crossed below the 20 EMA, then sellers of the stock drove the price lower. This is an example of a moving average crossover. Two numbers are used to create crossover patterns. If we were to see this pattern on a lot of different charts, then we would begin to describe this as a high probability chart pattern. Does it mean that we could just trade this one pattern and become rich? Probably not. All charts are not going to be this easy. Plus, there is one critical thing you have to realize when looking at these charts: these are historical charts.

Historical charts are completed charts, rather than live charts. When the 5 SMA crosses above the 20 EMA, it looks like it happened simultaneously with the big green candle. But when you're trading the charts in real time, it may not look this way. One of the weaknesses of moving averages is that they lag price. What do I mean by that? Well, if it is a moving average then that moving average is always lacking the last price action on the chart. Since this is a 5-minute chart we're looking at, then all of that upward price movement may have happened within the first minute of that 5-minute candle. By the time the 5 SMA crosses above the 20 EMA, most of the upward price movement may have already occurred. Now, I'm not saying this to burst your bubble. I'm saying it because it is true and you need to be aware of the strengths as well as the weaknesses of all technical indicators. When you are looking at historical charts, you have to remember that they will look differently than live charts.

Many day traders use smaller time frames to try and catch the beginnings of these crossover events. For example, let's drill down to a 2-minute time frame and leave our indicators at the same settings as before. Our 20 EMA will now be looking at only 40 minutes of data (20 candles X 2) whereas the 5-minute EMA looked at 100 minutes of data (20 candles X 5).

There are two things I want to point out on the above chart. First, we see that the 5 SMA crossed over the 20 EMA before the big price spike so we might have been able to get into the trade earlier using this smaller time frame. Second, if we only used the moving average crossover as the basis for our trading strategy, then we would be getting in and out of the trade quite often since the lines intersect with each other seven different times during this 3-hour chart.

This brings me to a point I want to make. You may find that some indicators are best used as a confirming indicator rather than as a predictive indicator. Here's what I mean by this statement. Since the moving average crossover is by nature a lagging indicator since it must wait on price movement to show

us direction, then it may be better if we don't wait on the actual crossover to occur before we enter the trade. We may have waited too long by that point. We might be better off watching price itself, as it moves across the 20 EMA, rather than waiting on the lagging 5 MA to give us the trade signal. But, the 5 MA crossover might be a good indicator to confirm our decision. If we see the moving average crossover after we enter the trade, then it is nice to have that confirmation that our trade decision was a good one. And if we don't see that confirmation, then we might need to be on the alert because our decision may have been pre-mature.

Let's get back to the 20 EMA again. I said that it is used by many day traders. Whether those traders use it on a 2-minute chart or a 5-minute chart and whether they use it as a confirming indicator or as the basis for their trading strategy is something we will not know. But the other reason the 20 EMA is important is because it is a central component of two other indicators.

Bollinger Bands and Keltner Channels

Bollinger Bands and Keltner Channels are two popular indicators that use the 20 EMA as their central line. While the formulas for each indicator are different, they both seek to assign an area surrounding the 20 EMA as a way of seeing if price is "beyond the norm". With both systems, there is a high probability that price will stay inside the bands created by their formulas. Let's take a look.

Staying with our 2-minute chart, removing the 5 SMA red line, and adding the standard setting for Bollinger Bands, we get the above chart results. There are two things I want to point out about this chart and they have to do with high probability trading. First, notice that when price crosses above the 20 EMA, it tends to stay in the upper channel of the Bollinger Band. Second, notice the small amount of time that the price candles stay outside the Bollinger Bands.

On the big run up in price that occurred between the two blue arrows, we see that the price candles are running along the top side of the Bollinger Bands. But for the rest of the time, price is fairly well contained within those bands.

So let's begin to add things up. Based on your knowledge of this stock (it was a gap down stock due to a bad earnings report) plus your knowledge of candle structure (price seemed to push back down after that quick run up in price) plus your knowledge of Bollinger Bands (price tends to stay within the bands), do you think there was a high probability that price would continue to run higher and stay above the top of the Bollinger bands? Probably not.

Do you see what you have just done? You have combined various elements of technical analysis in order to make a high probability trading decision. Armed with this knowledge, if you were long on this trade while price was running up, you might use this information to temper your greed and take some profit on the trade. Knowing that there was a low probability that price would continue higher, you take some or all of your profit while price is above the top side of those Bollinger Bands because you know it probably won't continue that way. This is the exact sort of technical analysis that can help you become a profitable trader. You are adding various layers of technical analysis, looking at the probability of the various situations, and then making your trade decisions. It can happen quickly, and there's a lot for the mind to process, but it gets easier the more you do it.

Now let's look at the Keltner Channels.

The above chart removes the Bollinger Bands and inserts the Keltner Channel. This chart shows even more contrast to those candles that ran up quickly. They stick far above the top of the Keltner Channel to let the trader know they are acting abnormally.

Some traders use the Bollinger Bands (probably the most popular), some traders use the Keltner Channels, and some use both. But whichever one(s) you choose, it's good to have these on your charts so you'll see what other traders are looking at and also to help you with your high probability strategies.

Strength Indicators

In the last group of technical indicators, we looked at bands that surrounded the 20 EMA as a way of looking at prices that were

"outside the norm", or outside the normal range of price. This helped us identify if a stock was subject to a possible pull back in price. But there are other indicators that day traders use to help them make this assessment. Some of these indicators are called oscillators because they deviate on a scale of 0 to 100. Once again, these technical indicators are derived from price.

Relative Strength Index (RSI) is one of those oscillators. As the name implies, it seeks to find the strength of a stock relative to its current price trend. It has a range of 0 to 100, but certain lines are watched closely by traders. As I said before, if other traders are watching certain indicators and lines then we want to be looking at those as well.

Take a look at the following chart of JOY:

As you can see, we're still looking at a 2-minute chart and we're still examining the price spike that occurred on the morning of 8-28-13. I have removed the Bollinger Bands and Keltner Channels so we can focus on this new indicator. You can see the RSI indicator in a separate pane beneath price. You'll also notice that I've added two horizontal lines to the RSI pane. There is a red line drawn at 80 and a green line drawn at 20. You'll also notice that RSI has the number 9 beside it and a moving average set at 4. Let me explain all of these numbers.

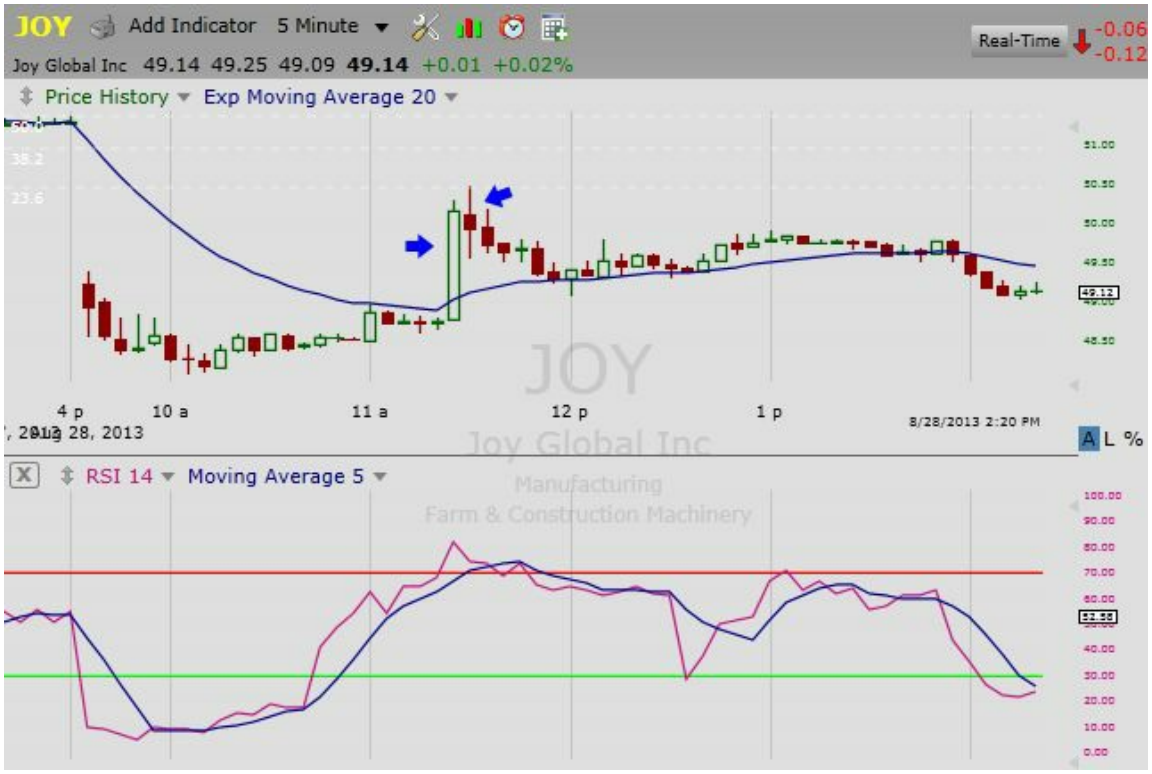
The standard horizontal line settings for RSI are 70 and 30, not 80 and 20. So I have stretched the areas out a bit. But the general idea is that when RSI is greater than 80 then the stock is said to be overbought and subject to a pullback in price. When RSI is less than 20 then the stock is said to be oversold and subject to a bounce. I am not going to go into the technical detail and mathematical formula for RSI because we can get bogged down in too much detail at this point. Knowing what the indicator is meant to measure and knowing how other traders view it and use it are the critical factors.

I've also changed another part of RSI on the above chart. The default setting for RSI is 14. I have changed that to 9 to make this indicator a little more sensitive to price because we are using it for day trading here. I have also adjusted the moving average of RSI to 4 on this chart.

Now go back up to the chart and see if this setting would have helped us with our trade decisions. If you had bought shares of

JOY long around 11:15 AM, when RSI touched on the green 20 line, then you would have entered the trade around $48.75. When you saw RSI crossover its moving average and fall below the 80 line, then you could have sold JOY for around $50.00. You would have gained over 2% ROI in less than fifteen minutes!

But there's one catch. All traders who are trading this stock are not using the 2-minute chart. Not all of them are using RSI at a setting of 9 with a 4 moving average. Some of them may be using a 5-minute chart and the default settings for RSI of 14 and a moving average of 5. And they may be using the standard settings of 70 and 30 for overbought and oversold. So let's see how the chart looks if we change all of the settings.



As you can see in the above chart, changing the time frame on

the chart gives us a significantly different view of what is happening on this stock. Changing the settings will give us a totally different read on when to enter and exit this trade. So which setting is correct?

The fact is that there is no one perfect method for technical analysis. While some of the indicators may be set at their default settings, such as Bollinger Bands, you may choose to play with the settings on other indicators. But there are a couple of key points here that I don't want you to miss.

First, there isn't "one perfect system" for trading stocks. Many new traders think it's just a matter of testing and tweaking until you find the perfect set-up and then once you find it then you'll get every trade right and never have to worry about money ever again. Wake up call! There isn't one way to trade. There isn't one system that fits all users. For example, some traders may prefer to use the 5-minute or 10-minute charts for day trading. Some traders never look higher than the 1-minute chart. You'll have to discover what works best for you. And the only way to find this out is by experimenting with various settings on indicators and time frames until you find a set-up that works for you.

Second, both of the above chart set-ups could help you make a profit on this trade. What is important is that you follow the system you've created. We'll get into trader psychology later in this book. But, for now, just know that all traders are not going to see the same trade at the same time. Some may use the 5-minute chart set-up just shown. Part of their strategy may be to

buy long when RSI 14 crosses above the 30 line and to sell when RSI 14 goes below the 70 line. It is a longer trader and the net gain may have been around 2% vs. the 2.5% for the 2-minute chart. But that is just this one trade on this one chart for this one day. Over time, the trader may experiment with both ideas and decide that the 3-minute time frame with different RSI settings has the highest probability of success for the type of stocks they are trading.

So, there isn't just one way to trade. There isn't one perfect set-up for your charts. You'll have to experiment and see what works best for you. But let's go ahead and talk about another popular oscillator.

The Stochastic Oscillator is a technical indicator that also oscillates between 0 and 100. It also measures oversold and overbought areas on the chart. Let's see how it looks on our chart of JOY.

I've gone back to the 2-minute time frame on the above chart and this time I'm using the default settings for Stochastics but I've added the 80 and 20 lines shown. Just glancing at the above chart, what are some of the things you notice?

Overall, we see that price tends to fall lower whenever the red line goes above 80 and price seems to bounce whenever the red line goes below 20. But you have to keep in mind that an oscillator cannot go lower than 0 or higher than 100. So, hitting those lines does not mean that price will immediately rise or fall at those lines. That is not what this indicator is telling you. Rather, it is saying "relative to the previous 14 price candles, price is high or low". That is not the same thing as saying price must necessarily turn around at this point. The Stochastic and

the RSI can stay above and below those 80 and 20 lines for extended periods of time when a stock is in a strong trend. And that is a mistake that many new traders make. They think "well, the Stochastic Oscillator is telling me the stock is overbought" so they decide to short the stock based on this one thing. But then the reading stays above 80 as the stock continues to trend higher and the new trader keeps holding onto his short sell of the stock waiting for price to fall. In the meantime, Stochastics stays above 80 and the trader continues to lose more and more money as the trade moves against him. Don't make this mistake!

So let's pull together what we've learned about candles and technical indicators. Let's put it all on a 2-minute price chart of JOY and let's see how it looks.

Based on what you've learned so far, do you see a high probability long trade on this chart? Can you write those ideas down and test them on other charts? Of course you can. But let's go ahead and list them here.

Rule #1. Buy long if the all of the following conditions apply to the chart:

a. Price is above the 20 EMA,

b. Stochastics red line (12 %K 3) is crossing above the blue line (%D 5), and

c. RSI 9 is crossing above its 4 MA.

Rule #2. Sell when any two of the following conditions are met:

a. Price is re-entering the inside of the Bollinger band top line, and

b. Stochastic red line crosses back down below the blue line, or

c. RSI crosses back down below its 4 MA.

What we have just done is create a trading strategy! But it isn't just any old trading strategy. It could be classified as a high probability trading strategy if the following reasons held true:

1. It is based on objective criteria found by technical analysis of our charts,

2. It has specific criteria for entering the trade,

3. It has specific criteria for exiting the trade.

4. We have back tested the idea on a specific group of stocks and found that it has a high probability of success.

5. Over time, we have found that trading this strategy in real time ends up making a profit.

These last two points are unknown at this point. We have only looked at one stock on one day. We need a larger sampling of trades to determine if this is actually a high probability strategy. As I said previously, we also have to determine if this strategy really works in real time on live charts. Looking back at historical charts and indicator crossovers, it is easy to think we've found the perfect strategy. But it is in paper trading this strategy over many charts that we find out whether it is a high probability trading strategy or not.

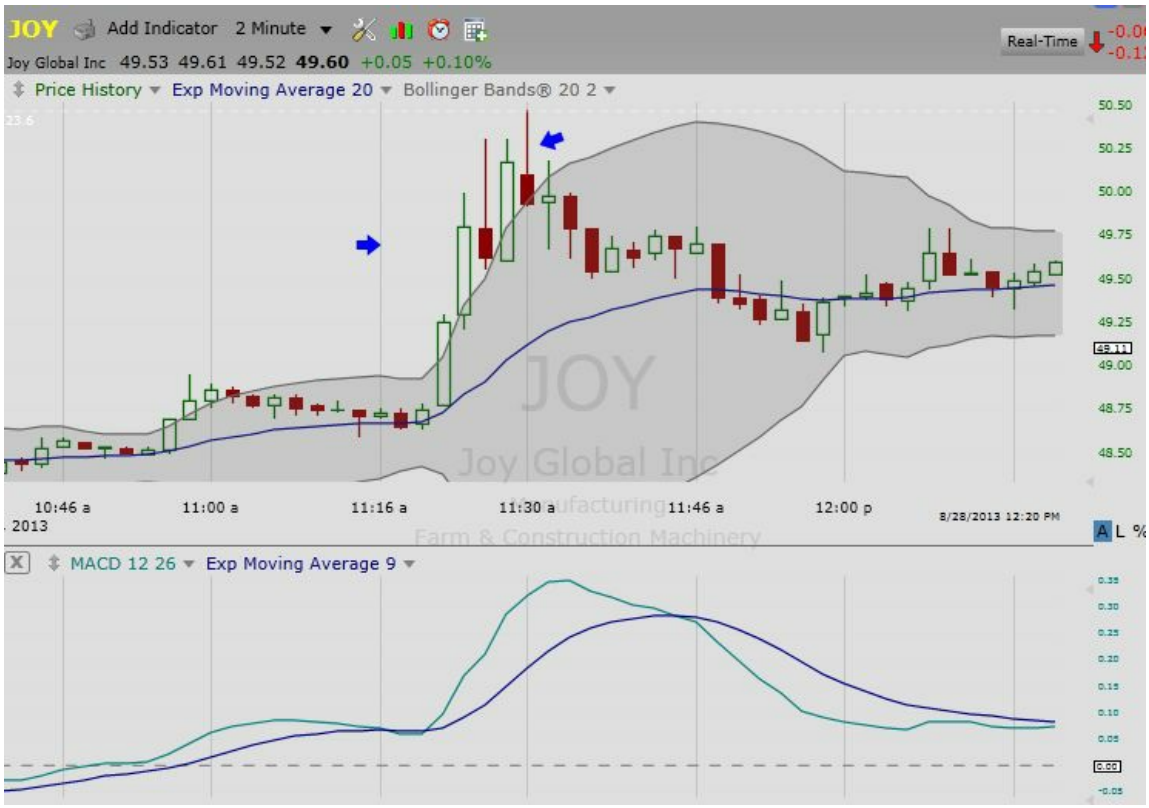
After testing this strategy, we may find that it works better with certain stocks than others. For example, the stock we chose to examine (JOY) was a gap down stock on a day when the market was trending higher. That factor might need to be added to our list of criteria for entering the trade. We might find that other criteria must be added. For example, JOY usually trades with over 2 million shares traded per day. If we try this strategy on a stock that only trades 200,00 shares per day, then we may find that the strategy has less of a probability of success.

We might also look at share price. We might find that stocks under $10 per share don't work as well for this strategy. If we combine low share price with low volume, then we might find that it actually loses money! So, there are many variables to consider before we can jump up and down and say we've found the perfect high probability trading strategy.

You may be thinking at this point, "I didn't know there was so much involved in trading stocks?" It is a common feeling among new traders. But the difference for you is that you are beginning to see some of the variables that go into making a winning strategy. You are learning some of the common mistakes to avoid as a new trader. You are learning that good trading requires a high probability trading strategy that has been back tested in real time, that has specific rules for entering and exiting the trade, and that might work best only when certain market conditions are present. So, congratulations, you have already come a long way.

There is one more technical indicator I want to mention before we leave this section. The MACD (Moving Average Convergence Divergence) is another popular indicator that many traders use so it deserves to be mentioned here.

Let's look at it on our chart of JOY:



The MACD indicator is made up of several moving averages. On the above chart, I'm using the standard setting of MACD which gives us a 12 26 setting and an exponential moving average of 9. You'll also see a dashed line at the bottom of this chart at 0. This dashed line is called the signal line. The "convergence divergence" part of the name primarily applies to the two lines you see on the chart. As the lines move further apart, then they "diverge". As price begins to fall lower, those moving averages "converge" until they cross down and diverge again.

So let's talk about you read the MACD. If the MACD is above the signal line and it crosses above its 9 EMA, then this is considered a bullish signal. If you were using this indicator, then you would go long when you saw that signal on the chart. A

wide divergence can be considered an extreme stretching of price and a flattening of the light blue line is our first indication that those lines might begin to converge again and therefore gives us a possible warning to take profit on the trade. Likewise, if we were to see a MACD cross down pattern while both lines were below the signal line, then this would be considered a possible short set up.

All of the technical indicators I've mentioned so far are derivatives of price. One indicator that is not strictly based on price is volume. There are various volume indicators available and some of them incorporate price into their formula as well. But let's look at volume in the following chart.

On the far right side of the volume pane, you'll see the number

of shares traded. You can see that the volume bars spike during the rally we've been examining. The red and green colors give some indication of whether buyers or sellers are dominating the price again. Eventually, volume falls back below its 20 MA that is also plotted on the pane.

As you can imagine, there are hundreds of different indicators. As mentioned, most of them are variations on a theme and that is "what is price doing?" We use the technical indicators to help us make decisions on the trades. But we also watch them because we know that other traders use them in their trading as well.

There is no one, perfect indicator that will do the job for you. You will have to experiment with various indicators to find which ones you are comfortable using and which ones give you the best signals. But a word of warning: don't overdo the indicators. Some traders make the mistake of thinking "more is better" and this simply isn't true. The problem is that you can add so many indicators that you're no longer looking at price. I've seen some charts of traders where there were so many lines, indicators, and moving averages that you couldn't even see the price candles. So, you don't want that because price is primary. Nearly every indicator is based on price movement, so you want to be watching that movement. The problem is that if you have too many indicators on your chart, then you get information overload. You're looking at so much that you're actually getting confused and that confusion can lead you to inaction. You become like a deer caught in the headlights, unable to move. Instead, you want to create your chart layout in a way that creates

clarity for you. Don't clutter it with too many indicators. Find what works best for you, and then get comfortable with it. If you are constantly adding and subtracting indicators, tweaking the settings to find the perfect setting, then you're going to get thoroughly confused. So, find a few indicators that you like and begin to use them every day. You'll learn both their strengths and weaknesses and you'll get more comfortable with them over time.

Limiting our Losses

Despite our best technical analysis, every trade is not going to be a winning trade. When you stop and think about what "high probability" means for a minute, then you realize that it means we win more than lose. It does not mean that we will never lose. And this fact is difficult for most traders to grasp. They know from experience that every trade does not make money. Most new traders have held onto their fair share of losing trades until the pain became so great that they finally took the loss on the trade before the pit became a canyon! But taking the loss and accepting it as an inevitable part of trading are two different things.

The difference begins with one's mindset. Let's take Mike for example, a fictitious trader. Mike cannot stand the idea of losing money. He has had his hardships in the past and it makes him

very cautious when it comes to losing money. He tries to be conservative in his trading. He doesn't take large risks. But, every now and then, he gets into a trade and it begins to move against him. Because he has not accepted that losing is part of the game, he holds onto those losing trades way too long. As the trade continues to move against him, he gets very emotional and mad at himself. He begins to argue the case on technical grounds about why the trade might be turning around now. But then it moves further against him.

During this whole process, Mike becomes disillusioned at a trader. He loses more than money. He loses his confidence. Rather than keeping an objective eye towards the charts in front of him, he becomes emotional and it affects other trades he is holding as well. His anxiety spills over into his other trades and he takes the profit too quickly on the money making trades because he knows how quickly they can move against him. Yet he keeps holding onto the losing trade as it moves against him because he cannot bear the thought of losing this much money.

If this story sounds familiar to you then rest assured that it is every trader's story. We've all "been there, done that". No one likes to lose money trading stocks. But the difference is in how we approach our trading and our set of expectations for this business.

Now let's talk about Jim. Jim has a different mindset. Jim has a carefully written trading strategy. And part of this trading strategy is that he has confidence in himself and in his trading strategy. He knows, based on solid testing and real-time trading,

that his strategy is correct 70% of the time. On average, his winning trades make at least 1.5% profit every time he executes this strategy. But this also means that 30% of his trades will not work out. Of those 30%, about a third of those actually qualify as trade reversals...meaning, they qualify as a trade in the opposite direction from what he originally thought.

Part of Jim's strategy is to set a 1% stop on every single trade. (The simple definition of a stop is that Jim tells his broker, through his online trading platform, that he wants to exit the trade if the price goes against him by 1%. Jim sets up this order online and when price hits that 1% loss then it automatically exits his position.) Jim has learned that setting this automatic stop is the best policy for himself because he knows how easily he can talk himself out of taking that stop. He has been in Mike's shoes enough times to know what that experience feels like. So he sets up the automatic stop order to protect himself from big losses. In a sense, Jim is protecting himself from his own ability to rationalize a bad decision like staying in a losing trade.

So, Jim averages 1.5% profit on 70% of his trades, he losses 1% on 30% of his trades, and then he gets back roughly 1.5% on the 10% that qualify as a reversal. Do you see what Jim has done? Not only does he have a high probability trading system, but he has a high probability trade management system. And it takes both parts to make money trading stocks.

You see, most traders don't want to deal with the reality of trading losses. They'd rather hide their head in the sand and

rationalize their poor decisions. Not only do they hate losing money, they hate being wrong. And when you lose money on a trade decision that you've made then it means you're admitting that you're not perfect. It means admitting that you're wrong. And that's just something that is difficult for a lot of people to do. They hate to admit that they're wrong. They would rather hold the losing trade because they know that some of them will turn around. It's true. Some of those losing trades will turn around and end up making money. But the reason they turn around is usually not because you were right in holding onto the trade. You just got lucky! And once luck shines your way, you tend to think it will happen all the time, or at least maybe one more time. So that lucky break causes poor trade management. You're no longer trading based on technical analysis and solid trade management. Rather, you're trading based on luck and hope. And that is certain to lead to an unhappy ending eventually.

Now that you've heard those two stories, I hope you understand the importance of taking small losses on your losing trades. The floor is littered with the stories of those who failed to do so. And it is the key reason why most day traders never make it past their first year of trading. They never learned to accept the fact that a certain percentage of all trades will end up losing money; the only question is how much of your money will you allow them to take.

We've established the fact that some of our trades will be losing trades. We've spoken to the wisdom of setting limits on your

losing trades. But all of this leads us to ask several questions:

1. How do you know when a losing trading is actually a losing trade? We've all had trades that turned slightly negative before they turned around and became winning trades. So, we need some objective method for identifying which trades are losers before they get to be big losers.

2. What is the basis for our exit of the losing trade? We have several choices here, so we'll take a look at those choices.

3. How far should we let trades move against us before we take the loss?

4. What can we learn from our losing trades?

Before we cover the answers to these four questions, then we need to talk a little more about the philosophy behind the answers. I have already mentioned the difference of mindset, how one trader refused to accept that losing was part of the game and how the other trader accepted these losses and had a trade management system for dealing with those losses. So that change in mindset is a big step in the right direction.

But any discussion about taking losses must be rooted in a high probability trading strategy. This strategy must come first and that is why we spent so much time in the last chapter on technical analysis. Strategy comes first. Once you have a strategy that has been tested and found to be true, then and only then does the answer appear to many of our four questions.

Let me give you an example. Let's use a very simple one.

Let's say that our whole strategy is built around a certain pattern on the charts. The strategy is defined as this: I will buy a stock long if: (1) the S&P-500 is positive for the day, (2) the price of the stock is above the 20 EMA on the 2-minute chart, and (3) the red line on the Stochastic Oscillator has touched the 20 line and it is now crossing back above the blue line (also on the 2-minute chart). I will take profit as soon as I earn 1% profit or whenever either one of the following occurs: (1) price has reached 1% profit from my entry, (2) price has crossed back below the 20 EMA, or (3) the red line on the Stochastic Oscillator has crossed back below the blue line, or (4) the trade moves against me and creates a 1% loss..

In the above strategy, we have defined the basis for our entry and we have defined the basis for our exit. Now let's look at a chart.

In the middle of the above chart, at 10:32, we can see where all of the criteria for entering the trade have been met. Although not shown on the chart, the S&P-500 was up on the morning of 9-3-13. Price is above the 20 EMA (the blue line that runs through the Keltner Channel). The Stochastic Oscillator touched the 20 line and the red line has crossed above the blue line. Our entry price was $12.61.

As you may remember, our rule stated that we would exit the trade when any one of three criteria were met. Can you look at the above chart and see which one occurred? Eventually all three occurred, but for this trade the following order was: (1) our 1% target was met at $12.74, (2) the red line of the Stochastic Oscillator crossed back below the blue line, and (3) price crossed below the 20 EMA.

Before we move too far from this example, I want to point out a few things. First, we made our criteria for entry of the trade more stringent than the exit of the trade. I say this because we required that three criteria be met before we could enter the trade and we only had one criteria that had to be met before we exited the trade. The net affect of this is that fewer trades will actually qualify for this strategy upon entry, but they quickly qualify as an exit. The fact that we have layered multiple criteria for entering the trade means that we will have a higher probability of finding a trade that can meet our 1% target. But we've done something else here as well. We've met the threshold for exiting the trade very low. Only one criteria has to be met. The way we've set

this up, our maximum loss on the trade will be 1%. One of the other criteria might be met before the 1% loss occurs. One of the technical crossovers could occur while I'm still positive on the trade but shy of the 1% target. One of the technical crossovers could occur when I've only lost two cents.

Now, a strategy such as the one just outlined might not hit 1% on seven out of ten trades. It might happen only 50% of the time. But what about the other 50%? The other five trades might work out to an average of break even. Some of them might be exited with a small profit due to a technical crossover and some of them might actually hit the 1% stop. But their average might be break even. If this were the case, would you call that a high-probability trading strategy? I would because it is a system that would create an overall profit. Yes, it only has a 50% chance for hitting our 1% target, but the losses are so well managed that we end up with an average of half % profit on every trade we make [(1% profit on 50% of the trades + break even on 50% of the trades)/2 = .5% on each trade]. If you knew every time you made a trade like this that you would average half % profit on every single trade, then would you a more confident trader? Would you have less anxiety about your trades? Would you make money every day? The answer is yes.

So let's look at what we just did in that strategy. First, we had a clearly defined basis for entering the trade. Second, we made it easy for us to exit the trade and placed a 1% limit on how much we were willing to lose on the trade. Third, we set up both a technical basis and a percentage basis for exiting the trade. And

this last part is significant.

Most traders know they should establish some sort of stop loss. But they get so hung up on the idea of a percentage stop loss that they ignore everything happening on the charts. Let me ask you a question. If the trade you got into no longer qualifies according to the technical basis of the trade, then do you need to let it go 1% against you before you exit the trade? I don't think so. Why wait? The reason that traders use the % stop loss is because they don't really have a technical basis for entering the trade in the first place. If they had a technical reason, then why would they let the trade go against them so much before exiting the trade?

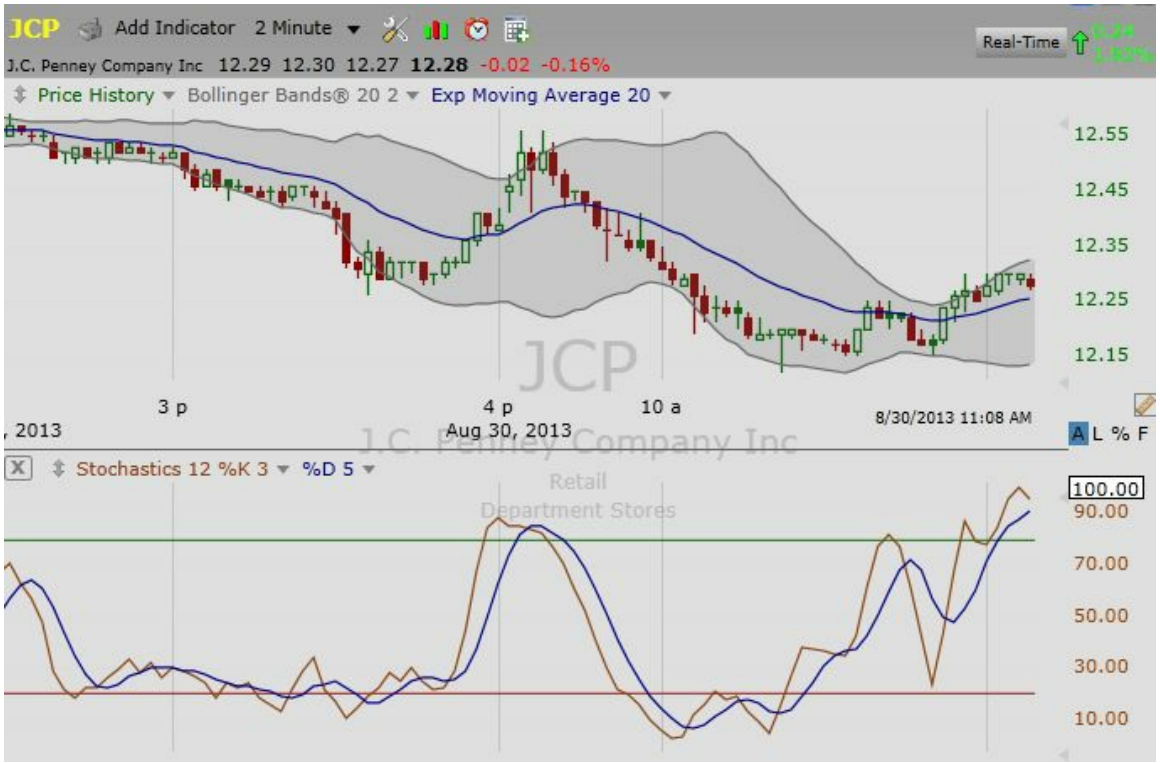
This is something I've seen far too many times. The trader says "well it hasn't hit my stop yet". And I ask, "Is it still qualified based on your criteria for entering the trade?" The answer: no. So why are they still holding the trade? They are still holding on because they have allowed their loss to cloud their objectivity. They are no longer trading the charts. They are trading their emotions and their dislike for taking a loss on the trade.

This may seem like a small matter, but in fact it is huge. Traders get so hung up on percentages, percentage targets and percentage stops, that they lose sight of the technical indicators glaring at them on the charts. Let me share something with you: the market doesn't care about your percentages. It is going to do whatever it is going to do. Your job is to respond to what it does as it does it. And if the trade is heading toward your 1% stop loss, it will often give you a technical reason to exit the trade

long before it reaches that 1% stop loss.

Before we get past this strategy idea, I want to mention one other thing. I alluded to it earlier, but I want to make sure we cover it here. The criteria for a long strategy can often be flipped and become the basis for a short strategy. As you probably remember, when we short a stock then we make money when the price goes down.

Let's look at JCP again, this time on 8-30-13 when the S&P-500 was negative.



As you can see on the above chart, the reverse of all our criteria was met in the middle of our chart and the trade hit our 1% short target before our technical reversals occurred. I wanted to

mention this because once you figure out one high probability strategy, then you often have two...one long strategy and one short strategy!

Alright, now that we've looked at our example of trading JCP, we need to go back and look at the answers to our four questions.

1. How do you know when a losing trade is actually a losing trade?

From the above discussion, you might realize there are several possible answers to this question. For example:

a. You know it's a losing trade when price hits your stop.

b. You know it's a losing trade when the technical reasons for entering the trade no longer exist.

c. You know it's a losing trade when your gut tells you it isn't working.

We might describe these stop loss ideas as levels of sensitivity. Let me describe it to you with a simple example. Let's say you're standing next to someone at a counter. Both of you have both of your hands on the counter in front of you. But the person to your right also has a hammer next to his right hand. Now, there are three levels of sensitivity here. The first level is when the person next to you picks up the hammer and uses it to hit your hand. That's your stop loss. The second level is when the person next to you picks up the hammer and you move your hand before the hammer reaches your hand. That's using technical indicators to exit the trade before stop loss percentage is hit.

The third level of sensitivity is when, after being in this situation several times already, you notice a twitch in the other person's hand and you take your hands off of the counter before he even picks up the hammer. That is trading from the gut, but it only occurs after years of trading experience.

That's a crude example, but it makes my point. Some traders, after months or years of experience, still insist on waiting for the hammer to the hit the hand. That is one way to trade, but it can create a lot of pain! Some traders are more sensitive to slight turns in their technical indicators and they reduce their risk (remove their hands) before the hammer hits. Other traders do not have to wait for the technical indicators to tell them that the hammer is getting ready to fall. They sense it. Call it intuitive trading, trading from the gut, trading in the zone, or any other name you wish. But it all amounts to the same thing. Some traders are so focused on the price action in front of them, after years of experience using the same indicators, that they have a sense of things and their response time is better than others. That slight difference in response times might mean slightly smaller losses and slightly larger gains. But those slight differences can add up over time and have a huge impact on your profit and loss statement at the end of the month!

You can think of these levels of sensitivity as stages in your progression as a day trader. But here's the important point: if you never master the first level then you'll never make it to the third level. If you cannot master the ability and the discipline to take losses in the market, then you'll end up losing all of your

money before you ever have a chance to trade from the gut. You don't just leap frog to level three. That would be nice, I know. But it just doesn't happen that way. First, you have to master the basics of setting stops and taking the losses. Then you can progress to using the technical indicators as the basis for your exit before your stops are hit. Finally, you can develop to this more intuitive approach to trading where nearly every trade works perfectly and your losing trades are kept very small.

For most traders, this third level of trading in the zone or trading from the gut happens infrequently. It's not as though it is a state of bliss in which you can do no wrong and you are "one with the market". Never underestimate the market's ability to surprise you. But still, even if you only reach level three on occasion, getting to level two in your trading will make a big impact on your bottom line.

To summarize the answer to the first question, you will grow in your ability to identify the losing trade. At first, it may be through the crude mechanism of stop losses. Later, it may be through increased sensitivity to the indicators and the movement of price.

Let's move on the our second question.

2. What is the basis for our exit of the losing trade?

The answer to our last question sets the stage for this question. The last answer paints a picture of how you want to progress as a trader. It provided some philosophy and theory and dreams. But now we need to get specific.

In the beginning, you need to start by identifying your stop loss and placing the order with your broker. The broker may allow you to draw a line on the chart and that line, once activated, will act as an automatic exit of the trade. The broker may allow you to type in a specific number at which your trade will stop out. The broker may allow you to set a stop based on a specific dollar amount or percentage. Many brokers will allow you to do all of the above options. So which one is best?

Let me first say that the reason the brokers have these stop loss options is to help you protect yourself. The broker makes money every time you enter and exit the trade, whether you make money or not. But the broker also wants to keep you as a customer. And if you lose all of your money due to the failure to set stops then they will also lose you as a customer. In this sense, the broker wants you to succeed. So they have these various stop loss mechanisms in place.

My suggestion is that you choose a broker who can clearly help you understand the various stop loss methods. But I will give you some pros and cons of the basic methods.

Mental vs. Physical Stops

Let me explain the difference between a mental and physical stop first. A mental stop is one that exists only in your mind. It could be a line on the chart, but not one you've activated as a stop loss with your broker. A mental stop is when you say to

yourself “if it goes down to _____ , then I’ll exit the trade and take the loss”. A physical stop is one that is actually placed with your broker. As long as the stop is already placed, the broker will execute the trade based on your instructions. You can’t call up the broker after the stop loss is hit and say “I’ve changed my mind”.

Here are the pros and cons of mental vs. physical stops. I don’t suggest using mental stops as you begin your trading career. Here’s the reason. You can talk yourself out of a mental stop. No matter how disciplined you think you might be, no matter how much you make promises to yourself, most traders are exceptionably capable of finding some logical reason for not exiting the trade at a loss when it moves against them. We’re kind of creative in that way.

One reason for this is that it is difficult for your mind to push a button that says “LOSE MONEY NOW!!!” written all over it. When you set a mental stop only, then it means you’ll have to press that foreboding button every time you want to take the loss on a trade. And that requires an awful lot of mental fortitude. If you’ve been trading any time already, then you know exactly what I mean. It’s just plain hard to convince yourself that the trade is not going to turn back around and go in your favor any second. We somehow think that we can will the price back up, that staring hard at the computer or yelling at the screen will somehow make a difference.

Part of this has to do with visual imaging. When you enter a trade, your mind’s eye sees the possible trajectory of price. You

know where you want price to go and you can almost see it before it happens. That's part of the reason you entered the trade in the first place...you thought you knew where price was going to go next. You had to spend a lot of time convincing yourself to take the action that you thought was going to be beneficial for yourself. So now you have to convince yourself that the opposite is true. And your brain is saying "But I thought you just told me that price was going up? I'm confused. Now you want me to believe price is going down? Common, dude." Okay, maybe your mind doesn't call you dude, but you get the idea. You're asking your mind to do the opposite of what you just told it and, not only that, but now you're asking your mind to do something that is not perceived as beneficial to you. You are asking your mind to help you lose money by pressing that big red button that says "LOSE MONEY NOW!!!"

Now, how receptive and responsive do your think your mind is going to be? Not so much, right?

Here's the other part of the problem. Researchers at Duke University have studied and described something called "confirmation bias". In simple terms, it means that the human brain is very effective at convincing ourselves that something is true if we are already biased in a certain direction.

Let me give you an example of confirmation bias. Let's say your wife wants to go to Paris. Now, you've only known two people from France your whole life and you found them to be snobbish. And you really don't like snobbish people. But your wife really wants to go on this trip so you take her to France.

Guess what you find when you get there? A bunch of snobbish people. Every encounter you have confirms your bias. The waiter doesn't speak English? What a snob. The people in Paris don't smile at you as they walk past you? What's their problem? Don't they realize how far you've traveled to get to their city? A bunch of snobs.

Your bias acts as a filter for the information you'll allow into your mind. Everything you see confirms this bias and you are not open to processing information that deviates from this bias. This has the affect of making us seem smarter than we really are since things were "just as expected".

So what does this have to do with trading? Our bias about the direction of the trade can close off our minds to processing information that disagrees with our bias. If we think price is going to go up, then we tend to ignore the technical indicators that say "price is going down". You'd think that we'd be open to that information since our goal is to make money and protect our capital. But we have such a need to be right that we tend to ignore these signals. Instead of keeping an open mind and asking "what is price doing now?", we tend to focus on every little shred of evidence that price might be getting ready to turn back around in our favor. We are, after all, very resourceful people.

So, for the reasons just stated, setting mental stops is not recommended. But more than this, I hope the previous discussion helps you understand yourself a bit more. The truth of the matter, and many experienced traders will tell you this, is that our greatest enemy in trading is ourselves and our ability to

rationalize poor trade management. It's not the market's fault. It's not the broker's fault. If we are losing money and we allow a losing trade to get out of hand, then there is only one person responsible for that fact. And we are that person.

So now let's talk about physical stops. Before we can consider the pros and cons of physical stops, then we need to examine a few of the varieties of physical stops. As I mentioned, there are many types and my recommendation is that you study your broker's specific types before deciding on your own approach. But let's cover the basics here.

a. Price based stop. A price based stop is when you set a specific price at which you will stop out of the trade. For example, let's say you bought IBM long at $183.30. You think it's going to go up to $184.30, at which point you'll take your $1 per share profit and be done with the trade. But, to protect yourself, you set a price based stop at $182.30. So, if you're right then you'll make $1 per share and if you're wrong then you'll lose $1 per share.

There are many reasons why you might set a price based stop. Let me just name two. A price based stop might be based on the most recent low or high traded by this stock. Let's look at the following chart of IBM.

Let's say we went long on IBM at the green arrows based on our strategy. Price is moving above the 20 EMA while the Stochastic Oscillator is showing a recent crossover and signaling price support. Our target might be $1 on this trade because that would be less than the morning's high. We set our price based stop at $1 because price would have to go to a new low for the day in order to hit that stop and it would be obvious that price is not going in the direction we thought.

We could make our stop loss tighter than $1 based on the above chart. The morning's low was $182.65, so could set our stop at

$182.60. One reason for doing that could be based on the chart. But another reason could be something called the risk and reward ratio.

The risk: reward ratio looks at trading as partially a game of math. If our target is $1 and our price stop loss if $1, then we have a 1:1 risk: reward ratio. We are willing to lose only as much as we think we can win and no more.

But let's look at another chart of IBM.

On the above chart, I've moved the stop loss line to 182.98.

This stop is below the more recent lows, before price moved above the 20 EMA. Now, instead of risking $1 on the stop loss, I am only risking 32 cents. This makes my risk: reward ration look like this: 32:100. My initial risk is only 32 cents per share and my initial target is 1.00 per share. This give me a roughly 1:3 risk: reward ratio. And what this means is that I can actually be wrong a lot more times and still make money. I have lowered my risk, protected myself in case price moves against me, and established a reasonable target based on the charts in front of me.

This second method for setting a price based stop is a bit more finessed that just throwing a number into our order matrix. But it can have great consequences for us over the long term. If we have a high probability trading strategy and couple that with a risk: reward ratio that tilts in our favor, then we have created a very solid method of trading. We have increased the odds of our success by marrying solid trade management to our trading strategy. In fact, some might argue that this sort of trade management is even more important than the strategy itself. After all, if you limit your trades to only those with a 1:3 risk and reward ratio, then one good trade can cover the mistakes of three bad trades! Your trading strategy might be only 25% accurate and you would still break even!

b. Percentage Based Stop. I touched on percentage based stops earlier, but let's look at it a bit more closely. Many brokers will allow you to set up your trading platform is such a way that every trade you enter has an automatic percentage based stop

attached to the order. So, for example, let's say you are using a 1% automated stop loss system. If you set up your order system in this way, then the most you can lose on any one trade is 1% of the price of the stock. Using this method on our previous trade of IBM, your buy order at $183.30 would generate an automatic 1% stop of $181.47. Since this would require IBM to get to a new low of the day, then hopefully you would have manually exited the order before that point. But the benefit of the automatic stop is that you set a stop without having to think about it too much. You can still go into the trading platform and exit the trade before that point, but the automated system gives you a stop in case you forget to do it yourself.

But there are some disadvantages to this automated 1% stop idea. For some traders, it might create a nonchalant attitude about the trade. "Well, I'm protected in case something goes wrong. I'll just play the odds and hope for the best." This attitude comes from becoming a little too comfortable with the 1% stop. And the market will soon teach you why this isn't always a good idea.

For one thing, your trade may get to within a penny of your target and then turn around and end up hitting your stop. If you were actively managing the trade, then would you allow this to occur? If you see your trade making money and then your indicators give you a sell signal before it hits your target, should you exit the trade and take the profit? I hope so. But setting up every trade as an either/or scenario is not the best method of trade management. If you have a high probability trading

strategy, and you have extreme confidence in your system because you have traded it for a long time, then this sort of attitude might be understandable. But, for beginning traders, I think the risks outweigh the gains.

There is another way in which percentage based stops can be used. So let's cover that now.

c. Trailing stop. A trailing stop can be used with either one of the two options already mentioned. In a nutshell, the idea is that you are setting limits on how far price can move against you. The language varies depending on whether you are going long or short. But let me use a long example and explain it. Let's say you buy IBM at $183.30. Now let's say you set a trailing stop of .5%. Here's what happens. Every time IBM goes to a new high for the day, the broker calculates .5% off that top and the answer becomes your new stop. It is called a trailing stop because it trails behind the new high of the day after your entry by half %. So, when IBM goes up to $184.01 at 10:24 (which is a new high after you bought the stock long), then your broker defines your new stop as 184.01 minus half percent, or 183.09. Since price doesn't go down to that price, but instead goes to another new high of $184.49 at 11:06, then the broker defines the new stop as $183.57. At 11:52, the price of IBM goes down to that price without making a new high first, so the broker executes your trailing stop at that price (or soon thereafter).

You can use trailing stops with specific dollar amounts as well. For example, you could set a trailing stop of 25 cents. So, at 10:25 on our IBM chart, price touches $184.08 and the drops to

$183.80. That drop is more than 25 cents, so your 25 cent trailing stop order would have been executed by your broker.

Some traders like to use trailing stops. There is one situation in which I will consider using a trailing stop. Some trades can create much more than 1% profit for you. And one of the oft-quoted rules of trading is "let your winners run". Let's say you are in a long trade and price is climbing slowly higher. The market is going higher also and you think this stock could move much higher than 1% profit because of the news associated with it. (Perhaps it's a biotech company that has had a successful Phase III trial and investors are jumping on board.) Instead of taking all of your profit at a 1% target, you might exit half of your position at 1% profit and then use a trailing stop on the second half of your position. By doing this, you would be locking in some profit on the first part of your trade and then you would set up a trailing stop (percentage based or price based) for the remaining part of your order. If price continues higher, then you enjoy the benefit of greater profit on the second part of your trade. You can also monitor the trade and wait until you see 2% profit before placing your 1% trailing stop order. This means you would still be guaranteed 1% profit on the whole trade with the possibility of greater profit on the second half of the trade if price continues higher. Without having to sit there and manage the trade, you can set this trailing stop in place and then go look for other trade set ups.

d. Adjustable stops. This fourth type of stop can also be used with price based stops or percentage based stops, but I usually

use it with a price based system. You can use this idea on the whole position of your trading or on a portion of the trade. The main idea here is to continually adjust the stop on your trade as the trade develops.

Let's look at the IBM chart again below.

On the above chart, you'll see three numbered lines. Let me illustrate how you might use adjusted stops on this chart.

#1. This purple line represents our original stop when we first entered the trade as a long position. Based on our risk: reward ratio and the recent price lows, we decided that this was where

we stop out on the whole position would be if price moved against us.

#2. This blue line presents our first adjusted stop and it is drawn at the place of our original entry price.. After price has moved higher and we are showing a profit on the trade, then we can adjust the stop on our whole position so that we will exit the trade if price comes back down to our entry price. What does this do? Well, for one thing, we know we cannot lose on this trade. We now have a break even stop on the whole trade so, whatever else may happen, we cannot lose any money on this trade. By taking this action, we can move our concentration to finding a good exit point. If we are no longer stressed about losing money, then we can focus on making money. When our stress level decreases as traders, especially new traders, then our performance usually goes up. So, the first thing we want to do is get to a break even position on the trade. But you have to let price move in your favor before you can do this or else you will stop out too early. For this reason, most traders prefer to wait until they've taken some profit on the trade (by exiting half of their shares at a profit) before moving their stop to break even on the remaining position.

#3. The red line shows where the third adjusted stop might be placed. Price moved up and then retreated slightly. Beneath the red candle might be considered a level of price support, so we could move our adjusted stop up to a point just beneath that candle. Once we do that, we have locked in a guaranteed profit on the trade. And this line can be adjusted higher as the trade

continues to move in our favor.

Do you see what we've done with this process? We have used adjusted stops to manage the trade based on the price action on the chart. In three stages, we went from an acceptable risk: reward stop, to a break-even stop, and then to a guaranteed winning stop.

Now, if you have already been trading stocks some and you are struggling a bit, do you see how this system of adjustable stops could improve your trading? You can use that same three-step system on every one of your trades to help you manage the trade for larger profits and smaller losses. And by doing this, you will be adding a high probability trade management system to your high probability trade strategy. Now we're getting somewhere!

The problem that most traders make with adjustable stops is that they move the stops too close to current price action. Since prices on stocks can fluctuate back and forth, too tight of a stop can mean you will get stopped out too soon. So, you have to give the stock some room to breathe.

Throughout this discussion of stops, there is one assumption that I've been making. That assumption is that there is more to using stops than just specifying a certain number or percentage and using that same formula on every single trade. As I showed in our discussion of adjustable stops, our stops can be based on our technical analysis of the trade. I mentioned, for example, using price action as a basis for setting our adjustable stops.

But the very nature of stops means that price has gone against

us before we make an exit on the trade. If price hits our stop, then it was evidently higher at some point and we failed to capture that higher price and a better exit. This can be frustrating for new traders. But you have to understand that your chances of exiting the trade at the most extreme price point is extremely rare. Speaking in terms of probabilities, there is an extremely low probability that you will ever exit the trade at the perfect moment. So you need to accept this.

Instead of accepting this fact, many traders will look at their trading account profit before they exit the trade. They may get excited about how much money they've "made" before they exit the trade. This is a bad idea. My suggestion is not to worry about the account. Focus on the trade and the chart in front of you. Otherwise, you will look at your "profit" before you exit, and then price moves against you. Looking back at your account, you see that there's less profit than earlier. This makes you think that you've been robbed because the profit was there just a minute ago and now it's less (or it's gone completely). This can have a bad psychological impact upon your trading because now you think the market owes you something. The market needs to give back your money. This makes you hold onto the trade as you say to yourself "Well, if it gets back up to that price, then I'm going to exit the trade this time". But price never goes back up to that price. Instead it goes lower. And where you once had a profit on the trade, you have allowed your disappointment and your greed (sorry, it's true) to get in the way of your solid trade management.

So, rather than focusing on the profit in your account, I suggest you focus on the technical indicators on your chart. Put your attention on trading to the best of your ability at this point in time, using all of the resources we've already mentioned in this book, and wait until the trade is over before you look at your profits.

Here's the other thing that can happen to new traders and old traders alike. They get into a winning trade and suddenly they get scared. They've seen stocks before where they waited too long to exit the trade and their profits got wiped out. So they rush in to exit the trade and take their nice profit when the charts are telling them that price could continue in their favor. This is the emotion of fear, of course, raising its ugly head and causing us to trade based on emotion rather than based on the charts in front of us.

So, I want to encourage you to put aside both fear and greed and focus on the charts and the price action in front of you. Use adjustable stops to manage the trade and continue to monitor the technical indicators on the chart so you can make the best trade decisions possible.

To do this, we need to focus on the technical indicators and learn to use them as a basis for our adjustable stops and our exits on the trades. But we also need to learn more about Support and Resistance.

Support and Resistance

We can think of support and resistance like the floors in a house. If you were jumping up and down inside your room, then there are certain limitations to how far you can fall and how far you can rise. The floor of the room acts as support and the ceiling acts as resistance (provided you're tall enough). You get the idea.

As the price of stocks move up and down, traders are watching a variety of indicators to determine if price is going to go up or down. But they are also looking at price with the question of "how far up can it go and how far down can it go?". Most traders aren't consciously thinking to themselves "what are the probabilities that price can go to $ ____?" And yet, they are looking at various lines of support and resistance and trying to determine good exit points for their trades based on probabilities.

Let's add some new lines to our IBM chart.

On the above chart, you'll see that I've added a purple dashed line to the chart. It is called a Pivot Line. Pivot lines can be added from your technical indicator pane if your chart provider offers it. Most of them do. Pivot lines consist of seven different lines, though only two of them show up on the above chart. The seven lines are the middle line, called the Pivot, plus three lines above this line and three lines below this line. The lines above the Pivot line are labeled R 1-3 where R stands for resistance. The lines below the Pivot line are labeled S 1-3 where S stands of support.

Here's a view of IBM using a 30-minute chart.

On the above chart, you can now see all seven lines. The reason that all of them didn't show up on our two-minute chart is that price was not moving far enough away from the pivot line for us to be able to see them.

So what are Pivot Lines? I won't go into the math, but it basically uses the previous day's high prices, low prices, closing prices, etc. to create a series of lines on the chart. What's really important though is that other traders use them. So, it has very practical importance for you. If you know that you're making a profit on a trade and you're trying to determine where to place your target, then it will be helpful to look at the pivot lines as

possible areas of support and resistance. In one sense, they are just imaginary lines or mathematical constructs, but they derive their importance from the fact that other traders use them.

Let's go back to the 2-minute chart now and look at five different lines on this chart.

Looking at the above chart, there are five colored arrows that point to different places on this chart. Let's take a look at each of them in turn.

#1. The red arrow points to the S1 line, which is a dashed red

line on the chart. This is the first line of support for our Pivot Lines. On the morning of 9-6-13, you can see how price touched on that line, bounced off, went below the line, and then we have a period where price went back and forth on this line for over 30 minutes. Price doesn't have to find support on S1 just because it is named a line of support. We have to watch price and see what happens. But the fact that it found support there added support to our argument that price was going to go higher.

#2. The purple arrow points to the Pivot, which is a dashed purple line on the chart. The Pivot line is the central line so it is of high importance to traders. Overall, we might think of it as the mid-point for recent price action. So, whichever side it ends up on is kind of important. On the above chart, you can see how price moved just above the Pivot line and fell back below it.

#3. The green arrow points to a yellow line on the chart. This yellow line is the previous day's closing price for IBM. Just as the Pivot Lines can act as support and resistance, the previous day's closing price can also act in this way. On the above chart, we can see that price moved up to that line and then fell back below it. We might also note that the pivot line and the previous day's closing price are in close proximity.

#4. The orange arrow points to the 80 line on the Stochastic Oscillator pane. We can also think of certain levels on the indicators as having support and resistance lines. We'll talk more about this in a minute.

#5. The blue arrow points to the 20 EMA on this chart. Since

the 20 EMA is a key measurement for Bollinger Bands and Keltner Channels, as well as an important stand alone price average, then this line can also act as a line of support and resistance.

So, on this one chart, we have identified five possible lines of support and resistance. In one way or another, they are all derivatives of price measured in various ways. Now let's look at how these lines can help us make high probability trades.

Let's go back to our analogy of the floor and the ceiling. Based on the above chart, we can look and see that S1 acted as a floor of support for price and the Pivot line acted as the ceiling of resistance. We notice that the previous day's closing price and the Pivot line are in close proximity, so we could say that there was a double line of possible resistance because of this close proximity. Thinking in terms of probabilities, we would say that a double line of resistance is stronger than a single line.

But we can also look at our Stochastic Oscillator as price encounters these lines. We have learned that a Stochastic Oscillator over 80 is considered over bought. Since it is over bought, then it is subject to a sell-off. So, if we combine this fact about the Stochastic Oscillator with a double line of possible resistance, do you think there's a high probability that price will find resistance at those lines? Yes, I think so. And evidently many other traders of IBM thought the same thing that day. The traders all had various reasons for their actions, but the net result was that price met resistance at that point and then began to fall.

As price fell lower, it also dropped through the possible support of the 20 EMA (#5 on the above chart). At that point we actually have a qualification to short IBM based on the flip side of our long strategy. Price is below the 20 EMA. The Stochastic Oscillator has recently dropped below the 80 line. And if we had taken that short, then our stop loss might be above the recent highs that occurred around 11:00. Since we knew that price had found support on the S1 line earlier in the day, we might be eyeing that area to take the profit on the short trade. But price never dropped back down that far.

As we study these lines of support and resistance, I want to point out one thing. Price can sometimes go back and forth across these lines for long periods of time. It's not as though price will just stop right on the exact line on the chart, though sometimes it can. So, it is best to think of these as **areas** of possible support and resistance. If you see price going slightly past the pivot line, don't assume that price will just keep going. As you can see on this last chart, price can move back and forth across these lines for 30 minutes or more until the consensus vote from the other traders involved is made known on the chart.

So, how do you use this information? If you had gone long on IBM at $183.30 as we originally discussed, then you should be eyeing those overhead double lines of possible resistance. You cannot predict with absolute certainty what price will do there, but you are ready to take action on your trade since you know there is a possibility of resistance there. Some traders will see those lines of resistance and go ahead and take their profit on the

trade very close to those lines rather than risking more time and money. Some traders will watch the price action before deciding. Other traders will see those lines and move their stops higher in order to lock in lock in more profit with a tighter stop.

Exiting part of your trade with a guaranteed profit in this situation seems like a high probability trade decision though, given the combination of double resistance plus an over bought Stochastic reading. If you exited part of the trade, then you would also move your stop on the remaining shares to lock in some profit on the remaining position. Since the 20 EMA sits between the double line of resistance and the #3 stop mentioned earlier, then this would be a reasonable place to put your stop. This would allow you to watch price while also protecting your profit. But there's nothing wrong with making a clear decision and locking in that $1 per share profit when you have it.

If all of this begins to look like an NFL strategy session, then you wouldn't be far off the mark. The trader faces an ever-changing chart as he/she trades. Decisions have to be made every few minutes as the trade is continually analyzed for possible points of support and resistance combined with probabilities of success given the current set of circumstances. While it is easy to analyze these charts after their completion, it takes intense focus to analyze this changing landscape as the trade is taking place. Just as a quarterback must constantly look and analyze the changing field in front of him, the trader must also constantly watch and analyze in order to make the best decisions possible.

There is one other tool that traders use for finding support and resistance lines.

Fibonacci Retracement

Fibonacci Retracements are a draw tool found on most chart packages. They can be used in a variety of ways and a full discussion goes beyond the scope of this book. But I would be remiss if I did not at least introduce the concept to you.

Let's look at the IBM chart again.

On the above chart, you'll see a series of dashed blue lines. The

two blue arrows point to the high and low for IBM on the morning of 9-6-13. Some traders will use these two extreme points on the chart to help them determine when to enter and exit a trade. They do this by taking those high and low points and drawing Fibonacci Retracement lines for the area between those two price points. On the above chart, I've circled the 61.8% Fibonacci Retracement line. Do you see what other lines are in this same proximity? Both the previous day's closing price and the Pivot line are in this same area.

Now let's look at our entry and exit points again.

I've blocked out two different areas on the above chart. The lower block shows a cluster of supporting lines with the 23.6%

Fibonacci Retracement line and the S1 from our Pivot lines in very close proximity. That is a double line of support and that area became support for the rest of the day. The upper block shows a cluster of resistance lines with the 61.8% Fibonacci Retracement, the central Pivot line, and the previous day's closing price is very close proximity.

When we view the chart with these additional lines, we might come up with a different strategy. This new strategy might state that we can go long at double lines of support when the Stochastic Oscillator crosses over and moves above the 20 line. That strategy might also tell us to exit the trade when we have at least two lines of overhead resistance and the Stochastic Oscillator gives us an over bought reading. This strategy is slightly different from our other strategy because we have now introduced some new evidence to our charts. We're now looking at points of support and resistance. Adding this new information might create a higher probability trading strategy than our former strategy. Or it might be a second strategy altogether.

Part of what I'm trying to illustrate here is the fact that there is more than one way to analyze a chart. There are all sorts of lines of support and resistance we can look at and there are hundreds of indicators from which we can choose. The key thing is to find the indicators and set-ups that work for you. You may not like drawing all of these lines on your chart. You may prefer using RSI instead of the Stochastic Oscillator. You may prefer Bollinger Bands to Keltner Channels, or no price ribbons at all. Instead of thinking that there is only one strategy or one system,

it might be best to think of strategies as a recipe. There are hundreds of recipes for apple pie. While all of them might taste like apple pie once they're finished, and the majority of them will probably use apples as one of the key ingredients, there are many variations on that recipe. The key questions for the recipe are "Can you follow the directions?", "Do you have all of the ingredients?" and "How does it taste once it's done?" Likewise, with trading strategies and systems, use the system that you can trade that produce a high probability of success for you. It may be the same one you've learned from someone else, or it may be your tried and true recipe. The key question is "Do you have a high probability trading strategy that can make you a good profit when combined with high probability trade management?"

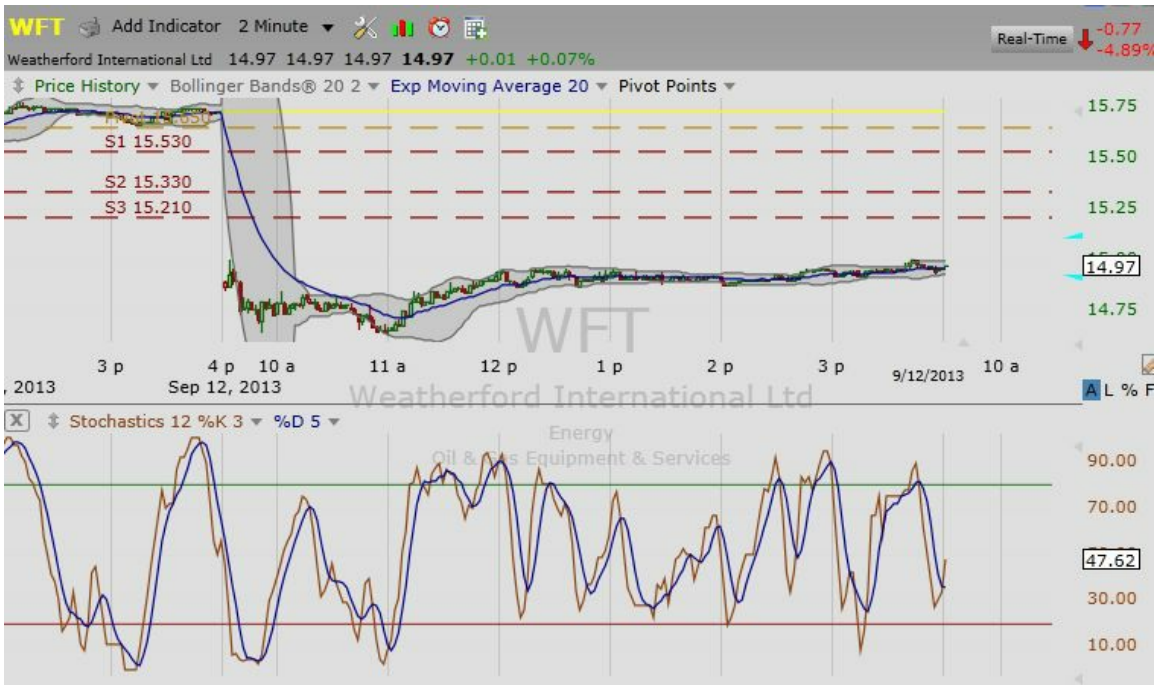
Trading and Not Trading

When new traders first learn to trade, it's often like a kid in a candy store. As soon as you see price moving, then you think you have to jump on it before you miss "the big one". But part of having a high probability trading system is knowing both "when to trade" and "when not to trade".

I've heard different statistics, but all of them point to the same fact: stocks spend more time in consolidation patterns than they do in trending patterns. What do I mean by that? I mean that stocks are not always moving up and down in big waves. Stocks

spend approximately 70 - 80% of their time in consolidation patterns, which means that most of time they aren't moving enough for us to trade them.

Let me give you an example.



The above chart looks at WFT using a 2-minute chart. You can see how it gapped down (a gap is a space between the previous day's closing price and today's opening price) on 9-12-13. Price fell below the S3 and never made much progress. You can look at the Bollinger Bands and see how close the outside bands are and this amplifies the small price movement on this stock for this day. The Stochastic Oscillator goes up and down over and over again. But price stays within a 1% trading range for nearly the

whole day.

Do you think this stock is a high probability trade? Probably not. I don't either. But it's an example of a consolidation pattern where price is moving in a very tight range and therefore gives the trader very little opportunity to make any money as a day trader.

All stocks are not created equal. Some of them are going to be better for day trading than others. And certain times of the day are going to better for trading than other times. Because of this, the trader has to know when to "not trade". If you think you have to be constantly trading, then you will take too many trades and your risk will increase. So, one of the things you can do to improve your probabilities for success is to accept the fact that it's okay not to trade. Trading is a choice. Even if you are trading full time and it is your only source of income, trading is still a choice. Just because you are sitting at your computer and watching stocks move in front of you does not mean that you have to trade them.

Let me break it down for you this way. The stock market sees most of its activity in the first few hours of each trading day. This is when stocks are catching up with overnight news, economic reports, world events, etc. So there is a lot of volatility in those first few hours, from 9:30 AM to 11:30 AM, Eastern. Most stocks are moving during this time as investors reposition themselves within the market and traders try to capture profits from the volatility. This is "prime time" for trading U.S. stocks. After that, the market often goes into a bit of slumber as it

approaches the lunch hour. Then the afternoon may see more news events and volatility as the market positions itself for the next day.

So, one way to improve your probability of success is by trading these first two hours of the market each morning. I know that some people's schedules don't always allow this. But, if you're able to set your own schedule, then you want to block out each morning for trading.

During that pre-lunch period, you should be able to find between three and six good stocks for day trading. It will seldom be more than this because you really need to focus on what you're doing. But, as a new trader, if you find yourself doing ten different trades on ten different stocks before lunch each day, then you are probably guilty of "over-trading". Over-trading is when you trade compulsively, as I've been describing, trading just to trade or trading because you think that's what you have to be doing every minute you're in front of the computer. If you find yourself doing this, then my suggestion is that you try and slow down. Spend more time analyzing the charts and the set-ups and less time actually trading. Learn to say no to trading. By doing this, you will probably increase your probability of executing good trades.

Other than time of day, you can also look at stocks that are in the news. Stocks that are being mentioned in the national media would be one example of this. But, as I mentioned earlier in this book, stocks have higher volatility (price movement) when there is some bit of news for the investors and traders to respond to.

Let me give you a few examples:

1. A company may have made its quarterly earnings report the previous evening or this morning before the market opened. If the earnings report beat the market's expectations, then the price will usually go higher. It may "gap up" when the market opens and then continue higher. If the earnings were less than expected, or the company warns about next quarter's prospects, then the stock may fall. The key thing is that you never want to assume you know how the market will react to that news. You might look at the headline of the earning's report and decide the market will drive the price higher. But you may have overlooked a small detail in the report that spooked investors and they are selling the stock as soon as it gaps up. So, rather than assuming the direction of the stock, you want to watch the charts and let the charts tell you how to trade the stock.

Some traders place a lot of emphasis on trading stocks that are getting ready to post their earnings reports. The stock sometimes tips its hand before the actual earnings announcement as investors buy on the rumor of good or bad news that precedes an earnings announcement. The key point is that earnings can create volatility. And where there is price movement, there is also opportunity.

One of the sources I use for tracking pending earnings reports can be found at the following address: http://biz.yahoo.com/research/earncal/today.html. This link will take you to a specific page on the Yahoo Finance site. You can also track a company's pending date by entering a stock symbol

as shown below and clicking “Get Earnings Date”.

2. A bio-tech company may issue a report on a new drug. This report could be telling about a successful drug trial or some FDA approval. It may be the report on a new test or a new distribution channel that could help sales. Bio-tech companies are very volatile but the market often cheers the new drug’s promise by driving the price of the company’s stock higher.

3. Stocks within certain sectors often move together. For example, if a big box retailer reports sluggish sales, then another big box retailer’s stock might suffer as well simply because they are in the same sort of business. So, there may be no direct news about a company, but the news in a sister company can impact price temporarily on other companies in the same sector. This is not commonly considered among traders, but the next time you hear news about a certain sector then think what other company might be impacted by this news.

This can also occur in the tech industry. If one company reports sluggish PC sales, then the makers of the components for those

PCs might also be impacted. Makes sense, right? But, again, these are not things that most new traders consider. So it is worth mentioning here.

4. Management changes will often impact a stock's price. I gave the example earlier of Microsoft and Steve Balmer. The sudden resignation of anyone in the C-suite will often cause price volatility as investors adjust to the news.

5. Stocks can also move due to politics and world events. For example, if tensions arise in the Middle East, what do you think that will do to the price of oil? It will go up. So what else will go up? Oil stocks. If Congress is showing no interest in helping to subsidize some industry, then watch for volatility within that industry. If health care is on the national adjenda, then watch for volatility in the insurance and health related stocks.

6. Economic reports can move the market. Nearly every morning, various reports are issued on the health of the U.S. economy. Unemployment reports, retail sales, and consumer sentiment are just a few of those reports. The market is very sensitive to this data so it is important to keep up with the timed release of those reports. Certain reports carry more weight and meaning that other reports. While most of them occur prior to the market's open each morning, some of them are released after the market opening.

One the sources I use for keeping up with these reports can be found at the following address: http://biz.yahoo.com/c/e.html. When you go to this link, then you'll see a list of reports listed by

week or day. For example, here are the reports for one recent week:

Economic Calendar

Last Week

Date	Time (ET)	Statistic
Sep 9	3:00 PM	Consumer Credit
Sep 10	10:00 AM	JOLTS - Job Openings
Sep 11	7:00 AM	MBA Mortgage Index
Sep 11	10:00 AM	Wholesale Inventories
Sep 11	10:30 AM	Crude Inventories
Sep 12	8:30 AM	Initial Claims
Sep 12	8:30 AM	Continuing Claims
Sep 12	8:30 AM	Export Prices ex-ag.
Sep 12	8:30 AM	Import Prices ex-oil
Sep 12	10:30 AM	Natural Gas Inventories
Sep 12	2:00 PM	Treasury Budget
Sep 13	8:30 AM	Retail Sales
Sep 13	8:30 AM	Retail Sales ex-auto
Sep 13	8:30 AM	PPI
Sep 13	8:30 AM	Core PPI
Sep 13	9:55 AM	Mich Sentiment

On the above report, the items listed in blue are links to details about the importance of that report and how to understand the report's importance.

Whenever the Federal Reserve convenes, then they will also make statements about economic conditions and policies. You'll

need to watch those statements as well.

As important as these reports are for you as a trader, it is more important that you try and not predict the market's reaction to these reports before they are issued. Knowing about the reports and the fact that they impact the volatility in the market is one thing. Trying to predict what the report will say or how the market will respond to that report is something else. This is one reason for using technical analysis for trading. If we believe that market sentiment is expressed in the price candles on the chart, then we do not need to try and predict anything. We just trade the charts! As market sentiment is expressed in the price candles and our various indicators, then we watch these things and simply "go with the flow". An important side note...if you find yourself arguing with the market, then it's probably because you are on the wrong side of the flow. If you find yourself yelling at the computer screen and saying that "the market's got it wrong", then it's probably because you are losing money on a trade and you are on the wrong side of it. So, don't try and second guess the market. Don't try to predict the market's response to these various reports. Just be responsive to the market and the charts and try to stay with the market. To make money in trading, it isn't a matter of you being right and everyone else being wrong. It's a matter of you accepting the market's direction and getting in line with it.

Time Frames

As we analyze the market and the charts to determine our trade entries and exits, then we also have to decide on the time frame we'll be trading. I just mentioned that we need to "get in line" with the market. But the reality is that a chart can look very different depending on the time frame you are trading. This creates a lot of confusion for new traders because a chart can look long on one time frame and short on a different time frame. They become confused and they don't know which one to choose. Or, what often happens, a trader gets into a losing trade and then they look to a different time frame to try and justify their reason for staying in the trade!

Let me illustrate.

Look at the following chart:

The above chart is a 2-minute time frame. This means that each candle shows two minutes of price action on this chart. I've placed green and red arrows on the above chart. Let's say you have a simple strategy that states "buy long when Stochastics crosses above 20 and price is above the 20 EMA" We can see this double qualified entry point with the green arrows. Now let's say our exit strategy is "exit the trade when price falls below the 20 EMA **AND** the Stochastic Oscillator falls below 80. We can see this double qualified exit point with the red arrows.

If we had used the 2-minute chart for this strategy, then we would have entered the trade around $92.53 and exited the trade around $92.79 and we would have made 26 cents.

Now let's change our chart to a 10-minute time frame.

See the chart below:

The above chart is a 10-minute view of this same stock. I have left the green and red arrows from the previous chart on this chart. As you can see, the 10-minute chart shows how this stock never "qualified" based on our strategy. If we were looking at the 10-minute chart, then we would have never taken this trade because price never moved above the 20 EMA. On the 10-minute chart, each candle shows 10 minutes of price action. The 20 EMA is based on the previous 20 candles. And price never moved above that line.

Now, why am I showing you this? Am I trying to confuse you? No, but I am showing how new traders can become

confused due to the conflicting information from different time frames.

Here's the important lesson. Find the time frame that works for your strategy and the time frame that works for your personal style. In the above illustration, the simple strategy we outlined worked fine for either time frame. With the 2-minute time frame, it created a possible trade (and one that needs some refinement) and a possible profit. With the 10-minute time frame, you never would have traded this stock on this day. Is one wrong and one right? No. Is one better than the other? No.

Let me talk about personal style for a minute. I have already mentioned how the same strategy can produce different readings on the same stock depending on the time frame viewed. But you have to discover which time frame works best for you. There are some traders who feel the 10-minute time frame produces too few trades for day trading. So they prefer to look at 1-minute charts and find lots of small price movements. This type of trading is much more rapid and the trader has to really be focused to trade on this quick time frame. Trading the 1-minute charts, trades often last for only a few minutes and rarely last more than 20 minutes. Other traders prefer the slower pace of the 10-minute time frame. The trades usually last longer and the gains per trade are larger. They find that there is too much "noise" on the 1-minute charts and they don't enjoy that frenetic pace of constantly moving in and out of trades.

If we had to categorize these two types of traders, we might say that one prefers canoeing in the rapids and one prefers the slow

moving river. There is nothing wrong with either approach. But you will have to experiment some and figure out which one works best for you. The main point I'm trying to make is that choosing a time frame is important. It will change the way you look at the market and at your trades. It will impact the results of your trading strategy. And most traders find that certain time frames work better for them than others.

I should add, however, that some traders use multiple time frames for trading. For example, a trader might look at the 10-minute chart to see the larger directional flow of a stock, but then use the 1-minute time frame for their actual entries and exits. While this approach may be confusing to you if you are just getting started as a day trader, it is something you might consider later.

Strategy Development

Throughout this book, I have referred to trading strategies. We have looked at a variety of charts using a few potential strategies. But I want to walk you through some of the aspects of developing your own strategy. I want to answer the question "How do you develop a high probability trading strategy?"

Before we jump in too far though, I want to make an observation. All day traders are not good strategists, and all strategists are not good day traders. What do I mean by this statement? I do not know the full reason, but there are market

analysts who do a great job of research and market analysis and yet they lack that Factor-X variable that makes them a good day trader. The analyst enjoys sitting for hours and looking at the data, pouring over charts, plotting, and diagramming. And their analysis, once completed, can be excellent guidance for others. But put them in front of a 1-minute chart with a $100,000 account and they freak out. Their entry on the trade may be late. They hold losing trades too long. They see potential on the chart before it actually occurs, and if it doesn't occur then their brain can not match up the two realities. For these analysts, there is a disconnect between the strategy and the discipline required to execute the plan.

I guess it's not too strange when you think about it. Great military generals are great leaders by requirement, but they are not always great strategists. And it takes much more than strategy to become a great general. So maybe it's not so strange that trade analysts and day traders are not always the same person. Perhaps it's an issue of personality types. One person enjoys the analysis and one person thrives on the adrenalin rush of getting in and out of trades.

The two types can be found in the same person. But, I'm just letting you know that this is a possibility. It is not required that you be able to wear both hats. If you want to be a day trader, then you can always hitch a ride on someone else's strategy and just focus on the trading. But, if you are somewhat analytical by nature, then you might also want to pursue some strategy development on your own. So this section will help you get

started.

Let me begin by showing you a chart. Now, before you look at the chart and before you read the text that follows the chart, I want you to do one thing. I want you to look at the chart and ask yourself "What are the patterns I see on this chart?" When I say "patterns", I'm talking about the combination of factors on the chart that seems to create a high probability situation that might repeat itself on other charts. I've used several of the indicators you've studied in this book on this chart. There's nothing new there. I've told you the definitions of the indicators and what those indicators are meant to reveal to the trader. But I'm showing you a fresh chart this time. This is one you haven't seen before. And I want you to look at it for as long as necessary and then write down your answers to the question "What are the patterns I see on this chart?"

Here's the chart:

As I said, take the time to look at the above chart for as long as needed. Then take the time to actually write down your answers before you move on to the next chart. “What are the patterns I see on this chart?”

Let me show you one of the patterns I see.

When I looked at this chart, the first thing my eyes went to were the few times that price stuck outside of the Keltner Channel. Those price candles stuck out to me because it was unusual. And then I noticed that the Stochastics Oscillator also matched up with these "beyond the bands" moments. These things stuck out to me for two reasons. First, the eye seems to gravitate to those areas. Second, I knew the definitions of the indicators.

Let me splice it together for you. I know that the Keltner Channel contains the movement of price about 80% of the time. The few times on this chart when price moves outside that channel were rare moments. I also know that the Stochastic Oscillator reveals possible areas of over bought and over sold conditions on the chart. Then we combine those two things. The red arrow shows where price is beyond the top of the Keltner Channel and the purple arrow shows the over bought condition of

the Stochastic Oscillator. The green arrow shows were price is beyond the bottom of the Keltner Channel and the blue arrow shows the over sold condition of the Stochastic Oscillator.

What I've just described on this chart is a visual pattern. It is one that, once you've seen it, you'll probably never forget it. It's a picture, a snap shot created by your mind's eye. And it is the first step to creating a strategy.

Creating a trading strategy requires that you know enough about the indicators to understand what they are telling you on the chart. It also requires a bit of curiosity. To the first question "What do you see?", we now have an answer. Once you've seen the pattern, the next question should be "Does this happen very often?" To answer this second question, we have to look at a lot of charts. We use the same criteria and look at hundreds of charts to see if this pattern repeats itself. This is called "back-testing" and it is required of us before we actually trade the pattern with real money. We want to discover if the pattern repeats itself and whether or not we can create a high probability trading strategy out of this initial pattern.

So, let's say we move on to another stock on our list and we see the following chart:

On the above chart, the green arrow points to the fact that price has dropped below the bottom of the Keltner Channel and we see that the Stochastic Oscillator is giving us an over sold reading. But the chart looks different, doesn't it? One thing, price doesn't just roll back up to other side of the Keltner Channel like it did in the other chart. On this new chart, price seems to hit resistance at the 20 EMA that runs through the middle of the Keltner Channel. We also notice that the Stochastic Oscillator doesn't run back up above the 80 line this time. It sort of flattens out and then it crosses back down around the time that price hits the 20 EMA. We might also notice that price eventually moves back up to the top and that it never goes back down to that first green arrow. So that might make us wonder, "What if we went long

whenever price drops below the Keltner Channel after Stochastics creates a crossover and moves above the 20 line? Then we place our stop at the day's low price (the purple line on the above chart) for protection."

That is how a strategy begins to develop. You see a pattern, apply the same pattern to other charts, see if the pattern repeats itself, and then see if there are any trade management rules you could put in place to make this a high probability trading strategy.

Some traders might see this last chart and say "Well, that idea didn't work. It doesn't look just like the last one, so it must not happen every time." By disregarding the pattern too quickly, they miss out on some potentially high probability trading strategies. They make the mistake of thinking that a pattern has to look the same way every time, expecting the test to be the exact same pattern 100% of the time.

Let's say you stay with it and you keep looking at other charts. Then you come across the next chart.

Now, you may be really confused. "I thought you said that price stays inside the Keltner Channel 80% of the time?" you might ask. Well, it does. But, on this particular day, the above chart shows an exception to the rule. Price stays above the top line of the Keltner Channel for nearly the whole day as it just keeps moving higher! So what about our strategy now?

Once again, some traders might look at this last chart and say "Just forget it. There's no pattern there." But there is a pattern here, using the same indicators, but it highlights one of the exceptions to the rule. If we look at the far left, we see that price moved above the Keltner Channel and price did move lower so a short at that peak would have worked. But then we might need an addendum to our strategy that says something like this "If price stays outside the Keltner Channel and then the Stochastic

Oscillator confirms the trend by crossing back up, then reverse the position and go long instead of short". If we had followed that rule on the above chart, then we would have made a nice trade.

The traders who didn't see the exact same pattern as the first one, and quickly bypassed this chart, would have missed out on a great trade. This process of back testing and looking at hundreds of charts is required because this is how high probability strategies get built. You take an initial pattern, you see the exceptions to the basic pattern, and you begin to make addendums to the initial idea. Over time, you create a strategy than can be traded in multiple ways instead of just one way. But you have to stay open and inquisitive. Rather than demanding that all charts look the same, we must be open minded about the chart in front of us, looking to see if there is some bit of detail that needs to be added to our ideas so that we can have a high probability trading strategy as our end result.

We only looked at three charts regarding our strategy. We would need to look at hundreds of other charts. And we also have to remember that back testing on non-moving charts is much easier than using real money on live charts. When the charts are forming right in front of us, moving averages and crossovers happen slowly. What is easy to see in hindsight becomes more difficult to see using live charts. But this is where you must begin before moving onto live charts. You see patterns, tweak entry and exit rules, and look at lots of charts. As you do so, you are preparing your mind's eye to see these

patterns on the live charts. You are developing a high probability trading strategy.

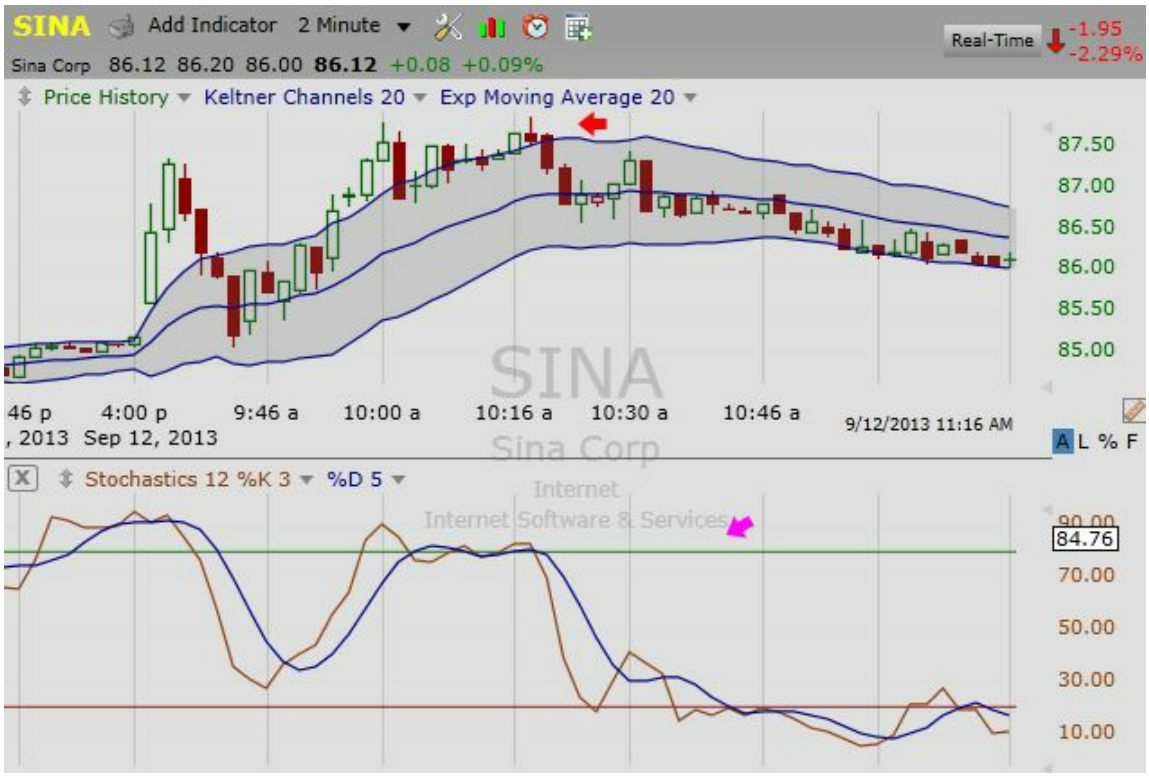
Part of developing a high probability trading strategy involves research and reporting, testing and tweaking. It is much like the work of a scientist who is working to develop a new vaccine. I will discuss record-keeping in a minute. But, for now, realize that you need to keep clear records of your tests and your results. You might see a tweak that could be made and then chase that rabbit for a while only to find out that it did not work as well as the previous experiment. Well, the only way to know this fact is because you kept clear records of your back testing results and you are able to compare one test with the other.

It is possible that slight changes in indicators could have large results. Part of this is visual. For example, you can take a 10-minute chart and create dozens of different viewpoints of this chart using a combination of various indicators. You might find that other indicators serve you better and give you a better visual of price action than the ones we've discussed in this book. That's fine. Feel free to experiment. There are no right and wrong answers in the beginning stages of creating a new strategy.

Let's take a simple example. Instead of changing any of the indicators, you might change the time frame perspective. Instead of using a 10-minute time frame, you might change over to a 2-minute time frame.

Looking at SINA on the previous 10-minute time frame, this

strategy gave us clear signals for entering and exiting the trade. But now let's look at the same strategy idea, and the same arrow placements, on a 2-minute time frame:



On the above 2-minute chart, we see a much different picture. While we could still use the strategy on this 2-minute time frame, we see that price gets outside the 2-minute Keltner Channel much more often. There is less clarity from our Stochastics Oscillator about when to enter and exit the trades. So, our 10-minute time frame seems to work better. But many traders never consider these sorts of adjustments to their strategies. They make the mistake of assuming that the same strategy and the same indicator set-up will work just the same on various time frames. And, as I've just shown, that's not quite correct.

There are so many variables that can be tested when creating a

new strategy. I've just shown a few examples in this book in order to make a point: changing the variables changes the results. Now, that seems obvious when you state it like that. But many new traders don't realize how profoundly different these results can be and they rush past good potential strategies because they don't produce winners every time.

So let's get back to our definition of "high probability". High probability assumes that there is no "perfect" strategy. High probability means that even if you find a great strategy, then there is going to be some failure mixed in there. You will not make money on 100% of your trades. And this is a truth that can impact certain personality types more than others. For example, if you tend to be a conservative perfectionist who recoils at the idea of losing money on 25% of your trades, then you are going to be frustrated with strategy development and also with your personal trading. Since you recoil at taking losses, then you will tend to hold onto losing trades longer than you should hold them. This will increase the amount of loss on your losing trades and this in turn will totally disrupt the whole mathematical basis for your strategy being a "high probability" trading strategy.

I have just touched on some key issues that we'll come back to later in this book. But I want to insert the idea here because it is very important. When you are testing and tweaking various strategies, you need to be as objective as possible. You need to accept imperfection because otherwise you will become very frustrated with trading stocks. And you need to keep meticulous records.

All of this testing and re-testing takes time. So you will need to be patient in the creation of new strategies. You may stumble upon a good pattern and it may take months to fully test it before you begin using real money to trade it. You may spend months on a strategy and then find that it only works when the market is having an up day, or that it only works in the morning session but not in the afternoon session.

A pattern can look obvious on a still chart and then you discover that there's no way to trade it in real time. That is one of the limitations of back testing on still charts. When you are looking at moving averages and crossover patterns on a still chart, then the crossovers seem so obvious. But, when you look at a live chart, those crossovers are just beginning to take shape as the chart develops in front of you. You may have to wait several minutes to get the chart to print with the same visual certainty that you had when you were doing your back testing. And if you wait for that clear print to occur, then your entry price may be vastly different that what you were showing in your back testing.

Researchers, and others, have blind spots. We run the risk of looking for the thing we want to see rather than seeing the thing for what it is. For example, when we first see a new repeating pattern on a chart, we get excited and think we have discovered a new strategy ripe for the picking. As we go back and look at other charts, we see the same pattern repeating itself over and over again. We think "Eureka!". But, after a more objective view of the charts, we might discover that there many other

instances where the pattern set up the same exact way as the "eureka pattern", but then failed to follow through. The pattern fell apart. So, when you first see a new pattern, then you must take on the mindset of an objective researcher and do your due diligence with the idea.

Most of the patterns you see and test will not work out over time. That's okay. You just move on the next idea. But you might also have to tailor your expectations. Some traders think the goal is to produce a strategy that never losses. But that is not what high probability trading really means. As I mentioned earlier in this book, high probability means by definition that every trade won't work out. That is why stops have to be figured on each trade and they have to be implemented by the trader. A good trading strategy is not required to be duplicate-able 100% of the time. We just need to tweak it so that we win more than we lose and our losses are small compared to our larger wins.

The more specific we can be about these numbers and test results, then the better our strategies. So let's discuss some of the key factors. We can think of these in terms of ratios. But our ratios assume that we have first written out a clear strategy. We have talked about many aspects of that strategy as we've looked at various examples in this book. Let's get more specific now.

A high probability trading strategy must cover certain essential areas. I won't go into great detail here about each area because I have been showing you those areas in previous sections of this book. The following list is meant as more of a summary of those ideas to make sure you have included all of them in your plan.

A high probability trading strategy must include specific language that details:

1. **The type of stocks forming the watch list.** A watch list is the group of stocks you will be using to test your idea. Will this watch list be biotech stocks reporting earnings within the next two weeks, stocks over $75 per share with over one million average shares traded per day that gapped down this morning, stocks that are under $5 per share that are in the news, etc.? You should be able to narrowly define the stocks that will be part of your watch list. This will limit the number of stocks that you have to test each day. You want to narrow the list so that you can narrow the time spent in research. Furthermore, the watch list is part of the overall strategy development, since your pattern may work well for stocks over $75 per share with high volume and not so well with stocks under $5 per share with low volume.

2. **The technical basis for the entry of the trade.** We have discussed many possible trade set-ups in this book. You can begin there or develop your own ideas. But the language needs to be very specific. For example, "I will buy the stock if the 5 moving average crosses above the 8 moving average on a 10-minute chart". List all of the variables you've included in your strategy. You can create a checklist so that you only take the trades that fully comply will all of the variables on your list.

3. **The amount of capital you will invest on each stock.** In order to create good tests, you need to be consistent in your

approach to equity investment. You can't go back and say "well, I would have used twice as much money on that trade because it really looked qualified". Your investment needs to be either the same amount of money per trade, or it must be tiered in some fashion. But it needs to be specific. You don't want to say 100 shares per trade because that will skew your results. For example, you wouldn't buy 100 shares of a $500 stocks and 100 shares of a $7 stock and expect the same results. So your investments can be tiered to reflect price differences. You might say "I will invest $10,000 on stocks under $10 per share, $15,000 on stocks between $10 and $25 per share, etc. The key thing is that you need to be specific and consistent with the capital used on each trade.

4. **The placement of the initial stop loss.** You have to draw the line somewhere. Every trade must have a stop loss for your own protection. And your strategy must state how this stop loss will be determined. For example, if your strategy is telling you to go long every time the 5 moving average crosses above the 8 moving average, then your initial stop loss might be stated as "My initial stop loss is half percent below the lowest price that preceded the 5 and 8 moving average crossover".

5. **The taking of initial profit.** You will have to decide upon an exit strategy. Will you take all of your profit at once or will you exit half of your shares at a certain percentage gain and then move your stop loss to break-even on the remaining position? Will you use a trailing stop on every single trade? Will you use various exit strategies based on how price is moving? Whatever

your answers to these questions, it needs to be written out specifically in your strategy.

6. The movement of the initial stop. In this section of your written strategy, you need to state the what, when, and why of moving your stop as the trade develops. Will you move the initial stop to break-even on the remaining shares after your first target has been hit? Will you set a trailing stop on the second half of the trade after you've secured some profits? All of these stop ideas can be tested and tweaked as your strategy develops. And this part of your strategy could become more important than your initial pattern recognition. So don't skim by this section and pretend it isn't important. It's very important and it can mean the difference between a winning and a losing strategy. In fact, the very question of whether this strategy works or not could depend upon your decisions regarding your stops on the trade! But you have to start somewhere. So go ahead and write out your initial ideas about the stops and then be sure to test various methods as your strategy develops.

7. Adding to a position. You may have heard the phrase "averaging down". Averaging down on a trade is when you add more shares to an existing position with the idea of lowering your average cost per share on the trade. For example, let's say you buy a stock at $9 per share because you think price is going to go up. But it doesn't go up. It goes down to $8.50 per share! Should you buy more shares at this lower price? After all, if $9 was a good price then $8.50 is even better! This is what some traders do. Unfortunately, it sometimes works. Some trades will

bounce back after sudden drops. Miracles do happen. But let's look at a few things. If you had a stop in place when you bought at $9 per share, then wouldn't your stop have been hit? If you didn't have a stop in place, then doesn't that go against everything I've been teaching you about managing your risk on the trade? Furthermore, if you average down on the trade then you've skewed the answers given regarding the amount of equity for each trade.

Some traders average up, which means they never average down on a position but they will average up. If the trade is going in their favor, then they will buy more shares and add to their winning position. This creates a higher average share price. The problem is that it has the same effect of skewering our research since we have messed with the average equity per trade idea. But I mention both averaging up and averaging down because if you are going to do it, then you need to make it part of your written strategy. Don't just do it on a whim or because a stock moved against you. If you're going to do it, then have a clearly written reason for doing it and do it consistently so that you can measure its success.

8. The final exit. When will you exit the trade? Will the exit be based on a specific technical aspect on the chart? Will the exit be based on your trade hitting a certain percentage profit? Will your exit be a combination of these factors? Once again, you need to be as specific as possible about your exit strategy. You can test various ideas and methods. Some might be percentage based exits. Some might be based on the

combination of price hitting Pivot lines or Fibonacci lines on the chart. Some might be based on the 20 moving average or some combination of these factors with a Stochastic Oscillator crossover pattern. But, whatever it is, it needs to be clearly stated in your strategy so you can test the variations.

These eight areas comprise your written trading strategy. As we went through this list, you might have become a bit overwhelmed and thinking "I just want to trade stocks". But the importance of having this written strategy cannot be overstated. I could make all sorts of analogies here. You wouldn't attempt a journey without a destination and a map, unless you just wanted to wander around and enjoy the scenery as it passed by. Likewise, if your goal is to become a profitable trader of stocks, then you need to have a clearly written strategy. There is a 99% chance that this initial strategy will need to be revised. Parts of the strategy will have to be tweaked. The initial strategy may have to be tossed out after several tweaks fail to produce a winning strategy. But, even so, you need a well written and specifically worded strategy. While it may not be a high probability strategy in its initial stages, it can become one if you continue to test and tweak it over time.

All of this testing begs the question "How will you measure your success?" Another good question, "How will you keep track of it?" So let's get into that in our next section.

A Trade Journal is Your Best Coach

As the title of this chapter suggests, I have a strong belief in the importance of a trade journal. But what is a trade journal and what goes in it? For starters, it's a place for you to keep all of your trade experiments in one place for handy reference. As you can imagine, the creation of a trading strategy takes time. It also creates a lot of paper. While scribbling notes on the backs of envelopes might work for some people, you will inevitably want to reach for something and be unable to find it if you don't get organized.

Your trading journal may be an online document, a three-ring binder, or some combination of these things. Some people believe they think better on paper, while others feel more comfortable typing everything into Word or Excel documents. The choice is yours. But I highly recommend you get started with this habit from the very start of your career. If nothing else, you will find it amusing to go back and read about your "significant breakthroughs" at some point in the future. You'll read about the rabbit holes you chased down, the number of times you figured how long it would take you to double your money, the trading strategies that you thought were fool-proof, etc. But also hidden in there will be a kernel of truth, a bit of wisdom gained over time, and these pearls can make the review well worth it.

For an online document, you can make it as simple as a Word

document. Most computers have some sort of “snipping tool” that allows you to draw a box around your charts and copy them directly into your document. So let me explain how this might be useful for you. Let’s say you have a strategy titled “moving average crossover strategy 12”. You can start by typing in all of the detailed answers we covered in the last chapter. Answer all of the questions with as much detail as possible. Then use the snipping tool to capture some of the charts that illustrate exactly what you’re describing. Let the snip show all of the indicators you’re using and then copy that snip into your document. (Be sure to save your document!)

As you begin to experiment with the strategy listed in “moving average crossover strategy 12”, then you can go back and make refinements as you go along. You might change the font color of these additional ideas so you can go back and see how your ideas progressed through the testing phase. At the very least, date every entry so you can see your progression over time.

Continue to add new information, refinements to your strategy, charts of trades that worked and charts of trades that didn’t work. Let it be as unbiased as possible. This document is just for you. So don’t worry too much about spelling and making it pretty. Just get the stuff down on paper and save it so you can review it later.

This online trade journal can become a great repository for ideas as you progress in your trading. But more than a collection of mere ideas, it shows how your strategies developed over time.

We'll talk about the psychology of trading in the next chapter, but let me mention part of that here. You will find that trading is one of the most challenging things you've every attempted in your life. It is not so much the difficulty of learning the fundamentals. It is learning how to master yourself. And the trading journal is your perfect place to record the new things you're learning about yourself. This is where you write down your weakness, your lack of discipline, your tendency to hold the losing trades too long and cut the winners off too quickly. This is where you note how you're feeling or the distractions from your focus and how these things impacted your trading. This is where you deal with your relationship with risk and with money. Yes, you have a relationship with these things and the journal is a good place to get it all down on paper. Allow yourself to think seriously about these things because you will find that most of your trading errors will be based in your self. The problems will not be with your strategies or the broker or the market. The problems will be with your thoughts, actions, attitudes, beliefs, and assumptions. Rather than blaming others for your poor trading habits, you will need to look inside yourself and find the mental and emotional blocks to your own success. You may not believe these things to be true. But after you've been trading for some time, you will know what I mean!

So get all of this stuff down on paper. Put it in a journal. I named this chapter "A trade journal is your best coach" because this process (if you will take the time to do it) will be more helpful to your trading than the next ten books you read. I believe that. What you will learn about the business of trading,

and what you will learn about what it takes for you to become successful in this business, will be contained in this document that you are writing.

If you've never kept a journal or a notebook, then I know you're probably balking at this assignment. "I just want to trade", you might be thinking to yourself. But the trader who just goes out there and starts trading, and does no reflection of the process, is doomed to fail very quickly. You have to accept the fact that you are a beginner in this new business. You wouldn't start a new business without writing some things down would you? Wouldn't you want a written business plan, a marketing strategy that was well thought out, a description of how you were going to increase sales, and a job description for key members of your team? So why would you want to do any less for this business **IF** you are really treating it as a business?

Here's another reason that the journal can be your coach. You probably don't know anyone else who is interested in trading. For example, if you are married, is your spouse interested in this business? Probably not. But even if they are, they are going to be dealing with their own internal issues as they learn the discipline of trading profitably. You will have your own issues. So both of you will need your own journals. But, if you're the typical trader, you don't have any family members or friends who will be interested in the details of your business. And putting your thoughts on paper is a good process when you lack the objectivity of a friend who understands your business and who can encourage you through the rough spots. You will have

to be your own coach, your own encourager, if you are the typical trader.

How much should you write? As much as it takes. A good rule in the beginning is that you should be writing more than you're trading. Most traders lose money in the beginning. So you're better off slowing down on the trading side of things and spending more time in analysis and reflection. If you find yourself thinking "I don't have time for this", then you're probably spending too much time trading and not enough time thinking and reflecting on your trading.

In case you don't know where to start, I'll give you some more questions that you can ask yourself and record in your journal.

1. Did I enter the last trade strictly according to my strategy?

2. Did I follow my exit strategy as outlined?

3. If you stayed in a losing trade too long, ask yourself "Why did I do that?" "What was I telling myself that made me not take the loss earlier?"

4. Were there any physical things I began to exhibit as the trade moved against me? (Did you get angry, begin to blame someone or something, etc.? Did your palms get sweaty, your neck tense up, or did you become short of breath?)

5. Could I have made more money on the trade? Was there a reason why I exited the trade when I did, other than the technical reason written in my strategy?

6. How much am I trading by gut instinct rather than following the technical basis for the trade? Do these trades have better results than my technical trades?

7. Was there anything else, not listed above, that influenced my entry and exit decisions on this trade?

For some of you, this may seem like I'm over-emphasizing the self-analysis bit here. I understand your objections. You're probably not used to doing this are you? But let me ask you another question. Have you ever been a solopreneur before? A solopreneur is an entrepreneur who works alone. When you are sitting at home, in your office, trading stocks, then you are one type of solopreneur. You are in business for yourself and you are in business by yourself. This is a highly viable career option. But it is one for which you are probably ill prepared.

Most people end up trading stocks after having worked their whole careers for other people and under the watchful eye of some sort of manager. Even if you were the CEO of a company, you still had a board of directors to whom you were responsible. That sense of responsibility takes a huge shift when you go to work for yourself. Who's there to look over your shoulder? Who's there to tell you that your performance is inadequate? Who is going to tell you when you do a stellar job? No one. And, for some people, this is a huge shift in how they view their work, how they measure their performance, how they set goals, etc.

So that is why this section on starting a trading journal is so

important. It makes you accountable to yourself and to your trading plan. It forces you to spend time on the internal process of trading, the decision making that goes into every aspect of making a successful trade. If you don't provide this reflection for yourself, then no one else is going to do it for you.

There are other things that need to go into this trading journal, and that is the math side of our business. Simple math does wonders for keeping a reality check on ourselves. While we may love sharing our great trades with friends and family members, as well as feeling the pride of doing well and making money, we are often reserved about facing the reality of our losses. Math solves this problem. Math makes us face the music.

Some traders prefer to put their trades in an Excel spreadsheet for their own analysis. That is beyond the scope of this book, but that is one approach if you are already comfortable with data analysis.

Otherwise, you can create a simple one-page summary and print copies of it to be filed in your notebook. That worksheet might have all of the questions listed above. But there also needs to be a place to record the math of each trade.

Here are some sample questions you might include:

1. How much money did you use on this trade?
2. How many shares did you buy/sell?
3. What was your entry price?

4. What was your exit price?

5. What was your profit/loss on this trade, based on dollars? (This math should include the trading fees associated with each trade.)

6. What was your profit/loss on this trade, as a percentage? (Include the trading fees associated with each trade on this line as well.) Here's how to figure your profit/loss on each trade. I'll use a long trade as an example.

(Sell price - purchase price)/purchase price = gross profit/loss

Let me give you an example. Let's say you buy AAPL at $500 and sell it as $505.

505 - 500 = 5 5 divided by 500 = 1%

You then have to account for the amount of your trading fees.

Knowing your percentage gain or loss on each trade is significant. It is one of the reasons that many traders have their order windows pre-set to a certain dollar amount rather than using a certain number of shares on every trade regardless of price. If you change the amount of money used on each trade (which is what you'll do if you trade based on number of shares), then the other reality math checks will be skewed.

7. For this day, what was your win:loss ratio? Before you leave your trading desk each day, you need to know this number. How many winning trades did you have and how many losing trades did you have? This is only a crude measurement of how

you're doing, but it's a start. Since our tendency is to remember the good trades and forget the bad ones, this number will give us an immediate reality check about our success. But it is not enough in itself.

8. For this day, what was your average loss on the losing trades and what was your average gain on the winning trades? Now, this one could be the big "ah-hah" for some traders. You see, you could look great in your answer to question # 7, but then you find out that your average loss on your losing trades is three times the average profit on your winning trades. That would be a problem. It would mean that your strategy would have to be extremely accurate in order for you to make a profit each day. You would have to win three times more than you lose in order to compensate for your average gains and losses ratio deficit.

That's why this number is critical for you to measure and know each day. If it is a problem for you, then it's best to know this as soon as possible so you can try and remedy the problem. Is the problem the strategy or is the problem your execution of the strategy? If you trade the strategy to the best of your ability, using the same amount of money on each individual trade, and you find that you are not making a profit, then the answer could be hidden in the data mined from some of these questions. That's why it is so important that you take the time to ask and answer these questions.

While all of these questions are important for daily review, I also suggest that you take some time at the end of each week to review your answers from the previous week. Figure the weekly

numbers for the questions listed above. Know your stats. Let me ask you a question. If you stopped a professional baseball player on the street and asked him his year-to-date RBI, do you think he would know the answer? Do you think a professional quarter-back knows his stats? While some may focus on this more than others, I imagine that any professional sports person knows how they are doing based on a whole series of mathematical formulas. So it makes sense that you know these numbers for yourself. No one else is going to figure it for you. It is totally up to you. But the mathematical answers will help you manage yourself as you learn to trade stocks. Like it or not, math is a highly important aspect of learning to become a high probability and successful trader.

There is one other option for journaling, and that is a video journal. There are free screen capture resources available (Jing is one of them) in which you can record a video of your computer screen and speak into your microphone while you're analyzing your trade. The beauty of this instant video is that you can speak and record moving charts and you may find it easier to record your thoughts without having to type anything into the computer. Using this technique, you can easily flip over to multiple charts and time frames to show a full analysis of a trade set up. Then you can go back and review these short videos at the end of the day and see how the trade progressed.

You can use this video technique for recording the actual trade entry decision or for reviewing several trades at the end of the day. But the key point is not to just record a video, but rather to

record your thoughts at the time so you can go back and review your thoughts and the trade later on. While the mere act of recording the video will probably help you articulate the reasons behind your trade, it is the review that is really important. If you can take an objective view towards your thoughts and actions, then you can see your own shortcomings as well as your brilliant insights. Upon your second look and review of the recorded chart, you might see something on it that you didn't see during the first recording. So the real benefits are gained in the review of these videos.

In this section, I have tried to make a strong case for creating some sort of documentation around your trading activity. I have stated the importance of this for your progress as a trader and I have detailed several methods by which you can do this. I sincerely hope you will do more than just read the words in this section. Beginning a habit of daily reflection on your trades can really ramp up your progress as a trader. I have heard from many other traders that this was a key part of their growth and progress as a trader. So I encourage you to take some steps in this direction and get started with it before you place your next trade.

The Psychology of Trading

There is a lot of work to be done in learning how to trade a high probability trading system and strategy. Many of the things I

have described in this book can be looked at as work projects with each completed task moving you closer to your quest of becoming a profitable trader. Along the way, I have talked about the importance of self-reflection, reviewing your trades, and of the mental challenges that face the solo trader. But I want to dig a little deeper into this last project, and that is the project of you working on yourself.

So far, I have talked about the important tools that you can pick up that will help you become a successful trader. But what I do not know is this: what do you bring to the table? You do not come into trading as a blank slate. You have many years of experiences and beliefs that shape who you are as a human being and these experiences and beliefs have a bearing on how you will approach this business of trading stocks.

While I cannot know your personal story, you know it. Since I do not know your story, then I cannot tell you the exact challenges you will face as a trader. I cannot warn you ahead of time about the difficulties and roadblocks you will face. But I can tell you that there will be challenges. I can share with you some of the common pitfalls that others have made and this might help you sustain less injuries as well as create a quicker route to success.

From having worked with hundreds of traders, I can tell you one thing that is certain. Your biggest challenge will be your self. The real challenge will not be whether you can learn how to place a trade with your broker. The real challenge will not be learning how to use a handful of indicators to analyze the charts.

The real challenge will be the stuff that goes on between your two ears!

In some ways, you can think of trading as a series of decisions. You decide to trade. You decide to look at a certain stock. You decide to use a certain amount of money. You decide to place the trade. You decide to exit the trade. But between each of those major decisions is a thought process. There is a reason why you did each of those things. There is a reason why you decided to look at this certain stock. There is a reason why you decided to use a certain amount of money to place this trade. There are reasons for your entry and exit decisions. And throughout this book, we have looked at those decisions and the reasons behind those decisions because that is part of what will make you a high probability and successful day trader. But if you dig a little deeper into those decisions and reasons, you will find a system of beliefs. Your decisions and the reasons behind those decisions are fueled by your system of beliefs.

While I cannot move you into the right mental frame of mind for day trading, I can point you in the right direction. There are certain habits of mind and certain belief structures that are more conducive to creating positive results in the world of trading. And one way we can get at those belief structures is through a series of questions.

Once again, you will take on the role of coaching yourself here. The questions that I will ask are the questions you need to ask yourself. I can tell you why the questions are important and how different beliefs can impact your trading, but obviously I cannot

provide the answers for you. Nor can I force you to take the time to read this section and think through your answers. But my hope is that you will take the time to think about these things. Knowing the questions early in your trading career might make you more mindful as you encounter struggles with your trading. Knowing the questions now, and possibly some of the answers, might make you better prepared to trade. So here are a few questions for you.

1. Why do you want to day trade? There is some belief you have that made you want to learn how to trade. What is that belief? After all, not everyone wants to trade stocks. In fact, you are in a minority. Most people have no interest in this sort of activity, so why are you interested?

I encourage you to think about this answer and write it down before reading my comments.

Traders come from a variety of backgrounds. There is very little that they share in common. But there is a core belief that I think holds true for nearly all of them and that is the core belief of "I believe I can improve my life". Other people have this belief and never get into trading of course. But this core belief is still there for most traders. And it is crucially important. This core belief contains several seed thoughts, so let me briefly mention them.

a. "I can." Two simple words, but they say so much about a person. These two simple words speak to your belief in your ability to change, learn, grow, and do. It is the power of self-

efficacy. It is the power of responsibility. It may be a belief that you take for granted without giving it much thought, yet it is the belief that you will come back to on your toughest trading day. It is the belief that will keep you going despite a series of set-backs. And yet, it is also the belief that can ruin you if you fall into the hubris of it...that danger being the belief that sheer will power can make you succeed by itself.

Some traders come from a background of running their own businesses. While some businesses succeed largely on the sheer determination of its owners, plowing through every obstacle with brute force, the stock market will not change its course based on your determination. So, your belief in your own efficacy must be balanced with the acceptance that the price movement of stocks is beyond your control. You cannot control the market. But you can learn to control your self. And that is an adjustment for some personality types. If you are the sort of person who is accustomed to bulldozing their way through business obstacles, then you will need to learn some humility. This humility does not diminish your power, but rather accepts your limitations.

b. The word “improve” in the above belief statement is also a core belief among traders. Day traders are not the only people who possess this qualify, but most traders have a forward thinking sense of self and life in general. They have an inner core belief that tomorrow can be better than today and that they can do something about it.

Perhaps you want to learn how to trade because your portfolio manager is losing your money. Perhaps you have the desire to

better yourself financially. Perhaps you want a better life for your loved ones. Within each of those beliefs is the assumption of improvement. This is a critical belief for traders because you will not begin your career in trading by making a million dollars in the next month. But, if you believe in yourself and in your ability to improve your life over time, then this belief will give you the fortitude and the positive attitude to stay the course and to continue learning and mastering this new skill.

2. What is your belief about trading? Do you think it's going to difficult or easy? Do you think you're going to make a lot of money quickly? Are you expecting it to be your financial savior?

People come to the business of trading with a whole host of expectations. Some are in dire financial straits and they are looking for a financial solution. Some are not expecting to make much at all, but they just don't want to lose a lot. These are two different extremes but they point to very different approaches to trading. While the one might be expecting too much too quickly, the other may be too timid and not aggressive enough for the fast pace of day trading. The first might be unwilling to take a necessary loss on the trade because they feel they cannot afford it. The other may not be willing to play with enough money to make it truly rewarding.

So, our beliefs and expectations about what trading will do for us definitely colors how we approach our trading day. Perhaps we can think of the correct approach as somewhere between these two extremes. We should be neither too aggressive nor too

passive. We should not be clinging to every trade as though our livelihood depended upon the success of this next trade. Nor should we be resigned to a mediocre level of performance simply because it feels safe to us. Again, there needs to be some middle ground in there where we come to trading from a place of calm and confident strength, goal oriented and yet unstressed.

3. What is our belief about the market? I have met some traders who will blame anyone for their failure and refuse to take responsibility for their trade decisions. They may blame the market and say the market is in a conspiracy against them making a profit. They may blame their broker for its failure to execute trades in a timely fashion. They may blame a person on the news channel for recommending a certain stock pick. They may blame any number of people or events that are outside the locus of their control, rather than owning up to the core statement "if it is to be then it's up to me". I'm not sure where I first heard that phrase, but it contains some of the core beliefs that I have been discussing here. It is a position of personal responsibility and not a position that abdicates responsibility by blaming someone or something outside themselves for the failure that they created.

While there are many other core beliefs that we could mention, the three I've just talked about will establish an important mind set for high probability trading. If you have a strong belief in yourself yet acknowledge your limitations, you believe in your ability to learn a new skill and yet have reasonable expectations, and you are willing to take full responsibility for your own trade

decisions, then you are on the path to success as a day trader.

But, as important as the correct belief system is for your success, nothing happens without one other key word: discipline. Discipline is the application of your belief system to your daily life. Discipline is the systematic application of your high probability trading strategy to the charts in front of you. It means that you do what you've written, not what you feel. It means sticking to your plan of action even though you are losing money on the past several trades. It means keeping a trading journal and measuring the success of your trading as well as the success of your strategy. Discipline is doing what you are supposed to be doing whether you feel like doing it or not.

I have talked in previous sections about the challenges of being a solopreneur. I have mentioned how few traders were trained for this path in their previous careers. Well, personal discipline is where it all happens or it doesn't happen. All of your carefully constructed strategies and trade management plans will fall apart if you do not exercise rigorous discipline on every single trade. And the minute that you let your guard down and begin to make excuses , that is when personal discipline breaks down and that is where you'll have your biggest losses.

Yes, you may get lucky a few times, but eventually the lack of discipline will cost you in a big way. So, there is no room for sloppiness here. There is no room for entering trades late, long after you've gotten your entry signal. There is no room for holding losing trades longer than your trade management system allows. Every break in discipline will cost you. And while those

losses might seem small at first, they will add up over time and they could spell the difference between the success or failure of your system and of your ability to make money in the markets.

Unfortunately, I've seen it happen too many times. A trader fails to set their stop and they let the trade run against them. They lacked the discipline of setting stops and living with those stops. They thought they could skate by or get lucky. And they tried to cheat the system a little bit and it ended up costing them big time. You don't want to be among those traders. You want to be sitting with the traders who have discipline, the traders who have confidence in their trading plan and who have the discipline to carry out that plan on even the toughest trading days. **No trading plan, regardless of its probability for success, can win in the hands of an undisciplined trader.** That's an important statement, so I hope you take it to heart.

Final Thoughts

I want to congratulate you on reading this book. My hope is that the thoughts expressed here can help you on your journey to becoming a successful high probability trader.

If you are new to trading, then you probably discovered that there's a little more to the business of trading than you expected. You might feel a bit overwhelmed. If that is the case, then I encourage you to go back to the beginning of this book and take

it step by step. The first reading can be an overview, allowing you to see the roadmap for your success. But it is in following each step that you progress to your destination. It is not quick. It won't always be easy. But my hope is that you will find the trading of stocks to be as enjoyable, fun, challenging, and profitable as I have now for many years.

Each of us begins at different points. What is important is how we grow and progress. If you are open to learning and if you have the core beliefs and discipline required, then I know you can be a successful trader. I've seen it happen many times. I have emails and testimonials from hundreds of happy traders, glad to have found success with their trading.

I also know that finding a community of like-minded traders can be a huge benefit for traders. Rather than sitting at home by yourself, you can communicate with other traders online. Rather than having to come up with your own high probability trading strategies, you can piggy-back on the success of other, more experienced traders.

My company, Wealthpire (www.wealthpire.com), has devoted itself to helping traders succeed in the trading of stocks. We have searched and found experienced traders with proven systems and made their experience available to you. Let me briefly tell you about two resources that might be of interest to you.

First Hour Trading (www.firsthourtrading.com) is a day trading chat room that I lead each morning. We focus on two specific

stocks each morning. These two stocks are picked among thousands of possible stocks because they have a high probability of earning a nice return in a short amount of time. Members in this chat room are told the stocks picks before the market opens each day, so they are ready for action. Then, I give a sound in the chat room to signify my entry on the trade. I provide a target exit price. And then I issue another sound when I am exiting the trade. Members simply copy my actions. Given this opportunity, members can often make enough money in the first few minutes of the trading day to take the rest of the day off. You don't have to sit at the computer all day, grinding out trade after trade. Just take and copy my high probability system and entries, and you walk away with the profit. It doesn't get much easier than this.

Morning Hours Trading (www.morninghourstrading.com) is a chat room that focuses on the morning gaps each day. This room is led by my good friend Bob Joiner. For three hours each morning, Bob focuses on 3 to 5 stocks and gives his entries, targets, and stops for those trades. After getting into the trade, he gives ongoing analysis of each trade so that members can make their own decisions about the exact exit for the trades.

We have some traders who are members of both chat rooms because each one is unique and each one offers different trades for the members. But in both rooms you'll find a community of traders who can contribute to your success. Rather than going it alone, you can participate in the discussion, learn from other members, and you'll also find continued education via the free

teleseminars.

I wish you much success with your trading.

Sincerely,
Manny Backus

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