

DIARY
of a
PROFESSIONAL
COMMODITY
TRADER



*Lessons from 21 Weeks
of Real Trading*

PETER L. BRANDT

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Diary of a Professional Commodity Trader

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PETER BRANDT



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This book is dedicated to my wife, Mona, and my children, who for more than 30 years have tolerated the ups and downs of the life of a commodity trader.

Also to some very dear folks I refer to as the Factor family, about two dozen fellow commodity traders who, since 1980, have served as a sounding board as I developed my trading plan and honed my craft.

Acknowledgments

I owe a debt of real gratitude to my friend Dave Forbes, CEO of Petra Financial in Colorado Springs, who allowed me to use his office and staff to prepare this book.

I am also in debt to Glen Larson and his awesome team at Genesis Financial Technology, who provide me with assistance in preparing the charts for this book. I use the Genesis data and charting platform, TradeNavigator, in my own trading and have found Glen and his team to be real partners in my market operations.

Dan Chesler, President of Chesler Analytics (a firm providing technical market research to energy traders) originally suggested that I write this book. Dan and I go back several decades as peers. If you have ever written a book, you will understand it when I say that I don't know whether to thank Dan or curse at him for encouraging me.

Finally, I want to thank Meg Freeborn and Kevin Commins of John Wiley & Sons for hanging with me during this process. I started this book in early 2009, but for health reasons I was sidetracked for nearly nine months. Meg and Kevin demonstrated great patience and guidance to get this project back on track.

Introduction

One of the first things I check out in a new book is the number of pages prior to Chapter —long book introductions put me to sleep. I will assume that most of you are like me—you want to cut to the chase. The last thing I wanted to do was write a book with a lengthy introduction, but my opinion has changed now that I’m on the author’s side of the equation. It turns out introductions can be useful in providing necessary context and perspective for a book. And so, please forgive me for committing the sin I have always disliked—I think it will be worth it.

This is a book about me as a trader of commodity and forex markets and how I use price charts in my craft. I think of it as a mosaic: eventually the parts of this book will tie together in the same way that a good mosaic becomes visible only in its entirety. Piece by piece or section by section, a mosaic makes no sense. Only at a distance and in its fullness does a mosaic gain clarity and perspective. The concept of a mosaic describes how this book will unfold. First, a bit about how I got started in the business.

The Invention of a Commodity Trader

In 1972, shortly after graduating from the University of Minnesota with a degree in advertising, I moved to Chicago to work for one of the nation’s largest ad agencies. A neighbor was a trader at the Chicago Board of Trade (CBOT). Through our conversations and my visits to see him on the trading floor, I became captivated by the futures markets. In commodity trading I saw the opportunity to earn a good living, work for myself, and be challenged in a very exciting field. In short, I became hooked.

Everybody started in the commodity field at the bottom. Being hired at a sizable salary was not a reality of the business. I needed a plan B if I were to quit advertising and enter the commodity field. So, I asked the president of the advertising agency if he would hire me back at a 30 percent increase in salary if I quit, tried the commodity business for a year unsuccessfully, and reapplied for my old job. He agreed to the deal.

I entered the commodity business in 1976 when I was in my 20s with the

singular goal of trading my own personal account. But I needed to learn the ropes first.

When I entered the business, most traders at the CBOT (as well as the Chicago Mercantile and the New York commodity exchanges) started at or near the bottom of the pecking order. The same thing exists to this day. An “MBA fast track” has never really existed in the trading pits. The learning curve is steep—the washout rate is high.

I learned the business by working for Continental Grain Company and Conti, its futures market brokerage operation. At the time Continental Grain was the second largest grain exporter in the world next to Cargill. Continental sold its grain merchandising business to Cargill in 1999.

During my time in the advertising field I had been working on the accounts of McDonald’s and Campbell’s Soup Company. It became a very fortunate coincidence that both companies were huge users of agricultural products.

Processors of agricultural commodities, such as Campbell’s Soup, had become accustomed to decades of oversupply conditions and stable commodity prices. But a number of events in the early 1970s, including global crop failures, led to massive bull markets in the price of agricultural products and nearly every raw material. In a matter of months the price of some commodity goods doubled. [Figures I.1](#) and [I.2](#) show gold and wheat prices as proxies for raw material prices.

FIGURE I.1 Spot Gold Prices, 1830–2009.

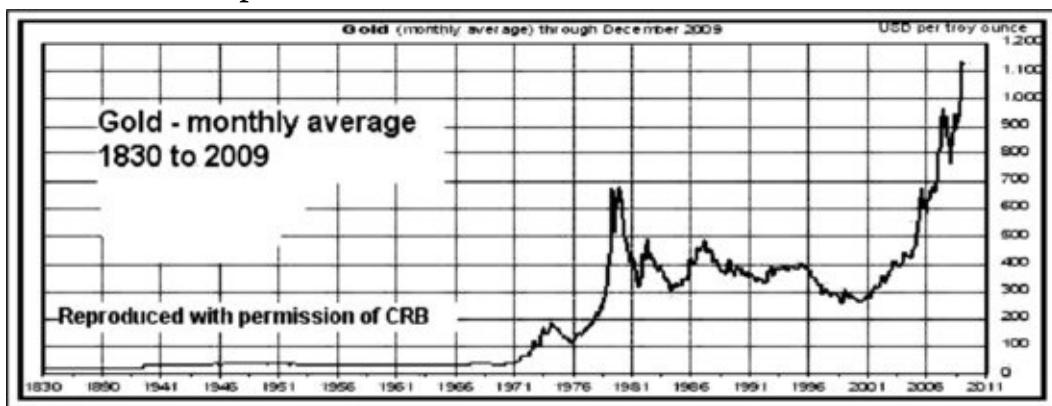
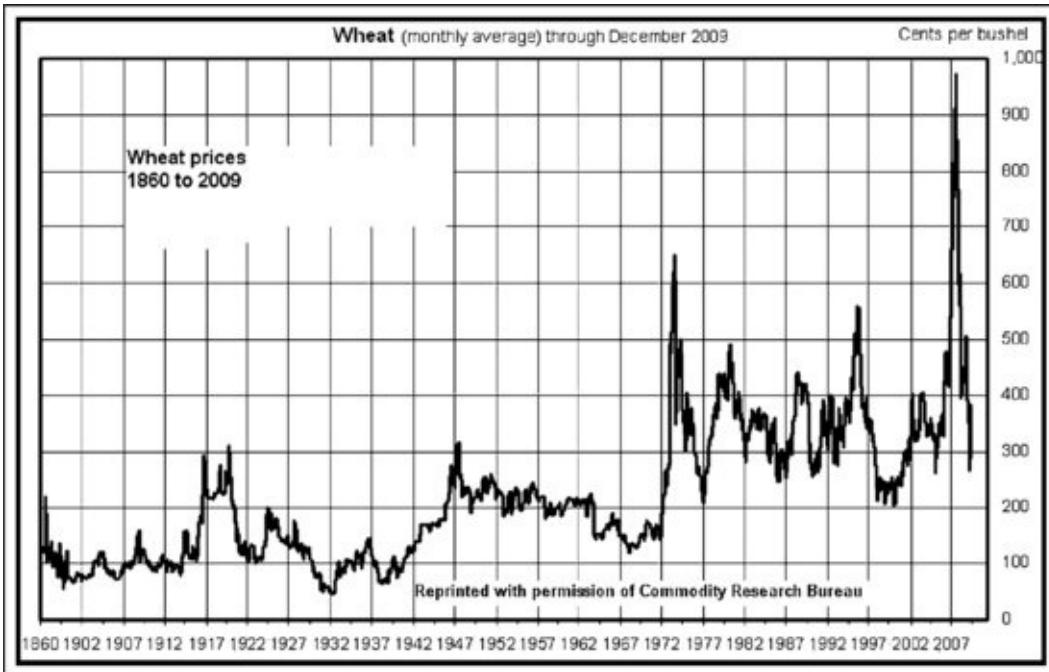


FIGURE I.2 Soft Wheat Prices, 1860–2009.



Food companies were not prepared for the price explosions taking place. Top management and purchasing executives of these companies were desperate for solutions. Few food processors had any experience with forward pricing in either the cash or futures markets.

This was the environment when I switched careers from advertising to commodities.

Immediately upon joining Conti, I approached the president of Campbell's Soup Company with a proposal. I thought perhaps the futures markets could be a way for Campbell's Soup to hedge its forward purchases.

I suggested that the company appoint a senior purchasing executive to relocate to Chicago for a time to determine if commodity contracts might be a beneficial management and purchasing tool. I further proposed that the designated purchasing executive and I would then submit a formal proposal to top management—and the proposal could just as likely nix as recommend the idea of futures contracts.

In the end, we recommended that the corporation could strategically use futures contracts in cocoa (Campbell's Soup owned Godiva Chocolate at the time), corn and soybean meal (to grow chickens for its various frozen and canned products), soybean oil, iced broilers (then actively traded at the CBOT), live cattle and hogs (depending on the price relationship between the cuts of meats used by the company and the price of live animals on the hoof), and the three major wheat contracts traded in the U.S. (Campbell's Soup made noodles

by the ton and owned Oroweat and Pepperidge Farms bakeries).

Campbell's Soup saw the wisdom in the use of commodity futures contracts. My consulting role with the company covered my business overhead and my family's living expenses while I learned the futures business. Had I begun trading for myself immediately, I would have likely been forced rapidly back into advertising or another career path.

After learning the ropes for a couple of years, I began trading proprietary funds around 1980, starting with less than \$10,000. Initially, my personal trading was not successful, although not disastrous. I tried just about every approach I heard or read about. The traders around me at the CBOT were making money, but I just couldn't seem to find a niche that worked.

Then a friend introduced me to the book *Technical Analysis of Stock Market Trends*, written in the 1940s by John Magee and Robert Edwards. The book was—and still is—considered the bible of classical charting principles. I consumed the book in a weekend and have never looked back.

Chart trading offered me a unique combination of benefits not available with the other approaches I had attempted or considered, including:

- An indication of market direction
- A mechanism for timing
- A logical point of trade entry
- A means to determine risk
- A realistic target for taking profits
- The determination of a risk/reward relationship

I have been a chart trader ever since. More specifically, I trade breakouts of classical chart formations such as head and shoulders tops and bottoms, rectangles, channels, triangles, and the like. I focus on weekly and daily chart patterns that form over a period of four weeks to many months. Even though my focus on charts is longer term, my actual trading tends to be short term, with trades lasting anywhere from a day or two (in the case of losses) to a month or two.

Since 1981, my principle occupation has been trading proprietary funds, although off and on through the 1980s I sold trading research to other traders. In the late 1980s and early 1990s I traded some hedge funds for a couple of big money managers such as Commodities Corp. (since bought by Goldman Sachs). A number of the best hedge fund traders in the world have worked for Commodities Corp. (I do *not* pretend to be in their league.)

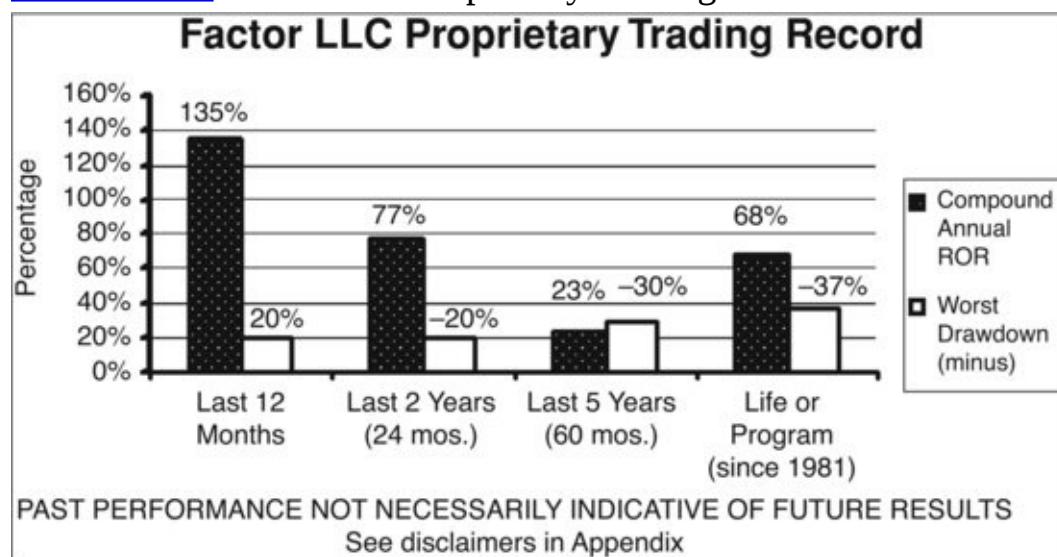
As a result of market burnout and an interest in nonmarket opportunities, in the early 1990s I began to distance myself from day-to-day contact with the markets and granted power of attorney over my own funds to another trader. It was not a successful experiment. From the mid-1990s through 2006 I pursued some personal non-profit interests (social causes) and did little or no trading at all. I started to employ my former trading plan again in January 2007.

In 1990, I cowrote a book with a since-deceased friend, Bruce Babcock, titled *Trading Commodity Futures with Classical Chart Patterns*, discussing in very general terms my approach to trading. That book sparked a desire to someday write a book providing much more detail on my trading operations. This book is the product of that desire.

My Proprietary Trading Record

For the active trading years of 1981–1995 (including four years when I granted power of attorney to another trader) and again starting in 2007, my average annual rate of return for proprietary funds has been 68.1 percent (annual Value Added Monthly Index [VAMI] method). I experienced one losing year during the time I was the sole trader for my proprietary funds (−4.7 percent in 1988). The numeric average of my worst annual month-ending drawdowns has been 15.4 percent. The performance capsule of my proprietary trading is shown in [Figure I.3](#). Please read the disclaimers and discussion of my proprietary trading in the Author's Note at the end of the book. Past performance is not necessarily indicative of future results.

FIGURE I.3 Factor LLC Proprietary Trading Record.



Why I Wrote This Book

In the business of commodity trading books, advisory services, seminars, and computerized trading programs, there is a lot of junk being peddled. There are numerous books written each year about speculating in stocks and commodities. Does the investment world really need another book?

Given my low opinion of most trading and investment books, it is ironic that I am even writing this book. Specifically, I have had a general disdain for books approaching technical trading on a hypothetical basis. In contrast, I love the *Market Wizards* series by Jack Schwager because it presents the human side of real-life traders who use their ingenuity to make money by outsmarting the markets. If you have never read these books, then you have really missed out on some great insight into market speculation. I also loved two books by Michael Lewis, *Liar's Poker* and *The Big Short: Inside the Doomsday Machine* because both offer a real look at the real lives of smart traders.

I accepted this book challenge because John Wiley & Sons and I shared a vision for a book that would be a diary of my real-time trading operations during the course of a set time frame.

This book contains a combination of seven characteristics that I believe are unique among commodity trading books:

1. I am a real trader who trades real markets in real time with real money. I am not an academician or a person who relies on the sale of books to pay my mortgage. I am not selling a trading system or subscriptions to an advisory web site. I am just a trader trying to make money from the markets.
2. This book will catalog real-time trading signals and endeavors, not some arbitrary set of optimized rules form fit to last year's charts. This book will be a real-time diary of my trading on a day-by-day, trade-by-trade, thought-by-thought, mistake-by-mistake, victory-by-victory, and emotion-by-emotion basis. I am stepping out in faith that I will even be profitable during the next 21 weeks. But traders take risks.
3. This book will reveal trading as an upstream swim against human emotions. Consistently successful trading is a tough job. I make no pretense to the opposite. If trading were easy, everyone would be doing it for a living. Some other authors can share the glory of their constant successes. I will discuss the emotions involved to take the next trade after eight straight losing trades. Successful speculation can lead to hair-graying, sleep-losing, and dog-kicking emotions. I hope to convey the same.

4. I will attempt to show that successful speculation is mostly about managing risks. In fact, good traders view themselves first and foremost as risk managers. Just like “Texas Hold-Em,” how one plays his or her cards is more important than the cards themselves. Money management has not been given the attention it deserves.

5. I will attempt to kill a really sacred cow whose death is long overdue—the idea that it is possible to be right on 70 or 80 percent of one’s trades. This cow really needs to die. Perhaps I can strike a successful blow.

Novice traders spend 90 percent of their time and money pursing methods to identify trades. In my own experience, “Trade identification” is the *least* important component of a consistently profitable trading operation. In fact, the method by which a trader identifies the markets to trade is of very little importance. I make no contention that the method I use is the best or is even above average. More to the point, how I select trades just does not matter at the end of the day. I believe that novice traders who chase systems that claim success on 80 percent of trades do so because they don’t have the stomach for losing trades. But a strong stomach for losers and a miniature pride on the need for winners are necessary for consistently profitable trading operations.

6. I have absolutely no desire in this book to show how I can turn a small fortune into a large one. Books that talk about turning \$10,000 into a million dollars may be good marketing, but let’s get real! A person who can achieve this type of performance would possess all of the world’s currency within a decade. Do the math!

I am risk averse. My goal in 2010 is an 18 to 24 percent return. I would be in hog heaven if commodity futures and forex markets could perpetually provide for me an average two or so percent monthly return—with a minimum amount of capital volatility. I will leave it to other authors to disclose their secrets to big fortunes. If you are looking for a book on how to convert a small account into a million dollars, this book is not for you. If you want a book that details a comprehensive process for speculation aimed at exploiting an edge, then keep reading.

7. Charting has been good to me. I know it may sound a lot nobler than it really is, but I would like to share what I have learned over the years about the craft of trading chart patterns. In hindsight, it is easy to imagine how a market should have been traded. But in real time the chickens come home to roost. I believe that I can add to the body of practical knowledge on chart trading. Perhaps I can spare others the torment of the learning process.

In the end, my goal is to display the actions and emotions of a professional trader—and this involves a whole lot more than a way to identify the next trade.

This Book's Audience

I am writing this book to:

- Professional commodity and forex traders
- The general investment public (especially Baby Boomers who are now concerned about their retirement assets)
- Novice commodity “wannabe” traders who have never really gained traction in their trading

Professional Commodity/Forex Traders

You will not learn a single thing from this book, although if you are a chartist, hopefully I can add something to your body of knowledge. Nor should you be reading this book to learn anything about my approach and niche. You are successful because you know precisely what your own game plan is. But you may get a kick out of some of the anecdotes I share as I attempt to exploit my “edge” in the markets. You understand that successful speculation is primarily a human endeavor as we attempt to “swim upstream” against our emotions.

My hat is off to you. You are absolutely the best traders in the world. The global financial meltdown of 2007 and 2008 would have never taken place if professional commodity traders were in charge things of things. As a group, you can be proud that you did not contribute to the global economic woes of recent years.

As professional commodity and forex traders, you have a lot to be proud of. [Table I.1](#) takes a look at the performance of the top 20 professional futures and forex trading operations during the past five years (measured by risk-adjusted rates of return).

TABLE I.1 Performance of the Top 20 Commodity/Forex Trading Operations from 2005 through 2009

Source: Managed Account Research Inc. web site.

Commodity and Forex Trading Firms	Avg. Annual ROR*	Avg. of Worst Drawdowns*	Avg. ROR During 2008 Meltdown*	% of Years Profitable in Past 5 Years (avg. of worst losing year, if applicable)*
Top 5 firms	20.5%	−8.9%	22.5%	88% (+.03%)
Firms 6–10	12.8%	−11.3%	27.0%	80% (−1.8%)
Firms 11–15	10.2%	−10.9%	20.6%	84% (−1.4%)
Firms 16–20	8.2%	−11.1%	11.7%	76% (−4.7%)
Composite* (unweighted)	12.9%	−10.5%	20.0%	82% (−1.9%)

*Commodity trading advisors managing at least \$10 million with drawdowns no greater than 15% were considered for the list of the top 20 CTAs and were ranked based on average annual rate of return (ROR).

Of the top 20 professional commodity-trading firms during the past five years, 19 made money in 2008 as the rest of the financial world lost billions in the global meltdown. Of these top 20 firms, the average five-year compounded rate of return (ROR) was 12.9 percent. Seven did not have a single losing year in the past five years. The average worst peak-to-valley losing spell was only −10.5 percent. The average worst year among the 20 firms was −1.9 percent. Compare this to the roller-coaster ride called the stock market.

I believe that there are four principal reasons why the community of professional commodity traders is profitable year in and year out:

1. Most commodity and forex traders started trading with proprietary money. You were not just handed a multimillion-dollar pool because you had your MBA in finance or your PhD in quantum physics. In fact, you are just as likely to be a college dropout, a European history or theology major, or a former air traffic controller.

2. You understand risk because you trade leveraged markets. You know the high price to be paid for being stubborn with a losing trade. You know that small losses have a way of becoming large losses, and large losses can sink a ship. You would have never let a massive pile of worthless mortgage paper dig too deeply into your pockets.

3. You trade transparent markets that have instant and real price discovery mechanisms. The instruments you trade get marked to the market every day based on real values. You can determine the liquidation value of your portfolio to the penny at any given time—and if you need to scramble for cover, you can do so within minutes. You just laugh to yourself when you think about AIG, Lehman, and the mortgage instruments that nearly sunk the global economy. How in the world did the major financial houses put billions of dollars into

instruments that could not accurately be valued at the end of every day? Imagine that some of the world's largest financial firms of their type were staking their future on financial derivative instruments they did not even understand, and when they failed, the government bailed them out. And after the government bailed them out, the executives of these firms paid themselves billions in bonuses. Nice gig if you can get it! Frankly, I think the entire bunch needs to be taken out behind the woodshed.

4. You know that a key to successful trading deals with how you handle losing trades, not in always being right. You understand that profits have a way of taking care of themselves if losses can be managed.

Average Investors

If you are like most "investors," you have experienced an "asset disappearing act" during the past several years as the value of your stocks, hedge funds, and real estate has tanked, at worst, or violently vacillated at best. Your assets have been on a wild ride.

Yet it is possible to generate consistent double-digit returns with a minimum amount of capital volatility in the commodity futures and forex markets. But you need to know that to do so is not easy work if you undertake the challenge on your own. Consistently successful trading requires diligence beyond easy description. There is not a simple golden egg.

You probably grew up hearing repeatedly that commodity markets were for speculators and that real estate and stocks were for investors. Hopefully, you now know that the traditional concept of an "investment" has no basis in reality. With the exception of T-bills, everything is speculation. Perhaps we may find out in the next few years that even U.S. government debt instruments are not a safe bet. It may even be that 30-year T-bonds will be the next bubble.

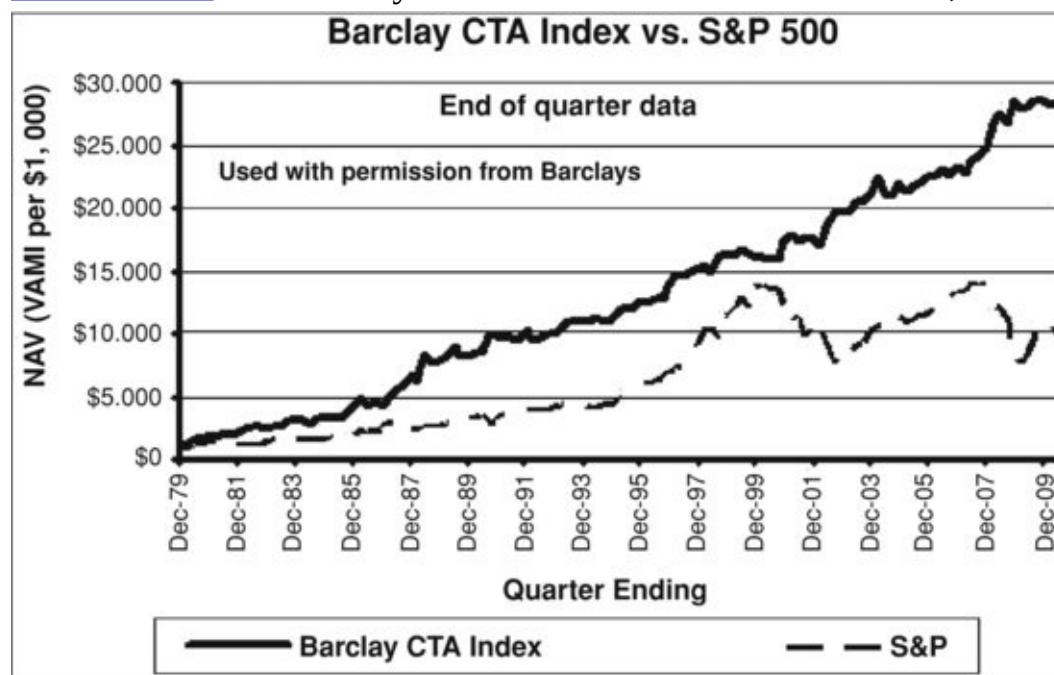
Like it or not, buy-and-hold strategies are a joke. Every decision you make in life represents a trade-off. Everything is a trade. Everything is a gamble.

You have also probably heard that commodity and foreign exchange markets represent "rags to riches" or "riches to rags" speculation because of the large leverage contained in the instruments traded.

Under the right hands, commodity futures and forex trading can be a rather conservative venture. As of March 2010, a total of \$217 billion was being managed by professional commodity traders who attempt to provide their clients with consistently above-average RORs with a minimum of asset volatility.

If I sound like a cheerleader for managed futures, it is because I am. Research has shown that having a managed commodity portfolio decreases the volatility of a balanced stock and bond portfolio. [Figure I.4](#) compares the Barclay Commodity Trading Advisor Index to the S&P 500 Index dating back to the early 1980s. You decide which roller coaster you would have rather ridden. I will allow this graph to speak for itself.

FIGURE I.4 The Barclay CTA Index versus S&P 500 Index, 1980–2010.



Novice “Wannabe” Traders

For you, I have some stark words! You have been duped! You have wasted your money buying expensive “black-box” trading systems, attending seminars promising you riches, thinking that the next great trading platform will solve your problems, or subscribing to the services of online trade pickers/scammers. And it is your own fault. It is your fault because you want to find an approach that overcomes your emotional inability to take trading losses in stride. Your ego and pride are too entangled with your trading.

You have had your share of profitable trades. In fact, perhaps you have even had some profitable years. But you have never become a consistently profitable performer because you spend the majority of your time, money, and energy seeking for a way to overcome your psychological ineptitude. Playing off the name of the song by Dolly Parton, you have been “looking for success in all the

wrong places.”

You have spent 90 percent of your effort on the least important of trading components: trade identification. I will explore all of the trading components I believe are necessary for consistent success later in this book, but trade identification is the least important of all. In my opinion, learning the importance of managing losing trades is the single most important trading component.

Years ago, while at the CBOT, I conducted an unscientific survey among about a dozen or so consistently profitable professional traders. Over the years I have asked the same question to trading novices. The question I asked was:

You have your choice—two different trading approaches. Both performed equally in recent years; one was profitable 30 percent of the time, and the other was profitable 70 percent of the time. Which approach would you be more apt to adopt?

Professional traders choose the 30 percent right approach by a two-to-one margin. Novice traders overwhelmingly choose the 70 percent approach. Why the difference?

Professional traders recognize something that the novices may not comprehend. There is no margin of error in the approach that needs to be right 70 percent of the time in order to produce its expected results. What happens if the 70 percent approach has a bad year (50/50 ratio of losers to winners)?

Professional traders recognize the inherently superior risk management profile of the 30 percent approach. The 30 percent approach intrinsically has a built-in margin for error. In fact, the 30 percent approach assumes that most trades will be losers. Every approach has good times and bad times. The expectation of bad times needs to be built into the equation.

There is an old adage that “it is easy to make money in the commodity markets, but just try to keep it.” There is a lot of wisdom in this adage. Keeping the money is a function of money and risk management. The good times will never occur unless a trader figures out a way to keep capital together during the tough times.

The Book’s Road Map

This book is about using price charts to trade the commodity and forex markets. More specifically, this book will simply examine how I use charts for market speculation.

I make no pretense that chart trading is superior to any other form of trading, or that my use of charts for trading is superior to how other traders use charts in their trading operations. In fact, I know that my trading approach has weaknesses. I uncover new weaknesses every year. I will uncover weaknesses during the course of writing this book.

The six major points that I want you to remember as you read *Diary of a Professional Commodity Trader* are:

1. Consistently profitable commodity trading is not about discovering some magic way to find profitable trades.
2. Consistently successful trading is founded on solid risk management.
3. Successful trading is a process of doing certain things over and over again with discipline and patience.
4. The human element of trading is enormously important and has been ignored by other authors for years. Recognizing and managing the emotions of fear and greed are central to consistently successful speculation. I make no pretense that I have this aspect of trading mastered.
5. It is possible to be profitable over time even though the majority of trading events will be losers. “Process” will trump the results of any given trade or series of trades.
6. Charting principles are not magic, but simply provide a structure for a trading process.

I will emphasize and reemphasize these six points throughout the book.

This is a book about how I trade the commodity markets using price charts. I do not want to oversell this book as anything else. I will simply relate what I have learned about trading with charts since 1980. I have picked up some major lessons along the way. I have made every mistake possible—some of them numerous times. I have eaten humble pie over and over again. I have never gained a taste for it.

Diary of a Professional Commodity Trader is a book about price charts, so I feel the obligation to provide some historical background on the subject. Chapter briefly discusses the history and underlying theory of classical charting principles. However, this book assumes that you already have a working knowledge about charting. Chapter ends with a discussion of what I believe to be the inherent and serious limitations of a trading approach based on charting techniques.

Trading is a business—and all successful businesses need a business plan to

guide decisions and operations. Over the years, I have come to the conclusion that all consistently profitable approaches to commodity market speculation are based on certain common denominators.

In Chapters 2 through 7, I explain the basic building blocks that have evolved within my own approach. All of my specific trading decisions flow from these building blocks. Other professional traders may have completely different building blocks or similar building blocks they refer to with different names. I have grouped the important elements of my own trading approach into three different categories:

- Preliminary Components (Chapter)
- Trading Components (Chapters 3–5)
- Personal Components (Chapter)

Chapter provides a case study anatomy of my trading in three markets during the past year, detailing how trades were entered, how protective stops were initially set and then advanced, how profits were taken, and how much leverage and risk were taken in each trading event.

Chapters 8 through 12 could be summarized with the phrase, “Let the games begin!” These chapters will be a real-time, day-by-day, week-by-week, and month-by-month diary of my actual trading from December 2009 through April 2010. These months were not cherry-picked based on performance. Sidebars and subsections will be included on just some of the following:

- Observations on market behavior
- The personality of different markets and different patterns
- Trading continuation versus reversal patterns
- The use of intraday charts
- Commentaries on trading
- Lessons learned (and relearned)
- Missed trades
- The human element exposed

These chapters will be rich with charts showing the evolution of patterns and the execution details of the Factor Trading Plan. You need to know that these chapters were written each day in real time without the benefit of hindsight. The chapters will reflect my trades—the good, the bad, and the ugly—as well as my thinking process and the feelings in my gut. Even as I am writing this draft in early December 2009, I have no idea if my trading will be profitable.

Chapter will be a summary, statistical analysis, and discussion of the trading

months represented by this book. Chapter will present the “Best Dressed List” of the best examples of classical charting principles for 2009 and the period covered by the trading journal. Hopefully, the Factor Trading Plan will have taken advantage of the most outstanding market situations. My profitability during the five months will depend on my real-time ability to recognize and properly implement my trading tactics in any market situation.

The appendices contain tables highlighting the trading operations of the period covered by this book. Appendix A contains the trading record covered by the journal. This table details the markets traded, the dates of entry and exit, leverage taken, pattern recognized, type of trading signal, trading result, and rules used for exiting the trade. Appendix B is a guide to the charts contained in the book, cross-referencing them based on the classical chart patterns identified and on the signal categories and trade management techniques used in my trading plan. Appendix C lists the books, web sites, and trading platforms I recommend.

If this book could accomplish one thing, it would be to show that successful market speculation is a craft, requiring an extensive and ongoing apprenticeship in studying the markets in the school of hard knocks. Successful speculation is a process that must address many aspects of market behavior and self-knowledge and mastery.

I have several hopes for the readers and the trading community as a whole through this book. First, I want to honor the difficult task undertaken by professional traders to achieve consistently successful performance. Trading is tough work that involves the mind, the spirit, and all of our emotions. Promoters that sell easy-money and quick-fix systems and approaches as a means to easy profits are a dishonor to the real-life challenges of trading.

Second, I want to communicate to nontraders and traders still early in their journey to consistent profitability that trading requires a comprehensive approach addressing far, far more than simply having a belief that a certain market is going to advance or decline. Trading is a business that must address a wide variety of decisions and contingencies.

Third, I want to pay homage to the field of classical charting principles as a trading tool. Chartists are inappropriately criticized for their “hocus-pocus” approach to understanding the markets when charting should never be understood as anything but a trading tool, not a method for price forecasting.

Fourth, and finally, the human factor is seldom mentioned in books on trading, yet it is the single most important component of consistently profitable market

operations. I want to address this underdiscussed aspect of market speculation.

Chapter 1

The History and Theory of Classical Charting Principles

Speculators have used charts to make trading decisions for centuries. It is generally believed that candlestick charts in their earliest form were developed in the 18th century by a legendary Japanese rice trader named Homma Munehisa. Munehisa realized that there was a link between the price of rice and its supply-and-demand factors, but that market price was also driven by the emotions of market participants. The principles behind candlestick charts provided Munehisa a method to graphically view the prices over a period of time and gain an edge over his trading competitors. An edge is all that a speculator can ever expect.

In the United States, Charles Dow began charting stock market prices around 1900. The first exhaustive work on charting was published by Richard W. Schabacker (then the editor of *Fortune* magazine) in 1933. Under the title *Technical Analysis and Stock Market Profits*, Schabacker provided an organized and systematic framework for analyzing and understanding a field now known as “classical charting principles.”

Schabacker believed that the stock market was highly manipulated by large operators who tended to act in concert. He observed that the activities of these large players could be detected on price charts showing the opening, high, low, and closing price for each trading session.

He further observed that prices, when plotted on a graph, were either in periods of consolidation (representing accumulation or distribution by the large operators) or sustained trends. These trends were known as periods of price “markup” or “markdown.” Finally, Schabacker noted that periods of consolidation (as well as some trending periods) tended to display certain geometric formations—and that, depending on the geometry, the direction and magnitude of a future price trend could be predicted.

Schabacker then identified the form and nature of a number of these geometric

patterns. These included such traditional patterns as:

- Head and shoulders (H&S) tops and bottoms
- Trend lines
- Channels
- Rounding patterns
- Double bottoms and tops
- Horns
- Symmetrical triangles
- Broadening triangles
- Right-angled triangles
- Diamonds
- Rectangles

The pioneering work of Schabacker was picked up in 1943 by Robert Edwards and John Magee in the book *Technical Analysis of Stock Trends*, commonly referred to as the bible of charting.

Edwards and Magee took Schabacker's understanding to the next level by specifying a number of trading rules and guidelines connected with the various chart patterns. Edwards and Magee made the attempt to systematize charting into trading protocols. *Technical Analysis of Stock Trends* has remained the standard reference book for more than three generations of market speculators who use charts in some manner for their trading decisions.

My Perspective of the Principles

As a trader, classical charting principles represent my primary means for making decisions. I maintained all of my charts by hand in the days before sophisticated computer programs and trading platforms. Now there are numerous computerized and online charting packages and trading platforms.

I continue to rely solely on high/low/close bar charts in daily, weekly, and monthly form. I pay no attention to the myriad of numerous indicators have been developed in the past 20 years, such as stochastics, moving averages, relative strength indicators (RSIs), Bollinger bands, and the like (although I do use the average directional movement index [ADX] to a very limited degree).

It is not that these methods of statistical manipulation are not useful for trading. But the various indicators are just that—statistical manipulations and

derivatives of price. My attitude is that I trade price, so why not study price directly? I can't trade the RSI or moving average of soybeans. I can only trade soybeans.

I am not a critic of those who have successfully incorporated price derivatives into their trading algorithms. I am not a critic of anyone who can consistently outsmart the markets. But for me, price is what I trade, so price is what I study.

Three Limitations of the Principles

Three important limitations of classical charting should be understood by market operators who use charts or are considering the use of charts.

First, it is very easy to look at a chart and call the markets in hindsight. I have seen unending examples in books and promotional materials of charts marked up retroactively to make magnificent trends look like "easy money." Unfortunately, in order to emphasize some charting principles, this book may commit this very sin.

It is the dominant and gargantuan task of a chart trader to actually trade a market in real time in a manner even closely resembling how a market would have been traded in look-back mode. Significant and clear chart patterns that produce profitable trends are most often comprised of many small patterns that failed to materialize. Charts are organic entities that evolve over time, fooling traders repeatedly before yielding their real fruit.

Second, charts are trading tools and not useful for price forecasting. Over the years, I have been extremely amused by "chart book economists" who are constantly reinterpreting the fundamentals based on the latest twists and turns of chart patterns.

There is a huge difference between being short a market because of a chart pattern and being "bearish" on the fundamentals of a market because of the same chart pattern. Charts represent a trading tool—period. Any other use of charts will only lead to disappointment and often net trading losses. The idea that chart patterns are reliably predictive of future price behavior is foolhardy at best. Charts are a trading tool, not a forecasting tool.

As a trader who has used charts for market operations for 30 years, I believe I am permitted to make this statement. I am an advocate for charting—not a critic. But I am a critic of using charts in the wrong way. In my opinion, it is wrong-headed to use charts for making price forecasts, and especially for making

economic predictions.

You may know trading advisory services that use charts to make predictions on the economy. They let you know when they are right. They make excuses or become silent when they are wrong. I think it is a much more honest position to just admit that I never know where any given market is going, whether or not the chart seems to be telling a story.

The third limitation is that emotions cannot be removed from the trading equation. It is impossible to study and interpret price charts separate from the emotional pull of fear, price, hope, and greed. So it is foolish to pretend that charts provide an unbiased means to understand price behavior. The bias of a trader is built into his chart analysis.

Summary

Classical charting principles provide a filter to understand market behavior and a framework for building an entire approach to market speculation. In the chapters to follow, I will display the construction of a comprehensive approach to market speculation using these charting principles—an approach I call the Factor Trading Plan. I will then proceed to apply the Factor Trading Plan, using classical charting principles as the foundation, to actual commodity and forex speculation for a period of about 21 weeks.

Part II

Characteristics of a Successful Trading Plan

Like any sound business, a trading operation needs a business plan—a comprehensive business plan that accounts for all variables to one degree or another. During my 30-plus years of trading, I have developed a set of guidelines, rules, and practices that direct my trading decisions. I refer to these components in their composite as the Factor Trading Plan.

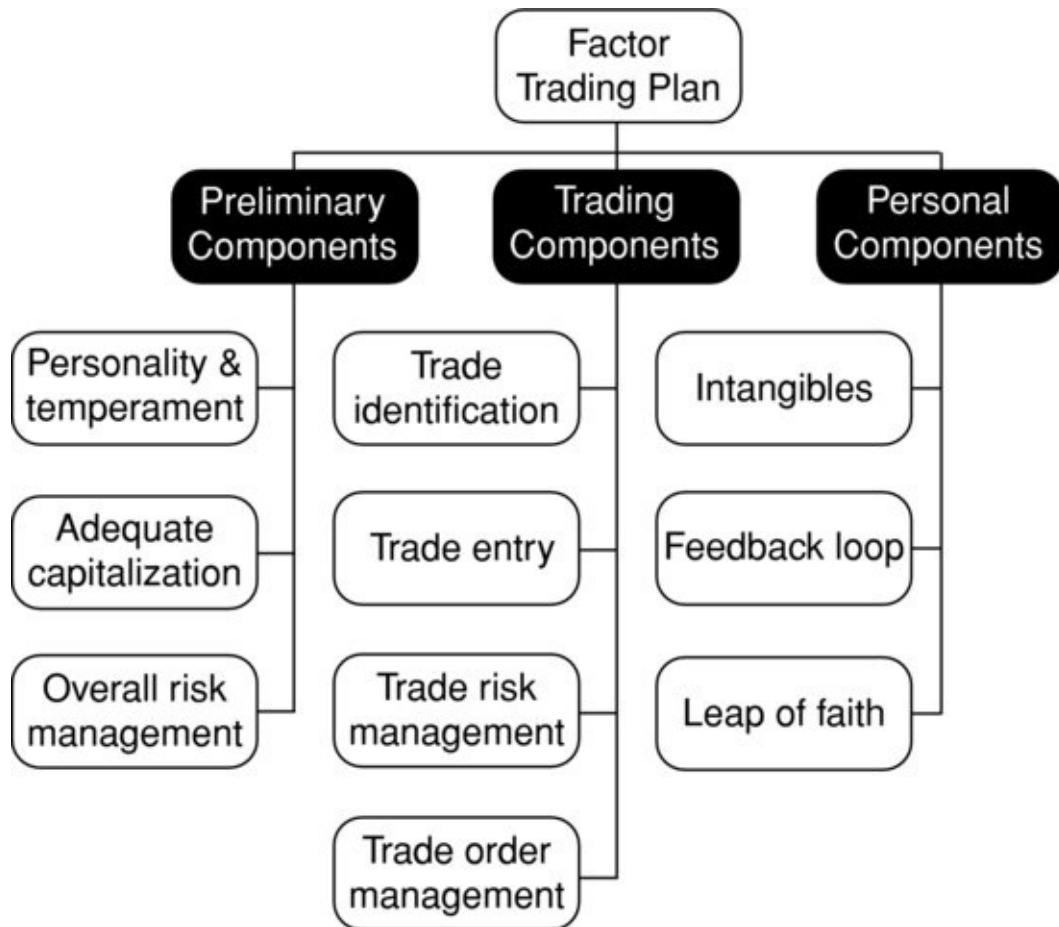
The Factor Trading Plan has evolved over the years based on trading experience and results, and continues to evolve as the behavioral nature of the markets changes. I acknowledge that the construction of other professional traders' plans may be quite different than mine, but many common themes will hold true. In fact, I strongly believe some common characteristics are by nature necessary for successful market speculation.

Part II explains the basic building blocks of my trading approach. The Factor Trading Plan is governed by three pillars under which reside 10 major components, as shown in Figure PII.1. The broad pillars include:

- The preliminary components—dealing with matters of personality and temperament, available speculative capital, and philosophy toward risky ventures.
- The components of the trading plan itself—dealing with how markets are analyzed, how trades are made, and how trades and risk are managed.
- The personal components—dealing primarily with the characteristics and habits of a successful trader.

Chapter will cover the pillar for the preliminary components. The pillar for the trading plan itself is the most complicated and is covered in Chapters 3 through 5. Then, Chapter provides case studies showing the trading plan in action. Finally, Chapter deals with the pillar discussing the personal characteristics and habits required for successful market speculation.

FIGURE PII.1 Pillars and Components of the Factor Trading Plan.



Refer to [Figure PII.1](#) as an overview of the pillars and components of the Factor Trading Plan. It should serve as your road map in the chapters directly ahead. You can refer back to this road map to understand each section in the proper context.

Chapter 3

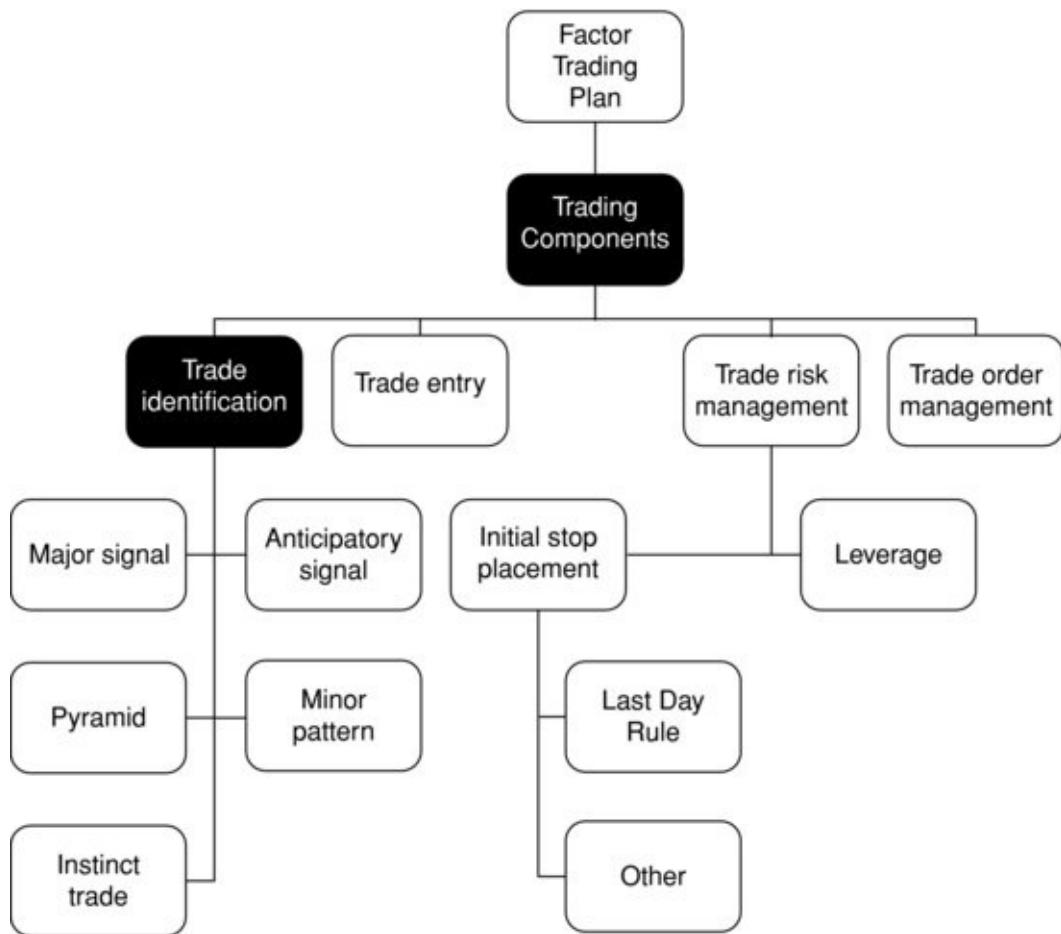
Identifying the Trades and the Trading Vocabulary

I will now move to the mechanics of the Factor Trading Plan. The trading plan attempts to answer such questions as:

- What markets should I trade?
- Should I be long or short?
- Should I get in now or wait—and if I wait, what exactly should I wait for?

These practical and tactical questions, and more, are answered by the components within the trade identification pillar of the Factor Trading Plan, as shown in [Figure 3.1](#).

FIGURE 3.1 The Trade Identification Pillar.



This is an appropriate point to reemphasize that I have no pretension that my approach to trading is the best for everybody or that my trading operations cannot be improved. In fact, as you read through this book you will no doubt see many warts on my trading plan.

The primary point I want to make by describing in detail the Factor Trading Plan is not that my trading is particularly clever, but that a comprehensive plan covering all of the important aspects is necessary for consistently successful trading operations. The process of trading is an important part of consistent success. A trader needs to anticipate as many contingencies as possible in his speculative maneuvers.

The Factor Trading Plan is based upon the following set of assumptions:

- The likely direction of any given market cannot be determined by studying charts.
- Charts are a trading tool, not a predictive tool. Charts can provide traders with a slight edge, but should not be used to make price forecasts.

- Charts should not be used to maintain a constant opinion or position in any given market.
- Do not assume that the next trade will be profitable.
- More often than not a market will defy what its chart structure implies.
- Markets make enormous moves that can't be explained by classical charting principles.

With these assumptions in mind, Chapters 3 through 5 cover how the Factor Trading Plan works, focusing on the trading components. This chapter lays down the general concept used to identify trades and defines the terminology or “shop talk” used by the trading plan. Chapter 4 shows examples of the ideal types of trades sought by the plan. Chapter 5 details the types and frequency of trades engaged by the trading plan, discusses how trades are entered and exited, and explains the logistics of how the entire plan is managed.

Trade Identification

There are numerous methods used by traders to define a trade. The important point is that a trader must be able to know what is or is not a trading signal, event, or moment. This is true whether a trader uses a mechanical or discretionary technical approach, a supply-and-demand fundamental approach, or an economic model. Lack of certainty if a market is or is not setting up a trade is a cardinal sin. This is why I recommend that novice traders paper-trade or trade a small trial account for a year or two prior to placing real skin in the game.

The Factor Trading Plan is based on a technical approach to market analysis. Technical trading approaches study price behavior itself to identify candidate trades and generate trading signals. In contrast, fundamental trading approaches are based on the supply-and-demand factors of a market and general overall economic conditions. It is not within the scope of this book to delve any deeper into different approaches to market analysis or trading.

The technical approach used by the Factor Trading Plan falls into a category known as *discretionary* (as opposed to the *mechanical* approach used by many technical traders). A discretionary trading plan requires that the trader makes certain subjective judgment calls from one trade to the next, whereas a mechanical (some market operators use the term *black box*) system is programmed to generate precise entry and exit instructions in order to eliminate day-to-day human decision making.

Using a discretionary approach is a personal preference, not in any way an indictment against mechanical systems. In fact, some of the more frustrating aspects of my own trading could possibly be resolved if I used a mechanical system. But, in general, I believe that a discretionary approach better fits my personality and understanding of price behavior and dynamics.

More specifically, the Factor Trading Plan uses classical chart patterns as the basis for all trading decisions. A discussion of classical charting principles can be found in Chapter 1.

Vocabulary of the Factor Trading Plan

All industries and companies have their own shop talk to describe concepts and practices inherent in their business operations. While definitions of terms often appear in the appendix of a book, I believe it is very important to lay out the operating and tactical terms of the Factor Trading Plan at this point of the book. Understanding certain terms will enable you to follow my discussion of charts and trades during the remainder of this manuscript.

The terms and definitions are not listed alphabetically but in the order I think through things during actual trading operations.

Trading Unit

As a trader, I think in units of \$100,000. When I calculate risk and leverage, it is always in relationship to \$100,000 blocks of capital. Thus, if I am trading a \$500,000 block of money, I think about it as five trading units.

Position Unit

A position unit is the number of contracts or size of a position taken per \$100,000 and determines the risk assumed on a trade. The risk is normally about six-tenths to eight-tenths of 1 percent. I refer to a position with less risk as an underleveraged position and positions with more risk as extended-leverage positions.

Position Layering

Often, I attempt to build a position by entering into a trade on multiple dates and at different prices. For example, if I establish a position in anticipation of a

future breakout, I consider myself to have established the first layer. If I establish another position at the breakout of a major pattern, I become two layers deep. Perhaps a near-zero-risk opportunity to extend leverage develops at a retest; then I could become three layers deep. Now if I can find a pyramid opportunity, I will end up with a four-layer position. I do not add to a losing position, but put on layers only as earlier layers are profitable. Even in a multiple-layer position, my combined risk in a market rarely exceeds 1 percent.

Multiple-layer trades are not the norm.

Breakouts

I am a breakout trader. But I define a breakout in two ways. First, all patterns have boundary lines that define the exact geometry of the patterns. Some traders and market analysts draw boundary lines precisely with a fine-point pen. I draw boundary lines roughly, often cutting through some highs and lows in order to provide the best fit of an area of price activity to a geometric pattern. I also use thick lines, not a fine-point pen, to establish the boundary. Of course, there are instances when I call a breakout too closely—and I often pay the price for doing this.

Robert Edwards and John Magee considered a breakout to be a price penetration equal to or greater than 3 percent of the value of a stock. This is far too generous when trading commodities. For example, a 3 percent breakout in \$1,000 gold would be \$30 per ounce.

A breakout is more complicated than simply penetrating a pattern boundary. All patterns are comprised of minor or intermediate high and low points. These high and low points define the parameters of the boundary lines. To be a valid breakout, I also want to see a market penetrate the most recent high or low price that defined the boundary. And to be most comfortable with a trade, I want to see a market penetrate the highest or lowest price within the completed boundary. [Figure 3.2](#) show these chart points on a weekly graph of the British pound/U.S. dollar (GBP/USD).

FIGURE 3.2 Pattern Breakout in the British Pound.



Ice Line

I use the terms *ice line* and *boundary line* interchangeably. The concept of the ice line is that once a market moves through the boundary of a pattern, that boundary line ideally should separate all the price action that preceded the breakout from the price behavior following the breakout. The ice line is analogous to a sheet of ice on a lake in the winter. The ice supports a person or vehicle from dropping into the water. But once the person breaks through the ice, the ice sheet then becomes a barrier to survival. [Figure 3.3](#) shows the ice line in GBP/USD. [Figure 3.4](#) displays the same concept in platinum.

FIGURE 3.3 Ice Line in the British Pound.

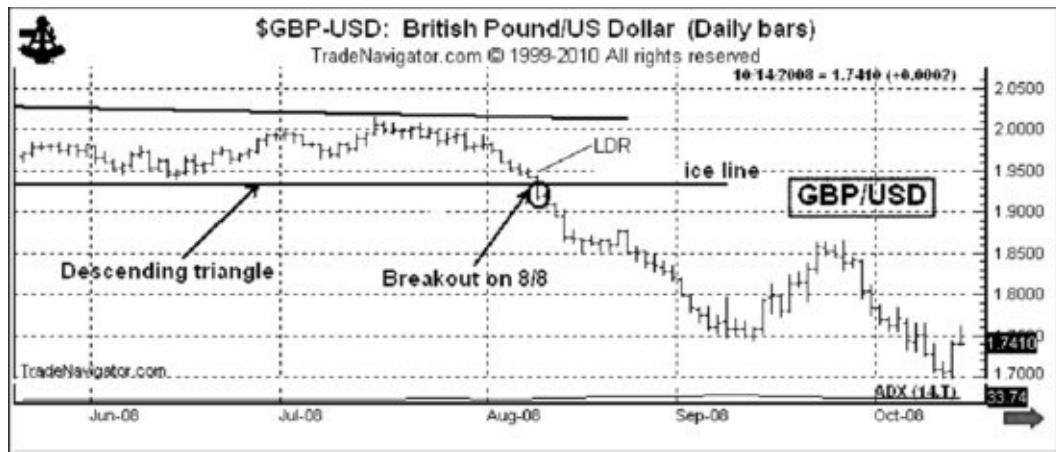
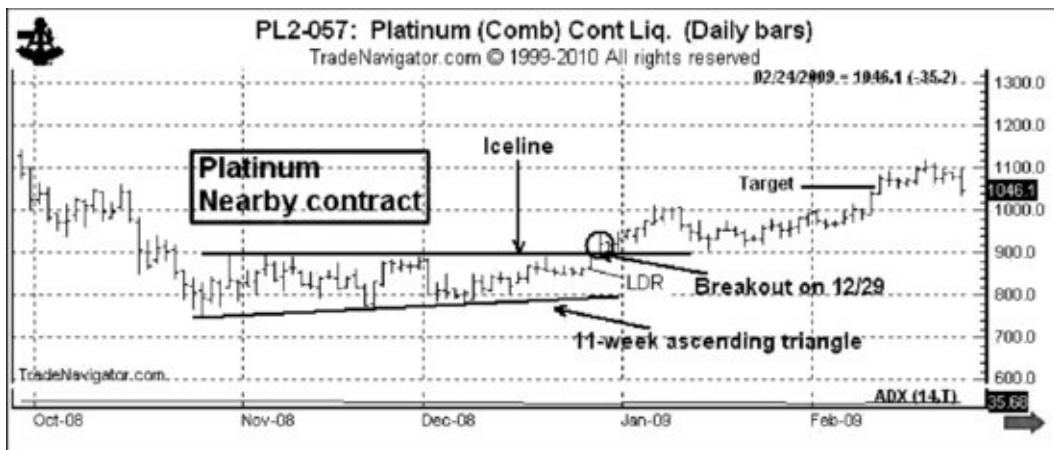


FIGURE 3.4 Ice Line in Platinum.



Out-of-Line Movement

Drawing boundary lines on chart patterns is not an exact science. The reality is that a market does not care where I draw a boundary line. There is nothing magic about geometric boundaries. It is great when the minor or intermediate lows or highs of a market provide a perfect demarcation for boundary lines, but this is the exception and not the norm. A boundary line should be drawn to best fit to an area of price congestion even if it means that the boundary line is drawn through some of the price bars.

There are occasions when a daily price bar significantly penetrates a boundary line on an intraday basis, but then almost immediately returns back into the geometric pattern. Such price action was defined by Edwards and Magee as an out-of-line movement. While out-of-line movements can create some tactical challenges to trading, history will usually show the out-of-line price activity as just a one-or two-day freak incident. Boundary lines do not need to be redrawn to accommodate out-of-line movement. [Figures 3.5](#) and [3.6](#) exhibit out-of-line movements in London sugar and New York sugar, respectively.

Premature Breakout

A premature breakout is different from an out-of-line movement in the sense that a premature breakout can close outside of a predrawn boundary line and even spend several days in breakout mode. Prices then return back to the geometric pattern. However, the initial breakout was only a harbinger of things to come, and within a few weeks a genuine breakout occurs. I call these subsequent breakouts *secondary breakouts* or *pattern recompletions*. [Figure 3.7](#) shows this concept in cocoa.

FIGURE 3.5 Out-of-Line Movement in London Sugar.

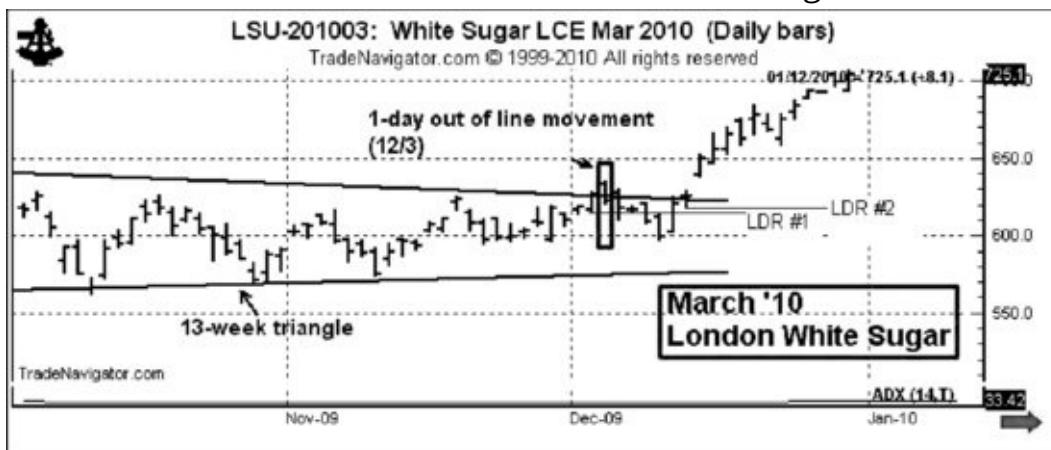


FIGURE 3.6 Out-of-Line Movement in March Sugar.



FIGURE 3.7 Premature Breakout in Cocoa.



False Breakout

Unlike the premature breakout, which is followed by a genuine breakout in the

same direction, the false breakout results in prices either developing a much larger pattern or strongly moving in the opposite direction. Some traders refer to false breakouts to the downside as a *bear trap* and false upside breakouts as a *bull trap*. This means that traders who normally position themselves in the direction of the initial price thrust get stuck on the wrong side of the market. [Figure 3.8](#) shows a false breakout in the German Deutscher Aktien Index (DAX).

FIGURE 3.8 False Breakout and End-Around in the DAX.



In 2009, a great example of the false breakout occurred in the U.S. stock index markets. As shown in [Figure 3.9](#), the Standard & Poor's (S&P) 500 futures completed a nine-week H&S pattern in July. Prices closed below the neckline and remained in a breakout mode for five days before turning up sharply. The full price action of July 14 was above the neckline and indicated that a bear trap had been triggered. On July 16, the market rallied strongly above the previous right shoulder high, generating a very reliable buy signal.

FIGURE 3.9 A False Breakout and Subsequent Buy Signal in the S&Ps.



Breakouts that are not genuine create a difficult trading dilemma. A trader who becomes positioned at the breakout does not know whether the subsequent return into the pattern represents a one-day out-of-line movement, a premature breakout or a false breakout. For this reason, I generally abandon any position that has a significant return to the pattern.

Horizontal versus Diagonal Patterns

I greatly prefer to trade a pattern that offers a horizontal or flat boundary, such as the boundaries of a rectangle, ascending triangle, H&S, etc. I consider such patterns to be horizontal. The reason these are superior patterns for trading is that the penetration of a boundary line most often occurs simultaneously with the violation of a major or minor high or low point within the pattern. An example can be seen in [Figure 3.10](#), a rectangle that developed in gold in 2007. The decisive penetration of the upper boundary also penetrated the important April high, signaling a bull move.

FIGURE 3.10 Gold Displays a Horizontal Chart Pattern.



Diagonal patterns, by contrast, have slanted boundary lines. This creates three practical problems. First, my experience is that there are far more false or premature breakouts of slanted chart lines than in the case of horizontal boundaries.

Second, the penetration of a diagonal boundary may or may not violate a minor or major preceding high or low. [Figure 3.11](#) shows a trendline in the EUR/USD, which was problematic in 2009.

FIGURE 3.11 Problematic Diagonal Chart Pattern in the Euro/U.S. Dollar Crossrate.



The trend line was violated in late October. The practical problem then becomes whether to redraw the trend line or deal with continued false trendline violations, such as occurred later in November.

Third, the retest of the boundary of a diagonal pattern line would be progressively adverse to the position as days or weeks go on. [Figure 3.12](#) shows a breakout of a falling wedge in gold followed by several days of retesting that put a breakout trade into a loss.

FIGURE 3.12 Diagonal Pattern in Gold.



The problems with the diagonal boundary become particularly acute when dealing with a trend line or a channel line. In fact, I normally do not consider a trend line to be a tradable event unless the market has tested the trend line numerous times.

Last Day Rule

The Last Day Rule is the principal method used in the Factor Trading Plan to determine the initial protective stop order once a position is entered.

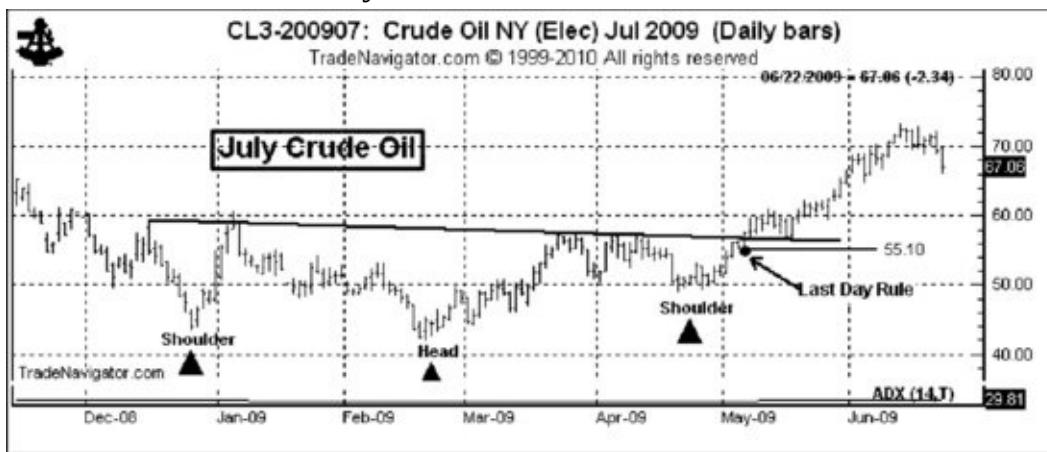
If a pattern breakout is valid, then it logically follows that the day of the

breakout is a significant event. Ideally, I establish a position at the point of a price breakout and use the low of an upside breakout day or the high of a downside breakout day to set my protective stop levels. This is called the Last Day Rule.

In cases when a market gaps through a boundary line or opens at or near a boundary line just prior to breaking out, I may elect the high or the low of the preceding day to determine the Last Day Rule.

[Figure 3.13](#) shows a Last Day Rule in crude oil that remained unchallenged. In fact, the Last Day Rule nearly always remains unchallenged in valid chart pattern completions.

FIGURE 3.13 Last Day Rule in Crude Oil.



[Figure 3.14](#) shows two Last Day Rules in silver, the first of which was breached, the second went unchallenged.

FIGURE 3.14 Two Last Day Rules in Silver—One Failed and One Worked.



Throughout the book, on as many charts as appropriate, I have noted the Last

Day Rule with the designation LDR and a thin line and price.

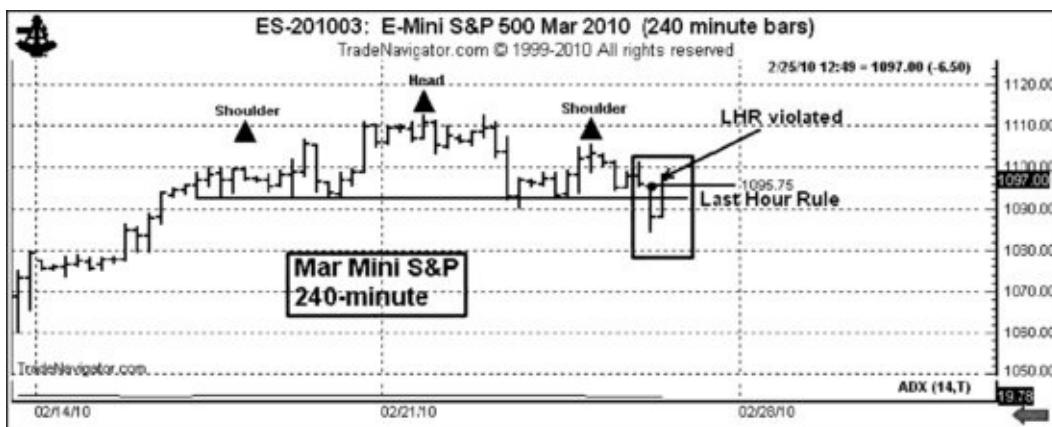
Last Hour Rule

There are instances when a very large trading range occurs within a pattern on the day of a breakout. As a result, the Last Day Rule may represent a risk far exceeding the idealized four-fifths of 1 percent determined by money management guidelines. In such cases I may elect to use tighter protective stop placement. But rather than simply using some dollar amount I prefer to set a tighter stop using a chart point.

This tighter stop point may be determined by the high or low of the last hour spent within a pattern prior to the breakout, or the last 120 minutes, 240 minutes, or whatever time frame fits the risk and reward parameters I seek for a trade.

Ideally, if using the Last Day Rule offers an inappropriate risk level, I prefer to find a point on an intraday chart that represented a minor rally or reaction prior to the breakout. Of course, there are occasional trades when a money management stop is the best I can do. I conveniently use the phrase *Last Hour Rule* whether the stop is based on an hourly chart, two-hour chart, three-hour chart, or any other intraday time increment. [Figure 3.15](#) shows a violation of the Last Hour Rule in the S&Ps.

FIGURE 3.15 Last Hour Rule in March S&Ps.



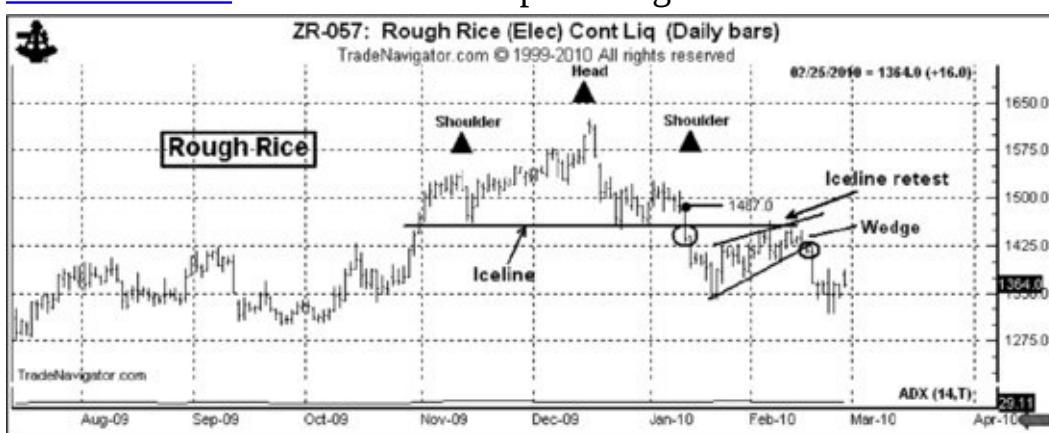
The concept of the Last Day Rule also applies to weekly and even monthly charts. This risk management guideline will hold true for valid breakouts on charts of any time length.

Retest

My experience through the years is that the best trades break out cleanly, go

almost immediately, and never look back. In fact, I believe that my net bottom line as a trader would have improved if I had exited every trade that closed at a daily loss. I wish I had the data to run such a simulation. But, often, a trade will hesitate following the initial breakout and retest the boundary within a few days to a week or so. Such a retest is normal and should not greatly concern a trader as long as the retest does not severely challenge the ice line. Retests in valid pattern breakouts normally do not penetrate the ice lines. [Figure 3.16](#) displays a retest of a breakout in the Chicago Board of Trade (CBOT) rough rice market. Note that the retest itself took the form of an 18-day flag.

FIGURE 3.16 Retest of H&S Top in Rough Rice.

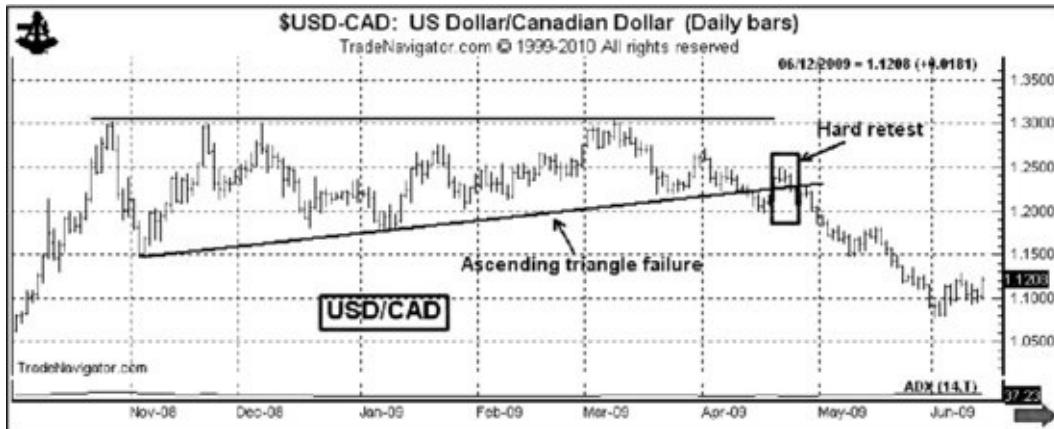


Hard Retest

A hard retest occurs when prices actually slice back into the completed pattern. While a hard retest can test the patience of a trader, it does not in and of itself mean that the pattern will fail.

I have been asked over the years if it would be wise not to take a trade at the breakouts, but instead attempt to establish a position upon the retest of the completed pattern. My answer to this question is an unqualified “NO!” Think about this matter logically. By not taking a trade at the point of a breakout, but instead waiting for some type of retest, a trader is eliminating trades that work immediately and do not look back, which are exactly the most desirable trades. A market that retests a pattern is inherently more likely to fail than a market that never has a retest. A hard retest is shown in the U.S. dollar/Canadian dollar (USD/CAD) in [Figure 3.17](#).

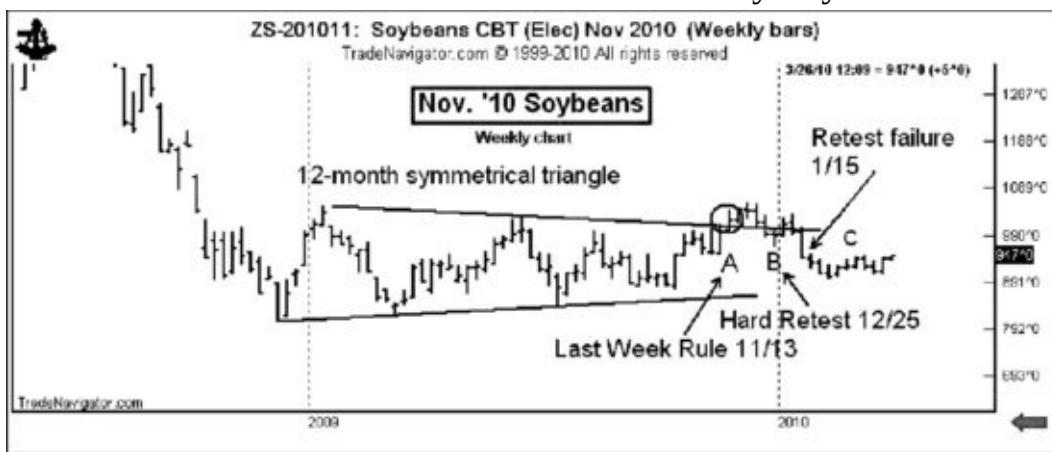
FIGURE 3.17 Hard Retest in USD/CAD.



Retest Failure Rule

A hard retest of a pattern allows me to adjust my stop using the high or low of the hard retest as a new protective stop point. Assuming that the initial stop was based on the Last Day Rule and a hard retest occurs, I can then advance a stop to just above the hard retest high in the case of a short position, or just below the hard retest low in the case of a long position. [Figure 3.18](#) displays this concept on a weekly chart of November 2010 soybeans. Note the breakout of the 12-week week triangle the week of November 11 (letter A), the hard retest the week of December 25 (letter B), and the subsequent retest failure the week of January 15 (letter C).

[FIGURE 3.18](#) Retest Failure Rule on the Weekly Soybean Chart.



Target or Objective

Each chart pattern carries the implication for the magnitude of an ensuing trend. As a general rule, the minimum move following the completion of a chart

pattern should be equal to the height of the pattern itself, although the exceptions to this rule are numerous and complex. In nearly every case, I take profits (partial or complete) when a market reaches its target. [Figure 3.19](#) displays that the target in sugar is based on the principle that the distance from C to D should be equal to the distance from A to B, as shown. [Figure 3.20](#) exhibits the same concept for the ascending triangle in the GBP/USD, where C to D should equal A to B.

FIGURE 3.19 Price Target from Triangle in Sugar.

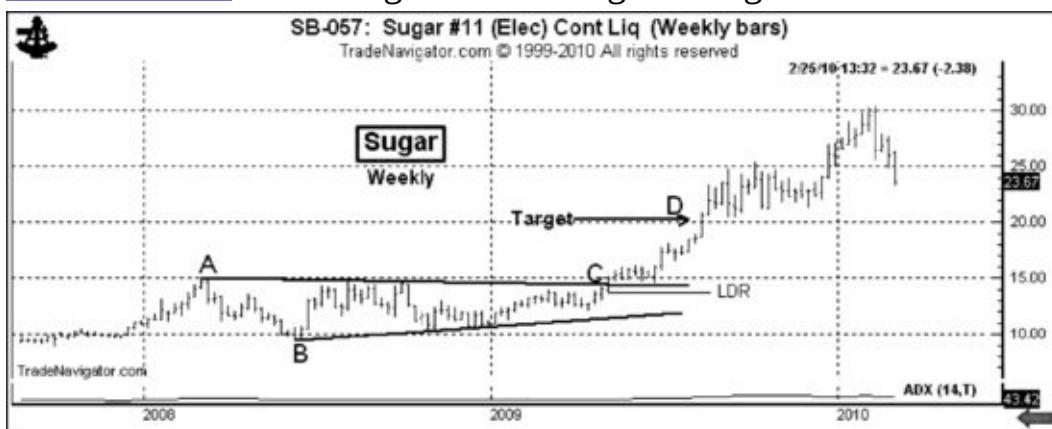
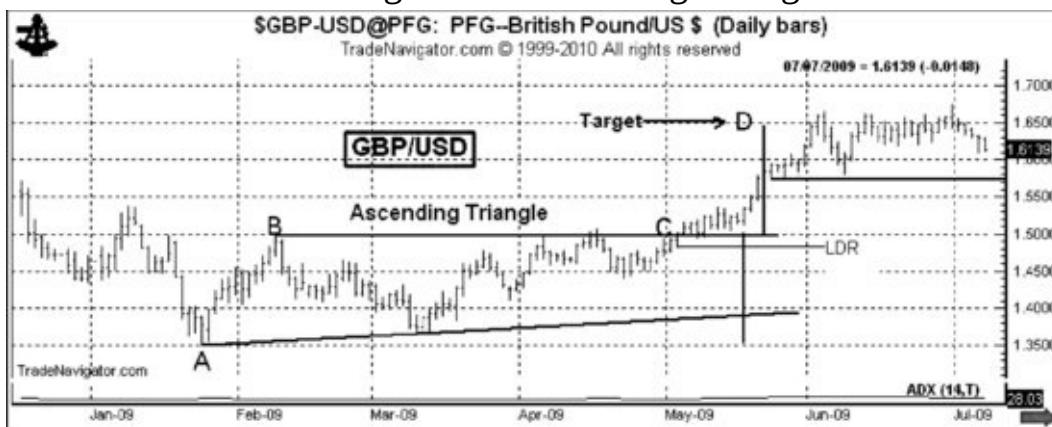


FIGURE 3.20 Price Target from Ascending Triangle in GBP/USD.



I use two other methods to determine price targeting. The first involves a technique known as *swing objectives*. The principle of a swing objective is that markets tend to advance or decline in legs that are of approximately equal distance.

Finally, I may periodically use point and figure (P&F) charts to calculate a longer-term target. P&F charts measure the amount of price action over a period of consolidation and are not time related. I use P&F counts several times each year when I believe that a period of consolidation (usually a large bottom or

base) will produce a trend much more extended than indicated by the pattern target.

Important note: There is *no* guarantee that any market will reach its target. Traders need to be alert for markets that run out of steam prior to attaining a target.

Intervening Patterns and Pyramiding

During a sustained trend, a market frequently will experience a pause. These pauses often form smaller independent consolidation patterns. These patterns can be a continuation in form, meaning that another thrust in the direction of the dominant trend will be produced, or reversal in form, implying that the previous trend has come to a temporary or more permanent end. Continuation patterns offer the opportunity to both pyramid an initial position and to tighten up the protective stops on the initial position. Reversal patterns offer the opportunity to avoid riding the initial position back to the starting gates (or what I call a *popcorn* or *roundtrip move*).

As a trader, I have mixed feelings toward continuation patterns—and my feelings differ based on the duration of the pauses within the main trend. Long pauses (more than three or four weeks) can wear down my patience. I much prefer shorter-duration pauses in a main trend, especially if the move coming into the pause was strong and the pause takes the form of a pennant or flag. [Figures 3.21](#) and [3.22](#) display continuation patterns in Australian dollar/U.S. dollar (AUD/USD) during the same advance on the weekly and daily charts, respectively.

FIGURE 3.21 Continuation Patterns on the Weekly AUD/USD Graph.

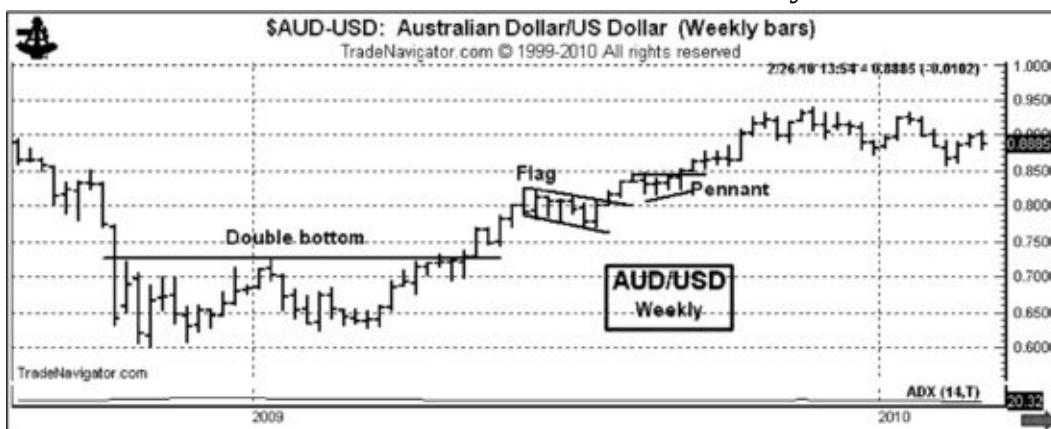


FIGURE 3.22 Continuation Patterns on the Daily AUD/USD Graph.



A continuation pattern during the course of a major trend allows me to advance my initial protective stop in the direction of a profitable trade. A breakout of a continuation chart will be accompanied by its own Last Day Rule. I may elect to move the protective stop from the initial Last Day Rule to the new Last Day Rule created by the continuation pattern.

It is also possible that a pattern implying a reversal of trend could develop prior to the attainment of an expected target. I may elect to move my protective stop in relationship to a pattern that carries trend implications counter to my position.

As previously discussed in this book, taking a profit before a target is reached can be very challenging to a trader. This area of my trading is most likely to be modified on an ongoing basis. All too often, unfortunately, my thinking is governed by the most recent trades. This type of optimization thinking is akin to a dog chasing its short tail—the short tail will always be moving just away from the dog's mouth.

Trailing Stop Rule

There was a time in my trading when I never moved my stops away from the Last Day Rule. A market would either reach its target or stop me out at the Last Day Rule.

There was an inherent risk management problem with this strategy. Assume, for example, that I entered a trade with a risk of \$800 per \$100,000 of capital and a target equal to \$3,200 per trading unit. The initial relationship of reward to risk was four to one. Next, assume that the position went my way and reached a point where I had an unrealized profit of \$2,400 per unit. This meant that I had \$800 left to gain before taking profits. Leaving my stop at the original level meant that I was now risking \$3,200 to the original Last Day Rule stop in order

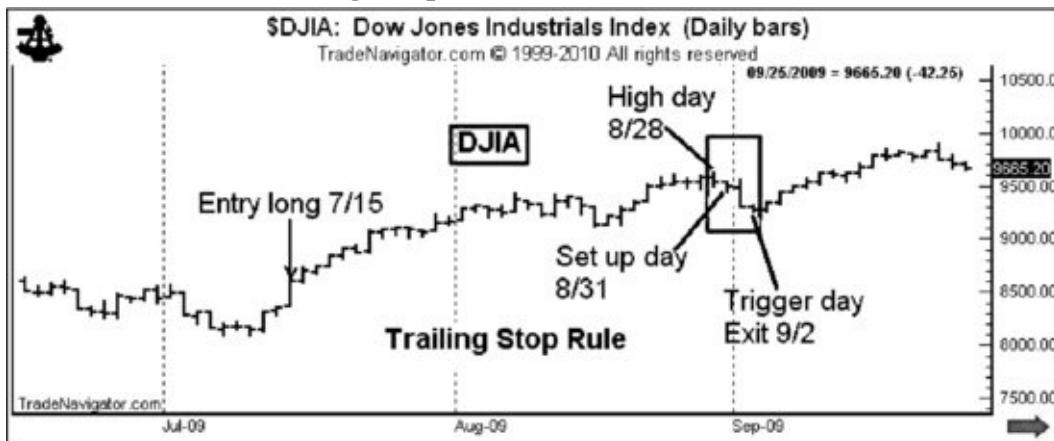
to gain the final \$800.

This was insane money management, so I had to come up with some means to readjust my risk and reward parameters. For the sake of brevity, I will not take the time or space to discuss the popular concepts of a trailing stop based on a dollar amount or percentage retracement.

I developed a concept I call the Trailing Stop Rule. This trading guideline requires three days of price action to be implemented: the new high or low day, the setup day, and the trigger day.

[Figure 3.23](#) shows the Trailing Stop Rule in action on a long position in the Dow Jones. The first step to the exit strategy is to identify the highest day of the move. Of course, it will change as new highs are made. The high day in the Dow was August 28. The setup day occurs on any day a market closes below the low of the high day. This occurred on August 31. The trigger and exit then takes place when the low of the setup day is penetrated. This occurred on September 1.

FIGURE 3.23 Trailing Stop Rule in DJIA.



I want to emphasize that there is nothing technically significant about the Trailing Stop Rule. It is simply a means to prevent a popcorn or roundtrip trade from occurring. [Figure 3.24](#) shows the activation of the Trailing Stop Rule almost immediately after a pattern completion in GBP/USD.

FIGURE 3.24 Trailing Stop Rule in GBP/USD.



Weekend Rule

The Richard Donchian Weekend Rule is a technique I may employ to extend the leverage in a trade. Donchian is considered to be the creator of the managed futures industry and is credited with developing a systematic approach to futures money management. His professional trading career was dedicated to advancing a more conservative approach to futures trading. Donchian passed away in the early 1990s.

The Weekend Rule basically states that a market that decisively moves into new high or low ground on a Friday is very likely to continue the move on Monday and early Tuesday of the next week. The reasoning behind the Weekend Rule is that a decisive new high or low on Friday indicates the willingness of “strong hands” to take a position home for a weekend.

The Weekend Rule is even more valid when there is a long, three-day weekend.

For me, the Weekend Rule becomes most significant and useful when a pattern breakout (especially a weekly chart pattern) takes place on a Friday. In such cases, I may extend my risk from six-tenths to eight-tenths of 1 percent to a full 1 or 2 percent.

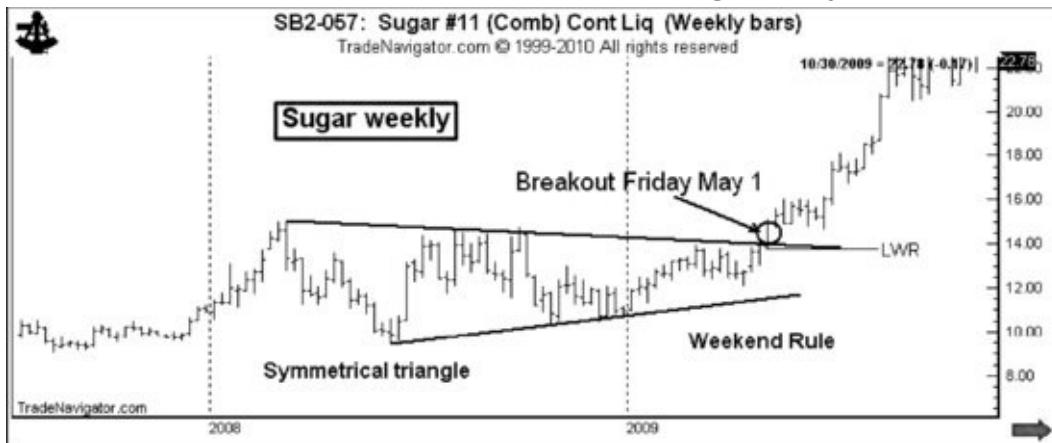
[Figures 3.25](#) and [3.26](#) show major breakout days (all on Fridays) in the bull market in sugar in 2009.

Market Runs

The type of trend I most appreciate are straight-line market runs. Such runs are actually quite typical of strong trends. There are two types of straight-line moves, as shown by the accompanying examples.

[Figure 3.27](#) of March soybean oil displays the first type of market run—a trend characterized by a series of continuous lower highs (or higher lows in the case of an advance). In this case, the market had 18 straight days of lower highs during a substantial drop. Nearly four weeks of lower lows is probably more than a trader can expect from a trend, but the point is that strong trends can be viciously persistent.

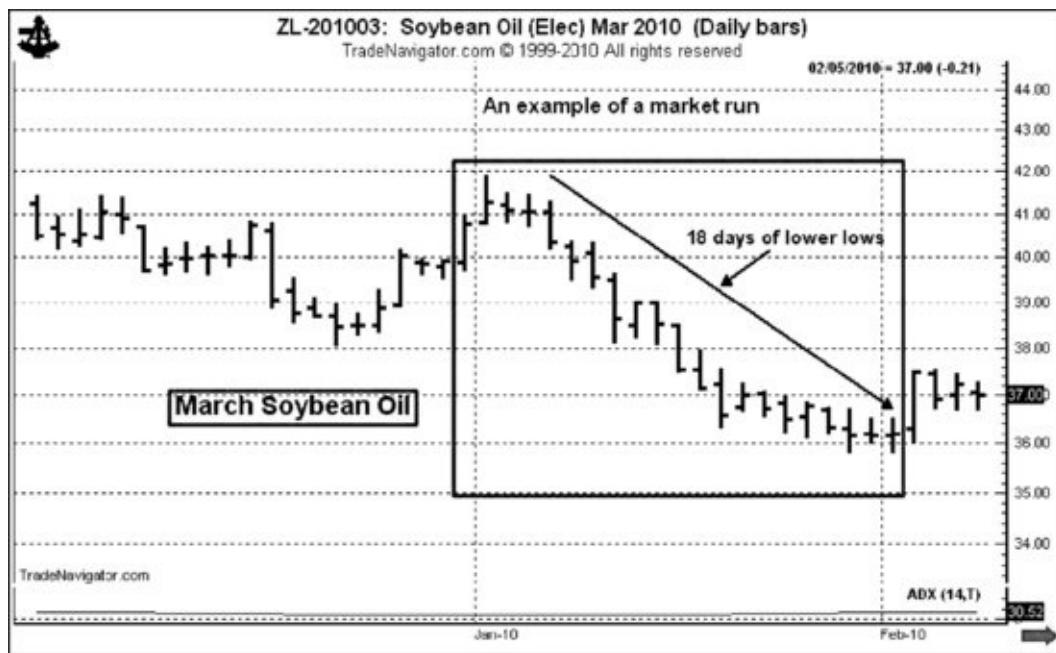
[FIGURE 3.25](#) Weekend Rule Breakout in Sugar, May 2009.



[FIGURE 3.26](#) Weekend Rule Breakout in Sugar, December 2009.

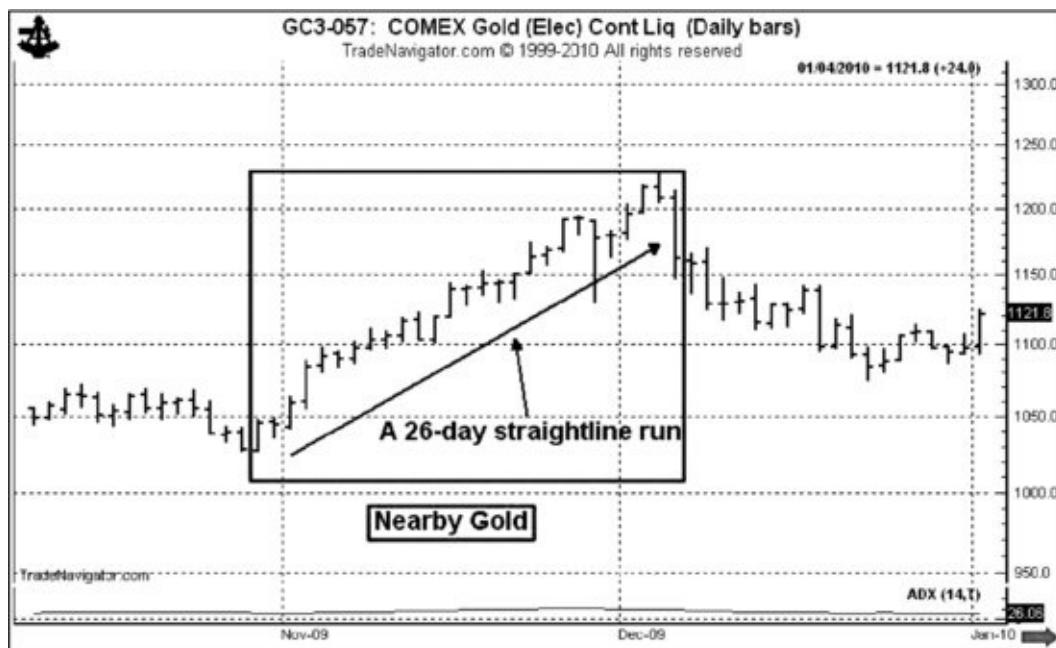


[FIGURE 3.27](#) A Sustained Market Run in Soybean Oil.



The chart of the nearby contract of gold ([Figure 3.28](#)) displays the second type of market run. In this case the trend contained days with intraday lows beneath the previous days' lows, but in no case from October 29 through December 4 did the market close below the previous day's low.

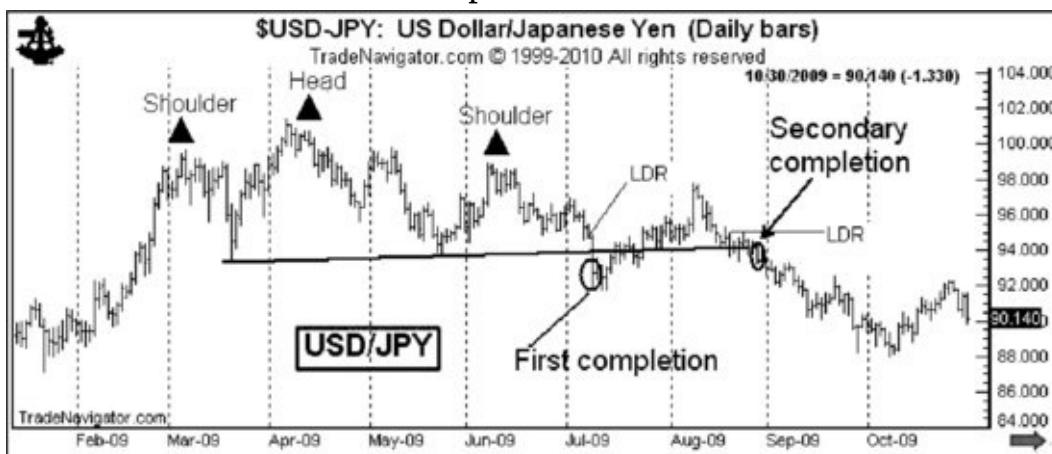
FIGURE 3.28 A Market Run in Gold.



Pattern Recompletion

I have discussed the concept of the premature breakout. A premature breakout assumes that there subsequently will be a genuine breakout. I refer to the secondary breakouts as pattern recompletions. [Figure 3.29](#) is an extreme example of this idea. In July, the U.S. dollar/Japanese yen (USD/JPY) completed an H&S top pattern. After reentering the pattern in early August, the pattern was recompleted on August 27. The market then trended to the target at 86.20. For risk management, I used the Last Day Rule of the secondary completion at 94.58 (the August 26 high) to establish my protective stop level. As a general rule, I will attempt one pattern recompletion per major pattern. After that, I will count my losses and go shopping elsewhere.

FIGURE 3.29 Pattern Recompletion in USD/JPY.



It is easy for a discretionary trader to become obsessed with a particular market that has delivered a few straight losing trades, thinking that the market owes him something. This is a bad mental state to enter. Being compelled to recoup losses from a particular market in the same market is a dangerous practice. At least once each year I get caught up in this vicious cycle. I must constantly remind myself that there will always be another market at another time.

Points to Remember

- It is necessary to have an organized method to make the important decisions involved in trading, such as what market to trade, when to trade it, how to enter, how to set stops, how to exit, and what leverage to use.
- A trading plan must be based on the key assumption that it is

impossible to know with certainty the direction of any given market at any given time.

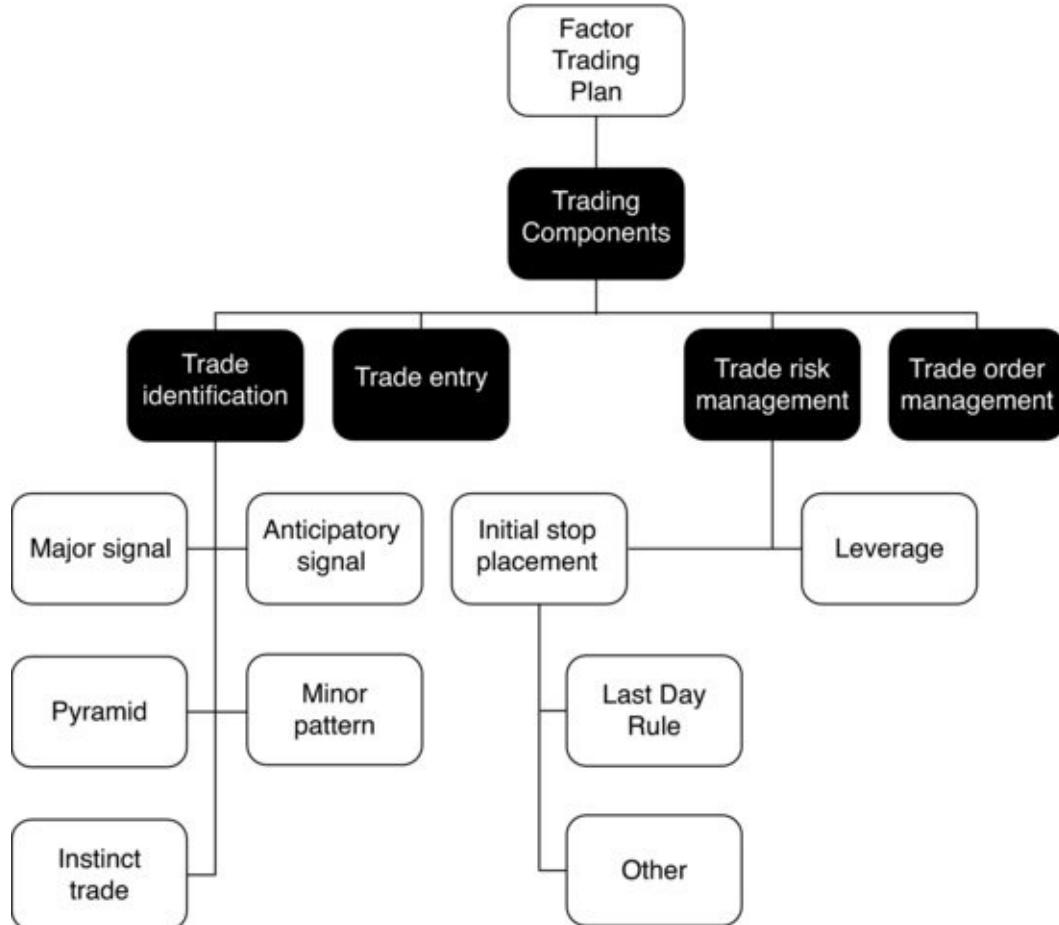
- Classical charting can serve as the basis for creating a trading plan.
- Successful trading plans must have precise definitions of market behavior and trading actions.

Chapter 5

How the Factor Trading Plan Works

It is time to get into the nuts and bolts of the Factor Trading Plan. [Figure 5.1](#) shows the four main elements of the plan, including trade identification, trade entry, trade risk management, and trade order management. This chapter will tackle each element individually and in detail.

[FIGURE 5.1](#) The Necessary Elements of a Trading Plan.



Trade Identification

I knew I wanted to be a trader before I knew I would become a chartist. Trading was the “what” of my career equation. Being a chart trader was the “how.” When I entered the commodity business, my goal was to make money as a trader. In reality, I did not have a clue what that meant.

Chart trading made an enormous amount of sense to me at the point in my career when I began finding my way. Chart trading offered me a unique combination of benefits not available with the other approaches I had attempted or considered, including:

- A means to understand market trend
- An indication of market direction
- A mechanism for timing
- A means to determine risk
- A realistic target for taking profits

However, I quickly discovered that there was a huge difference between seeing chart patterns and actually trading them. Thankfully, the book *Technical Analysis of Stock Trends* by Robert Edwards and John Magee offered some suggestions to the practical challenges of being a chart trader. Yet, one of my major challenges wasn’t addressed in the book; namely, when I began keeping charts, I saw patterns everywhere I looked. I needed to better define for myself exactly what I was looking for in a pattern in order to take a trade. Were all classical chart patterns created equal? Were some patterns a better fit to my personality, risk tolerance, and level of capitalization?

The Practical Problem of the Time Duration of Chart Patterns

With the benefit of hindsight, I now realize that the dilemma I was struggling with could be defined as *time framing*. There are two realities of classical charting principles that all serious chartists must confront.

First, it is patently easy to see chart patterns in hindsight. Promotional materials from various trading advisory services are replete with charts showing how they would have traded a certain market in hindsight. But I trade the markets in real time, and patterns clearly visible in hindsight might have not been so clear in real time. Chart structure constantly evolves. A pattern that eventually provides a profitable trend might be comprised of numerous smaller patterns, many of them failing to deliver an implied move. Further, a big move

might be ushered in with several false starts.

A second and related reality is that many patterns seemingly clear at the moment of a trade fail to deliver and become swept up into a much bigger chart structure.

The Story of the “Big” Soybean Move

During my first year at the Chicago Board of Trade (CBOT), a trader in the soybean pit befriended me. This man lived in a mansion in Evanston, drove a luxury German car, and showed every indication of success (which, in fact, he had achieved). He told me one afternoon about how bullish he was in soybeans, at the time trading around \$5.40. He said he had a giant position. So I watched the market for a few days. Prices crept up to about \$5.60. I jumped in with a contract, only to have prices return to \$5.40 the following week. Suffering from this losing trade, and seeking words of encouragement, I sought out my pit trader friend and asked him what he thought. His statement floored me. “I made a small fortune. Wasn’t that a great move?”

As it turned out, my friend was a scalper who seldom held a position for more than 10 minutes. He normally did not take positions home with him overnight. To him, a two-or three-cent move was his goal. When he initially spoke to me, he had an instinct that soybeans could rally 10 cents within a day or two, and he was willing to hold a position overnight to realize that gain. But he did not explain this to me until after the fact.

So, in the end, I learned a very good lesson. Being a “bull” or “bear” means nothing without a time frame or price horizon attached to the words.

Because the structure of a chart becomes redefined over a period of time (especially in broad periods of consolidation), it is crucial for a trader to understand the time frame that determines candidate trades. If a trader tells me he is bullish on a certain market, I ask him if he is long, at what price, what is his target, what is his time frame, and at what price does he admit he is wrong. The concept of being bullish or bearish means nothing.

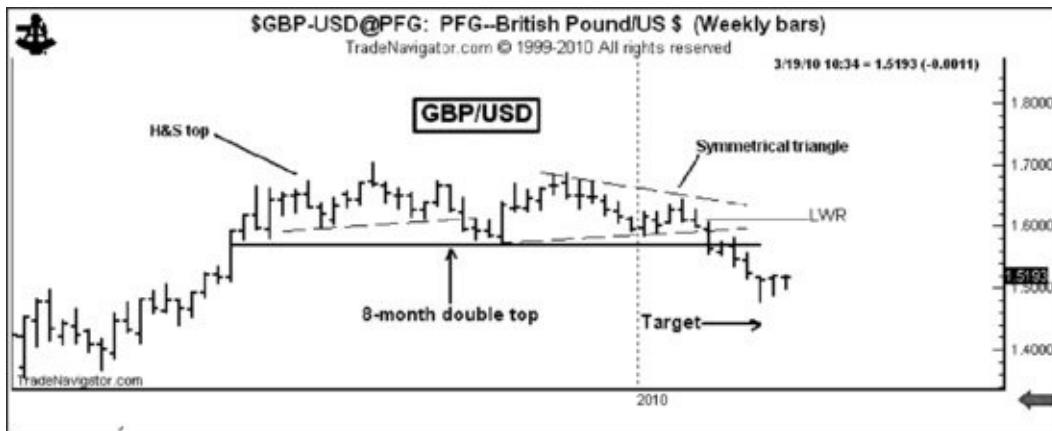
GBP/USD as an Example of Time Framing

Four charts of the British pound/U.S. dollar (GBP/USD) illustrate the importance and complications of time frame considerations.

[Figure 5.2](#) is a weekly chart of GBP/USD from January 2009 through March 2010. The dominant stages of price behavior shown on this chart are the run-up in prices during the first half of 2009, the formation of the double top from late May 2009 through February 2010, and the bear trend that developed from the double top. Two secondary patterns can also be seen, a 19-week H&S top that was completed in late September 2009, but failed, and a 17-week continuation

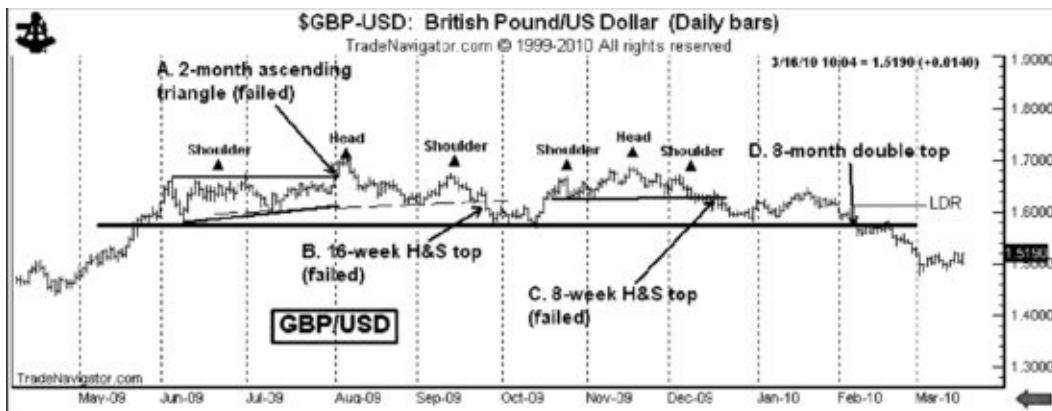
triangle that broke out in early February 2010 to launch the completion of the double top.

FIGURE 5.2 Double Top on the Weekly Chart of GBP/USD, June 2009–March 2010.



[Figure 5.3](#) displays the daily price bars of GBP/USD for an 11-month period of time from April 2009 through March 2010. It is the daily bar chart companion version of the weekly chart shown in Figure 5.2.

FIGURE 5.3 Double Top on the Daily Chart of GBP/USD, June 2009–March 2010.



This daily graph identifies classical chart patterns of eight weeks or more in duration to demonstrate how a broader period of consolidation is comprised of numerous small patterns—that at the time seemed to be important indicators of expected market behavior. The chronology of this chart was as follows:

A two-month ascending triangle (Pattern A) was completed in late July. This pattern failed to propel prices for more than three days. The brief rally out of the top of the triangle led to what became the head of a 16-week H&S top (Pattern B). This H&S top broke out in late September and also quickly failed.

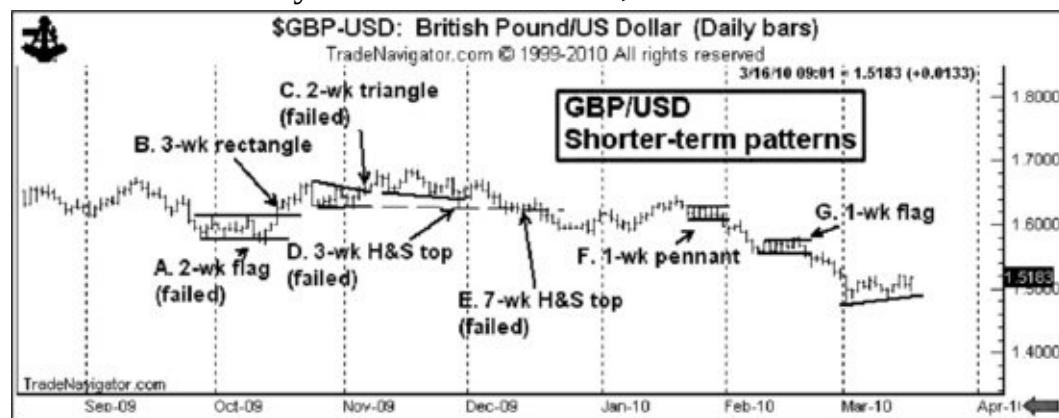
The advance from the early October low led to an eight-week complex H&S top (Pattern C). While the completion of this pattern experienced some initial downward momentum, prices stabilized at the December low and then chopped sideways to higher for the next four weeks. In the process, I was stopped out of the shorts I established based on the eight-week H&S top.

All of these patterns combined to constitute the broad eight-month double top completed in early February with a target of 1.440 to 1.470.

From my perspective, all four of these patterns (A through D) were worth trading—in fact, I traded them all. Had any of the first three patterns worked, they could have been considered as textbook examples of classical daily chart patterns.

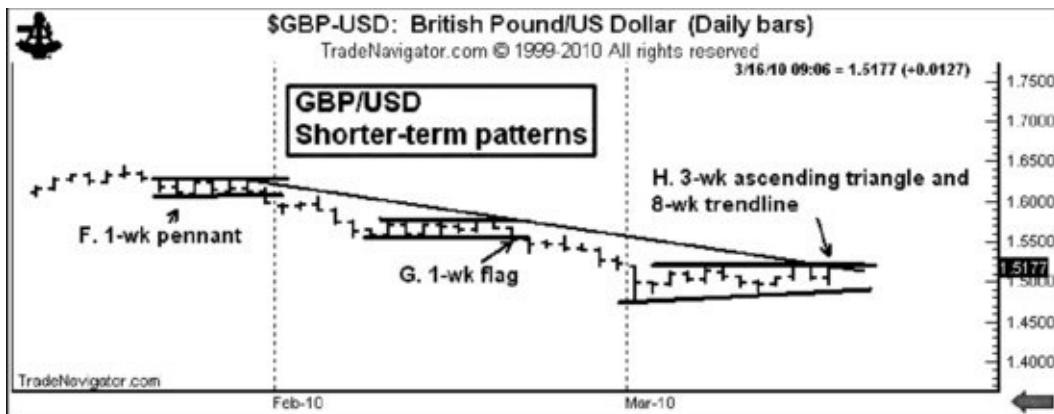
[Figure 5.4](#) examines the period September 2009 through March 2010, or the last seven months of the period covered in Figure 5.3, attempting to identify shorter-term patterns. In fact, seven patterns (labeled A through G) could have represented signals for the shorter-term classical chart trader. [Figure 5.4](#) further demonstrates how smaller patterns become part of bigger patterns that become part of even bigger patterns and so on.

FIGURE 5.4 Daily Chart of GBP/USD, October 2009–March 2010.



Finally, [Figure 5.5](#) is the daily GBP/USD chart from January through March 2010, the final three months of the original 15-month period of time from [Figure 5.2](#). Here, again, it is possible to see even shorter-term patterns that made up part the chart landscape of this forex pair. A very short-term chart trader might have considered taking trades based on these mini-patterns.

FIGURE 5.5 Daily Chart of GBP/USD, January 2010–March 2010.



In the example of the GBP/USD it would have been possible to base a trading perspective on the quarterly, monthly, weekly or daily charts or to drill down on the time frame to four-hour charts, two-hour charts, 60-minute charts, and so on.

I have used the example of the GBP/USD to make two points. First, a trading signal in one time frame might mean nothing in another time frame. Second, chart patterns of shorter duration often fail, only to become redefined as part of a larger chart formation.

Charts are a record of where prices have been, but trading is an operation that needs to be done in real time with an eye on the future. To be a successful chart trader, a person must have a firm fix on the time frame that will generate the trading signals.

Let me touch on one more point dealing with time framing. I believe it is important for a trader to use similar time frames to both enter and manage a trade. What sense does it make to enter a trade based on a weekly chart, and then manage the trade using an hourly chart? Or to enter a trade using a daily chart pattern, but then manage the trade using a monthly chart? I personally understand the importance of keeping time frames consistent because when I fall into the trap of not doing so it usually costs me money.

From my understanding, the Elliott Wave Principle is also sensitive to the issue of time frame by attempting to identify cycles or waves of differing degrees. By the way, this is the totality of my knowledge of the Elliott Wave Principle.

I have discussed this idea of time framing as a necessary precursor to introducing the signals sought and traded by the Factor Trading Plan.

The formula for the Factor Trading Plan in its most digested form is very simple:

- Identify clearly defined weekly chart patterns (with corresponding or

supporting patterns on daily charts), seeking trades in what may become the best 10 examples each year of classical charting principles as defined in *Technical Analysis of Stock Trends*.

- Once a possible weekly chart pattern has been identified, attempt to establish an anticipatory position at a stage in the pattern when the final completion could be imminent.
- Increase the leverage of a trade at that point when the pattern in question becomes complete by way of a breakout.
- Within the context of significant trends launched from weekly chart patterns as cited above, seek at least one opportunity to extend or pyramid the leverage in the trade using continuation patterns of shorter duration.
- Identify the best two or three daily chart patterns in each monitored market each year.
- Enter trades in the daily patterns when the boundary lines of the patterns are violated by a breakout.
- Seek a very selective number of additional trades that history has shown to have a high probability of success over a short time frame (two or three days).
- Use a logical spot to place protective stop orders, risking no more than four-fifths of 1 percent of assets on each trade.
- Allow for trades that show immediate profits every opportunity to grow into bigger profits.

Sounds simple, right? Of course, the demons are in the details. You will hopefully be exposed to these demons as my five-month trading diary unfolds.

Four Categories of Trades

The Factor Trading Plan has evolved over the years to identify and trade seven different types of trades fitting into four different categories.

MAJOR PATTERNS

Weekly chart patterns at least 10 to 12 weeks in duration with corresponding daily chart patterns of the same or slightly different configuration. The major patterns include three types of trades:

1. *Anticipatory or exploratory position*—an attempt to pre-position at or near

the final high or low of the pattern

2. *Pattern completion position*—the point at which the pattern boundary is violated

3. *Pyramid position*—using a continuation pattern of much shorter duration than the launching pattern (perhaps as short in length as a three-or four-week flag or pennant)

MINOR PATTERNS

Minor patterns include two different types of trades:

1. Continuation patterns—daily chart patterns of at least four to eight weeks in duration
2. Reversal patterns—daily charts patterns of at least eight to ten weeks in duration

Minor patterns do not need confirmation by weekly charts.

INSTINCT TRADES

Instinct trades are market situations that do not fit the major or minor pattern categories, but for which I have a very strong instinct. These are usually very short-term trades from which I exit quickly with a small loss if wrong, or cover for a profit within a day or so if correct.

Over the years of my trading, I have developed a sixth sense on when a market is vulnerable to a sudden advance or decline of two to three days. I try not to overdo these types of trades for fear of becoming too short term in my overall market analysis.

MISCELLANEOUS TRADES

Miscellaneous trades are largely driven by short-term momentum within the framework of an existing trend.

As previously stated, chart formations are always more readily apparent with the benefit of 20/20 hindsight. But in real time, it is more difficult to both identify and trade the types of chart formations specified by my trading approach.

There are many times when a particular pattern fails, only to become part of a more extensive chart construction. Other times a chart pattern may completely fail and propel a trend in the opposite direction.

Yet other times I am correct in identifying a chart formation, but the initial breakout is premature. Finally, there are times when I have become too short term in my orientation and what I believe is a signal does not stand up to scrutiny in hindsight. Chart trading is an imperfect science.

It is tough to be perfect when trading imperfect markets. It is impossible to be right on every interpretation and then be right on every entry. The result is that many trades become throwaways. Even when I am dead-on in interpreting a chart formation, it may require more than one attempt to get successfully positioned.

[Table 5.1](#) is the idealized construct of the Factor Trading Plan over the course of a typical year.

TABLE 5.1 Trading Events by Category and Type of Trading Signal

Trade Signal	Annual Goal (Number of Successful Trades)	Number of Attempts to Reach the Annual Goal
Major patterns — breakout (weekly charts)	10	30 patterns with an average of 1.5 entry attempts each to catch the 10 that will be successful (45 trading events)
Major patterns — anticipatory (daily charts)	10	1.5 attempts in 20 weekly chart pattern situations that offer the opportunity for an anticipatory position (30 trading events); not all major patterns will offer this opportunity
Major patterns — pyramiding (daily charts)	10 (or one pyramiding opportunity in each of the successful trends)	Two pyramid attempts in 15 developing trends (30 trading events—includes pyramids on trends that end up failing); not all major signals produce trends where pyramid opportunities even develop
Minor patterns (continuation or reversal)	20 (or one clearly defined daily pattern that works in each of 20 markets monitored for this opportunity)	With false or premature signals, need to take three patterns in 20 markets monitored (60 trading events)
Instinct trades	20	40 trades to gain 20 winners
Miscellaneous	Trading situations that made absolutely no sense whatsoever with the benefit of hindsight	30 trading events, of which five may be profitable through luck

Summarizing [Table 5.1](#), to accomplish the goals of the trading operations annually, an anticipated 235 trading events will occur, or approximately 20 per month, or eight trading events per market per year. At an average of one contract per trading event per \$100,000 of capital, a total of 235 contracts per \$100,000 of capital will be traded each year (or 2,350 contracts per \$1 million).

Built into the volume of 235 trading events represented by [Table 5.1](#) is the expectation that 75 trades (or 32 percent) will be profitable over the course of a typical year (whatever typical is). Yet, over a shorter period of time and number of trading events, it is possible that only 15 or 20 percent of trades may be profitable.

Bottom Liners Defined

I use a concept I refer to as *bottom line trades*, or *bottom liners*. Imagine for a minute that I would stack into a pile the profit-and-loss (P&L) statements for every trade I have ever made. The stack over 30 years would be quite high (my guess is 20 to 30 reams of paper). Next, I know what my total net bottom line has been as a trader through the years.

Now imagine if I would remove P&L statements one by one starting with the largest single profit, the next largest profit and so on, in descending order. The point at which the cumulative total of the removed P&L statements match my net performance is termed the *net bottom line* trades. As a historical average, about 10 percent of trades represent my net bottom line. Based on the framework of annual trading presented in [Table 5.1](#), about 20 trades (or less than two per month) will establish my bottom line during any given year. The other 215 trades each year will wash each other out—these trades will be throwaways.

When I conduct monthly, quarterly, and annual analyses of my trading, some of the more important metrics I look at are:

- Proportion of trades falling into each category—and the win/loss ratio within each
- The proportion of total trades that are profitable
- A measure of the net bottom liners
- Average profit per profitable trade and average loss per unprofitable trade

I have laid out the key elements of the Factor Trading Plan. But a plan is just a plan until it is implemented. Next, I will explore matters dealing with tactical implementation.

Trade Entry

Trade entry is such a vital component that Chapter 6 is entirely devoted to the topic. I am briefly mentioning the component here for the sake of flow only. Examples of actual trade entry will be found in Chapter 6.

I enter nearly all trades using stop orders, meaning that I buy strength and sell weakness. More precisely, once a chart pattern meeting my specifications becomes clearly identified, I place orders to take a position in the direction of the pattern completion—in other words, to go with a breakout.

I have developed a number of trading rules and guidelines over the years based on my experience of how chart patterns are supposed to behave. These rules are not a magic potion, but represent “best practices” to impose discipline on myself. Without such discipline I would likely evolve into a loose cannon and degenerate into knee-jerk emotional market maneuvering. I find the markets compelling. It would be extremely easy for me to lose the forest from the trees if I do not closely monitor my trading. Losing the forest from the trees—becoming too focused on shorter-term patterns and lacking patience to wait for really big patterns to develop—is my single biggest challenge as a trader.

Trade Risk Management

Trade risk management deals with how I manage a trading event once I have entered the trade. There are several elements to managing a trade.

Leverage

Leverage deals with how many contracts I enter per \$100,000 unit of capital. Keep in mind that I limit my risk per trade to eight-tenths of 1 percent and often as little as one-half of 1 percent of assets. The leverage is determined by the price of entry and the price of the initial protective stop. For example, assume I enter a trade in T-bonds and my initial risk is more than a full point (let’s say my short entry is at 121-00 and the initial protective stop is at 122-08). This represents a risk per contract of \$1,250. If I traded one contract per \$100,000, the risk would equal 1.25 percent of capital, in excess of my risk management guidelines. My main option would be to trade one contract per \$200,000 (for a risk of six-tenths of 1 percent). An alternative would be to use a money management stop point representing about \$700 per contract and trade one contract per \$100,000 unit of capital.

Trade risk management deals with the percentage of assets I am willing to risk in any given trade, how I determine leverage (the number of contracts per specified unit of capital), and where I place an initial stop-loss protective order. These determinations guide the maximum risk taken on any given trade.

Setting the Initial Protective Stop Price

My preference is to use the Last Day Rule to determine the protective stop

placement. See Chapter 3 for an explanation and examples of the Last Day Rule. There are instances when I select an initial stop that is different than the Last Day Rule. Fully explaining these instances is beyond the scope of this book.

Moving the Protective Stop and Exiting a Trade

Once a position has been established and the initial protective stop has been set, there are a number of techniques used by the Factor Trading Plan to exit a trade.

In nearly all cases, trade profits are taken if a market reaches the target implied by the pattern that launched the trade. Stops are also advanced in the direction of the position using several methods, including the Retest Failure Rule, the Trailing Stop Rule, and the Intervening Pattern Rule. Explanations and examples of these methods to move protective stops are found in Chapter 3.

Trade Order Management

Whereas trade risk management deals with the determination of the risks and leverage taken on any trade or combination of trades, trade order management deals with the actual physical process of entering and exiting trades.

My job as a trader is really nothing more than that of a glorified order placer. At its irreducible level, trading is basically the process of entering orders. I have no control over what the markets do. The real challenge of trading is to identify the controllable factors and build into the trading process means to control what can be controlled. The markets will do what the markets will do whether I buy, sell, hold, or do nothing. At the end of the day, the only control I have is over the orders I enter.

I will divide this section into trade order management on positions being considered for a new entry and trade order management on existing positions.

Entering New Orders

I review the weekly charts for about 30 different markets once each week—usually late Friday afternoon or early Saturday morning. This review gives me a good idea of any new developments taking place in the markets and if there are any new potential trades on the horizon.

The types of weekly chart patterns I want to trade take a very long time to develop. In fact, there are only about two to three significant weekly chart

patterns that qualify an individual market for a trade in any given calendar year. Finding more than three weekly chart patterns in a specific market even during a strongly trending year would signify that I might be reading more into the charts than I should.

By early Saturday afternoon, I have a pretty good idea if an entry trade will set up in the coming week in any markets. Usually, I see weekly chart patterns develop many weeks, and sometimes months, before an actual pattern is completed. This is a problem because once I see a pattern developing, I become anxious to become involved. This is where patience comes into play.

I print off weekly charts (and accompanying daily charts) that might offer a trading opportunity for the coming week. In addition to the many wonderful online charting packages available (I use three different web-based programs), I maintain printed hard-copy charts of the markets I am either in or looking to enter. Part of this exercise is because I was weaned on paper charts. I find that actually drawing in price bars by hand each day puts me in better connection with the markets than scrolling through updated charts on the Internet.

Next, I turn my attention to the daily charts. I pay particular attention to the markets identified by my review of the weekly charts, although I look at the daily chart of the active contract of every market in which I would consider a trade.

While my bias is to focus on weekly charts, daily charts provide more trading opportunities than revealed by the weekly charts.

If a daily chart trading opportunity develops during the week, I will print out a hard copy of that chart. At about 2 PM Sunday, I gather the charts printed the previous day. It is at this time I determine the entry strategy, risk parameters, and leverage I will use for each market, assuming that a pattern breakout occurs. I launch the online trading platforms I use and begin placing entry orders and setting up trading alerts so that I will automatically be notified if any of my entry orders are executed.

I most commonly use good-until-canceled (GTC) open orders to enter and exit trades. Some markets are notorious for running stop orders during the nighttime hours. I carefully avoid entering GTC stops in the night sessions in such markets as the mini metal contracts, grains, softs, fiber, and livestock (which I seldom trade anyway). I use day orders in these markets, each day entering the orders when the normal daytime trading hours commence.

By the time the Sunday afternoon markets open, I have just about completed

all of my order entry for new positions. Orders I do not place on Sunday afternoon (such as stops in thinly traded electronic markets) are placed early on Monday morning. I am normally awake and have checked Asian and European trading by about 3:30 AM mountain time. I am not a very good sleeper.

The exact time a trader does certain tasks and the process used are not important. I do certain things at certain times in certain ways because it works for me. The point is that a trader needs to develop a disciplined routine. The time of an action is less important than the action itself.

In addition to trading, I am a private pilot. Pilots go through a routine checklist during each phase of a flight—from preflight to postflight. A trader needs a similar routine.

In general, only a few new entry opportunities will develop during the trading week. It is a harsh truth that those trades I “discover” during the week (i.e., trades I had not seen coming the previous weekend) have probably been net losers over the years.

Different online trading platforms offer varying capabilities. My preference is to use trading platforms that offer the ability to place contingency orders. This means that if entry order using a stop is filled, then a protective stop-loss order will be placed automatically without my direct involvement. Without the ability to place contingency orders I would need to pay attention to the markets during the trading session. I will emphasize repeatedly during the course of this book that I want distance between myself and the markets during the trading day.

The more I follow the markets during the trading hours, the more apt I am to make an emotionally driven decision to override my trading plan. I know myself too well, and I know that my emotional reactions to intraday trading will be detrimental to my net bottom line over any period of time. Controlling my emotions is the biggest challenge that faces me as a trader. And this is a battle that never ends.

Existing Open Positions

Among all aspects of my trading, this is the one area that causes me the most aggravation and stress. How to handle a trade that immediately moves in the intended direction is the single most difficult aspect of trading, in my opinion. I lose sleep over this trading challenge. It is this component that I am most tempted to tweak at any given time based on trades that immediately preceded the moment.

It is easy for me to enter a trade, easy to take quick losses on trades that never work, easy to take pyramid trades, and easy to take profits at targets, but enormously difficult to deal with profitable trades that are somewhere between the entry point and the target.

At its most basic level, managing an open trade boils down to a balance between protecting a profit and allowing a trend the opportunity to run its course as implied by a completed chart configuration.

The process of entering orders on exiting positions is similar to that of the order flow for new trade entries. For every position held, two orders are in place in the market—a “limit” order for taking profits at the target and a stop order for exiting the trade if it turns against me. These two orders are commonly known as OCOs—one cancels the other. Within minutes of entering a new trade, I place both of these exit orders.

Each afternoon, I review the daily charts for each market in which I carry a position and make a determination whether any order should be modified. Most modifications occur during the late afternoons between the end of the day session when the closing prices are established and the beginning of the evening session, which represents the start of the next day’s trading schedule.

Chapter 6 provides numerous specific examples of the tactics used in trade management by examining actual case studies.

Best Trading Practices

Best practices are those things that would contribute positively to a net bottom line over an extended period of time if followed habitually. Worded in the opposite way, not doing the best practices will likely reduce profitability. Maintaining and reviewing a list of best practices can keep a trader grounded in a right mind-set. Best practices vary from trader to trader. My best practices would include the following items dealing with order management:

- Review weekly charts only on Saturday when the markets are closed.
- Scroll through every market that I consider trading. Use the weekly rollover continuation charts as well as the weekly chart of the most actively traded contract month in the case of futures markets.
- Look at daily charts only once each day—during nontrading hours.
- Place entry orders only once each day and do *not* second-guess the original order once the trading session begins.
- Avoid intraday charts. Avoid watching markets during the trading day.
- Do not pay attention to any other trader or analyst. Base my trades on my own approach.

Points to Remember

- A trader must have an organized method to resolve what constitutes a trading signal. Time phasing is a hurdle all traders must clear in order to be consistently successful.
- A trader must have a framework that defines an overall trading plan, including how to enter trades and how to determine the risks involved. Most professional money managers risk no more than 1 percent on each trading event.
- A strategy for exiting trades must be part of a trading plan.
- A trading plan must address the issue of risk management, namely, what proportion of capital will be risked on any given trading event.
- A trading routine, especially analysis and order entry, should be developed and followed.

Chapter 6

Three Case Studies Using the Factor Trading Plan

This chapter presents case studies of actual markets traded in 2009 by the Factor Trading Plan to illustrate the rules, guidelines, and principles introduced in earlier chapters of the book.

This chapter will use completed charts to answer such questions as:

- What does a trading signal looks like?
- How is a signal generated within the trading plan?
- How do I determine the placement for initial protective stops?
- How do I determine the number of contracts (i.e., the leverage for the trade)?
- What guidelines do I use to advance stops in the direction of a profitable trend?
- What provision is made for pyramiding a trade, and how does it work?
- How do I take profits?

The three case studies in this chapter include a particularly memorable and significant technical event producing two trades in the Dow Jones Industrial Average (DJIA) contract, a full year of trades in gold, and finally, a full year of trades in sugar.

These case studies were selected because they were markets in which I was active in 2009 and a variety of trading situations were presented. Gold and sugar were not typical markets in 2009. In fact, gold produced one of the best trades of the year and sugar was my single most profitable market for the year. I could have presented a case study in a market like the euro currency and U.S. dollar cross rate (EUR/USD) but chose not to. For the purpose of full disclosure, please know that there were some markets that completely frustrated me in 2009.

A Remarkable Technical Event in the Dow

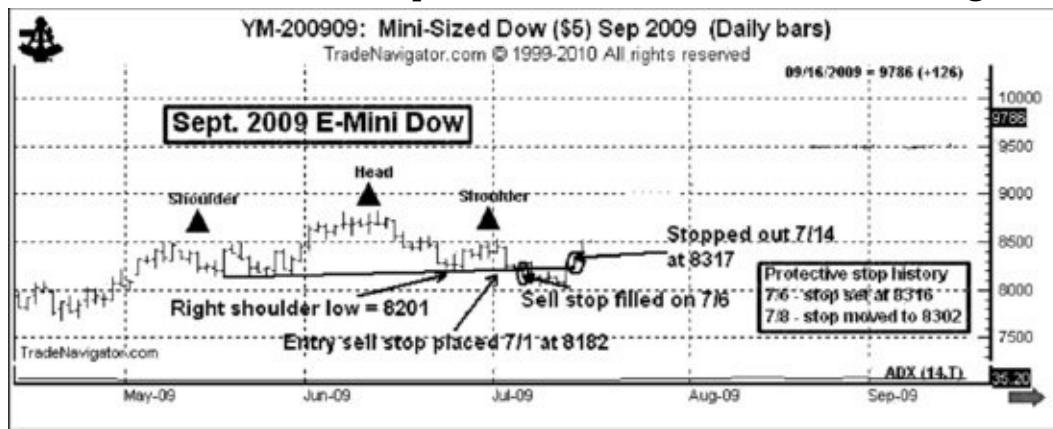
Jones

The DJIA produced a short trade followed by a long trade that will be featured in future textbooks on classical charting principles. A short trade is one in which a trader bets on a price decline. A long trade is one in which a trade bets that prices will climb. In forex and commodities, the sequence in which a trader buys and sells does not matter. A short position is established when a trader sells first, hoping to profit when a buy is made at a lower price. The opposite is true for a long position.

Short Trade: July 6, 2009

Once I identify a pattern that qualifies as a candidate trade, I place an entry order on my trading platform. [Figure 6.1](#) shows the September 2009 contract of the Mini Dow Jones. On July 2, I identified a possible H&S top. I immediately placed an order to short the market if the neckline and right shoulder low were penetrated. My sell stop was at 8182. I became short on July 6.

[**FIGURE 6.1**](#) An H&S Top in the Dow Jones Industrial Average.



The primary method used to establish the initial protective stop is the Last Day Rule. This rule is based on the assumption that the breakout day is sacred and that the high of a downside breakout day or the low of an upside breakout day will be the demarcation point between the trading range of the pattern and the start of a sustained trend. As a very general rule, I risk a short trade to above the high of the day during which the breakout occurred (or to below the low of the upside breakout day). When very little of the bar of the breakout day is above the boundary line, I may elect to revert to the day prior to the breakout day to determine the Last Day Rule.

When the September Mini Dow broke out on July 6, only 30 points existed

above the neckline of the H&S top. So, I elected to use the previous day's high and selected a stop of 8316, representing a potential loss of \$670 per contract.

I shorted a single September Mini Dow contract per \$100,000 of capital based on my normal risk tolerance of approximately six-tenths to eight-tenths of 1 percent.

I use the targeting methods detailed by Edwards and Magee in *Technical Analysis of Stock Trends*—a market breaking out of a chart formation will trade a distance equal to the height of the pattern itself. The high of the head within the H&S was 8828. The low of the right shoulder was 8194. The difference of 634 Dow points projected down from 8194 yielded a target for the trade of 7560. When I was filled on my short, I immediately entered an open order to cover the short at 7561.

My short position closed against me the very day I entered it. This is never a good sign. My historical bottom line would be greatly improved if I immediately had exited every trade that ever closed at a loss. Yet, the following day, July 7, the market dropped throughout the day and closed decisively below the neckline of the H&S top. This gave me a renewed cause for optimism. It also gave me an ability to move my protective stop to 8302, just above the July 7 high, a revised Last Day Rule. The market stopped me out on July 14 to officially end the trade, called the original H&S interpretation into doubt, and set the stage for a long position.

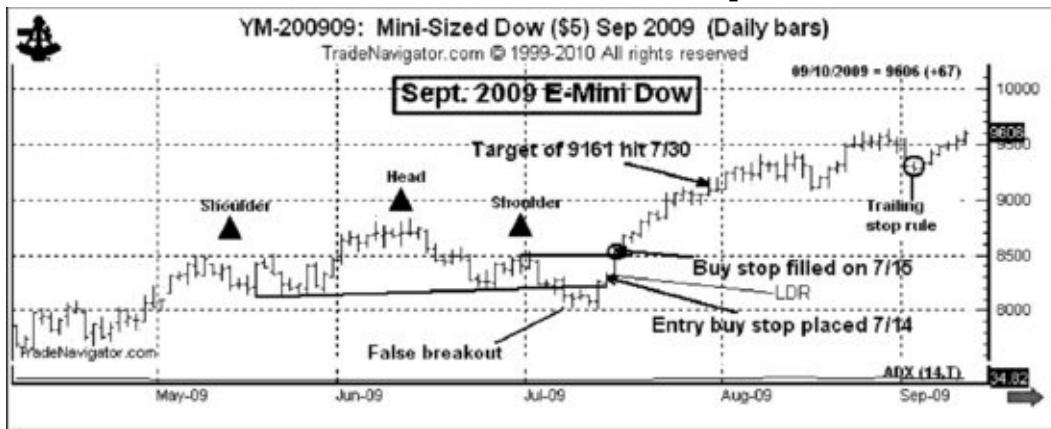
I should have known that the H&S top was suspect—the pattern was being discussed frequently on CNBC. Patterns being acknowledged as conventional wisdom normally do not work out as planned.

Long Trade: July 15, 2009

A pattern that I have found to be quite tradable in commodity futures and forex markets is the H&S failure. I consider this to be a pattern unto itself. The H&S failure pattern starts with a recognizable H&S formation. Whether the H&S is completed with a minimum of follow through (as in the case of the Dow) or the right shoulder begins to form but does not break the neckline, the signal is generated when the market climbs above the peak of the right shoulder of the H&S top (or declines below the right shoulder low of a H&S bottom).

After being stopped out of my short September Dow on July 14, I immediately placed a buy stop above the right shoulder high. As seen in [Figure 6.2](#), it was filled the very next day, July 15, at 8568.

FIGURE 6.2 Textbook H&S Failure on the September DJIA Chart.



The Last Day Rule was based on the low of July 14 at 8327. I set my protective stop at 8319. The risk from 8568 to 8319 was \$1,245 per contract, far greater than my desired risk of about \$700 per capital unit of \$100,000. So, I was faced with one of two decisions: to use a money management stop rather than the Last Day Rule or to restrict leverage to one contract per \$200,000. I chose the latter option. By risking a position of one-half of a contract per \$100,000 to 8319, my risk level was about six-tenths of 1 percent (\$1,245 divided by 2).

The objective of an H&S top failure is determined by projecting the height of the H&S upward from the high of the right shoulder. In this case, I projected the height of the original H&S of 634 points upward from the July 1 right shoulder high of 8527, producing a target of 9161. This target was met on July 30. In the case of the long trade in the Dow, the profit was \$3,100+ per contract, or \$1,550 per \$100,000 unit of capital.

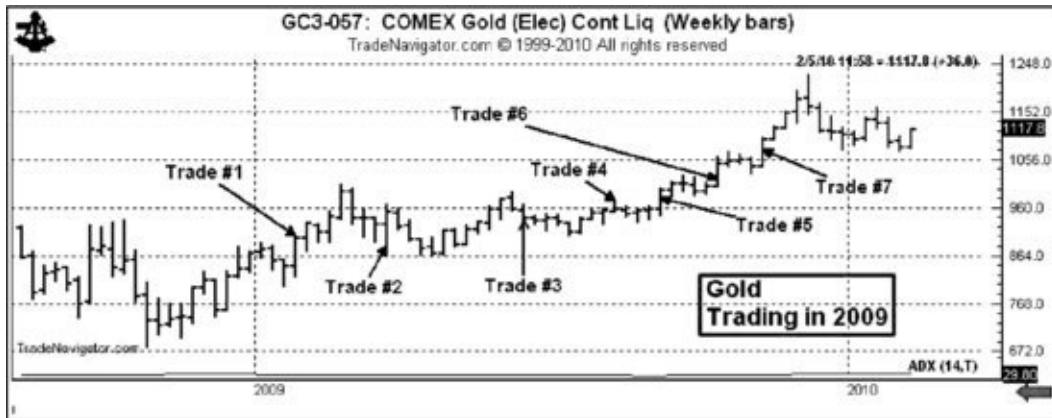
There is an overpowering temptation to remain involved with a market that just provided a nice profit. The emotion of greed almost demands an immediate re-entry into the trade lest money be left on the table. When facing this emotion I need to remind myself that there will be new opportunities next week, next month, and next year. Discipline demands that once I exit a trade I need to go shopping in a different market. Incidentally, rather than taking profits at the target I could have elected to use the Trailing Stop Rule, which was triggered on September 2.

A Year Trading Gold

In 2009, the Factor Trading Plan entered seven trades in gold. Even though I traded the individual futures contracts, for ease I will trace the trading history on

the weekly and daily continuation charts. [Figure 6.3](#) displays an overview of my year of trading gold.

FIGURE 6.3 Gold 2009 Trades.



On January 23, I entered a long gold trade as the market broke out of an H&S bottom and trend line dating back to July 2008. See [Figure 6.4](#). I bought a mini contract (a total of 33 ounces) of April gold at 884.2 per \$100,000 of capital. My initial stop was just under the Last Day Rule at 853.8 with a risk on the trade of about 1 percent of assets.

FIGURE 6.4 Gold Trade #1—H&S Completed in January.



I made mistakes on this trade. My interpretation was very flawed. A legitimate H&S pattern occurs when the head and both shoulders are singularly part of a process by which “strong hands” are distributing or accumulating a position. In hindsight, the right shoulder in January was probably disconnected with the left shoulder of September 2008. I think I was probably just looking for an excuse to be long gold. An H&S configuration that comprises just a portion of a more extensive trading range should always be treated as suspect. I tend to go in streaks with my interpretations. For a while, I see H&S on most charts I study,

then for another period of time I see wedges everywhere I look, then it might be triangles, then channels.

I exited the trade on February 25 at 958.2 using the Trailing Stop Rule. [Figures 6.5](#) and [6.6](#) display the three-step process of the rule.

FIGURE 6.5 Gold Trade #1—Trailing Stop Rule in Gold.

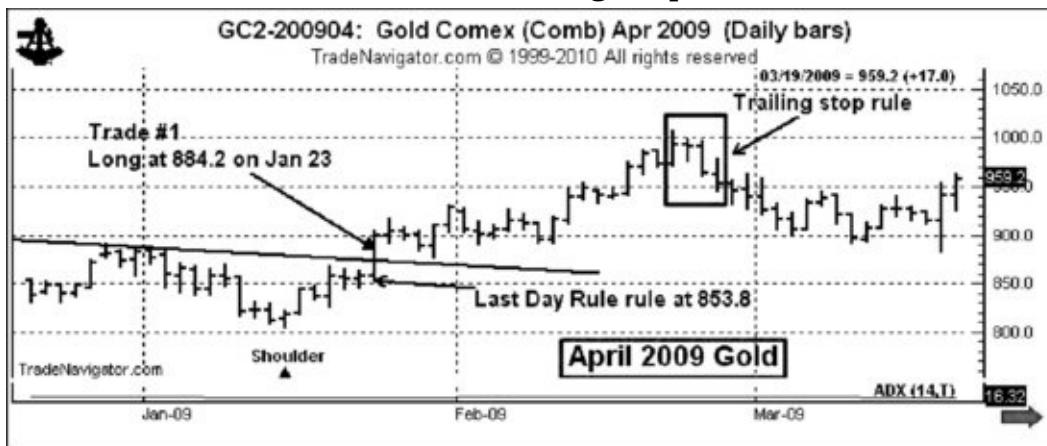
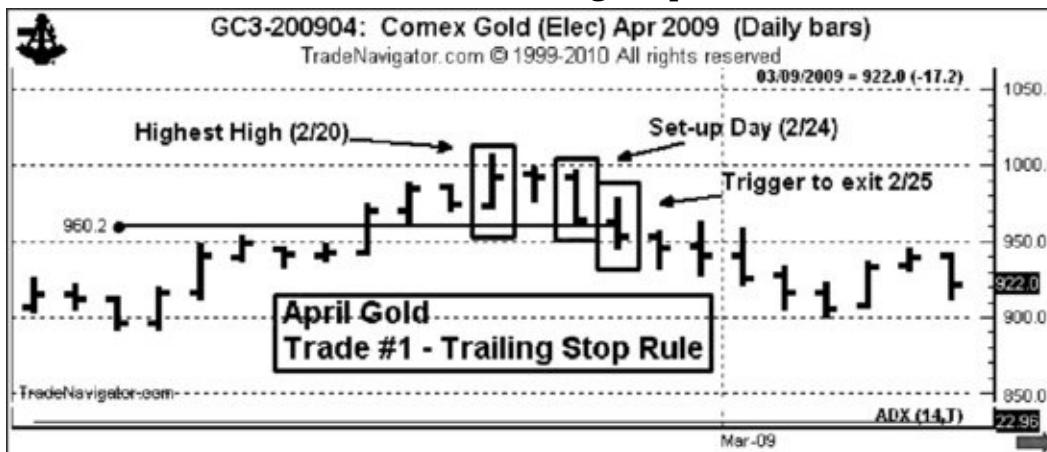


FIGURE 6.6 Gold Trade #1—Trailing Stop Rule Demonstrated.



A Government Report Causes Volatility and a Quick Loss

Several times per year a market will spin me faster than I know what is happening. This was just such a case, as shown by the out-of-line movement in [Figure 6.7](#).

FIGURE 6.7 Trade #2—An Out-of-Line Movement in Gold.



On March 18, I was stopped into a short position at 888.7 when the market sliced through the neckline of an H&S top early in the session in response to a government report.

The Last Day Rule at the time of the fill was at 916.3, but I used a money management stop of 900.7 in order to extend my leverage to two mini contracts per \$100,000. I was risking about eight-tenths of 1 percent on the trade. I was literally stopped out within minutes. Back in the “good old days” of pit trading, I remember at times getting back a fill on my protective stop before getting the fill on the entry order. Talk about adding insult to injury!

Trading a Short Position on a Small Pattern

Keeping with my obsession over H&S patterns, I shorted one contract of August mini gold on June 12 at 942.4 (see [Figure 6.8](#)). This was way too small a pattern for me to be trading and was a violation of my basic guidelines.

FIGURE 6.8 Trade #3—A Small H&S Pattern in Gold.



Knowing that this was not a good trade, I jammed my protective stop, exiting

the trade with a very small profit on June 24. I considered myself lucky for cheating my rules on the required duration of an acceptable daily chart reversal pattern.

Another H&S Pattern Fails

Continuing the H&S theme I went long mini gold on August 4 based on the completion of a seven-week H&S bottom with an upslanting neckline, as shown in [Figure 6.9](#). On August 6, the market had a hard intraday retest of the H&S pattern. I adjusted my stop to just below the August 6 low based on the Retest Rule. I was stopped out for a six-tenths of 1 percent loss on August 7.

[FIGURE 6.9](#) Trade #4—Another Failed H&S in Gold.



I hope these case studies are communicating a message I want to send clearly—that trade entry signals are relatively unimportant to my overall success. What I trade—indeed, what I call an entry signal—is secondary to money and risk management. Trade selection is highly overrated.

Spotting the Big Move

In early August, it was becoming apparent that something big was just around the corner in gold. The weekly chart displayed a massive inverted continuation H&S pattern, as shown in [Figure 6.10](#). This rare pattern was discussed briefly by Edwards and Magee in *Technical Analysis of Stock Trends* and earlier by Schabacker in *Technical Analysis and Stock Market Profits: The Real Bible of Technical Analysis*.

[FIGURE 6.10](#) Trades #5 and #6—H&S Pattern on Weekly Gold Chart.



Further, the right shoulder of the H&S was taking the form of a six-month symmetrical triangle. The triangle had six significant contact points (labeled A-F in [Figure 6.11](#)). I get very excited when I see markets set up in such a magnificent way.

FIGURE 6.11 Trades #5 and #6—A Massive Symmetrical Triangle Serving as the Right Shoulder on the Gold Chart.

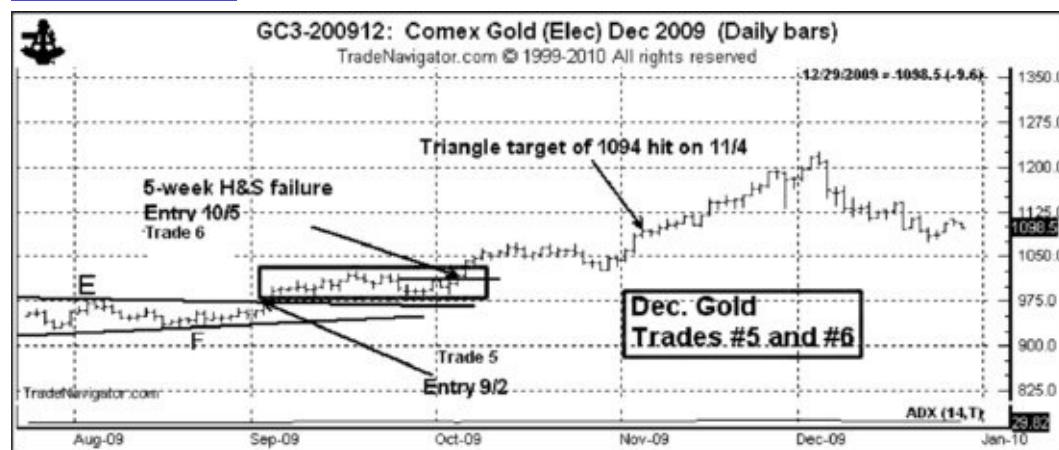


The advance on September 2 penetrated the upper boundary of the triangle and then rose above the last defining high within the pattern (point E). I went long December gold at 978. The objective of 1094 was determined by extending the distance from B to C upwards from E. Calculating the A to B distance would have also been acceptable. While I took profits at the target on November 4, the Trailing Stop Rule would have kept me in the trade until December 7. I could have gained another \$45 per ounce—there is always another case of coulda,

woulda, shoulda!

It is important to note that the lows of the breakout day of September 2 and the upthrust day of September 3 were never challenged. This is often the case with a substantial and valid breakout. Immediately following the breakout, the market drifted sideways for a month. In the process, the market appeared to be forming a small H&S top. I even advanced the protective stop on a portion of my long position to below the neckline of this small pattern (see [Figure 6.12](#)). On October 5, the market advanced through the existing right shoulder high of this small H&S pattern, providing a pyramid signal at 1014 with a target of 1050 (met quickly on October 8). I chose not to take profits at the target. Again, note that the Last Day Rule, the low of October 5, was also never challenged.

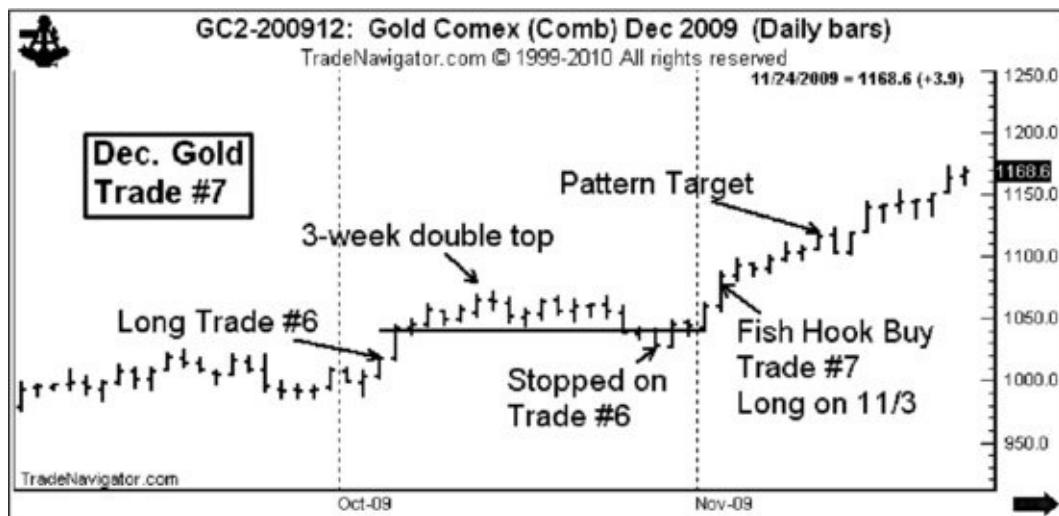
FIGURE 6.12 Trade #6—A Small H&S Failure in Gold.



The Gold Market Throws a Curve Ball

Seldom does a trade go from entry to the target without difficulty and challenge. The best laid plans of mice and men! Such was the case with the pyramid position established at the breakout of the four-week H&S failure on October 5 (trade #6). I chose not to take profits on this trade at 1050. Then, the decline on October 26 completed a small double top and placed the run for the glory into question. The October 26 decline was also a setup day for my Trailing Stop Rule. October 27 was the trigger day for the Trailing Stop Rule, but I did not jam my stop until the next day, when I was stopped out near the low of the bull market correction, as seen in [Figure 6.13](#).

FIGURE 6.13 Trade #7—Fake-Out in Gold.



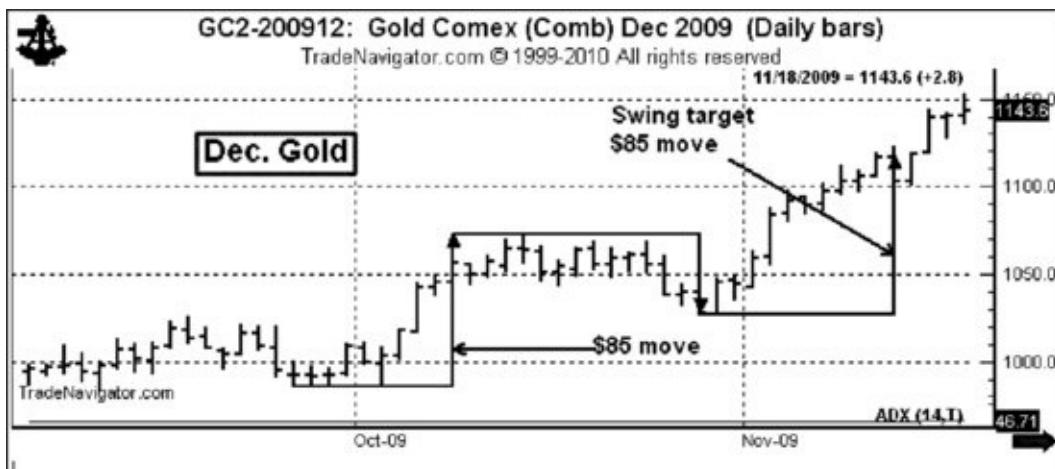
This situation created one of the most difficult challenges facing a trader—what to do when stopped out of a successful trade prior to the attainment of a much larger target. Unfortunately, there are no easy answers to this challenge, but there are some lessons.

Within days of completing the three-week double top, the market returned to its dominant bull trend. This raised the real possibility that the small top was a bear trap. It also established the possibility that the market was creating a fishhook buy signal. This is not a Magee and Edwards pattern, but something I have observed in my years trading chart patterns. A fishhook signal occurs when a pattern quickly fails followed by an immediate trend back into the failed pattern. The dynamic behind a fishhook buy signal is that weak longs get stopped out.

Markets almost always force sold-out bulls to chase a trend. The first real sign of a fishhook buy signal was on November 2 when the entire trading range was above the lower boundary of the three-week double top and the market closed near the high. I could have reentered at this point, but I stubbornly waited for a new high on November 3.

Fishhooks most often signal halfway moves that can be projected using swing targeting (see [Figure 6.14](#)).

FIGURE 6.14 A Swing Target in Gold.



The advance from the October 2 low to the October 14 high was approximately \$85. Projecting this amount upward from the October 29 low of 1027 yielded a target of 1112, met on November 12.

Lessons from Trading Gold in 2009

I hate being jerked around in the markets. I hate buying at the top end of a trading range and selling at the bottom end. I hate false breakouts. I dread being right on the direction of a market but losing money by getting whiplashed in the process. This can happen if I get stopped out of a long on weakness, reenter on strength, get stopped back out on weakness, and so on. It is possible to lose \$50 per ounce in a \$20 trading range in gold and end up correct on the subsequent direction.

A choppy market does damage financially. Choppy markets can impose emotional and confidence consequences on a trader that are far worse. I can't remember all the times I have missed really big moves because I was gun shy from a period of choppiness that preceded the big moves.

The biggest temptation after a premature stop-out is to get right back in before receiving another solid signal. Getting into this cycle throws discipline and patience right out the window. I got lucky on trade #7 in gold. Had this trade slapped me around, my head would have really been screwed on wrong.

The second lesson is that smaller reversal patterns, such as the little double top, are not likely to provide a serious threat to a trend that began with a strong thrust out of a substantial pattern (the triangle in the case of gold), especially when the market has a great distance to go to reach the implied target.

[Table 6.1](#) summarizes the gold trading signals in 2009.

TABLE 6.1 Record of Gold Trading Signals in 2009

Signal #	Pattern	L or S (contract month)	Entry Date/Price	Exit Date/Price	Resulting Move per oz.
1	Six-month H&S bottom	L (Apr.)	1/23 at 884.2	2/25 at 958.2	74
2	Six-week H&S top	S (Apr.)	3/18 at 888.7	3/18 at 916.4	(28)
3	Four-week H&S top	S (Aug.)	6/12 at 942.4	6/24 at 938.7	4
4	Seven-week H&S bottom	L (Dec.)	8/4 at 967.2	8/7 at 955.4	(12)
5	Six-month symmetrical triangle	L (Dec.)	9/2 at 978	11/4 at 1094	116
6	Four-week H&S failure	L (Dec.)	10/5 at 1014.4	10/28 at 1028.6	13
7	Six-month symmetrical triangle, failure of three-week double top, new highs	L (Dec.)	11/3 at 1076.2	11/12 at 1112	35
Total				202	

The target of the 1320 from the inverted 18-month H&S on the weekly chart has not been met as of this writing in January 2010. This fact has imposed a bullish bias on my view of gold.

I waste a lot of ammunition by taking trading decisions within broader trading ranges—by not waiting for the decisive breakout. This was the case for the first four gold trades in 2009. It was not until the trades #5 and #6 that the market was really breaking out of a major pattern. Trade #5 was really the only trade worthy of the Best Dressed List.

Exiting a Trade

There are six general conditions I use to exit a trade once it has been established: two with the trade at a loss and four with the trade at a profit.

At a Loss

1. The chart pattern breakout I use to enter the trade is either a failure or a premature breakout. The market reverses and penetrates my Last Day Rule stop (or money management stop if used instead of the Last Day Rule for risk management reasons. (See Figure 6.7 for an example.)

2. The breakout fails to provide immediate thrust in the direction of the trade. Within days (per perhaps a week or so) the market experiences a hard retest of the pattern, penetrating the boundary line used to enter the trade. If a hard retest occurs, I may elect to adjust my protective stop in relationship to the hard retest. (See Figure 6.8 for an example.)

At a Profit

- 1.** At the target. I normally take profits at the target indicated by the chart pattern used to initially establish a trade. (See Figures 6.11 and 6.14 for examples.)
- 2.** Successful trades often develop smaller chart patterns during the course of a trend. Depending on the nature and duration of these continuation patterns, I may even pyramid a trend. I will also use the Last Day Rule of a continuation pattern to advance the protective stop on the initial position in the direction of a successful trend.
- 3.** Prior to the attainment of a target, a market may form a pattern with implications counter to the position. In other words, an intervening pattern indicates that a reversal of trend is possible. I may elect to advance my protective stop in relationship to this intervening pattern. (See Figure 6.13 for an example.)
- 4.** At any time during the course of a trend, I may choose to elect the Trailing Stop Rule. (See [Figure 6.5](#) for an example.)

A Year Trading Sugar

Sugar was the market of my single most concentrated focus in 2009. My opinion of sugar in 2009 highlights the fact that as a chartist I am not a detached market observer. My biases often dictate my chart analysis.

Sugar was also my single most profitable market in 2009. As part of full disclosure, I want to emphasize that my trading experience in sugar in 2009 is not typical of my experience in most markets in most years. I only wish this could be the case. In fact, sugar provided nearly 40 percent of the net signal profits in 2009.

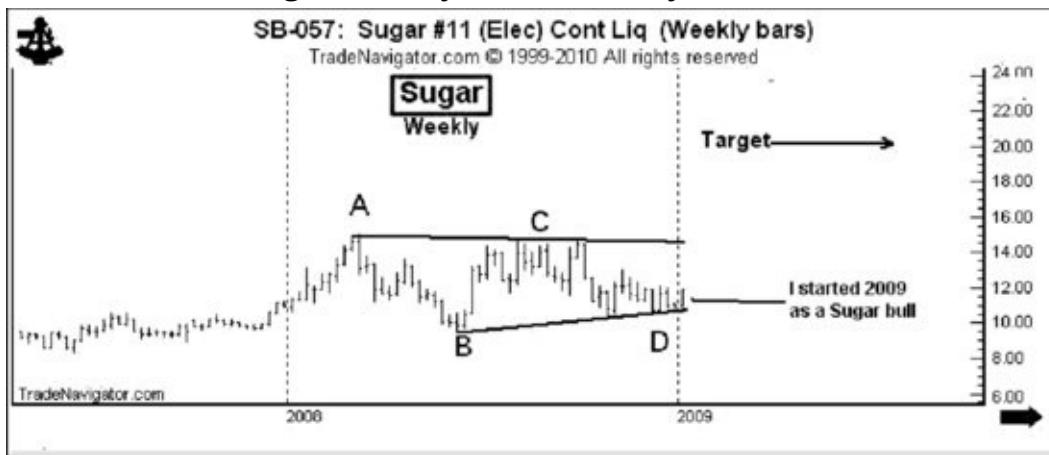
Yet the market completely frustrated my bullish bias during the first four months of the year as I lost money on trade after trade. Just because I am ready for a market to make a move does not mean that the market is ready to do so—or that it will ever be. A market could care less if I am bullish or bearish. In fact, if

I am a bull, once I do my buying, my only influence is as a bear because I become a source of selling.

Starting the Year a Bull

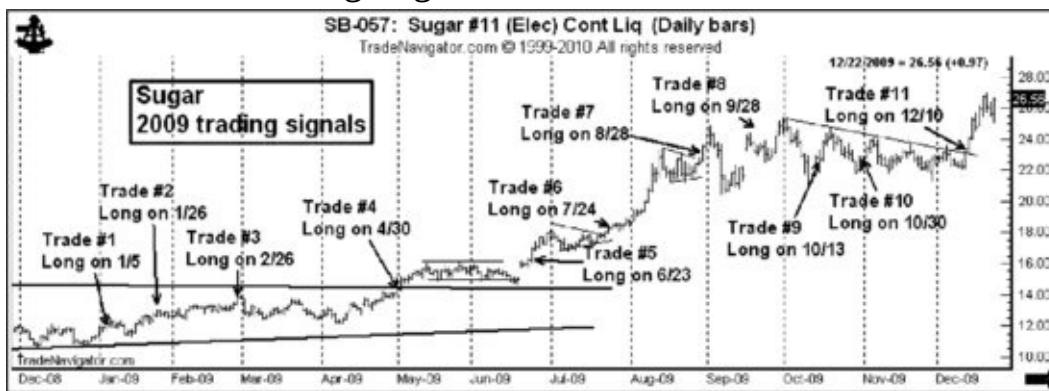
I was a sugar bull on the first day of January in 2009. [Figure 6.15](#) displays the weekly pattern I thought was dominant at the time, a possible nine-month continuation symmetrical triangle. In early 2009, the market was at the lower boundary of this triangle, so I was interested in establishing an anticipatory long position.

[FIGURE 6.15](#) Sugar Weekly Chart in Early 2009.



Little did I understand how frustrating that process would become. [Figure 6.16](#) shows a daily continuation chart listing all 11 of the Factor trading signals in 2009. My obsession with sugar resulted in far too many trades. An obsession with a market leading to overtrading has happened to me before, and it will happen again.

[FIGURE 6.16](#) Trading Sugar 2009: 11 Trades.



Three Losing Trades Started the Year

[Figure 6.17](#) shows the first three trades of 2009 in sugar. All three trades were losers despite the fact I was a major bull and the market was rising. Losing money trading the long side of a rising market challenges one's durability and sanity as a trader.

The advance on January 5 completed a two-month symmetrical triangle. I chose to use the last full day within the pattern, December 30, to determine the Last Day Rule. I was stopped out on January 14 for a 67 tick loss.

FIGURE 6.17 Trades #1–3—Early Frustration in Sugar Trading.



Buying New Highs

Bound and determined to be aboard a bull market, I kept buying new highs. Normally, this is not my style. I prefer to wait for recognizable patterns. I went long on January 26 (trade #2) and pyramided the trade when the market made yet another new high on February 26 (trade #3). The nosedive on March 2 took me out of both trades, costing a total of 94 ticks. The stop on trade #2 had been moved from the Last Day Rule of January 23 to a Retest Rule below the low of February 19.

Waiting for a Substantial Pattern

After being burned by buying new highs, I decided to wait for a recognizable

pattern. And I got one in spades in late April.

For decades I have been part of an e-mail network of a dozen or so fellow chart traders. We share ideas and chart analyses. Following is the e-mail I sent the group on April 30:

April 30, 2009

A sweet trading opportunity

The longer-term charts indicate that sugar could be the trade for 2009. Several technical observations are worthy of note.

The weekly chart displays a textbook perfect symmetrical triangle dating back to March 2008. This 14-month triangle would be completed by a move above 14.72 in the nearby July contract.

This weekly chart must be viewed in the historical context of a possible base dating back to 1981. A decisive close above the 2006 high at 19.75 would establish a point and figure objective in the 60s.

The July contract today penetrated the upper ice line of a nine-week rectangle. It is not uncommon for a massive move to begin with the completion of a relatively small chart pattern such as this. Daily charts need to be combined with weekly charts, monthly charts, and even quarterly charts to develop a mosaic on market opportunities.

An e-mail update one day later, on May 1, 2009:

Today, the distant March 2010 contract strongly moved above the upper boundary of a six-month running wedge. This pattern is likely to serve as the slingshot for the bull move in sugar. This chart formation represents a very low-risk opportunity for a relatively large position.

So during a two-day period all the contracts of Sugar experienced a decisive break out (the July, October, March and continuation charts). The daily continuation and individual contract months provided slightly different pictures. The July contract completed a two-month rectangle, while the October contract completed a seven-month running wedge (see [Figures 6.18](#) and [6.19](#)). October sugar met its initial and most conservative target on June 24.

FIGURE 6.18 Trade #4—A Rectangle in July Sugar.



FIGURE 6.19 Trade #4—A Running Wedge in October Sugar.



The weekly chart triangle is shown in [Figure 6.20](#). It is always a good sign when the weekly and daily charts complete major patterns at about the same time.

FIGURE 6.20 Symmetrical Triangle Launches Bull Move in Sugar.



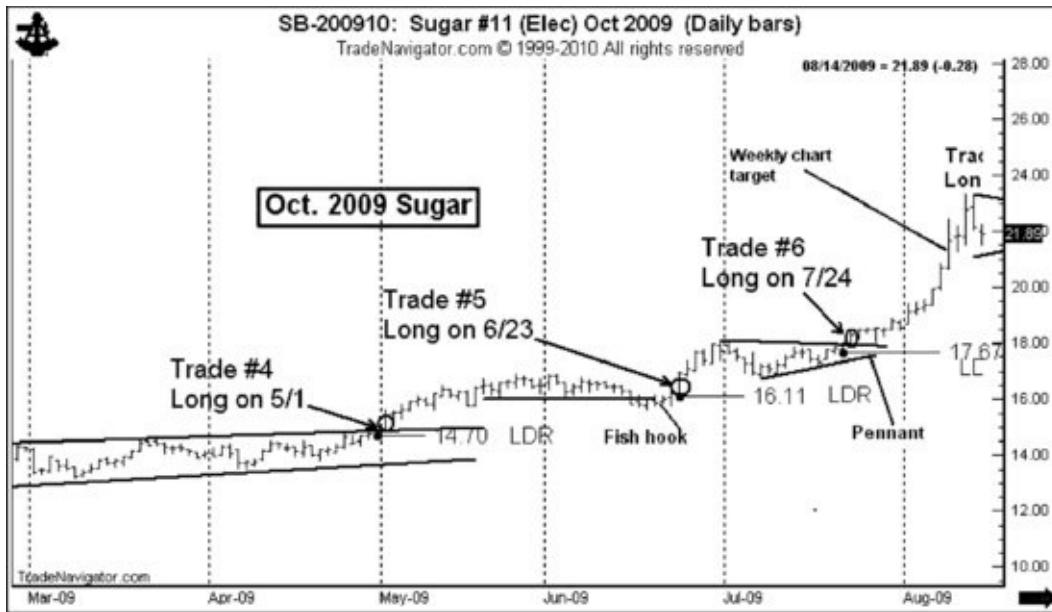
Sugar was off to the races. Importantly, because sugar was in the early stages of a bull trend, the risk was small. The Last Day Rule risk in the July contract

was 31 points, and 38 points in the October contract. This allowed me to assume larger leverage than is normal. The weekly chart gave me extra courage. If there was any doubt, the large-range upside breakout on May 1 was a Friday, a Weekend Rule. Markets that complete a weekly pattern on a Friday seldom fail.

The Market Pauses to Catch Its Breath

After its initial surge in May, the market drifted sideways for about five weeks, as displayed in [Figure 6.21](#). Then, on June 23, the October contract generated a five-week “fishhook” buy signal (trade #5), allowing me to pyramid my position, again with relatively low risk to the Last Day Rule. The target was reached on July 30.

FIGURE 6.21 Trades #5 and #6—Two Continuation Patterns during the Bull Run.



Trade #6 is a classic pennant pattern. On July 24 the market made a new high for the bull trend and penetrated a three-week pennant, another opportunity to increase leverage. Once again, the Last Day Rule was never challenged. I had a tiger by the tail.

The weekly chart target of 21.22 was reached by the October contract on August 10. I exited my position. I cannot really articulate why I sometimes use daily chart targets, sometimes weekly chart targets, sometimes swing targets and sometimes the Trailing Stop Rule. There is no formula for this decision. It is a matter of making a decision, stepping up to the line and living with the

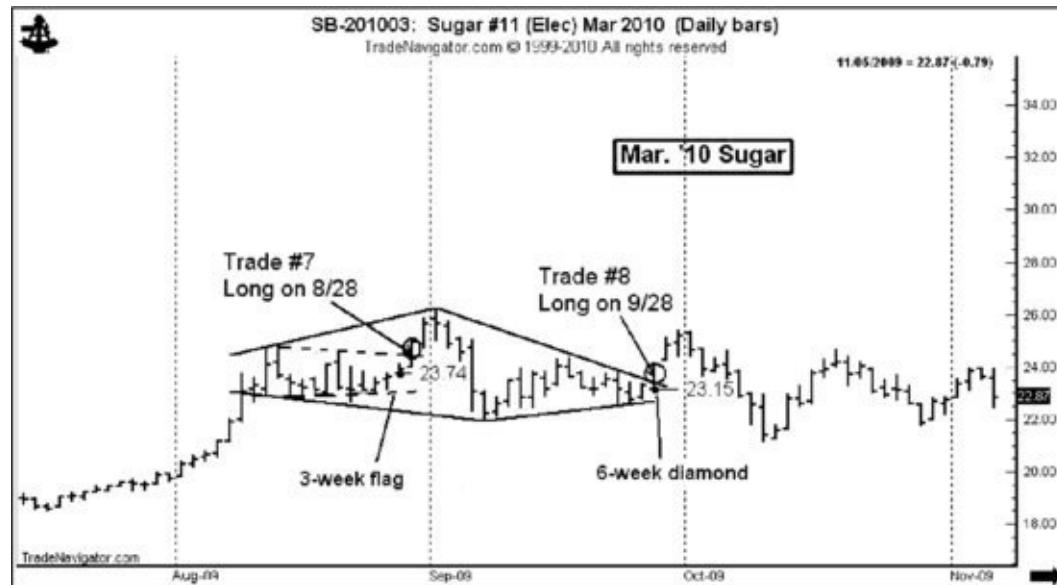
consequences.

Entering a Choppy Period

By mid-August I had exited all the positions accumulated since May 1. I was looking for an excuse to get back into the market. I was becoming concerned that sugar was headed for 60 cents without me aboard. The market did not make me wait long.

But as trading would have it, I entered a four-month period of trading frustration. It is not uncommon for markets that have had a good run to enter a period of choppiness and signal failure, as witnessed in [Figure 6.22](#).

FIGURE 6.22 Trades #7 and #8—The Sugar Market Begins a Large Consolidation.



The market completed a three-week flag on August 28 for trade #7 (see dashed boundary). My thinking at the time was that the flag was a half-mast pattern and that the market was headed straight to 30 cents. Prices spurted for two days and then rolled over, stopping me out on September 4 at the Last Day Rule. I was again out of sugar and felt as though a good friend had died.

On September 28, the market completed what I interpreted to be a six-week continuation diamond formation. I returned the long side (trade #8). The Last Day Rule stop was hit on October 7. I was once again flat.

Focused on Being Long Sugar

At this point, I became obsessed with being long sugar. Overattention to a market most often leads to foolish trades. Foolish trades lead to losses. Both trades #9 and #10 were established without the benefit of completed chart formations as shown in [Figure 6.23](#). These trades were driven by the fear of missing a move. Fear and greed are two emotions that will cost a trader money.

FIGURE 6.23 Trades #9 and #10—Sugar Trades without Clear Patterns.

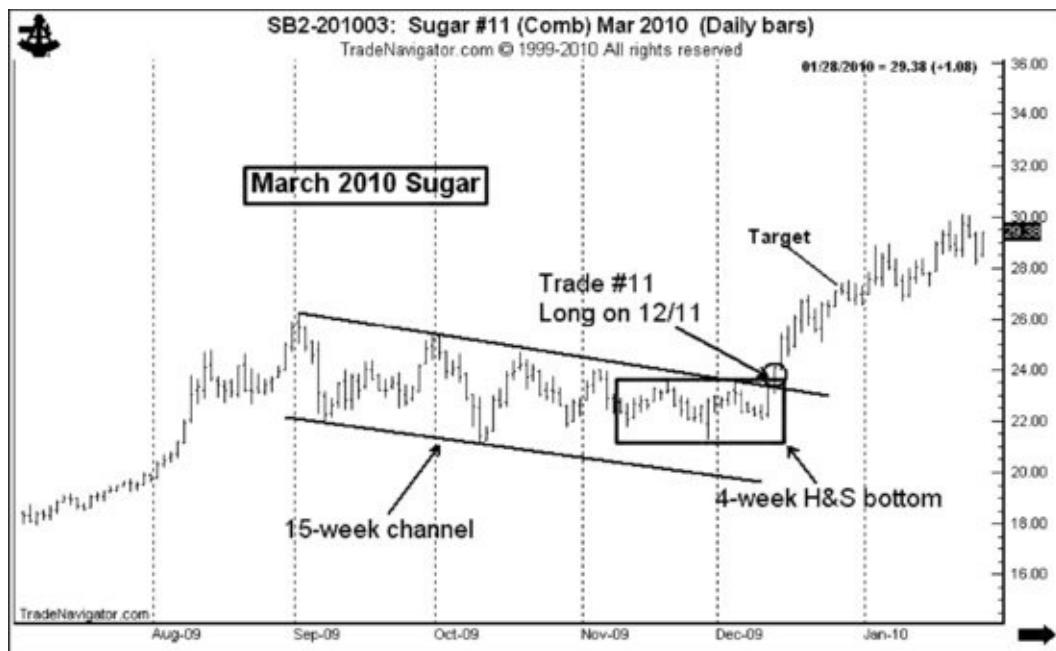


Both trades were established on days sugar rallied, on October 13 and October 30. Buying strength or selling weakness within a trading range is not a very good idea. Trade #9 was stopped out at the Last Day Rule on November 27. Trade #10 was stopped out earlier, at its Last Day Rule on November 10. Not only did I invent a reason for these trades, I also got stubborn with my money management, as highlighted by trade #9.

The Market Finishes the Year Strong

The sugar market finished the year well, getting back on track on December 11. The advance on this day penetrated the upper boundary of a 15-week channel and completed a four-week H&S bottom, triggering trade #11 (see [Figure 6.24](#)).

FIGURE 6.24 Trade #11—A Significant Buy Signal in Sugar.



As I have pointed out already in this book, smaller patterns often simultaneously launch larger patterns. Once again, the breakout was on a Friday, a significant fact. The target was reached on December 28, although the Trailing Stop Rule was not activated until January 11.

[Table 6.2](#) summarizes the trading signals in the sugar market during 2009.

TABLE 6.2 Sugar Signals and Trades in 2009

Signal # and (Position)	Pattern	Entry Date	Exit Date	Resulting Move in Points
1 (Long May)	Two-mo triangle	1/5	1/14	(67)
2 (Long May)	New high	1/26	3/2	(59)
3 (Long May)	New high	2/26	3/2	(35)
4 (Long Oct)	Seven-mo running wedge	5/1	6/24	+222
5 (Long Oct)	Five-wk fishhook	6/23	7/30	+206
6 (Long Oct)	Three-wk pennant	7/24	8/10	+309
7 (Long Mar)	3-wk flag	8/28	9/4	(98)
8 (Long Mar)	Six-wk continuation pyramid	9/28	10/7	(92)
9 (Long Mar)	Momentum	10/13	11/27	(76)
10 (Long Mar)	Momentum	10/30	11/10	(59)
11 (Long Mar)	15-wk channel	12/11	12/28	+365
11 trades, 7 losers, 4 winners				

Lessons from Sugar in 2009

Unfortunately, I need to relearn some of the same lessons year after year after year. Sugar in 2009 was a reminder that market behavior tends to greatly lag a strong opinion I may develop. Often, I see something big taking shape on the charts well before a trend develops. Markets have no obligation to immediately reward my opinion. My tendency is to force an interpretation of the daily charts to comply with an opinion I have developed with the weekly charts. Two of the early trades (#2 and #3) were based on market momentum absent recognizable chart patterns. Two of the late trades (#9 and #10) were also based on momentum without support from a pattern. Thus, four of the 11 trades were questionable and should not have been entered. I enter every New Year with a commitment to greatly increase my patience. Perhaps some year I will achieve that commitment.

Points to Remember

- Some of the best trades are moves in the opposite direction of a trader's initial expectations (such as the case in the Dow Jones).
- A trading plan must go through losing periods in any given market to find the gems. Persistence pays off.
- Taking trades that anticipate a move can often be frustrating. Attempting to get positioned within a trading range can result in becoming gun shy when the real move occurs.
- Markets most often provide signals when the real moves begin. Waiting for substantial patterns to become complete is where the profits are to be found.

Part III

A Five-month Trading Diary: Let the Journey Begin

Part III is a day-by-day, week-by-week, trade-by trade, emotion-by-emotion, victory-by-victory, and loss-by-loss account of my trading from December 2009 through April 2010. The time frame and dates are arbitrary and chosen to represent a typical trading period. I begin the trading period without having any idea whether I will be profitable.

Chapters 8 through 12 are the “month chapters”; each represents a different month of trading. I comment on trades in the order they are entered, on the fly, in real time. And when I trade a specific market more than once, I compare the entries and exits.

I attempt to explain why I enter trades, how I manage trades, and what I think about trades after the fact. I skip describing some trades if the comments and lessons for the trades are redundant. However, a record of all signals is shown in Appendix A.

I think by journaling. I have maintained a journal of my trading endeavors since 1981. Writing helps my mind become engaged in the trading process. I will add journal entries, as they are interesting, revealing, or educational. My journal entries may deal with trading techniques, possible trades, challenges with my trading plan, the uphill climb against my emotions, or other interesting tidbits. I analyze my trading at the end of each month and quarter and I will include excerpts from each analysis.

My major challenge as a trader is to translate the components of the Factor Trading Plan into real-time trading operations. I believe that every professional trader knows exactly what it is that he must do to maximize success. Doing it becomes the hurdle.

The criterion for a valid trading signal (as differentiated from a profitable trade) is whether each entry and exit, when plotted on a graph, can withstand scrutiny after the fact. Recognizing chart configurations on completed charts

after the fact is a lot different than trading charts in real time.

Bringing these two time dimensions—clearly seeing the patterns after the fact and responding in the present—into sync is the challenge. I cannot allow myself to read too much into any given chart at any given time. I need to allow charts time to fully mature.

My measure of success, or lack of the same, will be due in large part to whether my trading rules and guidelines are in sync with the markets. No trading approach is perfect, and markets and trading approaches get out of sync. What counts is whether I execute my trading rules and guidelines correctly.

For each trade, I will cite the following items:

- The market being traded
- The category of trade (from Chapter)
 - Major pattern (breakout signal)
 - Major pattern (anticipatory signal or early entry)
 - Major pattern (pyramid signal, a continuation pattern in an ongoing move)
 - Minor reversal or continuation signal—patterns on daily charts without confirmation from weekly graphs
 - Instinct trade
 - Miscellaneous trade (driven largely by short-term momentum or other factors). These trades largely respond to what chart pattern might develop as opposed to chart patterns that have already been completed.
- The pattern identified
- The exit rule used (from Chapters and)
 - Last Day Rule (or Last Hour Rule)
 - Retest Failure Rule
 - Trailing Stop Rule
 - Target
 - Intervening pattern—one that resets the Last Day Rule or indicates a reversal of trend
 - Other

I will also include a chart or two of each completed trade with notations as appropriate.

Do I have any expectations as I begin this process? Well, yes! Remember, I

am a conservative trader—the leverage I use today is one-third the leverage I used during most of my trading career. I am far more risk averse than I was in decades past. The exact leverage I use on any given trade will depend on the degree of confidence I have with a specific signal and on the risk inherent in how the breakout occurs.

Remember, the Factor Trading Plan is not designed to turn \$10,000 into a million. My goal is a consistent double-digit annual rate of return with limited capital volatility. During tough periods, I scale my leverage back even further. I increase my leverage (or “gearing,” as some foreign traders call it) when the markets start to click. I am sure that experienced Las Vegas gamblers would tell me I do it the wrong way around—that I should leverage up through a string of bad trades and leverage down during a profitable period.

The trading leverage used by the Factor Trading Plan is very conservative. Many readers may be shocked at the limited leverage I employ. As a trader, I think in terms of units of \$100,000. I refer to each unit of \$100,000 throughout the journal as a *trading unit*. Leverage, or number of contracts, is expressed in relationship to the \$100,000 trading unit.

For example, I may state that I bought or sold one-half of a contract per trading unit. This would equate to one contract for each \$200,000. In the forex markets, the reference will be to the leverage taken in the trade. If I state that I shorted 35,000 GBP/USD per trading unit, this means that I went short 35,000 pounds per \$100,000 of trading capital.

I will be in hog heaven if I achieve a rate of return of 10 to 15 percent during the next five months. If the markets do not cooperate, or if I poorly implement my game plan, then keeping my capital intact may be the best I can expect.

A significant concern as I start this real-time trading diary experience is that I trade best when I remain detached from the markets. I have the tendency to overread the charts if I am too close to intraday price behavior.

Writing this book may force me into much closer contact with the markets than I would prefer. I wonder how this could affect my ability to exercise my craft, but it will give me an opportunity to share my emotional journey as well as my trading experiences.

With a plan in place and my worries laid bare, let the games begin!

Postscript

The last regular entry into the trading journal was made on April 20, 2010. It is now very early June 2010, my last chance to add content to the book, and I'd like to take this opportunity bring you up to date on the Factor Trading Plan.

Final Performance

May was my best month by far in 2010. I closed out the *Diary of a Professional Commodity Trader* on April 20 with a cumulative gain of 5.4 percent. You will recall that my optimistic goal for the period covered by the book was a gain of 10 to 15 percent.

From April 20, the end of the diary, through May 31, the Factor Trading Plan experienced some excellent trades, and the six-month gain from December 7, 2009 (the first trade of the diary), through the end of May stands at 9.6 percent. This is the actual gain by the fund traded by Factor LLC. Of course, who knows what the future will bring. Specifically, the profits in the past five weeks have come from two markets.

The Stock Market Turns Down

As shown in [Figure PS.1](#), the June Dow Jones Industrial Average completed a small H&S top on May 4. I shorted the completion of this top. The target of 10630 was quickly met and far exceeded. The retest rally through May 13 took the form of a rising wedge and offered the opportunity to again trade the stock indexes from the short side.

[FIGURE PS.1](#) A Small H&S Pattern Created a Top in DJIA.



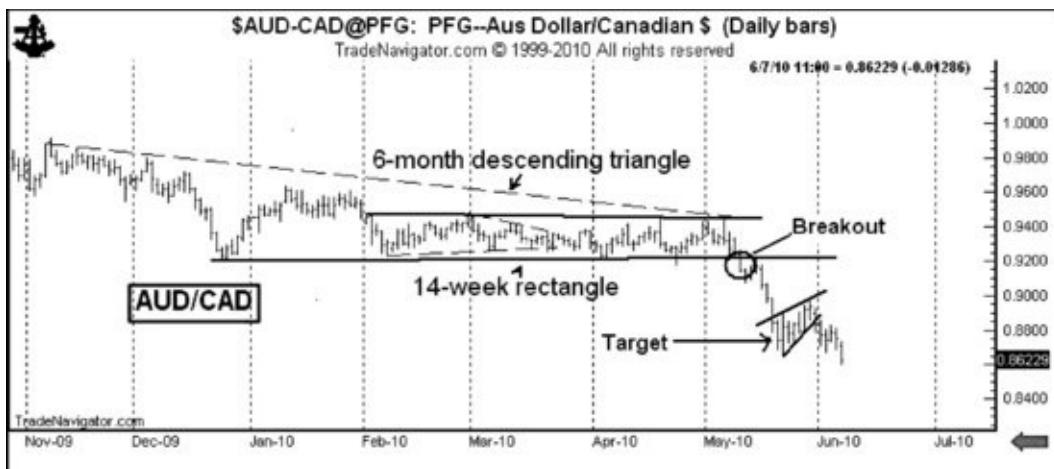
As of this writing, a multi-month H&S top looms large and the bears appear to be in control.

The Trading Range in AUD/CAD is Resolved

You may recall from Chapter , Figures 11.5 and 11.6, the severe whiplashing I endured when the daily AUD/CAD chart worked its way too far toward the apex of a triangle. I went from short to long to short, each trade being a loss.

[Figure PS.2](#) shows that the trading range in this forex pair was finally resolved. The decline on May 11 confirmed a 14-week rectangle and a possible six-month descending triangle. This chart has already qualified for the 2010 Best Dressed List. The downside target has been met.

[FIGURE PS.2](#) Major Sell Signal in AUD/CAD.



Performance Compared to Other Benchmarks

It has been a tough six months for commodity traders. [Table PS.1](#) compares the performance of the actual commodity/forex pool traded by Factor LLC in accordance with the diary in this book against some benchmarks commonly used by the futures and forex industry. The benchmarks are the Lyxor CTA Index, the Barclay Hedge NewEdge CTA Index, and the S&P 500. Lyxor and Barclay track the commodity trading advisors (CTAs) managing large assets in the forward commodity and forex markets.

TABLE PS.1 Factor Trading Plan (Actual) versus Industry Benchmark Comparisons, December 2009–May 2010

Note: Proxy for Factor Trading Plan is the Factor Classic Fund, all fees included.

Sources: SPX closing price; Factor internal audit; www.BarclayHedge.com; www.LyxorHedgeIndices.com.

Asset	Past Month (May 2010)	Past Six Months (December 2009–May 2010)
Factor Trading Plan	+7.8%	+6.2%
Factor Goal of 18% annual rate of return	+1.5%	+9.0%
S&P 500	(9.2%)	(0.5%)
BarclayHedge NewEdge CTA	(1.4%)	(1.3%)
Lyxor ST & LT CTA Index (equal weight)	(0.2%)	(2.38%)

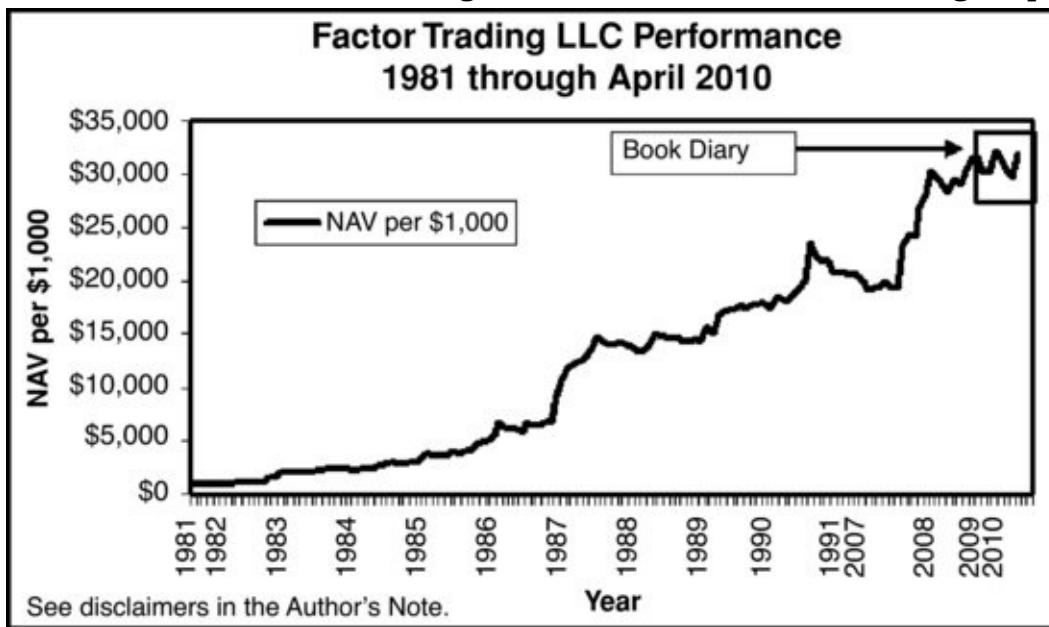
No representation is made that this relative performance would hold true for any period of time other than the time covered by the diary of the book. The Factor Trading Plan could underperform or outperform industry benchmarks during any other floating periods of time.

Putting it in Perspective

Five or six months is a microcosm in the life of a trader. Frankly, six months, or even a year, really do not matter very much. I want to end this book by placing the past six months into the perspective of my career as a trader.

[Figure PS.3](#) shows the trading performance of the period covered by this book into the context of my trading from 1981 through May 2010. This is a graph of the Value Added Monthly Index (VAMI) representing the growth of \$1,000 without factoring in additions or withdrawals. Note that the period of the book is marked on the graph.

FIGURE PS.3 Factor Trading LLC Performance, 1981 through April 2010.



This graph makes a pro-forma adjustment to reflect the fact that I am currently trading with about one-third of the leverage I used from 1981 through 2008. So, the VAMI is constructed using monthly rates-of-return that are only one-third of the actual monthly returns in my proprietary accounts from 1981 through late 2008. The VAMI beginning in 2009 is based on actual performance, reflecting the lower leverage currently being used.

Appendix A Factor Trading Plan Signals [Table](#)

A.1 contains the signals and trades of the Factor Trading Plan from December 7, 2009, through April 20, 2010. The results of the trades open as of April 20 are marked-to-market. Please read the disclaimers in the Author's Note for a complete explanation of the performance reporting.

[TABLE A.1](#)

Factor Classic LLC 2009 Trading Log

Pro-Forma Record Per \$100,000 of Capitalization

*Currency cross trades expressed in quantity of primary (first listed) currency unit

Part of split exit

Final as of Apr. 20, 2010

Date	Market	Month	L	Contracts per \$100*	Initial stop	Initial LDR	Initial % of NAV	Target	Initial risk as % of NAV	Pattern type	Daily pattern length	Weekly pattern	Other	Date stops moved	Exit date	Exit price	Net P/L per \$100,000	Net P/L per lot	Exit round lot used
7-Dec	EUR/USD	Spot	\$	1,4796	-35000	1,5092	1,5096	1.1	1.4446& MjC	5-wk	Channel	9-mo channed		12/9 to 15009	12/17	1,4446	\$1,215	Target	
9-Dec	GBP/USD	Spot	\$	1,6228	-65000	1,6376	1,6386	1.0	1,5668 Mtr	9-wk	H&S top				12/16	1,6386	(\$1,037)	DDR	
11-Dec	Sugar	Mar	L	2371	0.5	2312	2298	0.7	3500 MjC	14-wk	Channel	6-wk H&S	12/21 to	12/22	2528	\$374	\$1,748	Trd stop	
11-Dec	Sugar	Mar	L	2371	0.5	2312	2298	0.7	2736 MjC	14-wk	Channel	6-wk H&S	12/24 to	12/28	2736	\$2,039	\$4,078	Target	
14-Dec	Cotton	Mar	L	7522	1.0	7381	7378	0.8	7880 Misc	3-wk	Pennant			12/21	12/22	7421	(\$515)	Retest fail	
15-Dec	Soybean Oil	Mar	L	4037	0.7	3958	3949	0.7	Open MjC	17-wk	Sym tri	Possible 12-mo fulcrum	12/17 to 11/13 BA gap	12/17	4003	(\$150)	(\$214)	Retest fail	
16-Dec	AUD/USD	Spot	\$	0.8989	-45000	9140	9142	0.7	8486 MjCr	11-wk	H&S			12/17 to	12/28	8872	\$517	Trail stop	
														9021; 12/24 to					
16-Dec	DAX	Mar	L	5870.5	0.5	5759	5757	0.7	6390 MjC	5-wk	H&S cont	3+mo cont diamond		12/21 to	1/21	5833	(\$665)	(\$1,330)	DDR
17-Dec	GBP/USD	Spot	\$	1,6224	-40000	16342	16281	0.5	1,5668 Mtr	9-wk	H&S top	2nd completion	5933	12/29 to	12/30	1,5987	\$938	Other	
														to split prices					

17-Dec	Soybean Oil	Mar	\$ 3929	0.7	4080	4016	0.4	3743	Instinct	5-wk	H&S top	12/23 to	12/28	3971	(\$176)	(-\$262) Request fail	
17-Dec	Soybeans Mar	\$ 1024	1.0	1071	1042	1.0	956	Misc	5-wk	H&S top	12/21 to	12/28	1041	(\$860)	LDR		
21-Dec	Mini Nasdaq	Mar	1821	0.5	1803	1802	0.3	1876	MnC	3-wk	Asc tri	1041	12/28	1876	\$683	\$1,366 Target	
29-Dec	USD/CAD	Spot	\$ 1,0378	-40000	1,0446	1,0454	0.5	1,0106	MnR	9-wk	Desc tri	12/30	1,0456	(\$398)	LDR		
31-Dec	AUD/USD	Spot	\$ 0.8939	-120000	9012	9022	1.0	8486	MjC	11-wk	H&S top	Retest	1/4	0.9024	(\$1,140)	LDR	
4-Jan	Sugar	July	L 2324	1.0	2270	2269	0.6	Open	MjC	2-wk	Running wedge	1/8 to 2297	1/11	2297	(\$312)	LDR	
4-Jan	Corn	Mar	L 425.2	1.0	415	414.4	0.6	468	MnC	10-wk	Asc tri	1/20 to 9207;	1/4	414.2	(\$560)	Inter-vening LDR	
12-Jan	USD/JPY	Spot	\$ 91.69	-30000	9243	9271	0.4	87.55	MnR	5-wk	Rising wedge	Major down trend	2/1 to 9101	2/3	91.02	\$211	
12-Jan	Mini Nasdaq	Mar	\$ 1862.25	1.0	1883.8	1884.5	0.6	1831	Misc	2-wk	Broadening top	1/14 to 107.07	1/15	107.07	(\$318)	Retest fail	
13-Jan	T-Bonds	Mar	\$ 116-19	0.5	118-14 (12/21)	117-25	0.5	112-02	MjC	17-wk	Double top	Break-away gap	2/4 to 3702;	2/16	3664	\$339	(\$635) Target stop
14-Jan	Corn	Mar	\$ 3802	0.5	3924	397	0.5	3310	MjC	12-wk	Sym tri	2/12 to	3664	3664	\$678	Target stop	
15-Jan	Wheat	Mar	\$ 512	0.5	5256	526	0.4	461	MjC and 432	13-wk	H&S top	1/29 to 5052;	2/10	4966	\$376	\$753 Target	
15-Jan	EUR/JPY	Spot	\$ 130.74	-30000.0	132.41	132.51	0.5	127.4	MjA	3-wk	H&S top	Possible 11-mo H&S top	1/21	127.52	\$1,058	LDR	

Factor Classic LLC 2009 Trading Log

Pro-Forma Record Per \$100,000 of Capitalization

*Currency cross trades expressed in quantity of primary (first listed) currency unit

Part of split exit

Final as of Apr. 20, 2010

Date	Market	Month	L	Contracts per \$10k*	Initial risk as % of NAV	Initial stop	Target type	Pattern length	Daily pattern	Weekly pattern	Other	Date moved	Exit stops	Exit date	Exit price	Net P/L per \$100,000	Net P/L per lot used	Net P/L per round lot	Net P/L per Trail stop
19-Jan	Mini S&Ps	Mar	\$	1126.5	1.0	1137	1140.25	0.7	Open MjC	13-wk	Rising	10-mo wedge	1/19	1140.5	(\$710)				
19-Jan	Sugar	May	L	2716	0.5	2660	2654	0.4	Open MP	2-wk	Pennant		2/2 to 2763	2763	\$258	\$516	Quick profit		
20-Jan	Mini Gold	Apr	\$	1117.1	0.5	1143	1144.4	0.5	1096 Instinct	3-wk	H&S top	Possible 3-mo failure	1/21	1096	\$343	\$686	Quick profit		
20-Jan	Mini Gold	Apr	\$	1117.1	0.5	1143	1125.1	0.1	1079 Instinct	3-wk	H&S top	Possible 3-mo failure	1/28	1079	\$619	\$1,247	\$ mgmt		
20-Jan	Mini Gold	Apr	\$	1117.1	0.5	1143	1133.6	0.3	1093 Instinct	3-wk	H&S top	Possible 3-mo failure	1/28 to 1125.2	2/3	1124.4	(\$125)	(\$251)	Quick profit	
21-Jan	Mini S&Ps	Mar	\$	1125	0.5	1139.3	1140.25	0.4	1086 MjC	3-wk	H&S top	13-wk top	2/1 to 1124.3	1/26	1086	\$970	\$1,940	Trail stop	
21-Jan	Mini S&Ps	Mar	\$	1125	0.5	1139.3	1140.25	0.4	1024 MjC	3-wk	H&S top	wedge 13-wk wedge	2/4 to 1103.5	2/16	1084.25	\$1,014	\$2,028	Retest fail	
21-Jan	Mini S&Ps	Mar	\$	1125	0.5	1139.3	1140.25	0.4	1024 MjC	3-wk	H&S top	wedge 13-wk wedge	2/12 to 1084	3/5	1120.5	\$1,008	\$215	Trail stop	
21-Jan	G BP/JPY	Spot	\$	146.16	-20000	149.11	148.12	0.6	140.12 MjA	3-wk	Sym tri	Possible 4-mo desc tri	2/1 to 147.41	2/4	140.22	\$1,324		Trail stop	

26-Jan	EUR/JPY	Spot	\$ 1.2642	-20000	128.37	128.47	0.6	116.52	MjC	43-wk	Rounding top	Same	2/4 to 3/5	122.68	\$819	Trail stop	
27-Jan	Copper	Mar	\$ 323.95	0.3	335.7	332.1	0.6	311.60	MjC &	3-wk	Horn	10-mo channel	122.67	2/11	311.6	\$769	\$3,078 Target
29-Jan	GBP/USD	Spot	\$ 1.6069	-30000	16180	16187	0.4	15828	MnC	1-wk	Pennant	Possible 9-mo double top	2/4	1.5828	\$714	Target	
2-Feb	Soybean Oil	Mar	L 3670	0.5	3600	3573	0.3	3838	Instinct rev 5/8	43-wk	Sym tri		2/10 to 2/10	3698	\$499	\$999 Rest fail	
4-Feb	Mini Gold	Apr	\$ 1067.4	1.0	1111.8	1087.2	0.7	927	MnR	9-wk	Desc tri	Poor fill	2/10 to 2/11	1085.2	(\$597)	LDR	
5-Feb	GBP/USD	Spot	\$ 1.5661	-30000	1.5776	1.5806	0.4	1.463	MjC	39-wk	Double top		1085.1	2/17	1.5806	(\$445)	Rest fail
12-Feb	Mini crude Oil	Apr	\$ 73.95	0.5	75.8	76.225	0.6	58.2	MjC	52-wk	Fan principle	Same	2/16	76.25	(\$580)	(\$1,160) Rev. LDR	
18-Feb	GBP/USD	Spot	\$ 1.5583	-40000	1.5688	1.5701	0.6	1.463	MjC	8-wk	Flag	9-mo double top	3/16 to 3/15	1.5062	\$2,074	Rest fail	
18-Feb	T-Bonds	June	\$ 115.17	0.5	116.10	116.19	0.6	113-17	MjA	3-wk	Broadening top	Possible 8-mo H&S top	1.5061 116-12	2/22 to 2/23	116-12	(\$427) (\$854) Quick profit	
18-Feb	Mini Gold	Apr	L 1099.7	0.5	1094	1089.4	0.2	1124	MnC rev	11-wk	Wedge	H&S bottom away	Breakaway 1096.3	2/18 to 2/19	1124	\$396	\$792 Rest fail
18-Feb	Mini Gold	Apr	L 1099.7	0.5	1094	1089.4	0.2	1223	MnC	11-wk	Wedge	H&S bottom gap	Breakaway 1096.3	2/18 to 2/24	1096.2	(\$63)	(\$126) LDR
18-Feb	10-Yr T-Notes	June	\$ 116.01	0.5	116.14	116.15	0.3	114-24	Misc	3-wk	H&S top	Too tight	2/23	116-15	(\$224)	(\$448) Other entry stop	

Factor Classic LLC 2009 Trading Log

Pro-Forma Record Per \$100,000 of Capitalization

*Currency cross trades expressed in quantity of primary (first listed) currency unit

Part of split exit

Final as of Apr. 20, 2010

Date	Market	Month	L or S	Entry price	Contracts per \$100k*	Initial stop	Initial % of NAV	Signal type	Pattern length	Daily pattern	Weekly pattern	Other	Date stops moved	Exit due	Exit price	Net P/L per round lot used	Net P/L
23-Feb	GBP/JPY	Spot	S	139.36	-30000	141.68	141.23	0.8	128.1	M/C	22-wk	Desc triangle	2/26 to 3/12	137.62	\$565	Target	
													13976				
													3/11 to				
													13749	3/2	1976	\$706	\$1,412 LFR
23-Feb	Sugar	Oct	S	2103	0.5	2155	2161	0.4	1976	MnR	8-wk	Rectangle Channel	Rest of major top	2/26	326.8	(\$680)	(\$1,360) LDR
23-Feb	Copper	May	S	321.4	0.5	334.35	326.7	0.6	280	Misc	3-wk	Hourly chart					
25-Feb	Soybean Oil	May	L	3956	2.0	NA	3898	0.4	4069	M/C	2-wk	Flag	Possible 10-mo triangle	2/25	3897	(\$728)	LDR
25-Feb	Minil S&Ps	June	S	1085	1.0	1098.3	1098.5	0.7	Open	MnR	3-wk	H&S top	Rest of major channel top	2/26	1098.5	(\$685)	LDR
25-Feb	Mini Dow	Mar	S	10234	1.0	10355	10367	0.6	Open	Misc	2-wk	H&S top	Rest of major top	3/1	10368	(\$680)	Target
25-Feb	EUR/GBP	Spot	L	0.8861	35000.0	0.8773	0.8769	0.4	9062	M/A	17-wk	Channel	Possible 5-wk 14-mo H&S bottom	3/1	0.9062	\$1,045	Target
26-Feb	Soybean Oil	May	L	3954	1.0	3924	3906	0.3	4069	M/C	2-wk	Flag	Possible 12-month asc triangle	3/10	4069	\$680	Intervening
1-Mar	OJ	May	L	14485	1.0	14070	14045	0.6	158	MnC	9-wk	Sym tri	Same	3/8 to 3/16	14455	(\$55)	Retest full
2-Mar	Mini Gold	Apr	L	1133.6	1.0	1115.1	1114.8	0.7	1195	MnR	9-wk	H&S top	Monthly H&S unmet target	3/5 to 1124.8	1124.7	(\$304)	Rev LDR

3-Mar	USD/CAD	Spot	\$ 1.0352	-50000	1.0444	1.0451	0.5	9720	MjA	22-wk	Desc tri	Same	3/10 to 3/26	1.0301	\$238	Rest fail
													3/22 to 3/25	1.0351; 1.0332;		
4-Mar	Soybeans May	Spot	\$ 928.4	0.5	963	962.4	0.7	899	Misc	3-wk	H&S top	Possible 19-wk triangle	3/8 to 950.2	950.2	(\$306)	(\$598) Rest fail
12-Mar	USD/CAD	Spot	\$ 1.0198	-70000	10322	10326	0.8	9720	MjC	22-wk	Sym tri	20-wk triangle	3/22 to 3/24	1.0256	(\$406)	Rest fail
12-Mar	Mini Crude Oil	May	\$ 81.35	0.5	83475	8295	0.8	7740	MjA	7-wk	Rising wedge	Possible fan	3/16 to 8255	8255	(\$305)	LDR
19-Mar	AUD/CAD	Spot	\$ 0.9258	-100000	9381	9326	0.8	Open Instinct	4-wk	Triangle	Possible 3-mo triangle	3/19 to 3/27	0.9327	(\$688)	Trail stop	
19-Mar	EUR/USD	Spot	\$ 1.353	-30000	1.3627	1.3741	0.6	1.3132	MnC	6-wk	H&S fail	May down	3/27 to 1.3436	1.3436	\$158	LDR
22-Mar	Mini Gold	June	\$ 1096.8	1	1109.6	1111.2	0.5	1052	MnR	6-wk	H&S top	Possible 3+mo H&S fail	3/26 to 1111.3	1111.3	(\$489)	Rest fail
24-Mar	T-Bonds	June	\$ 117.08	0.5	117.22	117.24	0.3	Open	MjA	12-wk	Asc tri failure	12-mo H&S Dbl top	4/11 to 116-01	116-01	\$589	\$1,178 LDR
26-Mar	GBP/USD	Spot	\$ 1.4916	-40000	15049	15061	0.3	1.441	MjP	4-wk	Flag		3/30	1.5062	(\$594)	LDR
26-Mar	Wheat	May	\$ 470.4	0.5	478.2	479	0.3	MnC	New	New lows			4/7	479	(\$218)	(\$435) Rest fail
26-Mar	Com	May	\$ 358.2	1.0	366.4	367	0.3	MnC	New	New lows			4/8 to 4/14	360.2	(\$125)	Quick profit LDR
29-Mar	USD/CAD	Spot	\$ 1.0192	-30000	1.0273	1.0287	0.5	9720	MjCs	22-wk	Sym tri	2nd completion closed	4/20	0.9964	\$615	
31-Mar	AUD/CAD	Spot	\$ 0.9332	-30000	0.9382	0.9402	0.2	0.8812	MjA	14-wk	Sym tri	Same	4/5 to 93.27	93.27	\$5	LHR

Factor Classic LLC 2009 Trading Log
Pro-Forma Record Per \$100,000 of Capital

Pro-Forma Record Per \$100,000 of Capitalization

*Currency cross trades expressed in quantity of D

CUMI EBCY Does it have any bearing on the quality of life in elderly? 11

Part of split exit

Final as of Apr. 20, 2010

MEMO TO API: 20, 2010

Appendix B

Quick Reference to Charts *The following tables are intended to be a quick reference guide to the charts in this book. The tables list various elements of classical charting principles, trading signals, and trade management techniques used by the Factor Trading Plan and where they can be found in the book.*

[Table B.1](#) lists the charts in the book according to which classical chart pattern they illustrate.

TABLE B.1 Charts by Pattern

Figure #	Market	Diagonal				Horizontal				Other								
		Wedge	Sym triangle	Flag	Trendline	Channel	Diamond	H&S	Right angled triangle	Double top or bottom	Broadening or fishhook	Rounding	Rectangle	Pennant	Horn	Bull or bear trap	Secondary completion	False/premature breakout
12.2	Gold																	
12.3	EUR/GBP																	
12.4	EUR/JPY																	Retest
12.5	EUR/JPY																	
12.6	Soybeans																	
12.7	Soybeans																	
12.8	DJIA																	
12.9	DJIA																	
12.10	T-Bonds																	
12.11	T-Bonds																	
12.12	T-Bonds																	
12.13	Sugar																	
14.1	AUD/USD																	
14.2	AUD/USD																	
14.3/4	EUR/CHF																	
14.5/6	EUR/USD																	
14.7/8	GBP/USD																	
14.9/10	NZD/USD																	
14.11/12	USD/CAD																	
14.13A/13B	S&P 500																	
14.14	Sugar																	
14.15	Sugar																	
14.16/17	Gold																	
14.18	Copper																	
14.19	Crude Oil																	
14.20	Crude Oil																	
PS.1	Dow Jones																	Retest
PS.2	AUD/CAD																	

[Table B.2](#) lists the charts in the book based on the type of signal generated and the appropriate trade management strategy.

TABLE B.2 Charts by Signal Category and Trade Management Technique

Figure #	Market	Signal Type					Trade Management Strategy				
		Major Pattern		Minor Pattern			Misc	Last Day Rule	Retest Failure	Trailing Stop Rule	Target
		Completion	Anticipatory	Pyramid	Continuation	Reversal					
6.10	Gold										
6.11	Gold										
6.12	Gold										
6.13	Gold										
6.14	Gold										
6.15	Sugar										
6.16	Sugar	Multiple trades									
6.17	Sugar										
6.18	Sugar										
6.19	Sugar										
6.20	Sugar										
6.21	Sugar										
6.22	Sugar										
6.23	Sugar										
6.24	Sugar										
8.1	EUR/USD	Major trendline									
8.2	EUR/USD										
8.3	GBP/USD										
8.6	GBP/USD										
8.7	GBP/USD										
8.8	Sugar										
8.9	Cotton										
8.10	Bean Oil										
8.11	Bean Oil										
8.12	AUD/USD										
8.13	DAX										
8.14	Soybeans										
8.15	Nasdaq										
8.16	CAD/USD										
9.1	GBP/USD	Example of double top									
9.2	SPX	Example of channel									
9.3A	T-Bonds	Example of channel									
9.3B	T-Bonds	Example of H&S top									
9.3C	T-Bonds	Example of H&S top									
9.4	Gold										
9.5	Sugar	Example of multiyear base									
9.6	DJIA	Possible H&S top									

Figure #	Market	Signal Type						Trade Management Strategy			
		Major Pattern		Minor Pattern		Instinct	Misc	Last Day Rule	Retest Failure	Trailing Stop Rule	Target
		Completion	Anticipatory	Pyramid	Continuation						
10.16	DJIA										
10.17	EUR/GBP	■									
10.18	EUR/GBP										
11.1	USD/CAD	■	■								
11.2	USD/CAD	■									
11.3	Soybeans										
11.4	Crude Oil	■									
11.5	AUD/CAD										
11.6	AUD/CAD	■									
11.7	EUR/USD		■								
11.8	EUR/USD			■							
11.9	T-Bonds	■			■						
11.10	Wheat					■					
11.11	Corn										
11.12	Soybeans										
11.13	Copper	Missed trade									
11.14	OJ			■							
12.1	Gold										
12.2	Gold	■									
12.3	EUR/GBP					■					
12.4	EUR/JPY										
12.5	EUR/JPY					■		■			
12.6	Soybeans			■	■						
12.7	Soybeans	■						■	■		
12.8	DJIA	Signal Pending					Pending				
12.9	DJIA	Signal Pending					Pending				
12.10	T-Bonds	Signal Pending					Pending				
12.11	T-Bonds	Signal Pending									
12.12	T-Bonds										
12.13	Sugar					Pending					
14.1	AUD/USD	■									
14.2	AUD/USD										
14.3/4	EUR/CHF										
14.5/6	EUR/USD										
14.7/8	GBP/USD										
14.9/10	NZD/USD										
14.11/12	USD/CAD	■						■	■		

Appendix C

Recommended Resources

Barrie, Scott, *The Complete Idiot's Guide to Options and Futures*, 2nd ed. New York: Alpha Books, Penguin Group (USA), 2006.

Brandt, Peter L. (with Bruce Babcock), *Trading Commodity Futures with Classical Chart Patterns*. Sacramento, CA: Commodity Traders Consumer Reports, 1990.

Chicago Board of Trade, *Commodity Trading Manual*. New York: AMACOM, 1999.

Edwards, Robert D., and John Magee, *Technical Analysis of Stock Trends*, 8th ed. Boca Raton, FL: CRC Press, 2001. [Note: The author uses the fifth edition of this book for personal use.]

Elder, Alexander. *Trading for a Living: Psychology, Trading Tactics, Money Management*. New York: John Wiley & Sons, 1993.

Kiev, Ari, *The Mental Strategies of Top Traders: The Psychological Determinants of Trading Success*. Hoboken, NJ: John Wiley & Sons, 2009.

Kiev, Ari, *Hedge Fund Masters: How Top Hedge Fund Traders Set Goals, Overcome Barriers, and Achieve Peak Performance*. Hoboken, NJ: John Wiley & Sons, 2005.

Lewis, Michael. *Liar's Poker: Rising Through the Wreckage on Wall Street*. New York: W.W. Norton & Company, 1989.

Lewis, Michael. *The Big Short: Inside the Doomsday Machine*. New York: W.W. Norton & Company, 2010.

Murphy, John, *Technical Analysis of the Financial Markets*. New York Institute of Finance, Prentice Hall Direct, 1999.

National Futures Association, *Opportunity and Risk, An Educational Guide to Trading Futures*, 2006, PDF download at www.nfa.futures.org/NFA-investor-information/publication-library/opportunity-and-risk-entire.pdf.

Schabacker, Richard W., *Technical Analysis and Stock Market Profits: The Real Bible of Technical Analysis*. Hampshire, UK: Harriman House, 1998.

Schwager, Jack D., *Market Wizards: Interviews with Top Traders*. Columbia, MD: Marketplace Books, 2006.

Schwager, Jack D., *New Market Wizards: Conversations with America's Top Traders*. New York: John Wiley & Sons, 1992.

Schwager, Jack D., *Market Wizards*. New York: HarperBusiness, 1993.

Teweles, Richard J., and Frank J. Jones, *The Futures Game: Who Wins, Who Loses, & Why*. New York: McGraw-Hill, 1999.

In addition to the extremely insightful and informational books cited previously, I recommend a few services that provide web-based trading platforms, price quotes, charting capabilities, and other research.

FactorTrading.com: This is the official web site of Factor LLC. The web site attempts to identify and report on the best examples of classical chart patterns in the commodity and forex markets. Periodic chart stocks are also featured.

Mercenarytrader.com: This quirky and brilliant web site is written for professional traders by a couple of skilled professional speculators (using pseudonyms). Mercenarytrader provides unusual macro analyses of markets and global economics that break the mold of conventional wisdom. The authors/traders frequently blow holes through the sacred cows of Wall Street. Loaded with great insight on the things that really matter to be profitable.

Trade Navigator: By Genesis Financial Technologies, Colorado Springs, CO (800) 809-3282. For the money this is the best and most user-friendly quote and charting platform available. Actual trading can be executed from the platform through selected futures commission merchants (FCMs). Live customer support is readily available and extremely knowledgeable.

Commodity Research Bureau: I grew up as a trader with CRB products and services. CRB has been serving the commodity industry with excellent resources for more than 70 years. CRBtrader.com provides a multitude of valuable market research and quote and charting functions.

Barchart.com: This is a free web site with quote and charting capability. When I am on the road without my own computer I stay in contact with the charts through Barchart.com. I weekly print off the charts for the markets I will be closely monitoring from Barchart.com, using the “Classic Style Chart” setting. I then keep these charts up to date throughout the week by hand.

Author's Note

This book is educational and not intended to promote any product or service of Factor LLC now or in the future.

Monthly performance data for the period covered by the book represents a combination of data and not the trading activity of any specific account. The combination of data includes:

- An exempt commodity pool managed by Factor LLC
- Periodic trades in a proprietary account
- Management of trading signals according to the rules and guidelines specified by the Factor Trading Plan

Because no specific account has fully reflected the signals and trades reported in Part III of this book, the performance data reported herein should be considered as hypothetical. However, the performance reported in the diary portion of this book in Part III closely mirrors the trading performance of the actual exempt commodity pool managed by Factor LLC. Past performance is not necessarily indicative of future results.

Factor LLC traded proprietary accounts from October 1981 through April 1995. From October 1981 through March 1991 the proprietary accounts were controlled solely by Factor LLC under the trading program or early versions of the trading program represented by this book (see the performance capsule of Factor LLC in [Figure AN.1](#)).

FIGURE AN.1 Factor LLC Performance, October 1981–September 2008.

Factor LLC

Month	Actual Proprietary Performance Capsule (Triple Leverage Program)										
	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
January	-18.74%	71.18%	-12.62%	3.32%	145.59%	122.98%	-3.41%	8.79%	-1.20%	-11.05%	-2.55%
February	-2.71%	2.43%	-4.77%	74.99%	29.54%	43.48%	-7.22%	-9.91%	-8.20%	-2.29%	0.89%
March	-7.11%	-7.08%	15.37%	-2.06%	65.66%	32.31%	-5.79%	31.26%	19.03%	-1.22%	-2.66%
April	-12.27%	-0.49%	0.47%	-14.07%	-20.57%	9.25%	-3.07%	-11.58%	-2.41%	-1.50%	0.50%
May	-44.08%	6.96%	7.00%	16.17%	-7.39%	3.60%	11.10%	38.89%	-4.67%	-1.58%	-0.93%
June	-32.65%	5.88%	19.37%	-18.69%	1.02%	11.65%	23.90%	2.26%	14.50%	6.44%	1.90%
July	-26.35%	16.75%	29.72%	40.30%	-8.82%	16.04%	-3.65%	4.84%	2.35%	22.00%	-0.07%
August	-6.65%	24.08%	10.89%	-11.87%	34.50%	27.55%	3.06%	1.73%	17.92%	-1.10%	0.68%
September	-4.07%	12.33%	-1.34%	9.21%	-3.72%	-12.27%	-7.52%	5.64%	51.85%	-1.41%	4.31%
October	4.34%	9.09%	-1.06%	-11.54%	0.14%	-2.66%	4.66%	-4.56%	-16.25%	2.27%	-3.19%
November	21.77%	106.46%	12.37%	6.19%	39.14%	1.65%	-0.45%	-10.22%	2.90%	-8.81%	4.68%
December	-14.50%	8.90%	-1.73%	6.78%	15.18%	3.20%	4.73%	-1.58%	5.28%	-0.55%	6.86%
Year	8.64%	207.48%	190.20%	75.29%	220.57%	126.70%	604.67%	-4.74%	88.22%	60.06%	1.04%
Worst	-14.50%	-26.35%	-7.54%	-16.79%	-32.26%	-15.02%	-18.16%	-11.58%	-16.75%	-6.98%	-2.07%
D.D.											

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS

From time to time throughout this period, the accounts were capitalized in part by notional funds. The notional funds were included in the calculation of

performance. Performance data is reported in accordance to format and Value Added Monthly Index (VAMI) specified by the Commodity Futures Trading Commission (CFTC). Neither the CFTC nor the National Futures Association (NFA) has reviewed this material.

From April 1991 through April 1995, I granted a power of attorney over my proprietary accounts to another trader. However, because I made periodic trading decisions during this time, the performance of this trading period is included herein. The drawdowns of this period are not included in a table reporting the size and duration of drawdowns in Factor LLC's proprietary trading in Table 9.1. I retired from the trading business from April 1995 through the end of 2006. During this period I pursued some non-profit political and social endeavors. In January 2007, I once again began trading a proprietary account using the program represented by this book. In September 2008, I withdrew funds from the proprietary account to below the level required to implement the trading program described in this book. However, I took very selected trading signals for my proprietary account in 2009 and experienced a profitable year.

The performance of the proprietary trading record from 1981 through 2008 was at a leverage of three times that currently employed by Factor LLC.