

PART I

Introduction to Trading with Pattern Recognition

CHAPTER 1**Opening Thoughts**

We have had the opportunity to come in contact with many traders over the years. Some are just entering this field, while others are experienced, successful traders. We thought it would be helpful to the reader of this book to hear our comments and observations on why some traders succeed and why some fail at trading.

As you read this book and study the methodology, we hope these insights will help to keep you on a path to success in trading. Trading requires hard work and perseverance. At times it can be a process of two steps forward and three steps back. Once you do find a consistent successful approach, though, there is nothing like the business of trading.

In this first chapter we cover what is the best way to use this book. We give our thoughts on why traders succeed or fail in trading, and offer suggestions for actions traders can take for successful trading.

HOW TO USE THIS BOOK

You will see as you progress through this book, we present many specific chart patterns and include suggestions for how to enter and manage those setups. We would suggest you start by keeping it simple and study a couple of patterns each day.

We also suggest that you work through the patterns in the order they're presented. Start with the basics—geometry (Chapter 2) and harmonics (Chapter 3)—before moving

on to the pattern formations. This will help you build a solid foundation and understanding of what we are teaching.

We include many examples of trades in each pattern chapter. Once you have a basic foundation in place of the pattern structures, you will be ready to study how these patterns are traded, and begin to think in terms of implementing these into your trading. We always recommend traders do some form of paper trading or simulated trading before committing real funds.

Learning how markets work is accomplished through time and experience. This is invaluable to the trader or investor. Determining what type of trading environment one is in, such as a trend environment versus a range environment, is important. Recognizing the subtle symmetry in all markets is an absolute prerequisite for a pattern recognition trader; this is done only one way: practice, practice, and more practice.

The only way the information in this book can be used to make money is to understand each pattern and apply sound trading principles. To help each trader accomplish this, we offer guidelines on developing a trading plan, covering pattern recognition, thinking in terms of probabilities, money management, risk assessment, and techniques for entering and exiting trades. Other subjects include setting up trading as a business and preparing for the unexpected. Treating trading as anything other than a business is a mistake. Even if the trader is not trading full-time, trading activities should be treated and set up as a second business.

A note on some of the charts throughout the book: Many of the chart examples are of the S&P 500 E-mini contract. This is an extremely popular market for traders and very conducive to the patterns presented in this book. You will find some of these charts labeled as “ES,” which is the root symbol for the S&P 500; others are labeled as S&P 500.

SUCCEEDING OR FAILING IN TRADING

It is each trader’s responsibility to develop the skills and discipline necessary for successful trading. We have not found and do not know of a holy grail in trading or an easy trading method. In many classic trading books, like *Profits in the Stock Market*, by H.M. Gartley (1935), there are observations about what accounts for successful versus unsuccessful trading. Interestingly, we have not seen many changes over the decades in this area. It seems to be the same aspects that constantly plague traders. There are, however, many actions the individual trader can implement to succeed.

Trading is like any other profession; the student first learns the basics, and then expands to more sophisticated and in-depth learning in the chosen field. There are no skilled professionals in any field who have not reached a level of expertise without hard

work and substantial experience. Any professional field requires a commitment and willingness to go through successes as well as failures. The failures can be the greatest teachers. Study the failures to develop into a better trader. Perseverance will be a key to a successful trading career.

Developing a mind-set that is conducive to trading will be essential to a trader's success. This will include thinking in terms of probabilities, and accepting the fact that losses are as much a part of trading as wins. This is a process in itself to learn. These concepts must be internalized so they become a part of what you do each day without conscious thought.

Larry Schneider, director of business developments for the Zaner Group, futures and commodities brokers, states that often too much time is focused on learning the method or system in the beginning. This approach is contrary to the steps that must be done to meet success in trading. In his view and experience, focusing on learning a mental approach first would be more beneficial to novice traders. He says it is imperative for traders to understand that there is a learning curve and money can be lost if traders do not take steps to protect their capital.

Every trader has to go through essentially the same learning curve; no one seems to be exempt from it. Schneider suggests, from his experience of 34 years in the futures business, that traders start small, perhaps with the mini contracts available, while they are learning. If traders take the time to investigate the mental approach they will need to execute their plan, they will be far ahead of the game. His advice is to approach trading from the mental side first, *then* develop your trading methodology and plan.

Why Traders Succeed

We work with, coach, and mentor many traders. We see and have experienced the full gamut of things that can happen in trading. Here are some of the reasons we feel traders succeed:

- Solid knowledge and understanding of the markets they are trading.
- Technical expertise on how to trade their markets.
- A sound trading methodology with a proven edge.
- A trading plan based on the methodology.
- Sufficient capital.
- Thinking in terms of probabilities, rather than emphasis on the outcome of any one trade.
- Good money management; adherence to money management rules.
- Having mentors or seeking out experts and peers to gain trading knowledge.
- Assessing risk first, profits second.

- Employment of a set of trading rules.
- A foundation of daily routines, including mental preparation.
- Use of stop-loss protection.
- Maintenance of a high level of confidence and a positive attitude.
- Commitment to the process of trading.
- Perseverance.
- Taking 100 percent responsibility for each and everything that happens in their trading.
- Being in the habit of forgetting their last trade, win or lose, and moving on to the next trade.

Why Traders Fail

Conversely, we also see particular reasons traders fail. We would like to share these observations with you in the hope you can learn from these errors and avoid some of these pitfalls. An ancient proverb states, “The smart man learns from his mistakes—the wise man learns from the mistakes of others.”

- Lack of knowledge; traders enter the business constantly without a solid understanding of what the business of speculation involves.
- Lack of capital; small accounts typically lose money. Those few with smaller accounts who do succeed eventually hang on until they understand how leverage can be friend or foe.
- No trading methodology; they use a seat-of-the-pants approach.
- No trading plan.
- Failure to apply a solid money management system.
- Not seeking help from experts or mentors; not wanting to invest in an education of trading.
- Lack of understanding of the inherent risks present in trading.
- Failure to recognize the mental preparation necessary for successful trading.
- No trading rules applied.
- Altering a sound trading plan; early entries, early exits, moving stops, not entering trade setups.
- Random trading, which is trading anything outside of their trading plan and is usually emotion-based.
- Failure to develop the discipline necessary to trade successfully.
- Not learning from previous mistakes.
- Lack of commitment to the process of trading.

- Failure to use stop-loss orders, which is the number one way to turn a small loss into a large loss.
- Blaming outcomes on external sources and not taking 100 percent responsibility for each and every aspect of their trading.

STEPS TO TAKE FOR SUCCESSFUL TRADING

One very important item to keep in mind while learning to trade: *Each action you take repeatedly will become a habit.* The habits that form will lead to either your success or your failure. Habits in and of themselves are neutral; they do not know if they have a positive or negative effect. However, the results of the habits will have a negative or positive outcome in your trading. Therefore, it is in the best interest of each trader to strive to form the very best habits that will ensure success.

Traders want to strive for a point in their trading where they are just doing the necessary actions. They should have a high confidence level that over time the edge in their trading will have a positive expectation. This will be developed through testing and implementing a specific trading strategy. We hope the items we have listed will help you determine which direction you are taking.

If you are an experienced trader and you have already formed habits that are not producing the desired results, then take time to evaluate your trading and begin to form new habits that will get you the results you desire in trading. Chapter 13 has a worksheet titled “Twenty Sample Trades Worksheet” (Figure 13.2), designed to help traders instill new trading habits. It focuses on doing the same positive action through a series of trades to create new habits and to observe how the trading edge is played out.

Positive habits will produce positive results. Negative habits will produce negative results and will be self-defeating. It may be helpful to make a list of any negative habits that are present in your trading, and a separate list of positive habits to replace those.

An example of a negative habit may be that the trader consistently exits a trade before the profit objective is reached. The new positive habit will have the trader hold for the profit objective. Another example may be that the trader enters early before a pattern is completed. The new positive habit will have the trader enter at the correct entry point. Once traders understand and know what their edge is, they will begin to see the importance of consistently executing their plan. They will see if there is a gap between where they are and where they want to be. This is a point where the trader can then fill in the necessary steps to close that gap.

Conversely, pay attention to your positive habits. The actions you are doing right in your trading can be developed further into strengths.

Develop support systems to help you instill new positive habits. A support system may be using a buddy system with another trader. It never hurts to have accountability with someone else that can help keep you on the path to your goals, but in the long run each action is your responsibility.

Here is a list you can use to help develop your personal plan of action to reach the success level you want in trading:

- Create positive habits.
- Replace negative habits with positive habits.
- Take 100 percent responsibility for each outcome.
- Create a support system to help keep you on the path to your goals.
- Take a proactive approach to making changes in your trading.

Start with a list of actions that you need to take to reach your goals. Believe in yourself; know that you are a successful trader.

As you study the trading patterns in this book, we hope that the aforementioned items will help you to develop as a successful trader.