LESSON 1, DAY 1

The Structure of a Trade

INTRODUCTION

The stock and futures markets have several functions. In stocks, the market allows corporations to raise funds for expansion of their businesses. In futures, the most important function is to provide a means by which producers—such as farmers, mining companies, banks, and the like—and end users—such as manufacturers, food processors, petroleum processors, and the like—can market what they produce and buy what they need. By far these two groups of market participants comprise most of the transactions that occur in futures. However, the third major group, traders or investors, provide a buffer between the two major groups and also constitute a good portion of market activity.

Figure 1.1 shows the general structure of futures market participants and their orientation to the markets. This model does not apply to the stock market, where the structure is not as complicated.

THE PURPOSE OF TRADING OR INVESTING

As speculators or traders, we have only one purpose or goal in trading and that is to make money. *There is no other goal!*

If you are in the futures markets for any other reason, then you are doing this for the *wrong* reason.

Producers	Traders/Investors	End Users
Farmers	Short-term traders	Grain processors
Mining companies	Day traders	Petroleum "crackers"
Banks	Pit brokers	Food processors
Petroleum companies	Hedge funds	Meat processors
Money managers	Money managers	Banks and mortgage companies
Mortgage companies		
Can be buyers or sellers, but are primarily sellers for the purpose of locking in a profit	Can be buyers, sellers or on both sides using spreads (to be explained)	Are primarily buyers because they need the product in order to run their businesses but they can also be sellers at times

FIGURE 1.1 Futures market participants.

THE PURPOSE OF THIS COURSE

The purpose of this lesson is:

- To teach you the specific structure you will need in order to trade the futures markets objectively.
- To give you a solid education in the most effective way to structure a trade.
- To teach you trading tools and methods that are 100 percent objective and that eliminate vague decisions and unclear trading signals.
- To show you several methods of proper risk management.
- To elucidate and emphasize the *major* importance of profit maximizing strategies.
- To provide you with the proper organizational, analytical, and behavioral skills that are vital to consistent success in trading.

Without the proper structure for a trade, you have nothing!

If you truly want to succeed, then you need to structure every single trade correctly. If you do not, then you will likely lose money—and if you make money, then it will be out of sheer dumb luck. Making money by chance is a hit or miss proposition that does not bring lasting success. Furthermore, it does not teach you anything. If that is how you want to trade or invest, then you might as well buy a lottery ticket. Your chances of making money are about the same as they are if you trade without the proper structure.

WHAT IS "STRUCTURE"?

Every trade *must* have three aspects to it. These three aspects, or steps, comprise the structure of a trade. Structure in trading is necessary because it decreases the odds of random or emotional decisions and it brings vital organization to your trading. The three steps are:

1. **Setup,** which consists of a high probability repetitive pattern.
2. **Trigger,** which confirms or puts into motion a setup.
3. **Follow-through,** which is the method used to minimize losses and, most important of all, to maximize profits.

Now let's define each of these more specifically.

STEP 1: DETERMINE A SETUP

As noted above, a setup (*S*) is a pattern that has shown a strong tendency to repeat over time. There are literally thousands of setups, but few are reliable or accurate.

The following are examples of setups:

- Chart patterns such as gaps, pennants, head-and-shoulders, support, resistance, flags, trend lines, reversals, key reversals, island tops, and bottoms
- Formations such as Gann, Elliott, Fibonacci, regression line analysis
- Cycles, seasonals, ratios, anniversary dates

The first setups I will teach you are based on seasonal key dates. This method is highly reliable and constitutes one of the most effective approaches that I know of to futures and stock trading. Table 1.1 is an example of a key date seasonal setup.

As you can see, this setup or pattern has a *very specific* set of rules. It is totally objective. It is not a matter of opinion, a theory, or an assumption. It is an exact statement of history. The vast majority of traders use market entry and exit methods that have never been tested. They have no idea of how often their methods have been correct. They believe what they have read in a book or heard from another trader. *This is where and how the methods that I teach you differ dramatically from what you may now be using or what you may have heard elsewhere.*

TABLE 1.1 Example: A Key Date Seasonal Setup

Long May Crude Light		**Enter: 1/27**	**Exit: 2/2**	**Stop %: 4.00**	**P/L Ratio: 6.0**	**Trade # 92541921**
Contract Year	**Date In**	**Price In**	**Date Out**	**Price Out**	**Profit/Loss**	**Total**
1984	27-Jan	29.68	2-Feb	29.82	0.14	0.14
1985	28-Jan	24.86	4-Feb	25.93	1.07	1.21
1986	27-Jan	20.75	29-Jan	19.79	−0.96	0.25
1987	27-Jan	18.17	2-Feb	18.3	0.13	0.38
1988	27-Jan	16.58	2-Feb	16.75	0.17	0.55
1989	27-Jan	16.87	2-Feb	17.14	0.27	0.82
1990	29-Jan	21.56	2-Feb	21.94	0.38	1.2
1991	28-Jan	19.51	4-Feb	19.52	0.01	1.21
1992	27-Jan	19.49	3-Feb	19.24	−0.25	0.96
1993	27-Jan	19.8	2-Feb	20.07	0.27	1.23
1994	27-Jan	15.46	2-Feb	15.99	0.53	1.76
1995	27-Jan	17.8	2-Feb	18.13	0.33	2.09
1996	29-Jan	17.04	2-Feb	17.19	0.15	2.24
1997	27-Jan	22.98	3-Feb	23.25	0.27	2.51
1998	27-Jan	17.35	2-Feb	17.42	0.07	2.58
1999	27-Jan	12.47	2-Feb	12.53	0.06	2.64
2000	27-Jan	25.58	2-Feb	25.96	0.38	3.02
2001	29-Jan	27.65	2-Feb	29.61	1.96	4.98
2002	28-Jan	20.48	4-Feb	20.56	0.08	5.06
2003	27-Jan	30.49	3-Feb	31.34	0.85	5.91
2004	27-Jan	32.61	2-Feb	32.75	0.14	6.05
Trades: 21		Winners: 19	Losers: 2		% Winners: 90.48	Daily PF: 0.0636
Avg Prof: 0.3821		Avg Loss: −0.605	% Avg Prof: 1.66		% Avg Loss: −2.95	

What does the setup above tell us? It tells us that buying May crude oil futures on the close of trading January 27 and exiting February 2 (or on the close of business the next trading day if the market is closed on the given date) would have been correct over 90 percent of the time since 1984 using a stop-loss close of only 4 percent below the entry price.

Note that this is only a setup. It is *not* a call to action. It is only the first step. Even though this is a potentially excellent trade, we need to go to step 2, which is the trigger.

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STEP 2: USE A TRIGGER FOR EVERY SETUP

The *trigger* is a method used to confirm or validate a setup. The methods you will learn in this course require a *setup* and a trigger for every trade. *There are no exceptions to this rule!*

Triggers are similar to what most traders call timing indicators. The triggers I teach you are very simple and very specific. Remember, it is the combination of setup and trigger that places you way ahead of most traders.

In future lessons, you will learn specific combinations of setups and triggers that work well together.

STEP 3: EVERY SETUP AND TRIGGER COMBINATION MUST HAVE A FOLLOW-THROUGH METHOD

The follow-through method is designed to:

- Manage and/or limit the risk
- Maximize profits

Without both elements, you will likely be like most traders—you will have many small victories that will be more than neutralized by a number of large losses. Unless you are able to bank large profits, you will never succeed at this game.

In future lessons, you will learn specific follow-through methods designed to limit losses and maximize profits.

REVIEW

In this lesson, you learned the basic structure of each trade. The structure of every trade consists of three elements:

1. Setup
2. Trigger
3. Follow-through

Some specific examples were given.

Please take a few minutes to answer the questions below.

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LESSON 1 QUIZ

Instructions: Circle the correct answers.

1. The three major groups of participants in the futures markets are:

A. Buyers, sellers, and speculators.
B. Speculators, producers, and end users.
C. Winners, losers, and spread traders.
D. Setups, triggers, and follow-throughs.

2. A setup is:

A. A bad tip given to you by a broker.
B. A winning trade.
C. A losing trade.
D. A pattern that repeats over time.

3. A trigger is:

A. A trade that has over 90 percent probability of being correct.
B. A market that makes large moves based on weather.
C. The trading system used by all successful speculators.
D. A method that validates or confirms a setup.

4. Follow-through:

A. Consists of risk management and profit maximizing strategies.
B. Is not necessary in cases of 90 percent odds.
C. Is used only by losing traders.
D. Consists of three moving averages.

5. For our purposes the goal of futures trading is:

A. To help your children through college.
B. To help brokers generate more commissions.
C. To learn new systems and methods of trading.
D. To make money.

6. End users in the futures markets:

A. Are primarily buyers.
B. Always trade commodity spreads.

C. Are generally uneducated in futures trading methods.
D. Take advantage of small traders.

7. Proper structure of every trade is:

A. Necessary since it decreases the odds of random or emotional decisions.
B. An effective way of taking delivery on futures contracts.
C. Not possible because of low margin requirements.
D. Use by commercials as a tool for helping farmers.

8. Without the proper structure of a trade:

A. You will take small losses and large profits.
B. You will be forced to use a computer when placing your orders.
C. Traders will have to rely on tips for good trades.
D. You have nothing.