

CHAPTER 1

Blueprint for Success

CREATING YOUR TRADING PLAN

In 490 B.C. the Persian army invaded the plains of Marathon and met the forces of Athens in what was perhaps the single most important battle in Greek history. The Athenian army took the offensive against the vastly larger Persian forces while they were still preparing for battle. Against great odds, the Greeks prevailed. According to legend, a Greek soldier named Pheidippides ran from Marathon to Athens with the message, "Rejoice! We conquer!" He immediately collapsed and died from his efforts. Today, in the United States alone, nearly half a million runners participate every year in the 26.2-mile race that commemorates Pheidippides's valiant feat.

In preparation for this event, runners will lay out a schedule that covers diet, running mileage, hill workouts versus speed training, sleep, recovery days, and hydration. Entire web sites, books, and software packages are devoted to making sure the runner doesn't overlook any detail that could hinder performance when race day finally rolls around. Depending on the experience of the runner, weeks or even months are dedicated to planning and preparation for the marathon. If you scour through all the articles and books written on marathon competition, almost all will include, or at least refer to, some type of training plan. And yet, for all the preparation, most runners will be finished with the event just a few hours after the starting gun fires. Of course, they'll all walk away with a space-age

2 The Market Guys' Five Points for Trading Success

marathon blanket, T-shirt, goody bag, and sore legs that won't be back to normal for at least two weeks.

Why is it that the same person who wouldn't dream of running a marathon without a complete plan will manage their finances without so much as a thought about how they'll achieve their objectives? Take it a step further—many of these same people run through their investments without even defining their objectives! The reason we open this book with a discussion of a trading plan is that it will set the foundation for everything we do. One of the fatal flaws of trading is that it lets us enter the game without a trading plan. Worse, we may even be successful for a time.

It is not at all uncommon for a new trader to place a trade and make a profit. The new trader is especially careful to analyze the trade prior to opening the position. Then they step through the trade with the care that one takes when treading new territory. Before they know it, the trade is profitable and they close the position with a net gain. They start thinking, "Hey, this is easier than I thought!" and they move to the next trade. Before long, they're taking positions with more confidence and the assumed risk increases with each trade. This same trader may have a stretch of profitable trading but then falls into a losing pattern. Or they experience "The Trade"; the single trade that cures them of any remaining vestige of confidence as it falls below every support and drains their account into a maintenance call. The problem is that this trader may not even realize that they have fallen into a period of net losses or, if they do recognize it, they don't understand the reasons for their change in fortune. As a last resort, they'll change their trading style; opening exceptionally large positions to try to exact revenge on the market, trading options without proper training or becoming a long-term investor by holding on to positions that were originally meant to be short-term trades. All of this is the result of not having a trading plan and holding yourself accountable to the objectives that you're trading toward. In this chapter, we'll discuss in detail some of the key components of a trading plan and then conclude with a trading plan checklist.

Trading Is No Longer a Team Sport

Retail trading really came into its heyday in the mid-1990s with the explosive growth of day trading. In 1997, two guys from Houston, Chris Block and Jeff Burke, made the cover of *Inc.* magazine with the

teaser headline “Bad Boys of Wall Street.” The article started with this opening line: *Their aim: move fast, make money, have fun. Who knew they would threaten a whole industry in the process?* With talk about fast cars, new offices, and armies of traders who were practically siphoning money from the market in mere seconds, the phenomenon of retail day trading was launched. One example refers to Jeff Burke’s biggest day in the market when he made \$50,000. \$50,000 in one day! People were flocking to the Block Trading headquarters in Houston and dropping \$25,000 just for the right to lock down a city for opening a franchise at some point in the future. Block Trading is no longer around, but there are some lessons to be learned from those early days.

First of all, in the mid-1990s the state of technology required that people find a retail trading office to trade. Sure, there were some choices that allowed for trading remotely, but the quality of information and trade execution wasn’t nearly as high as what was available in a trading office. These offices created an atmosphere of anticipation and played on the trader’s ego. They were often dimly lit with the shades pulled over the windows. Multiple television monitors constantly played CNBC and other networks for immediate market commentary. Other monitors displayed real-time news feeds, which scrolled through headlines too fast to allow for any analysis but served to let the traders know they were still plugged into the action. Banks of trading computers sat side by side, with traders coming and going throughout the day. It wasn’t unusual to see a highly respected heart surgeon trading next to a college dropout and the two of them speaking to each other as colleagues. Occasionally, a trader would enter the room with one of the subscription-based split pagers. These creative devices did exactly what the name suggests. Whenever news hit the wires of a company announcing a stock split, the pager would send an alert with the information. For a time, the fortunate trader could take a position before the news was fully digested by the market and then sell into the crowd’s buying.

The technology also allowed traders on the floor to access Level 2 data. In addition to the National Best Bid and Offer (NBBO), with Level 2 you could see all of the price and volume levels below the high bid and above the low offer (see Figure 1.1). This was something that most *brokers* hadn’t seen at that time. Finally, these traders often traded before the market opened at 9:30 A.M. and traded well past the market’s close at 4:00 P.M. Using the new kids on the technology block,

4 The Market Guys' Five Points for Trading Success

International Business Machines					
Symbol	IBM		-1.33		
Bid	94.52	High	96.11	Volume 4,300,000	
Ask	94.55	Low	94.26		
MM	Bid	Size	MM	Ask	Size
NYS	94.52	1000	ARCA	94.55	100
ARCA	94.51	300	ARCA	94.58	400
INET	94.51	500	NYS	94.59	1000
PSE	94.50	500	PSE	94.61	500
(MM = Market Maker)					

Figure 1.1 Level 2 National Best Bid and Offer (NBBO)

electronic communication networks (ECNs), retail traders could buy and sell to each other even when the rest of the market was closed. Finally, these rooms were often separated from the lobby area by an attentive gatekeeper, who let only the chosen traders through a door that bore the sign, “Trading Room—Traders Only.”

While these retail trading rooms had many faults that are outside both the scope and objective of this book, there was one key benefit that they provided to the trader. An esprit de corps developed between traders because they were trading day after day with the same people. This camaraderie caused traders to help each other through education and accountability. One of the common practices of day traders in these retail offices was to call out fills. Let’s say several traders wanted to buy 1,000 shares each of Microsoft. The first trader to get his buy order filled would call out the details of the fill: which market maker filled his order, how many shares they sold, and whether the order was filled on the bid or offer. All of this information would be helpful to the other traders as they managed their orders. For example, if a key market maker (often called the Axe) filled the order very quickly on the bid, that told the other traders that there may be heavy selling pressure and they could lower their buy order or cancel it altogether in anticipation of a price drop. The point to be made here is that the group of traders as a whole had more information than individual traders alone.

The mechanics of a trade were also much easier to learn in the retail trading rooms. There are seemingly endless details that a new trader must learn about the trading software, types of trades, when to place trades, position sizing, and so forth. In the isolation of one's own home office, finding the answers to these questions or learning the nuances of the minor details can be difficult at best, impossible at worst. However, in the retail trading offices, these issues were discussed throughout the day, and a new trader would very quickly pick up the salient points of the game.

Besides the learning environment that trading floors offered, the accountability that naturally resulted from trading elbow to elbow was another significant benefit. If you took a position and called out the fill as we described a moment ago, everyone around you knew what you were trading. That meant they knew if you were making money—or losing money! There was a peer pressure that grew if you stayed in a losing position. Nobody likes to have to admit that they're losing money, so it was easier to close out a position for a small loss than to hold on to a loser and have to continually explain to your fellow traders why you thought this trade was going to be different. In today's trading environment, we trade with almost total anonymity. Often, a trader's own spouse isn't aware of the activity in the trading account. This situation makes it very easy to rationalize bad trades in our heads and continue holding a bad position.

To accommodate these deficiencies in the contemporary trading environment, a trading plan needs to include both points: education and accountability. It's imperative that the trader recognize that while the market is generally simple to enter, there are many facets of trading that require a sequential education plan. For example, any new trader can step in and place a buy order, followed by a sell order. But understanding how to properly analyze chart patterns prior to entering the trade isn't intuitive. Learning to read a chart is very similar to learning a new language. Both require some formal education followed by practice using the new language. The market is also constantly changing, and the education plan should include continuing education. In the past decade we've seen such changes as decimalization of pricing, increasing interest in options trading, and expanded capabilities of trading software platforms. If you hide your head in the sand and fail to advance with the market and technology, you will eventually be left at a disadvantage.

6 **The Market Guys' Five Points for Trading Success**

When a trading plan is developed, it becomes the benchmark for accountability. The plan will become the surrogate for the trader who once sat by your side and knew if you were following your defined strategy. Let's assume that your plan is to be a day trader. By definition, a day trader opens the day and closes the day in cash. Long or short positions are opened and closed during market hours, and the price moves are measured in minutes or hours. Because your plan includes a strategy for your time horizon, you'll know when that strategy is broken. We'll take a look at an example of how this would work. After analyzing the opening of the market, you see that the stock price gapped down and dropped to support. You decide to buy the stock on support based on the expectation that it will bounce off support in the next hour and you'll capture a profit from the quick rally. After entering the position, the stock languishes on the support line for the rest of the day. It neither bounces up to new highs nor drops below support to new lows. At this point, you have a decision to make. Based on your trading plan, you should exit the position and close the day in cash. You could always reestablish the long position tomorrow if the stock is still holding on to support. However, you decide to hold the position overnight by rationalizing that it could gap up tomorrow in the same way it gapped down today and you don't want to miss the move. This type of decision is really based on hope rather than any proper analysis. The worst-case scenario occurs the next day when the stock gaps down below support. Having rationalized the first departure from the trading plan, you now continue with reasons why the drop shouldn't continue. Two weeks later you find that you're spending every moment in the market staring at this open position as the stock continues on its downward course, searching for any semblance of support that you can hang your hopes upon. How did you get here? Simple—you broke the rules that you established in your trading plan. Even if the position had not moved into a loss, it didn't reach your objective (a bounce off of support) in the time frame that your strategy requires. Most traders find themselves in this situation because they don't have a trading plan, though, not because they ignored their trading plan. The point here is that a trading plan will highlight for you the proper course of action and help to hold you accountable to your decision.

Before we move on, we should take a closer look at the issue of trading time horizons. When The Market Guys present at trading expos, we'll often jokingly advise people to avoid becoming

investors because they're bad traders. But the painful truth is that many people have long-term positions in their portfolio that were originally meant to be short-term trades. In fact, the U.S. Internal Revenue Service recognizes "worthless stock" when a stock price has dropped to the point that there is no reasonable hope of recovery. Isn't it ironic that the IRS will recognize the truth in a trade before we will? Don't raise your hand as you read this paragraph (especially if you're reading this on an airplane or sitting next to your wife at an antiques auction), but how many of you still have Webvan Group (see Figure 1.2) somewhere in your account? At what point should you have recognized that maybe this stock wasn't going to return to its previous highs? At one time, this stock was a popular trading stock among retail day traders. Many of these traders made good profits over time on this stock, too. Somewhere along the way, though, the position they bought didn't behave the way it had in the past. For the unfortunate trader who held the position in the hope that it would recover, the stock never met their expectation. By the end of 2001, the price had dropped below a penny and has rested comfortably there ever since.

The reason we're spending additional time on this point is that it is one of the most common mistakes made by novice and experienced traders alike. As long as the position is open, there is hope for recovery, however remote. Once the position is closed, we've locked in our loss. There is a misleading belief that a loss isn't a loss

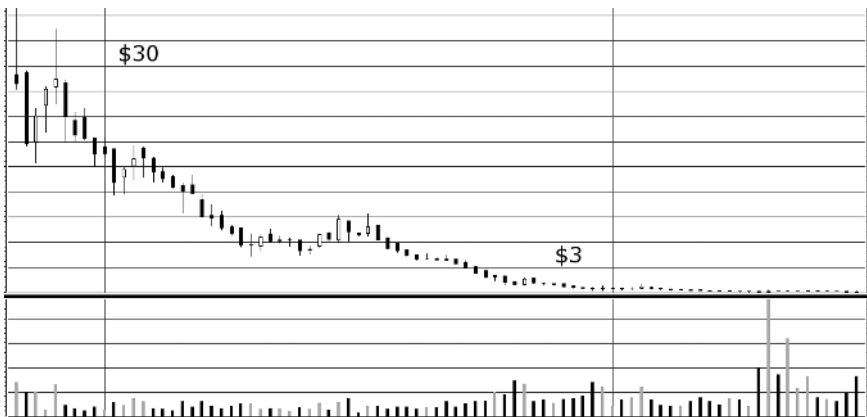


Figure 1.2 Webvan (Ticker: WBVNQ) 1999–2001

8 The Market Guys' Five Points for Trading Success

until the trade is closed. Nonsense! Don't ever use this fool's logic on yourself. Whether a trade is open or closed, if the stock price is lower now than when you bought it, you have a loss! One of the characteristics of trading options is that it forces you to admit your loss by a predetermined date when the option expires. Stock traders can fool themselves ad infinitum because a stock doesn't expire unless the company finally declares bankruptcy and reorganizes. Your trading plan should define your time horizon—whether it's intraday, short-term swing trading over one to two weeks, or position trading over a number of months. Your analysis of the trade should be based on that time horizon, and then you need to be diligent in holding yourself accountable to that plan. If you've opened a position and found that the trade has started to exceed your time horizon, close the trade and find a new position. You may not be losing money in the stock itself, but if you've locked your cash into a non-performer, you're experiencing a loss of opportunity. Remember, you could always place your cash into a certificate of deposit and get a nominal interest return.

Beware the Siren Song of Gurus

We'd like to have a dollar for every time someone asked The Market Guys about our opinion on the “winning stock market system du jour.” There are some common traits that may be found in the claims of these systems:

- They'll show you how to make money with unrealistically low risk.
- The founder has “discovered” a secret to the market that somehow evaded millions of other traders.
- The system will teach you what only the professionals know and don't want you to know.
- Their disciples will march before a camera with claims of having made thousands or millions in a relatively short time period.
- They'll tell you that you're not making money because you're trading the wrong product—for example, currencies are more profitable than stocks, gold is more profitable than mutual funds, and so on.

We'll assume that we're not surprising you here with anything that you haven't already seen on late-night infomercials or pop-up banners on your favorite search engine. One of the questions that comes to our minds each time we see these is: Why do they always include the caveat "Results Not Typical" when their followers are onscreen making claims of riches? If the system really works, shouldn't the results be typical? Let's be clear about the purpose of *The Market Guys' Five Points for Trading Success*—we're not showing you anything new or revolutionary. We especially don't claim to hold a "secret" that we'll tell you for the right price. We're offering this guide as a collection of best practices that are known to retail and professional traders alike. If you've reached this point in your reading with the belief that by the end of this book you'll have the secret to fast riches, then please stop now and discard those thoughts. The markets reward the patient and disciplined, not the greedy and careless.

Looking at this phenomenon from another angle, consider the following credentials and decide if you would listen to this person as a financial guru. Ben was diligent in attending to his financial plan. At least once a week, he would review the numbers and make the appropriate buy decisions. One thing about Ben, though, is that he never sold. He had been working with the same strategy for years and he stuck to his plan. As Ben would tell it, he didn't get caught up in complex investments. He never touched options, currencies, or futures. He had a single objective and pursued it with unassuming patience. Just a few years ago, Ben had less than \$100,000 cash. Last year, Ben decided to retire at 52 years old with over \$66 million in his account. Again we'll pose the question: Would you consider this person as a role model for your financial planning? Take it a step further. If you saw the previous biographical description under a sales banner advertising "Ben's Secrets to Wealth and Financial Security," a five-CD set along with accompanying workbooks for only \$99, would you drop the \$99? Well, it would certainly make sense until we give you the final piece of the profile puzzle. Ben Chason had just won the annuitized \$163 million Mega Millions jackpot, a multistate lottery. The \$66 million was his after-tax check from his winning numbers. Interestingly, we also see lottery winners in the markets. These are the people who, for example, had stock options loaded into their employee retirement accounts during the 1990s' tech boom and woke up to find seven- or eight-figure account equities. While we can admire them for their good fortune, we need to be

careful about setting them on a pedestal as the model of mastering the markets.

Chatter Box—AJ

While Rick and I are traveling around the world, it is not uncommon for us to meet people who are excited about the opportunities in trading the U.S. markets. If you are just starting out with your own trading plan, be sure your excitement doesn't get in the way of making good, sound investment decisions. If you are at the basic levels of trading, everyone you meet at the trade shows will look like an expert. Don't be fooled by the bells and whistles; simply check the resumes of those who claim to be experts and you will have a better chance of avoiding the "noise." We will be talking more about this in the chapters that follow.

When you look at others who exhibit the outward appearance of having mastered the markets, you'll be tempted to trade what they're trading. Take a look to your left and you'll see the gold trader and decide that gold is where you need to be. So you load up on gold stock, gold funds, gold futures, and rare coins. But then it hits you that gold can drop in price, too. You then look to the right and hear that options are the way to make consistent money. After all, you've always heard that the most you can lose is the price you pay for the option, right? Because you don't understand how to trade options, you still aren't making money but at least you're losing it more slowly. It may take longer, but the strategy will still deplete your account. It's a bit like getting nibbled to death by a duck; it doesn't really hurt along the way but the end result is the same. Finally, you decide that your real problem is that your analysis isn't comprehensive enough. Having pored through all the trading magazines and books you can find, you realize that you're only using less than 5 percent of the possible technical indicators. If the Fibonacci retracements, fans, and circles aren't important, then why are they discussed by the experienced traders? Surely, that's the reason why your trading isn't profitable. You decide to purchase the complete course on Elliott waves and get yourself to the point where you can discuss Fibonacci as if you'd discovered the Golden Ratio yourself.

Now your pretrade analysis includes a combined convergence of retracements, wave analysis, Bollinger Bands, and three stochastics. But you're still losing money.

Here's where your trading plan comes into play. Your plan includes a definition of what you plan to trade. If you're going to trade stocks, then ignore the calls to chase the riches of gold. If you want to trade gold, fine—then develop a new plan. Don't ignore your existing plan because you stayed up too late in the hotel room and the only entertainment on TV was an infomercial for collectible coins. The Market Guys are great believers in the power of options as a trading product. But if you don't have a plan to learn how to trade them properly and what your strategy looks like, then don't touch them! Your plan should also outline your trading objectives. If you've decided that your goal is to beat the broad market performance by 10 percent, then you should be working toward an 11 percent return when the Dow or S&P 500 is up 10 percent. That's a reasonably conservative goal for a trader who is approaching retirement age and can't sustain large drops in his account value. Now if you see a banner scrolling across your computer screen with claims of 700 percent returns in the market, your response should be to smile and move on. That's not your goal, and you're fooling yourself if you think that those kinds of returns don't come with a corresponding increase in risk.

Know When to Fold 'Em

We would be remiss in our discussion of a trading plan if we didn't take a few moments to delve into the trader-cum-gambler personality. In 1997, we had a trader who came into our day-trading office with a single trading objective. He had noticed that a particular stock had repeated the same cycle for the previous several years (see Figure 1.3). The stock would dip at the end of the year and then rise through the first part of the following year. Toward the end of the year, the stock would drop downward, only to rise again in the first quarter of the following year. His plan was to short the stock before the dip and ride the falling wave through the end of the year. He didn't have a what-if plan at all. If the stock failed to perform as he expected, there was no risk management. In essence, he was laying his fortune on "Red-One"—the highest payout slot on the roulette wheel.

Since his story made it into this chapter of the book, you've already guessed that the ball didn't land on Red-One. As the year

12 The Market Guys' Five Points for Trading Success



Figure 1.3 A Cycling Stock that Failed to Cycle

came to a close, not only did the stock fail to drop, but it was trending upward, which put him into a maintenance call. That's when the value of your equity drops to the point that any purchases or shorts made on margin (borrowed money) must either be covered or more money must be deposited into the account to protect the broker against the trader's defaulting on the loan. So the trader went for the double-or-nothing move. He collected more funds and shorted more of the same stock. His reasoning was the same that afflicts many traders who find themselves in losing positions. If the stock was a good buy a month ago, it's a great buy today. The problem, though, was that he was shoveling funds into shorting a stock that was on a clear uptrend. Not long afterward, he was in another maintenance call. What was different about this maintenance call was that he didn't have any more funds to feed the fire that was roaring from his positions that had crashed and burned. He was forced to close his positions at a substantial loss. The saddest part of the story is that all of this trading was done without his wife's knowledge. He had made the initial trade and, when the troubles mounted, he drew funds from his family's other accounts without telling anyone else. His gambling tendencies were too shameful to admit, and he hoped that he could recover without anyone's becoming aware of his follies. Unfortunately, he wasn't the only trader who came into our trading floor primarily because it was closer than the riverboats.

How do you know if you or someone close to you has a trading problem? The following behaviors can signal the need for help:

Preoccupation. Problem traders spend a lot of mental energy thinking about the next time they will trade, planning their strategy, or thinking of ways to get money for trading. This will begin to impact their health, their ability to sleep, and their ability to focus on other issues. The problem trader will be distracted at work or appear distant to family and friends.

Inability to stop or control trading. Problem traders find that they cannot stop trading when they want to. Maybe they decide to quit altogether, but then they still trade anyway. When they trade, they may try to control the amount of time or money they spend, but they are unable to stick to the limits they set. They often trade until their last dollar is gone. These traders will see trades that no one else sees because they need the miracle trade to make up for their losses.

“Chasing” losses. Problem traders get a strong urge or idea to win back money that they have lost in the past. They may say, “If only I could win back what I’ve lost, I wouldn’t have to trade anymore.” More and more, they feel trapped. They start thinking that the hole they have dug is so deep that only a big trading win can get them out of it. Their best hope is to hit a home run, and they’ll keep swinging until they do so.

Trading to escape negative emotions. Problem traders may trade in order to feel better temporarily or to change their mood. They may feel angry, lonely, bored, anxious, or depressed, and they trade to escape these emotions. Trading feels like an escape from their problems. After trading, the negative feelings return, as bad as ever. Because the act of trading gives them temporary relief from the negative emotions, they must trade more frequently and assume greater risks with each trade.

Lying to conceal trading. The problem trader has lied to his spouse, family, friends, or employer in order to hide or to minimize his trading losses. These lies range from concealment to outright lying. The trader feels a growing shame for his lack of discipline and hopes that if he can win back his losses, he’ll be able to avoid confronting the issue altogether.

14 The Market Guys' Five Points for Trading Success

Borrowing to pay for trading. Debts grow because of trading. Bills are unpaid. Money that could be used to pay bills is used for trading. Problem traders may have borrowed money from family or friends because of trading losses. They may have sold possessions, stocks, or bonds; borrowed from retirement accounts or savings; or gotten a second mortgage because of trading losses.

Allowing trading to jeopardize other parts of life. Trading can ruin marriages, friendships, careers, school performance, and reputations. Divorce, bankruptcy, or legal problems are all closely associated with compulsive trading. Compulsive traders act very much like someone with a drug habit. Former activities and social gatherings are shunned when the trader is experiencing mounting losses.

Ambivalence about quitting or controlling trading. A problem trader may say things like:

“I know I should stop but I love to trade.”

“My wife/husband/partner/parents/children want me to quit but I’m not sure I do.”

“Maybe I can slow my trading to the point where it is manageable.”

“I want to quit but don’t think I can.”

Now that you’ve read through the list of symptoms, you should know that this list is a compulsive gambling checklist. The only change that we’ve made is to replace the word *gambling* with the word *trading*. Nevertheless, you can see the patterns emerge in the trader we described. He was borrowing money to pay for trading, concealing his trading from his family, jeopardizing his entire financial well-being, and he was most certainly preoccupied with his trades. Toward the end of his short-lived trading career, he would enter the trading floor early in the morning and sit and stare at the stock chart all day. He was becoming physically drained from the mental and emotional energy that he was investing daily in a losing account. If we’ve cut too close to the truth about your trading habits with this discussion, then we encourage you to seek a helping hand. Sure, every trade involves risk and to a certain degree is a gamble. But there is a significant difference between taking a calculated gamble and being an out-of-control gambler. The former knows where the limits are and is disciplined to operate within those

limits. The latter may or may not understand the importance of limits but disregards them in any case.

Shucking Right Down to the Cob

Chatter Box—Rick

The Deep South has a lot to offer, but one of my favorites is the collection of homespun sayings that captures the essence of a thought better than most. When you're upset, you get your feathers ruffled; if something is hard to find, it's as scarce as hen's teeth; and if you're really worried, someone might say you're as nervous as a long-tailed cat in a room full of rocking chairs. I have a good friend who often talks about "shuckin' right down to the cob." It's his way of saying, "Let's strip the extras off and talk about what's really important."

Now it's time to take a look at the cob of your trading plan. What do you really need to make sure this plan is going to work for you?

1. Education

Before you enter the trading waters, you must first prepare yourself through education and training. As we've mentioned, the markets will let anyone onto the playing field, but that doesn't mean you're necessarily qualified. The only requirement for admission is a funded account. There are many willing players to take your account from you, one trade at a time.

The Market Guys have a basic rule: KISS—Keep it Super Simple. That should apply to your education, too. We've watched people who have listened to every podcast show we've produced, read every article we've written, participated in every web seminar we've conducted, and attended as many live events as they could. They've taken copious notes and requested copies of every presentation. Yet they still haven't placed a trade. Don't let yourself get caught in the paralysis-by-analysis trap. You need to be adequately prepared before you begin trading, but there is no virtue or benefit in creating your own trading PhD program. That said, what are the important areas of preparation?

16 **The Market Guys' Five Points for Trading Success**

First of all, you should be thoroughly familiar with the software that you plan to use for trading. Almost every brokerage firm offers a basic execution and analysis platform via the web. These are generally the simplest and most foolproof. They are usually designed for the beginner or part-time trader. You should take advantage of opportunities to learn the software, through either online tutorials or customer service assistance. Some of the deeply discounted brokerage firms offer little or no support when it comes to using the software. Stay away from these operations unless you are already familiar with the mechanics of trading and are confident that you're ready to use the software without assistance. We'll discuss the process of selecting a broker and software later in the book. If you decide to trade with one of the advanced trading platforms, make sure that there is a valid reason for moving up the technology chain besides the fact that the advanced systems look great on your computer monitor and draws the attention of your administrative assistant. Advanced trading software has more ways to get you in trouble if you don't know what you're doing. Hopefully, your parents didn't give you the keys to a Ferrari when you first learned to drive. The Ford Fiesta didn't have all the power and speed, but there was a time when that was actually a benefit. The same principle applies to trading software. The Level 2 screen is mesmerizing to a new trader. You can watch as market makers and ECNs jockey for position on the bid and offer, changing their share size and price every few seconds. The numbers stream like the prices on a gas pump when you're filling your car. It makes for fun eye candy, but the distraction often turns out to be pricey entertainment for many traders who use it as the basis for their buy and sell decisions.

You also need a solid initial education on the product that you're trading. If you decide to trade equities first—as many traders do—then ground yourself in the basics. Do you know the difference between a dividend-paying stock and one that doesn't pay dividends? The first time you see your position trading ex-dividend you will! When a company declares a dividend, it sets a record date when you must be on the company's books as a shareholder to receive the dividend. Once the company sets the record date, the stock exchanges assign the ex-dividend date. The ex-dividend date is normally set for stocks two business days before the record date. If you purchase a stock on its ex-dividend date or after, you will not receive the next dividend payment. Instead, the seller gets the dividend. If you purchase

before the ex-dividend date, you get the dividend. Here's the kicker: The stock price will often fall by the dollar amount of the dividend if the dividend is significant. If you didn't know this, you might be shocked to see your stock drop several dollars for no apparent reason and, consequently, you exit a good trade due to ignorance. With options, there are many more factors to consider than with stocks. When you trade stocks, you're looking at the trend and making a decision about whether the trend is up, down, or sideways. If you buy stocks, you want the trend to go up. If you short stocks, you want the trend to go down. Sounds easy enough, right? If you're trading options, you may want the trend to go up, but you also need it to go up within a certain time frame (before the option expires!). Of course, you may choose an option strategy that requires that the stock go neither up nor down but continue in a sideways channel in order for you to profit. Futures have a different type of account funding requirement than stocks or options and impact your account equity differently. This isn't the forum for explaining these nuances in detail, but you can start to see how your choice of trading product affects your training and education. Just because you're a successful stock trader doesn't mean you can walk onto the currency field and enjoy the same success.

Your education and training must include a proper foundation for understanding the psychology of trading. We cover this in more detail in Chapter 2, "Are You Out of Your Mind?" Keep in mind that since trading is not a proper science in the sense that there is not a quantifiable cause-and-effect relationship between stock prices and events, you need to understand and control the emotional part of the process. If you don't think that dealing with money is an emotional activity, then you probably have ice water flowing through your veins. For the rest of us mortals, we'll spend the remainder of our lives keeping in check the overwhelming urge to do dumb things when it comes to our money.

Part of your initial education and training may include some form of paper trading. The term *paper trading* comes from the days when you would simulate real trading by writing the trades on a paper trading log and make note of your profits and losses as well as any comments on the trade itself. Today, many trading software packages include a simulation mode, which will look and feel like the real thing with real market data. The only difference is that when you log off and log back on, you start with a clean slate. Paper trading gives

you the opportunity to analyze setups and buy and sell without actually putting your money at risk. You can begin to feel the emotional roller coaster that accompanies trading when you first get started. The criticism of paper trading is that it doesn't adequately prepare you for real trading because there is no substitute for actually putting your money on the line. It's like the old joke about a fellow who was asked about the difference between a recession and a depression. "A recession," he replied, "is when my neighbor loses his job. A depression is when I lose my job." We agree that paper trading may not tell you when you're ready to trade but it does a good job of telling you when you're not ready to trade. As we've said many times in our seminars, if you're losing money while you're paper trading, please don't start trading live!

Pilots often use a flight simulator to practice certain maneuvers that they may not want to replicate in actual flying. For instance, you can practice taking off and losing an engine on climbout. These exercises are useful to sharpen your skills and prepare you for the actual event, should it ever occur. However, a flight instructor would never stick a new student in a simulator for 20 hours and then bid him good luck on his first real solo flight. There is a distinct benefit of learning alongside an instructor who can help you through the actual maneuvers in real flight. The same thought applies to paper trading. Use it to refine your skills, learn the basics and prepare for the real thing, but understand that your first trade that places thousands of dollars on the line will affect you quite differently.

Your trading plan should provide at least a basic guide toward your continuing education. Many traders will be drawn toward trading clubs but approach them with care. Some trading clubs will sell you their preferred trading products or require that you pool your money with other club members for club trades. Pooled funds are traded as club trades and are often decided by the membership through a consensus vote. It would be difficult to think of a worse approach for deciding on trades. In our experience, the consensus is usually arrived at by one of two means. The first is the influence exerted by the most outspoken members. This is nothing more than putting your money into a nonregulated mutual fund with amateur managers who get their authority from the silent acquiescence of the rest of the club. The second way to reach club consensus is to take the path of least resistance in order not to offend anyone. Since the goal is to minimize risk, these trades will track the indices

or slightly lag. The club thinks the market will be rising so they buy a position in the DIAs (the Dow Jones Industrial Average tracking stock). Do you really need a club to help you decide to invest in the broad market? The better choice is to find reputable education on your own and continue to invest in your personal development.

2. Funding

Deciding how much to trade with and where the funds will come from are critical decisions as you start trading. As a general rule, most people should not trade with more than about 20 percent of their overall investment portfolio. This is a very broad statement and should be adjusted for such factors as age, time to retirement, risk tolerance, and total net worth. Most brokerage firms have a minimum account balance that is required for a trading account. However, some of these minimums are as low as \$500. It's difficult to assign a threshold for funding your first trading account but \$5000 to \$10,000 is the minimum that we generally recommend. To apply a baseball analogy, successful trading is about hitting singles and doubles. When a trader starts out with an underfunded account, the tendency is toward either extreme of (1) not swinging at all for fear of striking out or (2) swinging for the home run in order to grow the account as quickly as possible. The first extreme manifests itself in the trader who is afraid to trade. When they finally place a trade, they're unable to take a loss if the trade moves against them. They use the reasoning that they have to hold on and hope the stock recovers, because they can't afford to lose money in the account. The second extreme is the trader who decides to buy 50 out-of-the-money option contracts because they're so cheap. A better choice might be to buy 50 lottery tickets. The odds of making money on a single trade aren't too far apart, but the lottery payout is higher.

Don't take lightly the decision of when to add money to the account or when to transfer money out of the account. The rules for this decision should be clearly started in your trading plan in order to avoid being driven by your emotions. There is a strong temptation for traders to prop up their trading account when they're losing money because they can afford to. This is especially true for high-net-worth traders. They don't experience the same proportional pain of loss that others do, so they'll continually transfer funds into their trading account in order to hold on to a losing trade or to speculate on

high-risk trades. In Las Vegas, these characters are referred to as “whales.” They’re the ones who will continue placing bets, even though they lose money, for the sheer entertainment of the bet. Hoteliers love these people and will provide free rooms, escorts, meals, and entertainment as long as they play. Wall Street provides the same type of venue for masses of traders who feed the market in spite of their inability to profit. And they don’t even offer you a good meal in return—go figure.

There comes a time when you’ve diligently applied yourself to this endeavor called trading and you’re making a profit. You should also have rules for transferring funds out of your trading account into other investments. If you’re more successful in your trading account than your other investments, your trading account will eventually grow beyond the 20 percent rule we discussed earlier. Does this mean you should trade your entire portfolio? The answer is no, because trading carries a different type and level of risk. You may be outperforming the market and tempted to trade your entire portfolio, but resist the urge. Most traders go through swings between outperforming the broad market and underperforming the broad market. Sometimes this is due to market forces such as a shift into a sideways market when your trading skills work best in a trending market. Other times, this may be due to personal forces such as family stress or health issues. Having a portion of your portfolio in such investments as bonds, index funds, or real estate will serve to balance the risks and returns through various market conditions.

3. Goals and Objectives

Why do you trade? This needs to be specifically addressed in your trading plan. There is no right or wrong answer to this question as long as you’re honest with yourself. Is your goal to be a full-time trader? What’s your plan for transitioning from your current income source to trading? Have you talked to others who trade full time or have made the attempt and failed? You are not the first person to enter this field. Many have tried, with varying degrees of success. Learn as much as you can from the experiences of others. One of the key considerations in trading full time is the need to generate a profit consistently. Many traders are profitable when they trade part-time but begin to lose money when they start trading full-time. The reason is quite simple: The pressure that comes from using your

trades as your sole income source often causes you to make bad emotional decisions. It's similar to the underfunded trader. Neither of you believe that you can afford a loss so you do everything you can to avoid it. The part-time trader can afford to go for long periods without placing a trade; preferring to wait for a low-risk, high-reward setup. However, the full-time trader knows that he won't make any money if he's not trading, so he finds trades whether they exist or not.

Many traders simply use trading as a way to outperform the broad market. Their goal is not to be financially independent through trading or to build profits for a specific reward like a new boat or home. They want the ability to use their own research and judgment and direct a portion of their portfolio into opportunities that they've identified. This is one of the most conservative trading strategies and, as such, one of the most attainable goals. The decision rule for when it's time to stop trading becomes easy. You allow yourself a certain amount of time to learn the skills and reach your objective. If after one year, for example, you're still underperforming the broad market, then stop trading. Decide whether you need to learn more or end your trading altogether. If you can't beat the broad market, why not just invest your money in a low-cost index fund? It requires none of your time and attention and you'll pay lower fees.

4. Markets and Products

As part of your trading plan, you need to decide what and where you will be trading. Stocks are the easiest products for most people to understand and begin trading. Included in the stock category are exchange-traded funds (ETFs). These are essentially mutual funds that trade just like stocks. Traditional mutual funds are priced and traded once a day at net asset value (NAV). The NAV is calculated after the markets close by benchmarking the closing price of all the constituent stocks within the fund. Any buy or sell orders entered during the day are then executed after the NAV is calculated. ETFs, however, trade throughout the day and may be bought and sold just like stocks. You may be familiar with some ETFs without realizing what they are. For example, the Dow Jones Industrial Average can't be traded directly. However, you can trade the DIA ETF (referred to as the Diamonds), which follows the value of the index (see Figure 1.4). The Nasdaq 100 may be traded through the QQQQ ETF (the Q's) and the S&P 500

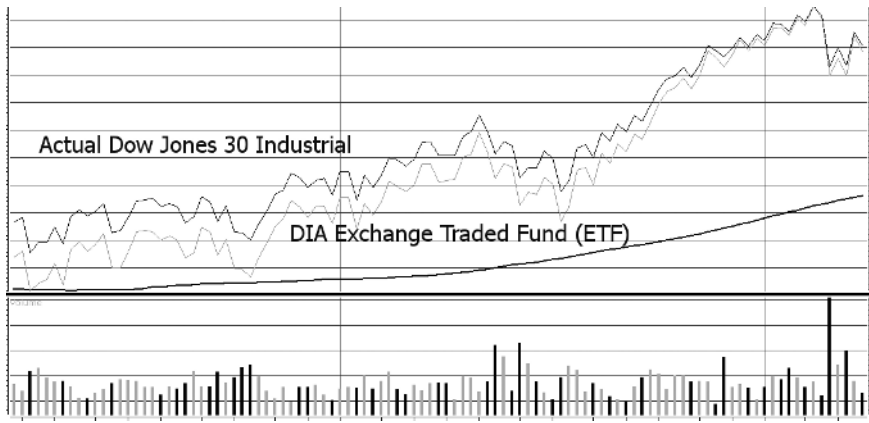


Figure 1.4 Dow Jones Industrial 30 versus DIA ETF

Index has the SPY ETF (the Spyders). Besides indices, ETFs are often used to trade specific sectors or industries. You can trade the biotech sector, for example, with the ETF ticker symbol BBH.

Traders will often graduate into options after learning the basics of stocks. It's important to understand stock trading before trading options because part of the options pricing model is the price of the underlying stock. If you don't understand the nature of price movement with stocks, you'll only magnify your confusion when you trade options. Having a plan to transition into options will help you avoid making the move too early. As we discussed earlier in this chapter, there are many so-called experts who will try to convince you that options (or gold or currencies or futures—you get the idea) are the path to riches. You'll be sorely tempted to drop your current trading strategy and style and follow their 12-step plan. If you decide to trade various products, then develop a plan for each. Each plan should include the salient points we're covering in this discussion and should stand alone. Your funding requirements for your futures trading will likely be different than the funding requirements for your stock trading. Likewise, if you're highly leveraged through futures trading, you should expect better returns than simply outperforming the broad market. The risk you assume should have a corresponding level of return.

Your trading plan should identify which market you plan to trade. Of course, this is often determined by the product. Some stocks only

trade on the Nasdaq exchange while others trade on the New York Stock Exchange (NYSE). Many traders around the world will trade their local exchanges for such products as contracts for difference (CFDs) while also trading the U.S. markets for the liquidity offered. The consideration of which market to trade is not as significant as it once was. There was a time when the execution difference between virtual markets and physical markets was drastic. Technology has created a forced leveling and the historic differences are becoming less of an issue.

5. Trade Setup and Execution

It may seem intuitive to define the process by which trades are identified and executed while ignoring the other trading plan components discussed in this chapter. Lest we gloss over this important concept, the following is an outline of the salient points to consider in this section:

Time horizon. You must decide in advance how long the trade will be held. Do not change time horizons in the middle of a trade to accommodate a bad trade. This is quite different from riding a profitable trade. Don't exit a winning position just to satisfy your defined holding period, but don't become an investor because you're a bad trader.

Stock screening. How are you going to pare down the population of thousands of stocks into a pool that you can reasonably analyze for trading? Are you a trend trader, or will you be trading channels, or both? Are you going to attempt to pick reversals? Will you screen stocks for large-capitalization companies, or will you be speculating with penny stocks?

Pretrade analysis. Charts are the primary tool of technical analysis, but there are many variations to charts and techniques for using them. Candlestick charts are the personal favorite of many traders, but some people will swear by point-and-figure charts because they remove the time scale from the analysis. Once you choose a charting style, what indicators and entry/exit rules will you apply?

Risk analysis. Knowing when to exit a losing trade is one of the most important skills that a trader develops from experience. However, the beginning trader must define risk management rules from the first trade. Are you going to use The Market

Guys' 1% Rule or do you have another risk tolerance level that you'll apply? You need to decide how you'll protect an open position. For example, a long stock position could be protected with a long put option or a sell stop order.

Position sizing. Some traders answer this question by looking at how much they can afford. We recommend tying your position size into your risk tolerance and have provided guidance to accomplish that later in the book. Your trading plan should include rules for your position size, including adding to the position as well as exiting the position. Remember, if you buy 1,000 shares, there's no requirement that you sell all 1,000 shares at the same time.

Trade execution. Finally, consider how your trade will be executed. You may have different rules for different market conditions. For example, some traders will use limit orders only in the first and last half hour of trading to help protect against the higher volatility found during these periods. Some traders enter a position with a market order and exit with limit orders.

6. Trade Diary

Knowing exactly how profitable you are through trading is critical for improving. The best way to keep tabs on your profits and growth is through a detailed trading diary. The trading diary will help you identify what works and what doesn't. Along with that, it will quickly show you when your trading strategy is starting to break down. Some traders employ a strategy that performs remarkably well in a bull market but underperforms in a sideways or bear market. Your trading diary will be the first to flag you when conditions are changing and you need to adjust your strategy.

There is no limit to the information that you choose to log into your trading diary, although it is possible to overanalyze your performance and spend more time with your spreadsheets and less time with the markets. Whatever your predisposition may be toward self-analysis, the following is a suggested minimum list of information that your diary should contain:

- Product traded
- Entry price, date, and time

- Reason for entry
- Position size
- Stop price
- Exit price, date, and time
- Reason for exit
- Net profit or loss
- Market conditions
- Miscellaneous notes

Grow with Your Plan

As we wrap up this discussion of the trading plan, there is one more important point that needs to be made. The trading plan should serve to make you a better trader and guide you through your growth. It is by no means a malevolent dictator that, once created, must be served without question. You'll find that your trading plan will evolve over time, reflecting your increase of both knowledge and experience. It represents your best effort at a set of rules that you believe will help you reach maximum profitability. However, it is a snapshot frozen in time. As you continue trading, you may find products that are more profitable for you. Some traders are most profitable in sideways markets when they learn to trade options. They don't enjoy the same success with stocks, which may be what they started trading. There's no problem with making the change as long as you develop a new plan. We've known many traders who were lured into the markets by the promise of quick riches that were supposedly available to anyone willing to commit to day trading full time. Reality set in very quickly, and these same traders discovered that trading was more profitable for them if they lengthened their time horizon from minutes to weeks. Once again, it is perfectly acceptable to switch from being a day trader to a swing trader if you've developed a plan to do so.

Your trading diary will be your feedback loop for changes that you'll make to your trading approach. Look for the patterns that tell you what time of day is best to enter an opening trade, which products produce the best returns, or when it's just time to take a break and regroup. The markets will always be changing; be sure you change with them.

