PART I

Psychological Truths and What to Do about Them

I'm amazed at how seldom the day-trading training programs address the vital subject of beginners' emotional response. Anyone offering instruction in this work should know that day traders *will not* have consistent success until they've learned to control their emotions.

Therefore, my first goal is to explore the psychology of day trading, and to offer my hard-learned advice. I've placed this part first so you'll study it first. My hope is to dissuade you from thumbing to the technical-strategy chapters—not until you've thoroughly internalized what's here.

Why is this so important? It's absolutely critical to understand yourself before you get deeper into this high-stress career.

CHAPTER 1

Truths about Yourself to Know First

You'd be totally realistic to ask this: *What is day trading, exactly? How does it differ from other types of stock trading?* And last but most definitely not least: *What's my skill level in day trading? Where do I fit in?*

Before you get into the profession full time, you should know all the answers to those questions.

You may find, however, that the answers don't come easily. Confusion about just what day trading involves is common in the stock brokerage industry, and gauging just how adept you are at it can feel a bit nebulous, too.

Consider the *Investopedia* definition of day trading:

> *Day trading is defined as the buying* and selling *of a security within a single trading day.*

Does that description define much?

As a beginner, you should start with an awareness of the distinct separation of day trading from investing. Be clear about which one you're interested in, and just how well-honed your skills are. You may find that sorting out these questions requires some headwork, because day trading has come to be associated with a variety of workplace scenarios.

Prior to the Internet takeover, a decade or more ago, for the most part day traders worked at bank or investment firms and were known as equity investment specialists, or else fund management pros. But now, in the midst of both changing legislation and proliferating prospects online, day trading has emerged as a popular calling for thousands hooked up at home. *Private equity trader* has become their official job title.

Approach two strangers on the street, ask them what they think a day trader is, and they'll probably mention either Wall Street or a person online in his den. One of them might talk about a brow-sweating guy with his tie loose and shirtsleeves rolled up, barking market orders across the pit to a just-as-harried colleague on the floor. The other one might talk about a barefoot guy in his shorts, glued to his PC all day.

Both of the people surveyed would be right. There's no single definition of a day trader anymore. Day trading has vastly diversified. And as if the expansions I've mentioned aren't enough, there are also, within those assorted scenarios, traders with assorted approaches. This is where things get even murkier. You've probably heard of the handles that express styles and strategies: momentum trader, scalp trader, equity trader . . . whew.

If you find yourself getting a little bit flustered by all that stuff to take in, remember that the main point to focus on is this: Professional day traders close out all positions at the end of the day; day traders don't **hold** overnight.

The best way to further get the gist of day trading is to recognize what it is not: It is not investing. With regard to stocks, investing differs from day trading because of four primary factors:

1. Investing in a stock requires substantial research and knowledge of the company.
2. Usually a large portion of your capital is used in a single position.
3. The general plan, when investing, is to **hold** a position longer to get a bigger return. How long you **hold** the security is a major indicator of your expected return on investment (ROI).
4. Investing requires forecasting the future.

Stock investments are classified as short term or long term. A short-term investment is usually a position **held** for one business quarter or less—that's up to three months, never longer. A long-term investment is usually **held** for longer than one business quarter, with an expectation of receiving dividends and future earnings growth in the company.

When the term *invest* is very loosely applied, you can actually call day trading investing. It's true that you're taking your funds, for the moment, and investing them in a stock. But you don't have to know the stock's company like you know the back of your hand, you're not (well, I hope you're not) putting up most of your money, you almost never **hold** overnight, and you don't need to forecast the future. That's why you're referred to as a *trader* as opposed to an *investor*.

When the term *investor* is aptly applied, we're usually talking about hedge fund managers and portfolio investment pros. Those brokers usually work in large firms, like Goldman Sachs or Merrill Lynch. They handle investment capital that numbers into the millions, and that money belongs to their clients. Because it's not their own capital, their licensure is a must. Their time is spent researching companies, forecasting earnings, seeking out new clients, and retaining existing clients.

Those managers, or licensed brokers, however you want to call them, decide on what companies to add to investment portfolios and how to manage the risks. Once they know how much of their clients' money they want to invest in a stock, they alert their firm's trading desk. A hired day trader then purchases the shares on the order form given to him.

That sort of day trader is not an independent. Like the broker, he has to be licensed. His job is to fill all the execution orders he receives throughout the day. Most likely he's paid a base salary and some sort of a commission.

The independent day trader (or independent equity trader) goes by the same name, but his job is decidedly different. He uses only his own funds. He doesn't have to get himself licensed. He either works alone from home or at a private-equity trading desk, usually at a pay-per-share firm.

The role that all types of day traders share is that they spend their time immersed in the business of placing intraday trades. Their attention is riveted to the volatile price swings that are so characteristic of stocks.

Day traders care mostly about how volume and price movement are being affected by those swings. They don't get caught up in the huge panorama of forecasts and company analysis. That would be like viewing the forest, not the trees. Day traders squint, up close, all day long, at the endless flitting motion in the trees.

Since day traders don't plan to **hold** overnight, news about stocks and any earning announcements aren't likely to affect their day's trading. Though company information and other fundamentals are somewhat important to traders, they aren't critical. Remember, they're not investors. They're not betting their lives on a company. They're trading on the volume created by intraday investor interest in a chosen company's stock price.

Well, at this point you may be thinking I'm making it sound as though day traders don't care about the companies they're trading. You'd be half right to assume that. Chapter 14, "Stock Picking: Simplifying the Process," and also Chapter 15, "Why News Can Be Just Noise," further drive that point home.

In response, you might pose the question: *Just what does a day trader do that's beneficial to the market?*

For starters, day traders are crucial to a stock's price movements, called market liquidity. The more liquidity there is in a stock, the better the stock will trade. Liquidity means that there are many buyers and sellers interested in the stock. Without day traders, investors wouldn't be able to buy large volumes of any given stock without driving up the price as they were buying up their positions. Conversely, and just as importantly, when investors begin to sell off, day trading liquidity helps keep the stock from dropping precipitously.

Now that you're clearer on what a day trader is and does, and also what a day trader isn't and doesn't do, your immediate priority should be to ascertain your *skill level*. If you were discussing that subject with me, I'd have several questions for you. Going from most to least important, they'd be:

- How *often* do you trade, and how profitably?
- How *much* are you trading in capital and leverage?
- How *long* have you been trading?
- *What* are you trading (your financial instruments)?
- Are you trading *other people's money*, or only your personal capital?
- Are you a *licensed* trader, or trading independently?
- *How* were you trained?

And then we'd elaborate on all of them.

HOW OFTEN DO YOU TRADE, AND HOW PROFITABLY?

More than any other factor, your skill level is based on how many trades you place per day and the consistency of the profits. If you do well with one trade per day, that's great, but the same intraday performance with a hundred trades is much more desirable. Your *frequency* of trades is the quintessential signpost that indicates your level of skill. Frequent trades, frequently profitable, are the visible proof of a pro.

HOW MUCH ARE YOU TRADING IN CAPITAL AND LEVERAGE?

An affluent beginner might trade with a million dollars. With a 50-to-1 leverage, he can capitalize on his margin mightily. Does this mean his skill level is higher than that of a guy with just five thousand bucks? The answer is clearly *no*.

In order to buy ten times the shares, of course, you always need ten times the capital. If you have that kind of capital, that's great. But that won't ensure you more profits. It just means you'll make more or lose more.

You don't want to increase the share size just because your funds make it possible. *Your share size should only increase with your skill.* I recommend a very slowly graduating climb from 100-share blocks to 200, onward and upward in increments that small, in careful correlation with your growing expertise. Whenever you find that increasing your share size is causing your profits to crash, you need to back down to something smaller. No matter how much capital you play with, there's no sense in losing big chunks of it just because your skill level is low.

I always use 100-share blocks as a starting point. Why? If you consistently trade at a profit by executing 100 trades per day and sticking with 100-share blocks, then what you've developed is a *high* level of skill when trading with the amount of capital required for purchasing 100 shares at time.

Here's the flip side. Take any average stock, let's say a $50 stock. All you need is $5,000 to purchase 100 shares. If you have $1 million in capital you can purchase 20,000 share blocks, or four similar stocks each in 5,000 share blocks, and so on. Can you see where I'm going with this? The more funds you have, the more likely you'll get in trouble if your skill level isn't sufficient.

Here's an unpleasant scenario I've lived through.

Part of being an amateur, for me, was learning to properly handle my leverage. With my initial, traditional pay-per-trade broker, it was usually 4 to 1. This increased my buying power (my capital), so I felt as if I was four times as rich. I immediately began to purchase larger share blocks, sometimes 10,000 share blocks at a time. What followed was a nightmare of loss.

As I take you through my confessions, which essentially make up this book, I reiterate that nightmare, and others, from different angles in different chapters, to help you see where I went wrong. In this chapter, what I want to make clear is that I lacked the skills that the increase in capital made me think I had.

I eventually discovered that a highly skilled trader profits, no matter how great or how little his funds. Even if he's playing with as much as $1 million, he'll wisely purchase only 100-share blocks, and he'll utilize his skill and decrease his risk by trading multiple stocks.

That guy could buy 20 stocks in 100-share blocks in a heartbeat. Maybe you're thinking, if he were to do that, then he'd be spread way too thin.

Watching 20 stocks is scary, that much is very true. But it's still better than putting all of your capital into one stock and one trade. You certainly don't want to start out as a day trader nervously eyeballing multiple stocks, but later on, after some practice, the wise thing to do is just that: to diversify your daily portfolio. Literally speaking, that's your stock list, and by making it longer and having a lot to watch, you minimize your risk by about 80 percent.

Though having more capital does not in itself increase your skill level at all, it does make you gradually smarter, because you have money for practice. But fear not, comrades with average funds: whether or not you have a truckload of capital, this is the thing to remember: learn how to manage your risk. The higher your skill level, the better you'll do that.

Risk management is knowing when to use your capital—just how much, and when. Chapter 6, "The Importance of Risk Management," illuminates that mastery, applied to intraday trading.

HOW LONG HAVE YOU BEEN TRADING?

This question implies some tough answers. I've heard of amateur traders who have gone to a mentorship program, read a couple of books, practiced for a couple months, and then began trading with a great degree of consistency and profit. In less than a year, all of a sudden they're exemplary professional day traders.

And then there are the traders, myself included, who must struggle for years to find their niche. It's difficult, if not downright impossible, to approximate how much time it takes for individual traders to build and improve their skills.

The longer you're in this industry, of course, the more skill you'll acquire. And here's something I'll assert with conviction to any and all day traders, no matter how quickly or slowly they profit, because time always proves this truth: The key to increasing your skill level is to remain very active in trading.

The question of how long you've been day trading does not just address the time spent; the underlying query—the important thing to know—is what have you been doing with that time? Have you been using it wisely?

Here's a list of suggestions that can help speed up your process of attaining trading skills.

- Be active. Stay with it—full time.
- Budget, borrow, or plan what you have to in order to be able to take some time off to focus *only* on day trading.
- Get involved in a mentorship program with someone you can watch.
- Get your New York Stock Exchange Series 7 (General Securities) license and go to work for a salary-based position at a brokerage firm like Merrill Lynch (optional).
- During your free time, inundate yourself with market information, especially day-trading tactics and strategies.

WHAT FINANCIAL INSTRUMENTS ARE YOU TRADING?

Are you trading stocks, commodities, treasuries, option contracts, future contracts, penny stocks, or some other financial instrument?

A professional day trader can trade virtually any medium of exchange. Most beginners, however, only trade in equities (stocks). That, in my opinion, is the safest place to start. Stock exchanges have the most transparency and market data available; what that means is that for the beginner, they're the simplest instruments to learn from.

That doesn't necessarily mean that if you never trade options or future contracts, you'll never reach professional status. It really boils down to what you're comfortable with and what interests you the most.

The key is to find your niche, and stick with it. For instance, if you choose to trade only stocks, then over time you'll become a master at trading in equities. Most likely you'll find that you only trade one type, such as tech stocks or energy stocks. The more you fine-tune your trading style—as a "scalp trader" or whatever—the more skill you'll acquire for that financial instrument.

ARE YOU TRADING OTHER PEOPLES' MONEY OR YOUR PERSONAL CAPITAL?

In order to invest clients' money, you have to be a licensed broker. And no one, of course, is going to trust you unless you're extremely experienced. But just the same, always remember: Just because you're an unlicensed, independent trader doesn't mean you're not a professional.

ARE YOU A LICENSED TRADER, OR TRADING INDEPENDENTLY?

If you're trading from home, you're most likely an independent. If you opt to trade at a professional trading desk, you have a couple of choices: You can remain independent and trade from the floor of a pay-per-share firm, or you can obtain a license (Series 7) and apply to work for a large investment firm like Goldman Sachs.

I've learned to never judge traders by where they're trading from or whether they're licensed. I've known some licensed day traders who can't be consistently profitable. And I've known some home-based, unlicensed traders who've had sterling track records for years.

In day trading, a license doesn't make you a professional. If you study for your Series 7 license, as I have, the first thing you'll notice is the manuals' remarkable thickness. They're loaded with virtually everything to know about corporations and all the information you could ever cram in about how the stock market functions. You'll learn all the federal Securities and Exchange Commission (SEC) regulations, and the entire process of how corporations disclose their earnings statements. Basically, you'll get an entire overview of the stock market universe.

Most large investment firms require the license as part of their application process. You don't actually learn how to day trade until they show you how. That's why the license means nothing—It's really just your pass for admission. Having one proves you've been checked out for things like a criminal record.

But you still have to learn how to day trade.

HOW WERE YOU TRAINED?

Training is everything. If you've only been to a seminar or read a book or two, you're like a lamb being led to the slaughter. You can't possibly learn how to day trade from reading manuals and getting tested or licensed. The most effective form of training is by far the mentorship programs, sometimes called in-house training. Most of those programs have you and a professional trader working one-on-one.

Stay tuned for a lot more on mentoring.

Well I hope that I've helped you be clearer, at this point, on whether you're meant for day trading or investing. And I also hope that I've helped you get a fix on your current skill level.

That way you're more likely to know just exactly what you're getting yourself into!

RULES TO REMEMBER

- Increasing your skill level is a gradual process; never rush it without the help of professional mentorship or in-house training.
- A Series 7 license doesn't mean you're a professional day trader. You still need to be trained.
- When day trading, always remain active. That's the key to increasing skill.