CHAPTER 1

THE ART OF TRADING

> It ain't about how hard you hit, it's about how hard you can get hit and keep moving forward. That's how winning is done!
>
> —Rocky Balboa

Trading is a battle between you and the market. The traders we interviewed for this book offered a wealth of insight into the art of trading. We distilled their most important ideas into this short summary highlighting one unique idea from each trader that can help you succeed in your battle with the markets.

1. IF THE NEWS IS GOOD BUT THE STOCK PLUMMETS, BUY THE CRASH

Buying crashes is not for the faint of heart. For many traders, the experience is akin to jumping out of a plane without a parachute. Yet Dana Allen has made his living doing just that. How does he profit from other trader's losses? By looking for tell-tale signs of divergence. Technical divergence where price makes a new high but momentum indicators do not is one of the bread-and-butter routines used by many successful traders. However, Dana Allen takes the idea one step further by trading fundamental divergence. He likes to buy stocks that sell off on good news speculating that the initial reaction is often simply due to short-term profit taking. Once the sellers are done, Dana likes to scoop in and buy value at a cheap price and then quickly resell it higher once demand reappears. By making sure that he only buys quality companies, Dana has the fundamental support for his trades and more often than not is able to bank gains in the process.

2. KNOW YOURSELF, KNOW YOUR TRADE

In trading, knowing yourself is more important than any particular trading strategy that you may choose. Your personality needs to be in sync with your methodology, otherwise you will not be able to follow the rules of the setup. Knowing your strengths as well as your limitations is rule one of becoming a successful trader. As Rob Booker points out in his interview:

> I am a 50- to 100-pip-a-week trader. Meaning I have pretty much decided that that's about the limits of my human capacity and over 50 to 100, I start getting a little bit crazy. I become a little bit less disciplined and a little bit more euphoric to put it mildly. So, I have not generally done a lot to increase that pip target over time, even though systems that I build might produce bigger gains.

If you have a short attention span and seek instant gratification, long-term swing trading strategies will not work well for you, no matter how robust they may be because you will not have the patience to successfully see them through. Conversely, forcing oneself to become a scalper is sheer suicide for a trader who may be much more analytically, rather than instinctually, inclined. Therefore, it is imperative that you know what type of trader you are and trade within your comfort zone. There are many ways to succeed in trading but they must be aligned with your personality.

3. TRIPLE YOUR DEMO TWICE BEFORE TRADING FOR REAL

This insight from Hoosain Harneker is perhaps the most practical piece of advice from any of our super star traders. Nobody can master a professional skill right away. Doctors practice on cadavers, lawyers spend countless hours in moot court, and mechanics toil for months in classroom garages. Practice does not guarantee success but lack of practice almost always ensures failure. In foreign exchange, which is Hoosain's market of choice, every dealer offers a practice platform allowing traders to experiment with virtual money rather than real capital. In other financial markets plenty of software tools exist to allow the trader to "paper" trade in realistic market environments. For example, our other interviewee, Paul Willette, who was already a successful equity trader, spent three months paper trading his account when he decided to make a switch to electronic stock index futures.

What makes Hoosain's advice even more valuable—albeit much harder to follow—is that one has to achieve substantial success on the demo before moving to a live account. By mandating that you triple the demo, Hoosain requires that your trading methodology has a discernable edge that should serve you well in the real market. While his rules of trade are difficult, they are well worth following because they instill the discipline necessary to succeed in the real market.

4. DON'T LOSE YOUR COOL—ALWAYS USE A STOP

Although this rule is practiced by every professional trader to control risk, Franki Law, a Forex (FX) trader from Hong Kong, offers additional insight into why it is so valuable. In his interview, he states:

> There are many people who will go long a currency pair and keep injecting money into their accounts if they get margin calls to buy at even lower prices in hopes that a rally will help them recover their entire account. For example, if you are long 10 lots, and the price falls, you add 20, if it falls again, you add 30 etc. Although

> the ability to recover quickly may seem extremely attractive, it is very dangerous and it is something I will rarely use. The reason is because I feel that if I keep on posting money into my account to meet a margin call and adding into a losing position, I am essentially at the whim of the market. I can only hope that the trade moves in my desired direction, but I am essentially stripped of my decision making power. Perhaps the price movement would have called for a short, but since I am buried so deep in the long position, I can only let the market take me where it wants to. So what would I do if I got a margin call? I would close my position and wait for the next clear opportunity or setup to get into the market because it avoids letting the market dictate my profits and losses and allows me to be the decision maker once again—I get to choose when to get into the market, what product, and what size and this control is very important to me.

If you do not use a stop, you are at the mercy of the market and lose all control over your trade. Since trading at its core is ultimately an exercise in control over the chaotic and often unpredictable markets, a stop is a must for any long-term trading success

5. PROTECT YOUR CAPITAL—PROTECT YOURSELF

This is perhaps the most basic but often the most overlooked aspect of trading. According to Indi Jones:

> Clint Eastwood would be a great commodity trader because he told the Million Dollar Baby that rule number one in boxing is to protect yourself. And I think the same is true in trading. If you want to trade, your capital is everything. So, if you want to be a great trader, you have got to protect that capital. No capital, no trading, no life and its the same whether you want to be a Million Dollar Baby in boxing or a Million Dollar Baby in commodity trading, I think it's the same thing—protect your capital.

The market will forgive many things including bad, even stupid trades, but it will not forgive the loss of capital. Once all of your capital is gone there is no opportunity to recover. That's why capital preservation is always the foremost concern of every trader we interview.

6. AVERAGING DOWN IS FOR LOSERS, BUT AVERAGING IN CAN BE THE DIFFERENCE BETWEEN SUCCESS AND FAILURE

Most traders will tell you that averaging down into a trade is a mug's game. However averaging in is a strategy employed by a number of our interview subjects to great success. What's the difference? Intent. Traders who average into the positions expect to be initially wrong on price and size their trades accordingly. Roland Campbell is one such trader:

> That to me is absolutely the key to my success. I average in on every trade I make and I average out whenever I exit. I have a tendency where, as soon as I buy a currency, it will dip 10 pips. Before I would get upset, but now I love it because I feel like I can get in at a better price, so I hope it dips another 10 pips. I know the price I want, so I will average into that price.

Roland allows himself about four average ins before he calls it quits. "If it goes much further than four average downs, I have to start considering whether this is the right trade to be in," he notes, "but nine times out of ten that strategy works for me." Roland always knows his "uncle point" and unlike novice traders who are never willing to pull the plug on a bad idea, Roland will always stop himself out when a trade goes bad. However, the majority of the time, he will succeed in turning a profit on most of his scale in strategies, showing once again that all rules of trading can be broken if you have a legitimate reason for doing so.

7. TOPS OR BOTTOMS ARE ONLY EVIDENT IN HINDSIGHT

There is an old trading adage that goes like this, "They don't ring a bell at the top." While tops and bottoms may seem obvious in retrospect, in the heat of the battle they are rarely clear. That is why Tyrone Ball's point is so valuable. He said, "I came to understand that you can't pick the top and the bottoms of your trades, you just got to be willing to take money while it's still in your favor and cut your losers small. I mean it sounds too simple, but most can't do that." Market profits can be very elusive. Like ice cubes in your hand. Therefore, banking at least some profits when you get them is a cornerstone to most of our traders' success.

8. TURN HAPPENS ONLY ONCE BUT TREND IS CONTINUOUS

For anyone who is a fade trader trying constantly to pick tops or bottoms, Ashkan Balour's deceptively simple observation should provide a moment of pause. He states, "Basically I am continuation trader. When the trend is going in that direction, I don't see any point in trying to find the turn. It will tell you when it's reversed. If you look at any chart pattern where the market's reversed, you'll see a daily reversal. Reversal only happens once, but the continuations happen all the time until the moment the reversal is hit." In a sense, Ashkan argues rather persuasively that the higher probability trades occur with the trend since, like in physics, price will stay in motion until it is counteracted by a stronger opposing force. Until such time comes, Ashkan believes, it is much more productive to trade in the direction of the major trend.

9. THE LAST 25 PERCENT OF THE POSITION CAN MAKE A DISPROPORTIONATE CONTRIBUTION TO YOUR OVERALL PROFIT

Everyone wants to be able to let their profits run, but in real life financial instruments rarely follow a smooth straight path to riches. Instead prices often retrace the majority and sometimes all of their gains leaving many inexperienced traders empty handed. Paul Willette, however, has come up with a method to harvest some profits right away while ensuring that he can still benefit from an occasional extension run in his favor. What's noteworthy about his insight is that even leaving a small proportion of his original position on could contribute significant profits to his overall account.

How does this work? Let's assume that we trade like Paul does with a position of 20 contracts. The stop on the position is 1.00 ER (a mini-Russell 2000 stock index future) point. At +1.00 points in his favor, Paul would sell five contracts and move the stop to breakeven. At +2.00 points he would sell another five contracts. At +3.00 points he may sell an additional 5 contracts. At +5.00 he may sell two more contracts and at +7.00 he may finally sell the last three remaining contracts. In total the trade would have netted +61 points, but note that fully 31 of those points—or more than 50 percent—came from the last five contracts or just 25 percent of the original amount of the trade.

Paul teaches us that we do not need to make money on more than a small portion of our position in order for the whole trade to be substantially profitable.

10. MAKE YOUR MONEY WORK FOR YOU

In a rush for capital appreciation, many traders often overlook the immense power of compound interest. Marcelino Livian is not such a man. Instead, much like the largest money center banks and the savviest hedge funds in the world, Marcelino always looks to get paid while holding a position. That's why he trades FX exclusively on the side of the carry, letting the positive interest rate differential between the currencies help improve his average entry price while he waits for his trades to become profitable. While his method may be far less glamorous than the swashbuckling style of the scalpers it is no less profitable and should be taken just as seriously.

11. BEAT COMPUTERS AT THEIR OWN GAME BY USING PROBATIVE ORDERS

Almost 70 percent of trading on Nasdaq is now done through automated order-entry programs. Many traders have bemoaned the onset of computerized trading robots as the end of face-to-face markets, but Steve Ickow has not only adjusted but prospered under the new regime by probing out the logic behind the software algorithms. Steve says, "A high percentage of Nasdaq volume is now composed of black box trading. So a lot of times I will test price just to see where the market is. Let's say I am long and I start bidding up and bids come with me then I know I am good. Let's say I offer and now no one joins me, no one is an aggressive seller. That's how I get information on the stock by constantly bidding and offering." Whether you are a machine or a human being, when it comes to financial markets ultimately you are either a buyer or a seller. By constantly probing the logic of the machines, Steve Ickow is able to figure out their true intentions and turn that information into profitable trades.