

- » Figuring out just what day traders do
- » Setting up a trading business
- » Knowing what being a successful trader takes
- » Dispelling a few day trading myths

Chapter **1**

Doing Day Trading Right

Looking to conquer the markets from the comforts of home? Some people can. But day trading is a crazy business. Traders work in front of their computer screens, reacting to blips, each of which represents real dollars. They make quick decisions because their ability to bring in profits depends on successfully executing a large number of trades that generate small profits. They close out their positions in the stocks, options, and futures contracts they own at the end of the day, which limits some of the risks. A lot can happen in a year when you're a day trader, increasing the likelihood that your trade idea will work out, but in a day? You have to be patient and work fast. Some days offer nothing good to buy. Other days, every trade seems to lose money.

The individual human day trader is up against a tough opponent: high-frequency algorithms programmed and operated by brokerage firms and hedge funds that have no emotion and can make trades in less time than it takes to blink your eye. Artificial intelligence has the potential to level the playing field, but the market will still crush unprepared players all the time.

In this chapter, I cover what day traders do, share the advantages and disadvantages of day trading, list the personality traits of successful day traders, and give you information on your likelihood of success if you choose to be a day trader. The more you know before you make the decision to trade, the greater your chance of being successful. If you decide that day trading isn't right for you, you can apply strategies and techniques that day traders use to improve the performance of your investment portfolio.

Defining Day Trading: It's All in a Day's Work

The definition of *day trading* is that day traders hold their securities for only one day. They close out their positions at the end of every day and then start all over again the next day. By contrast, *swing traders* hold securities for days and sometimes even months; *investors* sometimes hold for years. The short-term nature of day trading reduces some risks, because nothing that happens overnight will cause losses. Meanwhile, many other types of investors go to bed thinking their position is in great shape only to wake up the next morning to find that the company has announced terrible earnings or that its CEO is being indicted on fraud charges.

Ah, but there are two — or more — sides to every story: The day trader's choice of securities and positions has to work out in a day or it's gone. Tomorrow doesn't exist for any specific position. Meanwhile, the swing trader and the investor have the luxury of time, because it sometimes takes a while for a position to work out the way your research shows it should. In the long run, markets are efficient, and prices reflect all information about a security. Unfortunately, a few days of short runs may need to occur for this efficiency to kick in.



REMEMBER

Day traders are speculators working in zero-sum markets one day at a time. That makes the dynamics different from other types of financial activities you may have been involved in. When you take up day trading, the rules that may have helped you pick good stocks or find great mutual funds over the years no longer apply. Day trading is a different game with different rules.

Speculating, not hedging

Professional traders fall into two categories: speculators and hedgers. *Speculators* look to make a profit from price changes. *Hedgers* look to protect against a price change. They make their buy and sell choices as insurance, not as a way to make a profit, so they choose positions that offset their exposure in another market.

As an example of hedging, consider a food-processing company and the farmer who raises or grows the ingredients the company needs. The company may look to hedge against the risks of price increases of key ingredients — like corn, cooking oil, or meat — by buying futures contracts on those ingredients. That way, if prices do go up, the company's profits on the contracts help fund the higher prices it has to pay for those ingredients. If the prices stay the same or go down, the company loses only the price of the contract, which may be a fair tradeoff to the

company. The farmer raising corn, soybeans, or cattle, on the other hand, benefits if prices go up and suffers if they go down. To protect against a price decline, the farmer sells futures on those commodities. Their futures position makes money if the price goes down, offsetting the decline on their products. And if the price goes up, they lose money on the contracts, but that loss would be offset by their gain on their harvest.



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The commodity markets were intended to help agricultural producers manage risk and find buyers for their products. The stock and bond markets were intended to create an incentive for investors to finance companies. Speculation emerged in all of these markets almost immediately, but it was not their primary purpose.

Day traders are all speculators. They look to make money from the market as they see it now. They manage their risks by carefully allocating their money, using *stop and limit orders* (which close out positions as soon as predetermined price levels are reached), and closing out at the end of the night. Day traders don't manage risk with offsetting positions the way a hedger does. They use other techniques to limit losses, like careful money management and stop and limit orders (which you can read about in Chapter 2).



REMEMBER

Markets have both hedgers and speculators in them. Knowing that different participants have different profit and loss expectations can help you navigate the turmoil of each day's trading. And that's important, because to make money in a zero-sum market, you only make money if someone else loses.

Understanding zero-sum markets

A *zero-sum game*, discussed in Chapter 2, has exactly as many winners as losers. And options and futures markets, which are popular with day traders, are zero-sum markets. If the person who holds an option makes a profit, then the person who *wrote* (which is option-speak for *sold*) that option loses the same amount. There's no net gain or net loss in the market as a whole.

Now some of those people buying and selling in zero-sum markets are hedgers who are content to take small losses in order to prevent big ones. Speculators may have the profit advantage in certain market conditions, but they can't count on having that advantage all the time.

So who wins and who loses in a zero-sum market? Some days, whether you win or lose all depends on luck, but over the long run, the winners are the people who are the most disciplined: They have a trading plan, set limits and stick to them, and can trade based on the data on the screen rather than on emotions like hope, fear, and greed.

Unlike the options and futures markets, the stock market is *not* a zero-sum game. As long as the economy grows, company profits grow, which in turn leads to growing stock prices. The stock market really has more winners than losers over the long run. That doesn't mean that any given day will have more winners than losers, however. In the short run, the stock market should be treated like a zero-sum market.

If you understand how profits are divided in the markets that you choose to trade, you have a better awareness of the risks that you face as well as the risks that the other participants are taking. People do make money in zero-sum markets, but you don't want those winners to be making a profit off you.

Some traders make money — lots of money — doing what they like. Trading is all about risk and reward. The traders who are rewarded risked the 90 percent wash-out rate. Knowing that, do you want to take the plunge? If so, read on and check out Chapter 6 where I discuss risk and reward in greater detail. And if not, read on anyway, because you may get some ideas that can help you manage your other investments.

Being disciplined: Closing out each night

Day traders start each day fresh and finish each day with a clean slate. This daily regimen reduces some of the risk, and it forces discipline. You can't keep your losers longer than a day, and you have to take your profits at the end of the day before those winning positions turn into losers.

That discipline is important for day traders. When you day trade, you face a market that doesn't know and doesn't care who you are, what you're doing, or what your personal or financial goals are. There's no kindly boss who may cut you a little slack today, no friendly coworker to help you through a jam, no great client dropping you a little hint about their spending plans for the next fiscal year. Unless you have rules in place to guide your trading decisions, you'll fall prey to hope, fear, doubt, and greed — the Four Horsemen of trading ruin.



REMEMBER

So how do you start? First you develop a business plan and a trading plan that reflect your goals and your personality. Then you set your working days and hours, and you accept that you'll close out every night.

In other words, you prepare and have a plan. That's a basic strategy for any endeavor, whether you're running a marathon, building a new garage, or taking up day trading.

Committing to Trading As a Business

For many people, the attraction of day trading is that traders can very much control their own hours. Many markets, like foreign exchange, trade around the clock. With mobile trading apps, day trading seems like a way to make money while the baby is napping, during your lunch hour, or on just a few mornings a week in between golf games and woodworking.



REMEMBER

That myth that day trading is an easy activity that you can do on the side actually does make *some* traders rich. Who are these traders? They're the professional traders who approach day trading as a business rather than a pastime. They make money when traders who aren't fully committed lose their money.

But day trading is a business, and the best traders approach it as such. They have business plans for what they will trade, how they'll invest in their business, and how they'll protect their trading profits. Part 3 of this book is about that very topic. If you catch a late-night infomercial about trading, the story will be about the ease and the excitement. But if you want that excitement to last, you have to make the commitment to trade as a business to which you dedicate your time and your energy.

Trading part time: An okay idea if done right

Can you make money trading part time? You can, and some people do. Successful part-time day traders approach trading as a part-time job, not as a little game to play when they have nothing else going on. A part-time trader may commit to trading three days a week or to closing out at noon instead of at the close of the market. A successful part-time trader still has a business plan, still sets limits, and still acts like any professional trader would, just for a smaller part of the day.

Part-time trading works best when you can set and maintain fixed business hours. Working on a fixed schedule helps your brain know when to go to work and concentrate on the market, because the habit is ingrained. The successful part-timer operates as a professional with fixed hours. Think of it this way: My son is a patient in a group pediatric practice that has some part-time doctors. These part-time doctors keep set hours and behave like the other doctors in the practice; the only difference is that they work fewer hours each week. They commit their attention to medicine when they are on the job, and patients only know about their part-time hours when it comes time to make an appointment. These doctors don't pop into the office and start giving shots during their lunch break from their "real" job, sneaking around so that their real boss doesn't find out.



TIP

If you want to be a part-time day trader, approach it the same way that a part-time doctor, part-time lawyer, or part-time accountant would approach work. Find hours that fit your schedule and commit to trading during them. Have a dedicated office space with high-speed Internet access and a computer that you use just for trading. If you have children at home, you may need to have child care during your trading hours. And if you have another job, set your trading hours away from your work time. Trading via cellphone during your morning commute is a really good way to lose a lot of money (not to mention your life if you try it while driving).

Trading as a hobby: A bad idea

Because of the excitement of day trading and the supposed ease of doing it, you may think that day trading makes a great hobby. On a boring Saturday afternoon, you could just find out what people on Reddit recommend and make more money than if you spent those few hours playing video games! Right?

Uh, no.



WARNING

Trading without a plan and without committing the time and energy to do it right is a route to losses. Professional traders are betting that plenty of suckers are out there, trading in just such a random way because that creates the losers that allow them to take profits in a zero-sum market.



WARNING

The biggest mistake amateur traders make? Making a lot of money the first time trading and then assuming that all such successes will come as easily. That first success was almost definitely due to luck, and that luck can turn against a trader on a dime. If you make money your first time out, take a step back and see whether you can figure out why. Then test your strategy, using Chapter 14 as a guide, to see whether your strategy is a good one that you can use often.

Yes, I have two warnings in this section, and for good reason: Successful day traders commit to their business. Even then, most day traders fail in their first year. Brokerage firms, training services, and other traders have a vested interest in making trading seem like an easy activity that you can work into your life. But it's a job — a job that some people love but a job, nonetheless.



TIP

If you really love the excitement of the markets, you can find ways to invest on a hobbyist's schedule: You can spend your time doing fundamental research to find long-term investments, look into alternative investments to help diversify your portfolio, and trade with play money, either in demo accounts or in trading contests, to try trading without committing real money.

By all means, replace your Saturday video game habit with forex (foreign exchange) trading if you have the money and the inclination. Just make sure to set regular hours so that you find out how the markets normally trade during that time. Track your trades. Figure out what works right and what can go wrong. That's the only way you will level up in the trading game.

Identifying the Personality Traits of Successful Day Traders

Successful traders are a special breed. They can be blunt and crude because they act fast against a market that has absolutely no consideration for them. For all their rough exterior, they maintain strict discipline about how they approach their trading day and what they do during market hours.

The discipline begins with a plan for how to start the day, including reviews of news events and trading patterns. It includes keeping track of trades made during the day to help the trader figure out what works and why. And it depends on cutting losses as they occur, reaping all profits that appear and refining a set of trading rules so that tomorrow will be even better. No, this strategy isn't as much fun as just jumping in and placing orders, but it's more likely to lead to success.

Not everyone can be a day trader, nor should everyone try it. In this section, I cover some of the traits that the best day traders possess.

Independence

For the most part, day traders work by themselves. Computers and monitors are relatively inexpensive, high-speed Internet connectivity is easier to get, and many brokerage firms cater to the needs of traders who are working by themselves — all of which leaves the day trader at home, alone, stuck in a room with nothing but the computer screen for company. Being alone all day may be boring and make it hard to concentrate. Some people can't handle it.

But other traders thrive on being alone all day, because it brings out their best qualities. They know that their trading depends on them alone, not on anyone else. The trader has sole responsibility when something goes wrong, but they also get to keep all the spoils. They can make their own decisions about what works and what doesn't, with no pesky boss or annoying corporate drone telling them what they need to do today.

If the idea of being in charge of your own business and your own trading account is exciting, then day trading may be a good career option for you.



TIP

What if you want to trade but don't want to work by yourself? Consider going to work for a brokerage firm, a hedge fund, a mutual fund, or a commodities company. These businesses need traders to manage their own money, and they usually have large numbers of people working together on their trading desks to share ideas, cheer each other on, and give each other support when things go wrong.



REMEMBER

No matter how independent you are, your trading will benefit if you have friends and family to offer you support and encouragement. That network can help you better manage the emotional aspects of trading. Besides, celebrating your success is more fun with someone else!

Quick-wittedness

Day trading is a game of minutes. An hour may as well be a decade when the markets are moving fast. And that means a day trader can't be deliberative or panicky. When it's time to buy or sell, it's time to buy or sell, period.

Many investors prefer to spend hours doing a careful study of a security and markets before committing money. Some of these people are enormously successful. Warren Buffett, the CEO of Berkshire Hathaway, amassed \$114 billion from his careful investing style, money that he is giving to charity. But Buffett and people like him aren't day traders.

Traders have to have enough trust in their system and enough experience in the markets to act quickly when they see a buy or sell opportunity. Many brokerage firms offer their clients demonstration accounts or educational modules that enable traders to work with their system before committing actual dollars, helping them learn to recognize market patterns that signal potential profits.

A trader with a great system who isn't quick on the mouse button has another option: automating trades. Many brokerage firms offer software that executes trades automatically whenever certain market conditions occur. For many traders, automatic trades are a perfect way to take the emotion out of a trading strategy. Others dislike this type of trading because it takes some of the fun out of the job. And let's face it, successful traders find the whole process to be a good time.

Decisiveness

Day traders have to move quickly, so they also have to make decisions quickly. You can't wait until tomorrow to see how the charts play out before committing capital. If you see an opportunity, you have to go with it. Now.

But what if the decision is a bad one? Well, of course some decisions are going to be bad. That's the risk of making any kind of an investment, and without risk, there is no return. Anyone playing around in the markets has to accept that.

But two good day trading practices help limit the effects of making a bad decision. The first is the use of stop and limit orders, which automatically close out losing positions. The second is closing out all positions at the end of every day, which lets you start fresh the next day.

If you have some downside protection in place, you're more psychologically prepared to make the decisions you need to make in order to earn a profit. And if you're one of those people who has a hard time making a decision, day trading probably isn't right for you.

Understanding What Day Trading Is Not

So much mythology surrounds day trading: Day traders lose money. Day traders make money. Day traders are insane. Day traders are cold and rational. Day trading is easy. Day trading is a direct path to alcoholism and ruin.

In this section, I bust a few day trading myths. Someone has to do it, right? You find both good news and bad news in this section, so read it through to get some perspective on what, exactly, you can expect from day trading.

It's not investing

While swing traders hold positions for a few days, maybe even a few weeks, and investors hold their stakes for the long term, with some looking to hang onto their securities for decades and maybe even hand them down to their children, day traders never hold a position for more than a day.

Day trading is most definitely *not* investing. Day traders perform an important function to the capital markets because they force the price changes that bring the supply and demand of the market into balance. Day trading, however, doesn't create new sources of funding for companies and governments. It doesn't generate long-term growth.



TIP

Just because day trading isn't investing doesn't mean day traders don't have investments elsewhere. Many day traders withdraw their trading capital on a regular basis to put into investments, helping them build a long-term portfolio for their retirement or for other ventures they may want to take on. Still, because investing and trading have different mindsets, chances are that the trader will have someone else manage this money.

It's not gambling

One of the biggest knocks on day trading is that it's just another form of gambling. And as everyone knows, or should know, in gambling, the odds always favor the house. That's not the case with day trading, however. Consider these points:

- » **In day trading, the odds are even in many markets.** The options and futures markets, for example, are zero-sum markets with as many winners as losers, but those markets also include people looking to hedge risk and who thus have lower profit expectations than do day traders.
- » **The stock market has the potential for more winning trades than losing trades, especially over the long run.** For this reason, the stock market isn't a zero-sum market, like options and futures markets. In the stock market, the odds are ever so slightly in the trader's favor.



REMEMBER

In all markets, the prepared and disciplined trader can do better than the frantic, naive trader. That's not the case when gambling, because no matter how prepared the gambler is, the casino has the upper hand.



WARNING

People with gambling problems sometimes turn to day trading as a socially acceptable way to feed their addiction. If you know you have a gambling problem or suspect you are at risk, taking up day trading is probably not a good idea for you. Day traders who are closet gamblers tend to make bad trades and have trouble setting limits and closing out at the end of the day. They turn the odds against themselves. Chapter 2 has some information on the line between day trading and gambling.

It's not dangerous — if you use risk capital

A lot of day traders lose money, and some lose everything that they start with. Others don't lose all of their trading capital; they just decide that there are better uses of their time and better ways to make money.

A responsible trader works with *risk capital*, which is money that they can afford to lose. They use stop and limit orders to minimize their losses, and they always close out at the end of the day. They understand the risks and rewards of trading, and that keeps them sane.



REMEMBER

Many day trading strategies rely on *leverage*, which is the use of borrowed money to increase potential returns. Leverage carries the risk of the trader losing more money than is in their account. However, brokerage firms, which don't want that to happen, will probably close a leveraged account that's in danger of going under. That's good because it limits your potential loss. See Chapter 6 for a detailed discussion of leverage.

It's not easy

Along with the relatively low rate of success, day trading is really stressful. Concentrating on the markets and knowing that real money is at stake takes a lot of energy. The profit amounts on any one trade are likely to be small, which means that you have to be persistent and keep placing trades until the end of the day.

Some traders can't handle the stress. Some get bored. Some get frustrated. And some can't believe that they can make a living doing something that they love.



REMEMBER

Day trading is difficult, but it's not impossible. You can improve your chances of success by taking the time to prepare and by having enough money to fund your initial trading account. During the first year, you want to handle trading losses and still be able to pay your rent and buy your groceries. Knowing that you can cover your basic expenses will give you more confidence, and that can help your performance.

Although day trading is tough, many day traders can't imagine doing anything else. The simple fact is that a lot of occupations are difficult ways to make a living, and yet they are right for some people. Every career has its advantages and disadvantages, and day trading is no different.

When you finish this book, you should have a good sense of whether or not day trading is right for you. If you realize that it's the career you have been searching for, you can find lots of good ideas in the coming chapters for how to set up your day trading business and plenty of advice on how to increase your chances of success.

If you find that maybe day trading isn't right for you, I hope you get some ideas that can help you manage your long-term investments better. After all, the attention to price movements, timing, and risk that is critical to a day trader's success can help investors improve their returns. What's not to like about that?

CRUNCHING THE NUMBERS: THE DATA ON DAY TRADING SUCCESS RATES

Academic researchers like to work with data from the financial markets because there is so much of it. They are always looking at who makes money and how they are able to do it. Here I review some of the literature to show you the current state of day trading success rates. Note that they are low. Few people who take up day trading succeed, in part because few people who take it up are prepared. And even many of the prepared traders fail.

- **Do Individual Day Traders Make Money — Evidence from Taiwan:** This is an oldie but goodie. This paper, written in 2004 by Brad Barber, Yi-Tsung Lee, Yu-Jane Liu,

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and Terrance Odean (available at <http://faculty.haas.berkeley.edu/odean/papers/Day%20Traders/Day%20Trade%20040330.pdf>) found that only 20 percent of day traders in Taiwan tracked between 1995 and 1999 made money in any six-month period, after considering transaction costs. Median profits, net of costs, were \$4,200 (USD) for any six-month period, although the best traders showed semi-annual profits of \$33,000. The study also found that those who placed the most trades made the most money, possibly because they were the most experienced traders in the group. This paper is one of the most cited on the subject, and the authors have found similar results looking at other time periods and in other markets.

- **Day Traders Don't Typically Learn from Experience:** A 2017 paper by researchers at the University of California and Peking University examined whether day trading performance improved over time as traders learned from experience. They worked with data from Taiwan and found that, in fact, traders did not seem to improve their returns over time. Traders who made gains in their early days of trading were more likely to continue trading, but they were not more likely to be successful. You can read this paper at <https://faculty.haas.berkeley.edu/odean/papers/Day%20Traders/Day%20Trading%20and%20Learning%20110217.pdf>.
- **Overconfident Individual Day Traders: Evidence from the Taiwan Futures Market:** Researchers Wei-Yu Kuo and Tse-Chun Lin looked at the results of 3,470 traders between October 2007 and September 2008 and found that most of them had significant losses after transactions costs were considered. The biggest problem seemed to be that traders over-estimated the quality of the news they received as well as their ability to evaluate it. This led to excessive trading — especially for those that ended up with the largest losses. The abstract is available at www.sciencedirect.com/science/article/pii/S0378426613002331.
- **What Retail FX Traders Learn:** Simon Hayley and Ian Marsh of City University in London collected data from a retail trading platform that had 95,000 individual investors over 30 months. Not all of these people were day traders, although many of them were. They found that traders didn't necessarily learn to trade in order to get better over time, but they did learn how to manage risk and position sizes based on their own skill and results. In addition, those who had an unsuccessful trading day were more likely to trade less, trade smaller amounts, or take a break from trading all together. They also found that even experienced traders often lose money. You can see an article about their findings at www.cass.city.ac.uk/faculties-and-research/research/cass-knowledge/2017/november/what-do-retail-fx-traders-learn.