HOW TO DESIGN AND CONSTRUCT AN EFFECTIVE TRADING PLAN

The road to trading success

by Norman Hallett

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Chapter 1: Introduction

You haven't thought much about it other than you want to take a vacation. You grab the keys to your car and head out on the highway. Hours pass and you watch the scenery change from metropolitan landscape to bucolic greenery. You feel the tension leave your body. Darkness falls and you pull into a motel for the night. After getting settled in you room, you turn on the television, kick off your shoes and flop on the bed. You reach for the phone to call a friend to tell them about your trip.

Your friend picks up the phone and hears the excitement in your voice. But then he asks a question that shocks you and you sit up straight in your bed. "Where are you headed", your friend asks. This seemingly innocuous question hits you like a slap across the face. It's hard to believe but you have no idea. You look around the room and realize that you haven't packed any clothes. No tooth-brush….nothing. You suddenly feel disoriented and can't believe what you have done. You feel so stupid that you blurt out, "the Keys". You slowly replace the receiver while you friend is still talking on the other end. Are you in the Twilight Zone?

Needless to say, this absurd scenario is highly unlikely because nobody would ever take a trip without planning first. You know, decide the destination, check the route, make advanced reservations and that sort of stuff. Nobody would just takeoff without planning.

But that's exactly what takes place with most new traders. No defined destination, no road map, no idea of how to get there; "there" meaning making money by trading. What are the chances of being successful in your journey if you don't even know such basic things as where you are going? It is truly unbelievable how many traders bite the dust (it's estimated that about 90% of all beginning traders are out of trading within several months) mainly because they lack the proper preparation. Apparently, to most new traders success appears as just a simple matter of choosing the proper direction of movement. That's like believing that a band aide will cure any disease. Indeed, trading is a much more complicated undertaking and requires extensive preparation. If it were so easy to make money, everybody would be doing it. Being a successful trader is not a matter of luck or even skill, it is a matter of proper preparation.

And that is what this book is all about.

If you read this book and follow its advice, your chances of becoming a successful trader will be greatly improved.

Why is that so?

Because successful traders say so.

None of the ideas put forth in this book are revolutionary or “leading edge”. What will be presented is a proven formula used by most professional traders. The methods are based upon the mentoring-guided training format that most professional trading companies and departments use to train their new traders. The reader will be led step-by-step through the same type of training program that

most pros went through and use to this day. It’s not brain surgery or rocket science. But it’s one thing is to read about it and another to live it. That, dear reader is up to you.

How to define your trading “destination”

One of the first things you need to do when planning your journey to becoming a successful trader is to define what “successful” means. Does it mean becoming a millionaire? Does it mean you can make a living by becoming a trader and working out of your laptop and cell phone? Does it mean that you can provide an opportunity to earn extra income apart from your regular job? Does it mean you can live in an area you desire without the need of finding a “real job”?

Yes, success means different things to different people but one thing in common with trading is that to stay in business as a trader, you have to win more than you lose. In other words, you must make a profit or eventually you will come to the realization that you are no match for the market. So, let’s take it for granted that making a profit is a major goal in trading.

But that’s not enough. You need to be much more specific. A goal must be relevant and realistic. So first, you must identify why you want to trade before you can define what your picture of success will look like.

For example, if you want to be independent and live where you want, you must first decide how much income you will need to lead the lifestyle you want. If you need $6,000 per month for living expenses, you can quickly see if your trading capital can provide you with that level of income. If you have trading capital of $100,000 (not including savings of at least 6 months living expenses), you would need to generate an annual return of 72% or 6% per month return on your trading.

If you just want to make extra money for a vacation, home, or other material item, first decide how much that material item will cost in the future and use that as your goal. For example, if you want the down payment for a new home, you establish that amount and then look at what amount you have to invest. If you need to have a $50,000 down payment on that dream home and you plan to invest $10,000, if you can produce a 40% annual return (3.33% per month) you could accumulate the $50,000 in about 41/2 years discounted for inflation and not including taxes.

If you just want to earn enough for that yearly vacation, find out how much it costs and figure out what sort of return on investment (ROI) you will need to get there. For example, if you want to travel to Peru and spend one month mountain climbing in the Andes, you estimate that it will cost about $7,000. If you have $20,000 to invest, a 40% annual (3.33% per month) ROI would return the amount you would need in about 12 months-not including taxes. Sounds simple, doesn’t it! As always, however, the devil is in the details. But to have a realistic goal, you first need to accurately describe your goals….your destination.

A trader must also develop a clearly defined process to identify what is feasible and desirable for each individual trader. As most traders vary in their levels of knowledge, wealth, temperament and risk tolerance, developing a trading plan is a customized affair. However, once developed it must be followed. Before preparing for a flight, all pilots-regardless of experience, go through a checklist to make sure that everything is set up properly before embarking on a flight. It's just plain common sense and in this book you will learn how to develop your checklist that will help insure that you reach your intended destination.

What is a Successful Trader?

"Success means having the courage, the determination, and the will to become the person you believe you were meant to be"- ***George Sheenan***

The Caribbean water is crystal clear and inviting as you sail on toward Tortola. Your cell phone rings and it's your broker in New York. You listen intently and then say "sell and transfer the funds to my commodities account". You disconnect and do a feeble fist pump and mutter, "cha ching".

You are in the waiting area at JFK. Your flight to Hawaii leaves in an hour. As you don't want to be disturbed, you re-check today's positions and stops and close the laptop. You're taking your family on a winter escape to paradise. No clients to worry about. No office politics. Just you and your laptop have made it all possible. You look at the Armani crowd and remember what it was like before you were able to work in your jogging suit. "No risk….no reward", you say to yourself.

You are up in your "command center" as you and your spouse jokingly call it. You hear your children and husband getting the kids ready for school. He lives the buttoned down life and you are still in your robe. You've been up before the markets open and are in the midst of planning today's trades. Yesterday wasn't a fun experience; you didn't make your daily goal and your win-loss was upside down. You try not to think about it prefer to focus on setting up for today's trading. You come down from the command center to say goodbye to hubby and the kids; your mind is still focused on the three trades you plan to make as soon as the entry points presents themselves. Your husband starts to say something and you hold up your hand to stop him. "Don't say a god damned thing, you know the rules." He smiles and herds the kids to the car. With coffee in hand, you bless the skills you have acquired but curse the loneliness of the isolation. But there is no other way you have the possibility to make the kind of money you can earn by trading and your husband makes enough to pay the bills.

But both you and your husband have a dream of moving out of the city and out of the rat race. You both want a better home and are able to send your kids to the best schools possible. As h withholding and social security taxes are sucked right out of your husband's paycheck, accumulating wealth is almost impossible. but becoming a successful trader may be the only way to reach those dreams and ambitions. Up until now, you have been able to actually make fairly steady profits in your trading accounts and you feel that after three years of full time day trading , you seem to have what it takes to make a go of it. But the pressure and isolation can become intense.

Which one of these scenarios is a more realistic picture of a "successful trader"?

Success is defined by the achievement of pre-established goals. The key to becoming a successful trader is identifying, quantifying, strategizing, implementing, tracking, analyzing, learning and growing as a conscious person. You see, there is no such thing as “easy money”. Let’s get this upfront right now, trading is not easy and not for just anybody.

How many people do you know who have an idea of what they want out of life? How many people do you know who understand what makes them happy and what fulfils their needs? Probably not many and this is where becoming a successful trader begins…..understanding yourself. You define what success means to you. If you don’t know what that is, how can you reach it? In this book, we will devote a lot of discussion to help you define yourself, your goals and how you plan to reach them. Indeed, this process lies at the heart of building a trading plan for success.

Chapter 2: The Strategic Philosophy of Trading

There are two fundamental and interconnected strategies in becoming a successful trader: 1) A trader learns how to identify high probability trades with regularity and cut losses immediately; 2) a successful trader has more winning trades with more profits than losing trades. That's it folks!

For example, if you make 20 trades and win 60% and the winners have an average gain of 10% and losing trades have an average loss of 3%, you will have a net overall gain of about 7% It is the combination of win-loss ratio and the average differential between profitable and losing trades that determines success…over time.

> Trading is not about hitting home runs but hitting for average.

Traders develop a trading system which will provide a higher than chance win-loss ratio and try to make sure that profits have higher return on investment (ROI) than losing trades. In theory, even a less than chance ratio can still provide for profitable trading if there is a significant difference in profitable versus losing trades.

Typically, successful trader will develop trading system that will provide at least a 65% win-loss ratio. Some even go as high as 75%. But the rule of maintaining higher profit margins than losing margins is key. If you win more trades but have higher overall loses, the win-loss ratio means nothing. So, to become a profitable trader, try to maintain a higher win-loss ratio and a higher overall percentage profit margin over losing trade margins. But being a profitable trader may not mean the same thing as what you define as a "successful trader". That is defined by your goals.

Once a trader develops a proven system, it then becomes a matter of discipline in following the established rules and procedures of the trading system in a totally consistent manner and it then becomes a matter of the number of trades and not deviating from the trading system. Sounds simple, right? Needless to say, the devil is in the details.

Once a viable trading system has been defined, tested and proven, success is mainly a matter of discipline and a mechanical approach to implementing the trading system. But herein lays the weakness of most trading systems…..the trader. All kinds of psychological factors such as fear of losing, fear of being wrong, fear of losing precious resources and many other human emotions can throw the trader off the defined track and cause the trader to deviate from the trading system.

You will see as we progress through the book that successful trading is a combination of developing mechanical systems based upon fundamental and technical indicators and the most difficult skills of all: self control, patience and ego dominance.

You see, it is the human elements of emotions, expectations and subconscious programming that make or break most traders. You can read all the books there are on the subject of trading but real time emotions are the greatest challenge to a trader.

All of us develop our own particular baggage and much of it we are not fully aware until confronted. Trading, with its pressure points of fear and greed, forces that confrontation with ourselves. In fact, most successful traders will tell you that it's the "headwork" that makes the difference in winning over time.

An essential part of the philosophy of trading is the mental preparation needed to confront our weaknesses. In fact, many call this part of proper preparation as the Zen of Trading.

In the book, we will discuss how to develop proper mental preparation and creating the mental discipline to confront our fears associated with losing and self doubt. In fact, there is currently only one program designed to train traders in the techniques of maintaining the proper mental mindset for trading and that is ***The Disciplined Trader Intensive Program*** (thedisciplinedtrader.com).

Identifying High Probability Trades

Central to successful trading is the technical skill of identifying high probability trades. What we mean by "high probability" is a trade that has a higher than chance probability of being a winner. We are not talking about "hitting the home run" but hitting for average. If your trading objective is to make at least 9% on each trade, then you are willing to get out of the trade at that point. Often times, even a fairly conservative trading strategy can consistently yield such returns. Using a trading strategy such as writing covered calls or using vertical spreads can produce such results. As mentioned, trading is not about the big winners but the small consistent winners that add up over time to become very impressive annualized returns. For example, if you use a strategy that produces a 7% monthly net return, that translates into an annual return of 84%! Little frequent victories win the war.

It is important to mention that essential to the success of this strategy is the aggressive and consistent timely exit of losing trades. Conservative stops are always set and never tampered with unless locking-in profits. It is the ability to accept defeat immediately and without second thoughts that is essential (your ego doesn't like to lose). Once a position has been entered, the next thought should be "cut any losses immediately and don't look back".

Traders understand that losing is part of the trading reality. In other words, trading is no place for perfectionists because no trader will be a winner all of the time. As a matter of fact, just winning a majority of the time is the goal!

The mechanics of learning how to identify high probability trades begins with deciding you're your goals are and what are the best investment vehicles to trade. Each type of investment has its own advantages and it depends largely on the trader's knowledge and preferences. However, in most cases the more flexible the investment, the better. For example, options allow for numerous strategies and the ability to hedge risk; however, options require a lot more education normally not needed in the more traditional types of investments.

A good trading vehicle should have enough volatility and liquidity to make for active trading in a variety of strategies. That being said, some strategies call for little volatility but whatever trading vehicle you choose, you should make yourself an expert on what you choose. Not only, is it incumbent upon a trader to become an expert on what he or she trades but also *how* it trades. That is to say, a trader needs to become not just an expert on the technical and fundamental aspects of an investment but also how it acts over time. How does one go about that process of deep familiarity?

Risk and Reward

The optimum trade offers low risk and high reward. Unfortunately, not many trades become optimum trades. In fact, most types of investments can be measured as far as its risk by comparing its price performance over time with that of the average price of the market in which it trades. For example, stocks have a parameter that measures individual stock correlation with that of the index. This is referred to as Beta. A beta of 1 means a stock has about as much variation in price as does the market it trades in. A stock with a beta of 1.25 means that the stock has 25% more variation (risk) than the market it trades in.

If a trader is hunting for large gains, high beta stocks would most logically bring higher rewards because of the risk premium. If you are a trader who doesn't like much risk, you will need to have a strategy that will provide many low profit wins that will add up to an attractive sum over time. If you are a trader with a higher risk tolerance, you may look for trades with larger risk but offer higher rewards. Normally, this means a lower win-loss ratio than that of a risk adverse trader.

But measuring risk can be itself risky. There are times when a normally low risk stock or investment can become very volatile. As a result of this fact, there is some controversy about using measures of risk as measured by the *Normal Distribution* of data. A fundamental event such as the development of new technology, an industry in crisis or other macro events can send the statistical relevance of Normal distribution out the window. For example, a certain event may "normally" move out two standard deviations only 1% of the time. But in many stocks, it is often seen that large price movements can happen much more often than predicted by Normal Distributions of data. As a result, most traders understand that all trades have risk and take measures accordingly. I know that you may have a hard time understanding what I just said, but this is a very important reality when talking about of measurement risks and what might be considered as more or less risky.

The Trading System

Developing a *trading system* is the central core of trading. A trading system is a set of procedures and rules designed to provide a specific recipe for trading. Some people like to call it a trading methodology but in reality it is a set of clearly defined rules and procedures for trading. It is a customized trading paradigm. The end result is to create a system that if implemented consistently on every trade will result in a higher than chance win-loss ratio.

It doesn't mean that the trading system is set in stone. On the contrary, a trading system should be in constant evolution with the spirit of reaching for perfection. But because of the "chaos factor" of the effect of infinite permutations of variables, perfection is not possible. As many in the trading field like to say: "there is no Holy Grail in trading system.

The trading system is made up of fundamental and technical analysis, money management, and all procedures that take the trader-step by step- from selection process to closing out the trade and journalizing entry. Additionally, the trading plan is written out and can be used as a checklist for each trade. Specific profit and loss targets are pre-established and violation of any parts of the trading protocol is heresy.

The trading plan is the formalized description of exactly how the trading process is to be implemented by the trader. The implication is that if the trading system is followed to the letter, the trader's goals will have a high probability of being realized.

As the market is loaded with chaos factors (the unexpected), few trades go exactly as planned. But this fact is an important driver in the continuing learning and tweaking process. An important part of the trading system is to do a "postmortem" on every trade. This is done by way of a ***Trading Journal*** and we will cover this important part of the trading system later in the book.

Once a system has been developed and tested over time by the use of paper trading, a trader develops a sense of the reliability of the system and builds the necessary confidence needed to develop the "faith in the system" and formulate trading into more or less a mechanical event.

In a later chapter, we will go into more detail about developing a trading system but suffice it to say that by now you can see that it takes time and study to become a trader. But traders can make a lot of money and live a lifestyle few can imagine. Did think it would be easy? Trading is not easy money. It is very difficult money and not a profession for most people. Looks may be deceiving and this is indeed the case with the image of being a trader.

In summary, the underlying philosophy of trading is to design a trading system which can provide a higher than chance win-loss ratio together with a strict set of trading rules that will allow the trader to trade mechanically and divorce-as much as possible-trading from human emotions.

Chapter 3: Developing your Personal Profile

"To live is to choose. But to choose, you must know who you are and what you stand for, where you want to go, and why you want to get there" Anonymous

Who are you? What are your needs? Why do you trade? All of these questions and more are just a prelude to developing your daily trading objectives. But a very important concern needs to be addressed: can we be objective about ourselves? Few of us can completely strip away the façade we have created for ourselves over time. Often, many of the basic personal characteristics and preferences we have may have been the result of subconscious processes.

As part of process of developing a trading plan, we must define our goals; what really motives us. However, to get the most accurate results, we must do the best job we can to honestly examine ourselves. As a trader's career unfolds, we learn much more about whom we actually are and this helps to separate our self image from who we really are. Sometimes, there is a divergence between the two. This is one of the intangible benefits of interacting with the crucible of trading. Winning and losing is a daily event in trading and both of those events can be very telling about our attitudes about our lives in general.

If you are an independent trader, you do most of your trading in isolation. You have to be your own boss and employee at the same time. Knowing how to "manage yourself" and how to keep motivated and disciplined is a much under-estimated required skill a trader needs to develop. The more you analyze yourself, the better.

The isolation can be dangerous in that we all have the tendency to agree with ourselves and we can miss opportunities to grow and improve. Indeed, trading is all about constant learning and evolution. Evaluation is so important to keeping things tuned up that traders analyze every trade to help determine how well the system is anticipating the proper direction and movement of the investment. To accomplish this task, traders keep a ***Trading Journal***.

After each trade, the trader analyzes and records specific information about the trade and the mindset of the trader. Not only does the trader learn about the effectiveness of the trade but also the trader learns more about themselves and how they react in certain situations. This regular self appraisal helps to refine the knowledge of ourselves which becomes an invaluable tool not only in trading but also for daily living.

But, to get things started in the process of self-evaluation, we ask a series of questions to help us focus on answering some important questions. Try not to side step this process as our egos don't like to see too much sunlight. The tendency is to pass this part off as "touchy-feely" but it is an important part of the process.

Many people get into trading for the wrong reasons and the sooner that can be made obvious, the better for the aspiring trader. For instance, some might be trying to create a job for themselves when they are really afraid of the rejection that can be encountered in the job seeking process. If an ego is that fragile, it will never hold up during the trying process of trading with money on the line.

Personal Goals

Try to be as honest as possible as you answer these questions. Moreover, it might be a good idea to have somebody who knows you well to participate in the questionnaire in an attempt to keep the answers as objective as possible.

1.1a What are your professional goals today? (Not limited to trading)

1.1b Why are you trading?

1.1c What are your trading goals?

1.1d Where do you want to be in your professional life five years from now? (Not limited to trading)

1.2a What do you see as your greatest strengths as a trader?

1.2b What strengths do you have that you can make even better and how can you do that as quickly as possible?

1.2c What are your most detrimental weaknesses as a trader?

1.2d How can you improve these weaknesses?

1.2e What do you see as the greatest threat to your success as a Trader?

1.2f How can you eliminate or best handle this threat?

1.2g Are you enchanted by the image of being a trader?

1.2h What would you tell people when they ask you what you do for a living?

1.2i How would your trading activities fit into your life?

1.2j How much time can you commit to trading?

1.3a What are your personal goals for the next 18 months?

1.3b Where do you want to be in your personal life five years from now?

1.3c How do you deal with stress in your life?

1.3d What do you do when you are burned out?

1.3e Do you have a plan in place to keep healthy in mind and body?

1.3f How do you plan to keep as positive an attitude as possible?

1.3g Do you have a daily routine to keep physically and mentally alert?

1.4a How to you react to failure?

1.4b On a scale of 1 to 10, how do you rate the importance of money (10 being the high).

1.4b How do you react to losing money?

1.4c Do you consider yourself to be intellectually curious and enjoy constant studying?

1.4d Do you have a lot of patience?

1.4e Are you persistent and usually finish what you start?

1.4f Do you worry about not having enough money?

1.5a Is the idea of being a trader an important factor in your decision to become a trader?

1.5b How would your family and friends feel about you becoming a trader?

1.5c If you run through your trading capital, what would you do?

1.5d When you think of profits do you consider the effect of taxes?

1.6 What is your idea of a successful trader?

When you complete the book, many of the questions you answer in the above questionnaire may change. Go back and review these questions and analyze why the answers to some of the questions changed. If none of the questions change, something is wrong. Either you are already an experienced trader or you are not giving serious thought to the questions.

Most of us-if we are doing the proper things-will experience fairly constant change as we mature. Our view on life changes and what may have been important before may lose significance. Money may have been a major motivator but as you experience financial success it loses some of its importance. We should not remain static and we should be in constant pursuit of our potential. It is desirable to change and being constantly tested and constantly evaluating is an excellent way to progress.

As a matter of fact, to successful traders, money is only a way of keeping score. The emotional significance of money is always there but as traders learn to live more of their lives without certainty, the impact of having money becomes diminished. And with that comes victory over fear of uncertainty and the increase of the understanding that life is not threatening but bountiful.

Trading capital and financial objectives

Wealth is a relative thing. Economists have a term called the “wealth effect” whereby a person maintains a certain standard of living regardless of the income being earned to maintain that standard of living. Americans are notorious for living beyond their means because credit allows them to appear and feel wealthier than they really are. That is becoming painfully clear as the current financial meltdown hangs heavy on the public consciousness. Traders don’t do that. They are actually realists and fiscal conservatives. Does that surprise you?

Here is the nitty-gritty truth about trading: You only trade money you don’t need.

If you lose it all, no problemo vis a vis your lifestyle and ability to meet your financial obligations.

The following is a step-by-step way to help identify how much of your liquid wealth you should consider as trading capital.

1. Establish your monthly budget for all living expenses.
2. Deduct six months of your budget needs from your total liquid capital. (Liquid capital refers to cash and all assets that can be converted to cash within 30 days). The six months capital reserve not only acts as a safety buffer but also helps keep the “wealth effect” in your mind. If you begin to start “feeling the pinch”, you are probably more emotional about losing trades and this may subtly alter the way you implement your trading system. If you get nervous about losing money, you probably need more free capital for trading or you may need to reduce the amount of money you are trading.

To trade with little fear of losing money, you need to feel enough of the wealth effect that losing trading capital doesn’t faze you at all.

3. Review your insurance needs. Do you have adequate health coverage? Are your assets adequately covered in case of loss? If you are married, do you have adequate Health and life insurance? Have you established a will and/or trust to protect your wealth?
4. Do you have an investment portfolio? Investing for the long term uses a different strategy than trading. Typically, an investment portfolio will contain a certain percentage of cash, bonds stocks, real estate and other long term hold types of investments. Trading funds should be separate from the portfolio even though trading funds are considered as part of your overall investment strategy.

   Modern Portfolio Theory (MPT) subscribes to the idea of having a percentage of investment funds in higher risk-reward vehicles to help increase ROI and reduce risk by way of low correlation with the more conservative portfolio investments. But for practical purposes of execution and tracking, it’s a good idea to segregate your trading accounts from the investment portfolio. As a matter of fact, many traders will assign a different trading account for different trading vehicles. For example, a separate account for stock options, commodities, currencies, etc. This makes it easier to organize and analyze and audit statements.

A very important consideration is whether or not you will be using a tax deferred account such as IRA, 401K, etc. Trading profits are normally short term capital gains (if you have profits) and as most trading accounts are seeking high profits (high risk), using a tax deferred account makes a lot of sense. However, for traders who plan to use profits generated from trading as income, tax deferred accounts are usually not practical.

Another consideration is if you plan to be a trader who will use gains as income, if is a good idea to set up a trading company so you can write off applicable expenses. Whatever your situation, it is always a good idea to consult with your accountant or tax attorney concerning your particular financial situation.

5. Now that you have determined your budget for living expenses, your reserves, your insurance needs and other investment accounts, its time to earmark trading funds. Now, you can see why traders are really conservative in their approach to trading. Unfortunately, many people see trading as a way to build wealth where in reality it is usually the case that most traders are already rich according to most standards. Remember the old question: "how do you make a million dollars investing? Answer: "by starting with two million dollars".

   However, that is a bit extreme and many W-2 employees are now viewing trading as the only feasible way to create additional wealth. Almost every employee in the USA has some sort of IRA or 401K and has some capital for investing purposes. Most often, these funds are "professionally managed" and are by the nature of the "prudent investor" rule very conservative and may only keep up with inflation, at best.

   More employees want to take over the management of their own retirement funds. Many people don't know that they can manage and trade their retirement accounts by making their retirement account a "self directed IRA or 401K. To find out more about this subject, contact your pension fund trustee or go to http://ezinearticles.com/?Self-Directed-IRA-Rules-Simpler-Than-You-May-Think&id=1025777 Particularly in the case of younger employees, using part of the retirement funds for trading can, make sense over time. For employees over about 50 years old, trading pension funds is not advised.

   Once you have determined the amount of funds available for trading, ask you self what would happen if you lost all of those trading funds. If the answer is "not much" than that amount of wealth has little meaning in your overall financial picture and that's what we want. But wait!

   If you are married, you'd better consult your spouse. You may not put much value on your trading capital but your significant other may have other ideas. You do not want any outside pressure creating stress in your trading activities. More about that later.

6. Take the amount of trading capital you have identified and ask yourself: "If I can make at least an annualized 30% return, is it worth the time, dedication, ongoing education and stress of trading to give serious consideration to trading? When you have finished reading this book, you will have a much better idea of how to answer this question.

   Suppose you have $25,000 as your trading capital. As a general rule, most traders will not trade more than 5% of the trading account on any one trade and will establish a maximum trading account *drawdown limit* of about 40%. In this case, a trader would not risk more than $1,250 on any one trade nor draw the account down below $15,000. Typically, when a drawdown limit is reached, the trader stops trading and analyzes what is happening. This is why traders are actually fairly conservative.

One of the major objectives of being a successful trader is to stay in the game so that probability can work its magic.

If your trading plan calls for achieving a 30% annual return on your trading capital, your trading activities would need to generate $7500 before taxes in trading gains. That works out to be $ 625 per month in gains. Let's say your trading system can normally produce a 65% win-loss record. If you plan to trade at least three times per week, that would be 12 trades per month. With your estimated win-loss ratio of 65%, that means about 8 winning trades per month. But that also means that you will probably have 4 losing trades per month. If you set your stop loss at 4% of any trade ($1,250), then you would lose about $50 plus any transaction fees; therefore, you would lose about $200 on losing trades, not including fees.

That means you need to have about $825 in gains on the 8 trades for an average gain of $103 per wining trade to achieve the 30% ROI. That is a profit target of 8.24%. So before you enter any trade, you will be looking for at least an 8.24% gain and a stop set loss set at 4%. You never back off of you stop loss and you decide whether or not to let profits run after hitting your profit target.

Now you know approximately what you must make on the $1,250 or 5% of your trading capital based on your estimated win-loss ratio and 3 trades per week. Consider this: you will lose 4 trades and $200 per losing trade. Does that bother you?

From the above walk-through of how to develop trading objectives (goals are ideas and objectives are metrics that will lead to the goal), you can see that it all starts with the trading capital and the goal (in this case 30% annual ROI). Please keep in mind that some traders produce a much higher ROI but until you have the experience to actually generate a fairly consistent return using your system, it is best to be conservative when establishing goals and objectives.

It's also important to consider all transaction fees and taxes when establishing your financial targets; a 30% ROI goal is much less if traded in a taxable account.

Establishing your risk profile

What do you prefer… to make a trade that will give you a potential return of 100% but with only a 10% chance of winning or would you prefer to have a trade that would yield a 15% gain and have a 60% chance of winning? Will you require your system to provide a fairly consistent win-loss ratio of 75% or 60% before you start real-money trading? Will you trust your own analysis or will you lean heavily on recommendations of others?

Consider the following examples. A very popular strategy is writing stock options which are akin to selling insurance. It's not very exciting but it can provide a fairly low level of risk but with a fairly low level of reward-about 2-8% per month. But if done successfully on a fairly frequent basis, the annualized returns can be impressive. In other words, it is vital to set your goals and then consider the best strategy in terms of risk-reward to achieve the monthly objectives to reach your yearly goal.

Another strategy is to use strategies that identify stocks that may be breaking out or down and try to catch the wave. Rewards can be substantial as other investors rush in to partake in the frenzy. The trader let's profits run and exits with a large profit. Which strategy appeals more to you? Would you rather trade more often with lower gains or less frequently with larger gains? You can only do that after setting your goals and then find a trading style that best matches your risk profile and how you plan to trade.

The following is a questionnaire usually provided by a brokerage to new clients to help the broker establish the new client's risk profile. Helping to determine risk tolerance helps the trader to better define the most appropriate strategy for the level of risk. For example, a risk adverse trader would lean toward hedged positions like vertical spreads or writing covered calls or puts. A more aggressive trader may take a much more predatory strategy and "stalk" highly volatile investments with the purpose of making fewer but more profitable trades. Each trading strategy requires a different set of parameters and trading rules.

Risk Profile Analysis[1]


1. Your age:
- More than 60 years old
- 51 - 60 years old
- 41 - 50 years old
- 31 - 40 years old
- Less than 31 years old

2. Your future potential income:
- Probably decreases
- Not sure
- Remains unchanged
- Some increase - from savings / investment income
- Probably increases - from employment income, savings / investment income

3. For how many months can you maintain your lifestyle without any income?
- Less than 3 months
- Less than 6 months
- Less than 1 year
- Between 1 - 3 years
- Over 3 years

4. How much time do you have to attain your financial goal?
- Less than 1 year
- 1 - 3 years
- 3 - 5 years
- 5 - 10 years
- More than 10 years

5. Which one of the following statements best describes your feelings and attitude?
- I cannot accept any capital loss.
- If my investment loses 5%, I will redeem without a second thought.
- If the investment consistently pays out income I will continue to invest, even though the investment suffers a loss of 20% in a year.
- If my investment drops by 10% in value, I will stop investing and wait for it to appreciate.
- I am prepared to invest for long term and I will average down my cost by investing more money when the price drops.

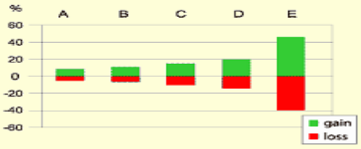
[1] http://www.ambg.com

6. Which of the following securities best suit your needs?

- High-quality corporate bonds.
- Mixture of both corporate bonds and stocks that pay high dividend.
- Stocks that offer the potential for modest dividends and growth.
- Stocks that pay less dividend but offer long term growth.
- Aggressive stocks that pay no dividend but offer great potential for long term growth.

7. Given the distribution of yearly return of 5 different investments, which one matches your risk tolerance level?

A. B. C. D. E.



8. After allocating your financial assets, what will you do after substantial initial gain / loss?

- I would sell.
- Switch to safer investment vehicles.
- Price fluctuation is common, so I will wait for a moment before making any changes.
- It depends solely on the economic situation and market outlook.
- I will continue my long term investment plan and maintain my asset mix.

9. Your past investment experiences:

- I have most of my money in Savings Account.
- I have Savings Account but mostly in Fixed Deposit.
- I have Savings Account, Fixed Deposit and Unit Trusts Fund. (Government / State / Private).
- I have Savings Account, Fixed Deposit, Unit Trusts Fund and Shares / Property investment.
- I have Savings Account, Fixed Deposit and Share / Property investment (leveraging).

By identifying your risk profile and specific financial goals, you will be better prepared to look for a strategy that best matches your profile. Unfortunately, some aspiring traders find that their trading capital can only meet financial goals by assuming an aggressive trading strategy. This can be a real mismatch if the trader is risk adverse.

It is very important to first determine if your trading capital can realistically produce the financial goals you want to achieve.

During the process of evaluation, you may have to re-adjust your goals. For example, if you have a five year plan but see that the trading capital will not realistically allow you to reach your goal in five years, you may need to either adjust your time horizon or select a more aggressive strategy. But be warned that if the strategy isn't compatible with your risk profile, trading will be very stressful and more than likely, short lived.

Identifying your Strengths and Weaknesses

Trading requires as much honesty as is objectively possible. To be able to go over each trade and determine what you did right and what you did wrong requires putting ego aside for the benefit of becoming a better trader. You have to be able to admit "I was wrong". With that being said, you can move foreword and find out why you were wrong and try to learn from the loss.

You may feel that you can be honest with yourself but ego is a very strong factor in forming your self image. You must ask yourself if the goal is to become successful in reaching your goals or is trading really just an exercise in trying to pump up your self image. If it is the later, there are less expensive and more easily achievable ways to accomplish that goal.

At this point in the process of self analysis, it might be a good idea to sit down with somebody who really understands you and knows what makes you tick. Of course, they may be a bit off in their analysis (your ego will whisper that in your ear) but at least some objective input may help you answer these important questions more accurately. More than likely, you know your strengths but admitting to weaknesses is a much more difficult task.

Statements you may not want to hear:

- You may think you are a cold, calculating trading machine but others may see you as emotional and too influenced by the opinions of others.
- You think you are decisive but you spouse thinks you are wishy-washy.
- You think you are good with money but others may point out your propensity to make emotional purchases.
- You think you are ready to work independently but you are really a social animal and will miss the "office politic".
- You think you can accept losing but you really become depressed and blame others for your losses.
- You think you are persistent and don't give up easily but your mother says once you get burned you move on to other things.
- You think you were found in a reed cradle floating down a river but you are actually just like everybody else.

As a trader, you want to become the seeker of the cold, hard truth about yourself. The goal of a trader is to be successful as measured by the achievement of pre established goals and objectives. Anything else is rather meaningless. The job of the trader is to constantly monitor and make sure that the trading plan is being followed and that the trader is keeping the proper attitude.

Attitude

Consider that we are brought up to compete and aspire to win. Losing is for losers. From an early age, we are taught losing is a negative thing. However, as winners mature they learn that mistakes are really learning opportunities. Traders must have this attitude at all times. It's normal to be a bit peeved when losing but a successful trader learns to swallow the emotion, analyze what happened from the losing trade, and move on. This is a necessary attitude for a trader and an excellent one for life in general.

Imagining your worst trading nightmare

Often, we keep our fears locked up in our subconscious and they lurk there, grumbling and threatening. It's always a good idea to draw those monsters out and see them for what they are. For example, you have done all your analysis and you feel very positive that a stock will be making a big move very soon. Perhaps it will be the announcement of a new cancer cure or other big news that will send the stock soaring. You buy a substantial long position on the stock and, as called for by your trading plan, you place your stops and wait and watch. The stock starts to move in your direction and you add to your position. It moves even higher but not in the explosive manner you expected because the news hasn't come out yet. But you can feel it in your bones. This is going to be a slam-dunk. The stock starts a gentle slide back down toward your stops. You don't want to get stopped out. The price creeps a little lower and you start to get nervous. You need this big trade. You quickly call your broker to have the stops lowered to give the price some "room to breathe". Then it happens.

Your other line rings and it's your spouse. He is tied up at the office and can't pick up the kids at school. You dash to your car thinking of the heavy fine for being late for the pick up. Silly you, you have tens of thousands of dollars on this trade and you run in fear of a two digit fine. You pick them up and race back to the house. You try to make yourself walk calmly up the stairs to the office but as you reach the top steps, you take them two at a time and burst into the office-room and are stopped in your tracks. This wasn't supposed to happen!

The price has gapped… straight down! Something horribly unexpected has happened. Thank god for stops! Then it hits you. You had asked your broker to take off the stops but didn't specify a new stop. You were naked! You took the ride down the elevator shaft. OH NOOOOO!

Of course there is no lack of trading nightmares but the idea is to think it through and decide how you should react. Would you quit trading after a massive loss? Would you punish your self through self flagellation or would you just submit to the cruel silence of your spouse? Anyway, it's always good to have a positive attitude but it is also good to try to imagine the worst case scenario and walk it through in your mind. Airline pilots practice in-flight emergencies in a simulator so that they will learn how to react even while the emotions may be boiling over. The same strategy is a good idea for a "trading emergency".

Writing out your trading premise:

Now that you have done some serious self examination, it's time to put down on paper the reasons why you trade. By writing it down, you have the opportunity to think it out more carefully and by making your declarations on paper you lift your reasons from a level of consciousness known only to your self and proclaim it publically. By making it "public", you have a tendency to take it more seriously and with a higher level of commitment.

Example trading premise

"My salary does not permit me to save enough capital to accumulate to buy my own business. My work schedule doesn't allow me to engage effectively in any other business. During the course of my work day, I do have time to enter and monitor trades. As long as my trading doesn't interfere with my job duties, I have a chance to earn extra money through trading".

"I anticipate that it will cost about $100,000 to purchase the equipment I will need for my new business and with a trading account of $30,000, I should be able to accumulate the necessary money within five years if I have a 40% annualized ROI; or a monthly gain of 3.33% ($990). I plan to use my self directed 401K to allow my capital to accrue in a tax deferred account When my goal has been achieved, I will borrow the money from the 401K as permitted by law". "In this fashion, I can maintain a regular income and take advantage of the insurance benefits I currently receive from my employer. I will limit my maximum trading account drawdown to $15,000 and if it is reached, I will stop trading and re-evaluate."

This is not the place to write out your detailed *trading plan* but rather to clearly define why you are trading and how you plan to integrate trading with the rest of you life. You will also see how the trading premise is integrated into a trading plan in the example trading plan in the final chapter of the book.

Chapter 4: Developing an Effective Trading Strategy

Developing an effective strategy requires a clear understanding of your goals, your risk tolerance, the time you can devote to trading as well as the appropriate investment vehicles.

If you have ambitious goals such as trading for a living or trading to accumulate a lot of wealth as quickly as possible, you should be considering trading as a **full time business**. In this case, you will need to develop “the full Monty”, which means building your lifestyle around your trading activities. All trading activities should start with a trading plan but trading fulltime will require the most comprehensive plan. It starts with defining what is important to you. If, in reality, trading allows you to spend more time with your family or live where you want or any goal other than just the money, your trading plan should be designed with this in mind.

Full or part time trading?

Consider this: if you are going to be a full time trader, invest in your total education as a trader. Successful traders have the potential to make impressive amounts of money and live a most impressive lifestyle. Most professionals spend years in expensive higher education and taking a continuous series of professional courses. They must invest a lot of time and resources before they can even begin to earn a decent income. A successful trader can develop a career with high rewards but it too has some costs. Just because you don’t need a degree doesn’t mean that a significant targeted education isn’t necessary.

Fortunately, with the Internet and a recent rifting of pro traders and market makers from their professions as more markets have gone to electronic trading , getting an excellent education on all aspects of trading is now available to just about anybody, anywhere. But it does take financial resources, time and the commitment to learn some fairly sophisticated concepts.

Keep in mind that professional traders usually go through an intensive training program of study and at least several years of mentoring before they can be considered ready to trade by their employers. That training cost money and you will be “employing” yourself. To think that you can start trading without proper preparation is naïve and self destructive. Not only does a trader need a comprehensive program of education on economics, investments and rules and regulations but also a program on how to trade. This is why professional trading houses prefer a mentoring program because it combines straight book work and the soft, yet subtle psychology of trading.

All aspects of trading can now be obtained from a competitive industry, usually internet based. For instance, there are professional traders who offer a complete mentoring course from beginner to advanced levels. There are online Universities that will teach a wide array of specific courses taught by professional traders. There is even a program solely dedicated to the psychological aspects of trading found at ***The Disciplined Trader*** (www.thedisciplinedtrader.com).

Many of the online brokerages offer an excellent selection of courses, seminars and forums for all levels of traders. Additionally, essential to all traders is the paper trading account offered by the brokerage. This is an essential tool in developing and tweaking the trading system before risking capital.

In summary, before you can develop a trading strategy-no matter whether you trade full or part time-, you need to become educated on the many types of trading vehicles and which ones might be best for achieving the goals you set.

If you plan to be just a part time trader, you will need to make sure that your trading won't become a distraction to your other activities and vice versa. Often, business owners will trade a portion of their cash reserves to help boost total income; however, it is easy to get caught up in the spirit of the whole thing and take your eye off the ball (your business).

If you are an employee who will be trading and monitoring your trades while at your primary job, make sure to first clear it with your boss. Try to establish some mutual rules about when you trade and how to keep your trading activities separate from your duties as an employee. Assure your boss that the business duties come first.

Round-the-clock trading

If you are unable to trade at work, find a type of investment vehicle that won't interfere with your work. For example, many markets now trade 24 hours a day somewhere in the world. . If you trade foreign markets, you will need to have a solid understanding of how to place orders properly which will guarantee execution as per your directions. Additionally, if you trade on foreign markets, you must make sure you know all of the rules, regulations and legal recourse if a problem arises. It is fairly common for part time traders to trade foreign markets through their broker where the trading day opens well after a trader in the USA comes home. Consult with your broker to find out what markets you can trade on and understand the type of trading you can do on those markets.

Trading Style

Depending on several factors such as time available to trade, amount of capital and the personality of the trader, there are several main "styles" of trading. Sandy Jadeja describes the most common styles as:

- **Position Trading** is where you would hold your trades from a few days or weeks to a few months. This is ideal if you cannot watch the markets all day and want to avoid entering and exiting markets frequently. However, as markets become more volatile this is considered to be more risky as you are also open to adverse overnight movements and unpredictable events.
- **Swing Trading** is becoming increasingly popular as traders look to capture short term movements lasting from two to five days. Although this has more frequent trading activity than position trading, one can also look to profit from both the up and down movements of the market within a short period of time.

- **Day Trading** was very popular during the Dot com era and is considered to be dangerous. But on the other hand, because you are not holding positions overnight, you eliminate the risk of large overnight movements which could go against you and also has less margin requirements compared to Position and Swing Trading.
- **Scalping** is essentially capturing very small moves during the Day Trading timeframe but holding trades from as little as seconds to minutes. This would be suitable for professional traders rather than beginners.

All successful traders have learned that the key to their own success is to find a trading style that best suited their own personality. Deciding on which one of these styles is suitable for you is a matter of study and experimentation.

Using the paper trading account to experiment with will help define the mechanics of the system but until actual trading with real resources takes place, the emotional impact of the style can't be measured. For example, you might like to scalp but you find that the continual need for constant vigilance does not match with your goals to have more free time. This is why it is necessary to take a holistic approach to defining your trading goals.

So, rather than trying to find the best system, try to find a style of trading that suits you. Keep in mind that you might think it suits you but until you have actually traded, you might not understand the full implications of what a particular style might present.

Deciding on which is the style best suited for your needs will play an important part in what technical and fundamental indicators and parameters you will use in analyzing potential trades.

Many of the same technical and fundamental indicators and paradigms are used for each style but it is much more a matter of timing the shorter the trading period. All styles require analysis; however short term trading (Scalping, and Day trading demands a more engaged relationship with the investment vehicle.

Many traders trade only a few select investments as they become experts on the particular characteristics of the investment and the market. For example, trading the same investment vehicle allows the trader to become more in tune with small variations in the way the instrument trades and this fact can provide a "momentum signal" which is not as obvious to follow as technical analysis. In other words, short term traders (Scalpers and Day traders) are much more momentum traders than the fundamental-technical traders. Some may feel that this makes it easier for novices to avoid the months of hard study needed for the longer time frame styles of trading. But it is always preferable to know more than less about what you trade and short term trading can be more trying because of its intensity.

It is not the purpose of this book to go into detail about how to trade but rather how to prepare to trade. However, regardless of what style a you may choose, the more compatible it is with your goals and personality the greater your chances for success.

Again, there are few careers that can actually offer the potential wealth and freedom that trading can offer. In today's digital world, trading on information is perhaps one of the best ways to make money using the benefits of the information age. But like all things worthwhile, it does have a price.

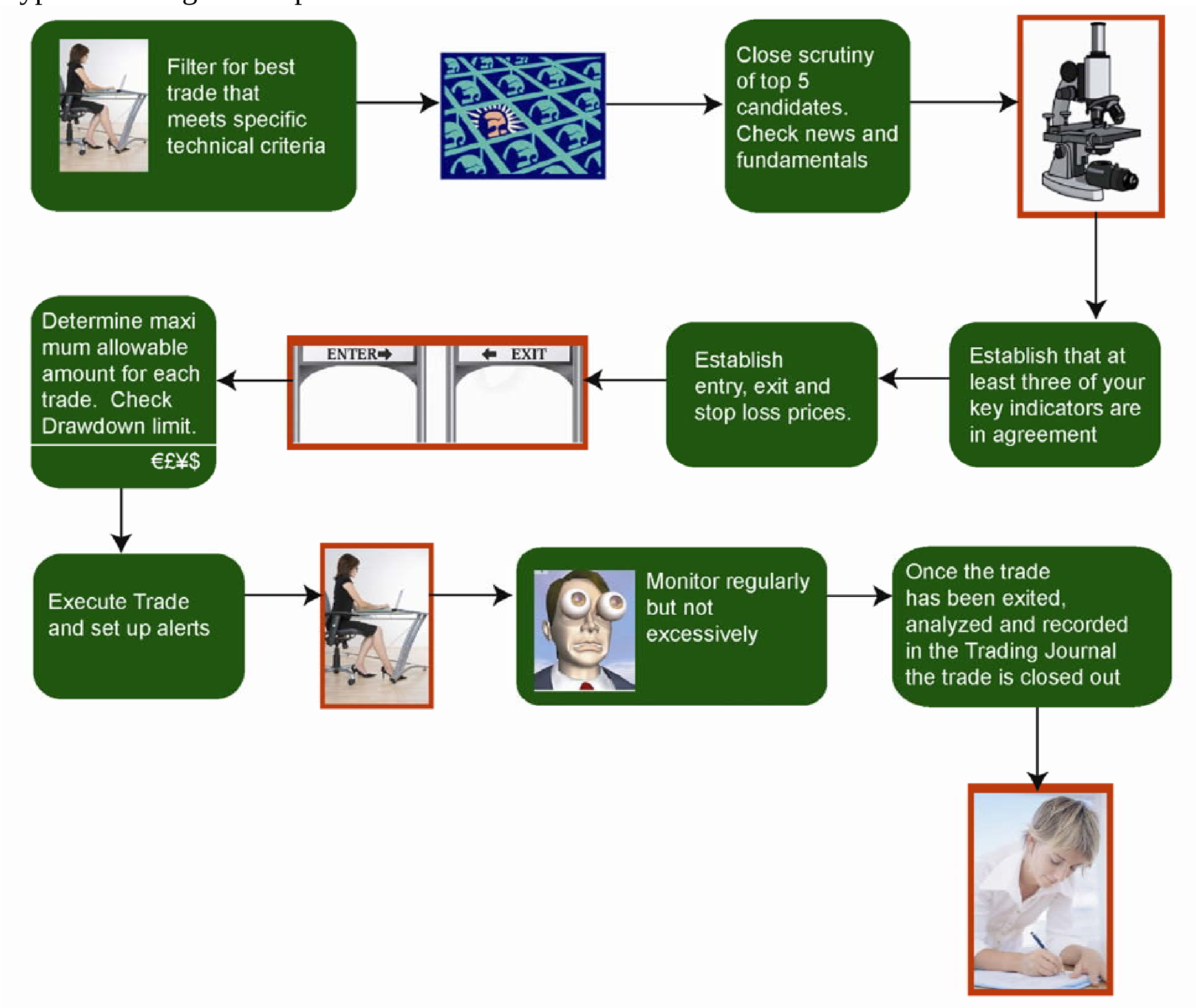
It starts here. It starts with a plan and leads to details of how to make it happen. When you build a home, you don't just go out and start building. So, take your time and do it right; start from the foundation and build upwards.

Developing an effective trading strategy is essential in helping to focus the trader on the most appropriate investment vehicle and markets in which they trade. This does not mean that a trader should be limited to just one strategy. There may be times when the nature of the market changes and may demand a different strategy. For example, a volatility trader may move from one market to another as the volatilities change. Or, just by rotating strategies, a trader may keep from getting bored or develop new learning about new opportunities. Recently, the Philadelphia Exchange just introduced currency options, which allow traders to now combine the benefits of currency and option trading. For the novice trader, however, it is probably best to begin with one strategy that is most appropriate for the trader’s goals and become an expert using that strategy before broadening strategies.

Chapter 5: Trading System and Trading Rules

The word Paradigm refers to a thought pattern in any scientific discipline or other epistemological context and is focused on analyzing the nature of knowledge. When a trader develops a trading system, they develop a paradigm to formalize a process of choosing a trade candidate, selecting entry and exit points and post trade analysis and feed back loop into the trading system.

Typical Paradigm for a position trader



Regardless of the style you may choose to trade with, there is some commonality to almost all of the trading styles. To be able to analyze a potential trade, there are two general types of analytical philosophies that most traders consider in tandem with any screening and analysis. The two are: 1) Fundamental Analysis and; 2) Technical Analysis.

These two philosophies are not mutually exclusive and are usually used together to help the trader select a successful trade. These two approaches are not natural laws of nature and they are in a state of endless "tweaking" as each trader hunts for a "secret formula for success", which is usually guarded as closely as a secret love affair with a close relative. Many books and articles have been written on both approaches, but the fact that both are based on past history underscores that there is no guarantee that history will repeat itself; therein lays the risk to all investors and traders because **the future is nothing but a probability.**

"Never try to time the market" is one of those clichés one constantly hears but in the world of trading it's all about timing.

As a quick side track, let's take a few minutes to review these important schools of approach to analysis.

Fundamental Analysis

Equities fundamentalists look mostly at the financial information about the company, which is similar to a doctor reviewing a blood test. The company might look healthy on the outside but its financial numbers may reveal something else. Fundamentalists also like to look at the "story" surrounding the company: is there a new product coming out which will knock the socks off the competitors?; is the SEC about to investigate the company?; has the company just entered into a risky strategy?, what affects will a corporate restructuring have on the company?, etc. A fundamentalist will throw all of these factors into the mix and subjectively weigh the risk-reward.

Because the fundamentalist philosophy is probably more appropriate for *investing* (long term), we will not go into great detail but touch upon some of the important sources of financial information that even an option trader should understand.

The Balance Sheet

The Balance Sheet is a financial statement that summarizes a company's assets, liabilities and shareholders' equity on a particular day. These three elements of a balance sheet can give investors an idea as to what the company owns and owes, as well as the amount invested by the shareholders and how well the management of the company is using assets and managing its debt. The balance sheet is divided into two parts that, based on the following equation, must equal (or balance out) each other. The main formula behind a balance sheet is: **assets = liabilities + shareholders' equity.**

Financial ratio analysis uses formulas to gain insight into the company and its operations. For the balance sheet, using financial ratios (like the debt-to-equity ratio) can show you a better idea of the company's financial condition along with its operational efficiency. It is important to note that some ratios will need information from more than one financial statement, such as from the balance sheet and the income statement. The main types of ratios that use information from the balance sheet are financial strength ratios and activity ratios. Financial strength ratios, such as the working capital and debt-to-equity ratios, provide information on how well the company can meet its obligations and

Balance Sheet for Wal-Mart
As of Jan 31, 2006

Assets		**Liabilities and Shareholders' Equity**	
Current Assets:		*Current Liabilities:*	
Cash and Cash Equivalents	6,414	Commercial Paper	3,754
Receivables	2,662	Accounts Payable	25,373
Inventories	32,191	Accrued Liabilities	13,465
Prepaid Expenses and Other	2,557	Accrued Income Taxes	1,340
Total Current Assets	43,824	Long-term Debt, due within one year	4,595
		Obligations Under Capital Leases, due within one year	299
Property and Equipment, at cost:		**Total Current Liabilities**	48,826
Land	16,643		
Buildings and Improvements	56,163	Long-term Debt	26,429
Fixtures and Equipment	22,750	Long-term Obligations Under Capital Leases	3,742
Transportation Equipment	1,746	Deferred Income Taxes and Other	4,552
Total Property and Equipment, at cost:	97,302	Minority Interest	1,467
Less Accumulated Depreciation	21,427		
Property and Equipment, net	75,875	*Shareholders' Equity:*	
		Preferred Stock	0
Property Under Capital Lease:	5,578	Common Stock	417
Less Accumulated Amortization	2,163	Capital in Excess of Par Value	2,596
		Accumulated Other Comprehensive Income	1,053
Property Under Capital Lease, net	3,415	Retained Earnings	49,105
Goodwill	12,188		
Other Assets and Deferred Charges	2,885	**Total Shareholders' Equity**	53,171
Total Assets	138,187	**Total Liabilities and Shareholders' Equity**	138,187

how they are leveraged. This can give investors an idea of how financially stable the company is and how the company finances itself. Activity ratios focus mainly on current accounts to show how well the company manages its operating cycle (which include receivables, inventory and payables). These ratios can provide insight into the operational efficiency of the company. There are a wide range of individual financial ratios that investors use to learn more about a company.

The current ratio is used to test the short-term liability-paying ability of a business. It's calculated by dividing total current assets by total current liabilities in a company's most recent balance sheet. From the data in the example below:

Balance Sheet for Wal-Mart
As of Jan 31, 2006

Assets		**Liabilities and Shareholders' Equity**	
Current Assets:		*Current Liabilities:*	
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Other Assets and Deferred Charges	2,885	**Total Shareholders' Equity**	53,171
Total Assets	138,187	**Total Liabilities and Shareholders' Equity**	138,187

The total current assets of $ 43,824 (millions) divided by the total current liabilities of $ 48,826 equals a Current Ratio of: is .9[2] . This means that the company has 90 cents of current assets (can be turned into cash within 12 months) to cover $1 of debt due within 12 months. As a general rule, a company with a Current Ratio of 2.0 or more is considered in good financial position to meet its short term obligations.

A more severe measure of the short-term liability-paying ability of a business is the **acid test** ("Quick") ratio, which excludes inventory (and prepaid expenses also). Only cash, market-able securities investments (if any), and accounts receivable are counted as sources to pay the current liabilities of the business. It is also called the quick ratio because only cash and assets quickly convertible into cash are included in the amount available for paying current liabilities. ***The rule of thumb is that a company's acid test ratio should be 1 to 1 or better,*** although you find many more exceptions to this as compared with the 2 to 1 current ratio standard.

2 Wal-Mart is a little different in that much of its inventory is not owned. Wal-Mart leases-out its shelf space to vendors. Normally, a company owns its inventory which would raise the ratio considerably.

The Operating Statement

The income statement is the most popular Financials statement in an annual or quarterly Company report required to be filed by the SEC. The income statement is the “sexy” portion of the financial statements because it includes figures such as revenue, net income and earnings per share (EPS). In essence, an income statement tells you how much revenue a company produced and the profits made after all expenses, which are clearly described in the income statement (also called the operating Statement).The income statement is simply designed, and is even simpler to read. The statement is looked at from top to bottom. The top line lists the revenue (sales) brought in. Each subsequent line deducts expenses and costs from the revenue figure until you finally get to the bottom line (net income). Each item that has a line above the number means that it is a subtotal or total (the net income usually has a bold or double line below the number). Below is the typical layout of an income statement. There isn’t one cookie-cutter way to present a company’s income statement. The exact information presented depends, to some extent, on the type of business the company operates.

YEARS ENDED	1999	1998
NET SALES	$12,154	$8,488
Cost of sales	4,240	2,924
Gross margin	7,914	5,564
Expenses:		
Research and development	1,594	1,026
Sales and marketing	2,447	1,572
General and administrative	418	262
Purchased research and development	471	594
Total operating expenses	4,930	3,454
OPERATIING INCOME	2,984	2,110
Realized gains on sale of investment		5
Interest and other income, net	332	196
Income before provision for income taxes	3,316	2,311
Provision for income taxes	1,220	956
NET INCOME	$ 2,096	$1,355
Net income per common share—basic	$ 0.65	$ 0.44
Net income per common share—diluted	$ 0.62	$ 0.42
Shares used in per-share calculation—basic	3,213	3,094
Shares used in per-share calculation—diluted	3,398	3,245

The Operating Statement (aka Income Statement)

Earnings per share (EPS)

One of the most-used ratios in stock value and securities analysis is earnings per share (EPS). The essential calculation of earnings per share is as follows:

Net Income Available for Common Stockholders / Total Number of Outstanding Common Stock Shares = basic earnings per hare

Price-Earnings ratio (P/E)

The market price of stock shares of a public company corporation is compared with its basic EPS and expressed in the price/earnings ratio (P/E) as follows:

Current Market Price of Stock Shares / Basic Earnings per Share = Price/Earnings Ratio

How to estimate the future value of stock shares using P/E Multiple

A P/E multiple can be used to forecast a future value of a stock. Let’s say a company has a current stock price of $30 and earned $2 per share. If an analyst comes out with a forecast for next year for earnings of $4 per share, we can use the current P/E ratio of 15 and forecast a future stock price of $60 ($4 per share estimated earnings x 15 P/E ratio).

Return on Investment (ROI) or Return on Equity (ROE)

Owners take the risk of whether their business can earn a profit and sustain its profit performance over the years. How much would you pay for a business that consistently suffers a loss? The value of the owners' investment depends first and foremost on the past and future profit performance of the business relative to the capital invested to earn that profit.

For instance, suppose a business earns $100,000 annual net income for its stockholders. If its stockholders' equity is only $250,000, then its profit performance relative to the stockholders' capital used to make that profit is 40%, which is very good indeed. If, on the other hand, stockholders' equity is 10 times as much ($2,500,000) then the company's profit performance is 4%, which is terrible relative to the owners' capital tied up in the business to earn that profit. It would be better to purchase government bonds with no risk!

The point is that profit should be compared with the amount of capital invested to earn that profit. Profit for a period divided by the **amount of capital invested to earn that profit is called return on investment, or ROI for short.** ROI is a broad concept that applies to almost any sort of investment of capital. The owners' investment in a business is the total of the owners' equity accounts in the company's balance sheet.

Dividing annual net income by stockholders' equity gives the return on equity ratio (ROE). ROE should be compared with industry-wide averages and with investment alternatives.

Quarterly and Annual Reports

We find most historical data in the annual and quarterly reports released by a company's management. These can be found over the internet or in physical form.

Financial statements are required by law and must include a balance sheet, an income statement, a statement of cash flows, an auditor's report and a relatively detailed description of the company's operations and prospects for the upcoming year.

The annual report is sometimes also referred to as the **10-K**, but don't be fooled. The 10-K contains the same information but in much more detail than many annual reports.

The following information is presented in most financial reports. Please note that the order in which these are presented might vary:

- Summary of the previous year
- Information about the company in general - its history, products and line of business
- Letter to shareholders from the president or the CEO
- Auditor's report detailing the accuracy of the results Where to find company reports

Thanks to the Internet, finding financial reports is easier than ever. Nowadays, every reputable company has an investor relations section on its website that is a wealth of information.

If you want to dig deeper and go beyond the slick marketing version of the annual report found on corporate websites, you'll have to search through filings made to the Securities and Exchange Commission (SEC). All publicly-traded companies in the U.S. must file regular financial reports with the SEC. These filings include the annual report (known as the 10-K), quarterly report (10-Q) and a myriad of other forms containing all types of financial data.

Reports are filed through a system known as EDGAR (Electronic Data Gathering, Analysis and Retrieval system). EDGAR performs automated collection, validation, indexing, acceptance and forwarding of submissions by companies and others required by law to file forms with the SEC. Information on EDGAR can be found on the SEC's website, where you can search through forms as well as familiarize yourself with the system using its *EDGAR tutorial*.

Fundamental analysis boils down to: if the company has good ratios and a good story the price of the stock will most probably go up over time if the underlying market is also moving up. On the flip side, anyone looking for a stock to "short" would turn the good ratios and good story upside down: a company with ratios below standards and with a gloomy story will probably have declining stock price over time particularly in a declining market.

But fundamental analysis does little to address the problem of when an anticipated price movement might happen. This fact tends to make fundamentalists investors and not traders. Traders normally find technical analysis more appropriate to their objectives of determining what direction and when a stock price might move.

Fundamentals for other types of investment

Currency traders have a different sort of fundamentals to work with. Fundamental FX analysis takes a look at- not one company or industry- but an entire nation. As a nation's currency is correlated with a nation's economy and politics, the types of fundamental information usually concerns itself with things specific to each country such as Balance of Trade, Interest rates, Domestic Politics, National Budget and other macro economic issues.

Commodity traders look at things such as world demand, weather, transportation costs and other factors specific to the type of commodity being traded.

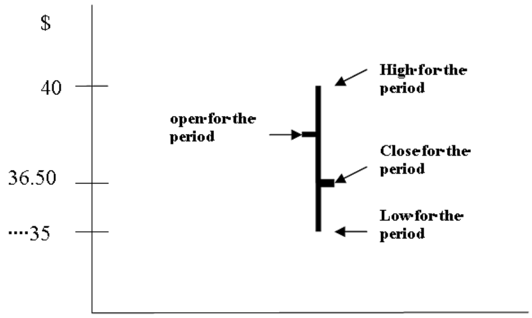
Fundamental analysis relates to the overall understanding of the factors that can affect price and interpreting the current and extrapolated implications of what is currently happening to the fundamentals.

Technical Analysis

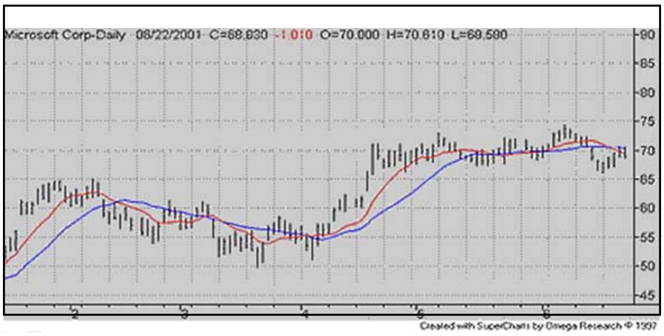
The central idea of technical analysis is that all of the myriad of factors that investors and traders through out the markets take into consideration about a company, currency or commodity are reflected in the price of the stock and other measurable parameters. The thousands or millions of investors/traders that drive the market reach a sort of consensus symbolized by what has happened to price as an indicator of what will happen to price in the future. Even though technical analysis tries to put on a good front as something scientific and predictable, it is at its core still soothsaying the future, which is never for certain. Indeed, a trader or investor who practices technical analysis is in a way still reading the "tea leaves" of quantifiable, historical performance. The following discussion on technical indicators can be found at www.shaefer.com.

Charting

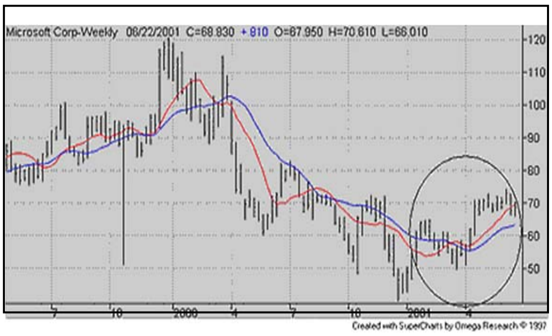
Technical analysis takes full advantage of the fact that a "picture is worth a thousand words". The basic way to depict the daily price movement of a particular asset is depicted as a bar which will demonstrate the daily high, low and close for the stock.



Daily



Weekly



Yearly

The red and blue lines are called moving averages which we will talk about in detail. But as you can see, it is fairly easy to see trends in the price movement of the stock. Learning to read these patterns of movement is vital to helping the trader pick **entry and exit points**, estimate which **direction** the stock will move, when a change in direction might take place and where a possible move might find **support** or **resistance**.

Charts also help to identify repetitive patterns of movement which can act as high probability indicators. Moreover, charts can graphically display when certain key events took place and what impact they had on the price of the stock (this is a point where fundamental and technical analysis may coincide).

Moving Averages

Don't freak out when we start doing some math. There are fantastic computer programs and online stock screens that do all the number crunching for you but it is important to under-stand the principles involved in producing the charts that are the basic tools of the trade.

A chart of a Moving Average is another way to picture what shorter term cycles are doing within a larger cycle. As in channel analysis, after we note the overall trend of the price movement we try to locate supporting trends which work within the long trend.

What is a moving average? Moving averages are used to smooth out short-term fluctuations, which make it easier to identify trends or cycles. There are several variations of the moving average concept so we will begin with the simple moving average.

Simple moving average (SMA)

The following examples are from StockCharts.com a provider of professionally produced charting and technical analysis tools.

A simple moving average is formed by computing the average (mean) price of a security over a specified number of periods. While it is possible to create moving averages from the Open, the High, and the Low data points, most moving averages are created using the closing price. For example: a 5-day simple moving average is calculated by adding the closing prices for the last 5 days and dividing the total by 5.

$$10 + 11 + 12 + 13 + 14 = 60$$

$$60 \div 5 = 12$$

The calculation is repeated for each price bar on the chart. The averages are then joined to form a smooth curving line - the **moving** average line. Continuing our example, if the next closing price in the average is 15, then this new period would be added and the oldest day, which is 10, would be dropped. The new 5-day simple moving average would be calculated as follows:

Day	Daily Close	10-day SMA
1	67.50	
2	66.50	
3	66.44	
4	66.44	
5	66.25	
6	65.88	
7	66.63	
8	66.56	
9	65.63	
10	66.06	66.39
11	63.94	66.03
12	64.13	65.79
13	64.50	65.60
14	62.81	65.24
15	61.88	64.80
16	62.50	64.46
17	61.44	63.94
18	60.13	63.30
19	61.31	62.87
20	61.38	62.40

$$11 + 12 + 13 + 14 + 15 = 65$$

$$65 \div 5 = 13$$

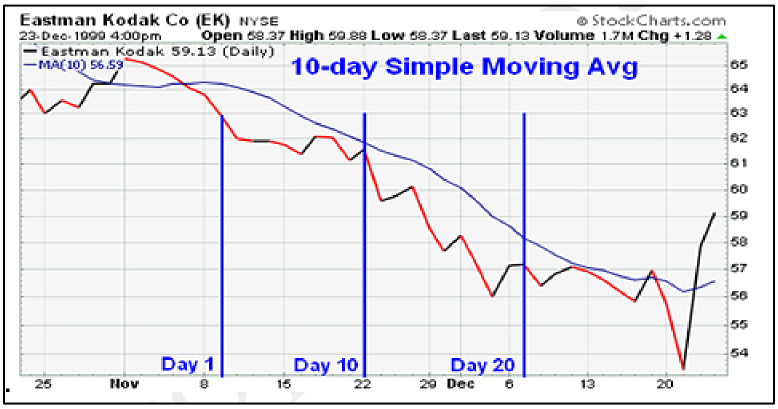
Over the last 2 days, the SMA moved from 12 to 13. As new days are added, the old days will be subtracted and the moving average will continue to move over time.

In this example, using closing prices from Eastman Kodak (EK), day 10 is the first day possible to calculate a 10-day simple moving average. As the calculation continues, the newest day is added and the oldest day is subtracted. The 10-day SMA for day 11 is calculated by adding the prices of day 2 through day 11 and dividing by 10. The averaging process then moves on to the next day where the 10-day SMA for day 12 is calculated by adding the prices of day 3 through day 12 and dividing by 10.

The following chart for Eastman Kodak displays the data in the left column.

Eastman Kodak SMA

This simple illustration highlights the fact that **all moving averages are lagging indicators** and will always be "behind" the price. The price of EK is trending down, but the simple moving average, which is based on the previous 10 days of data, remains above the price. If the price were rising, the SMA would most likely be below. Because moving averages are lagging indicators, they fit in the category of **trend following indicators**. When prices are trending, moving averages work well. However, when prices are not trending, moving averages can give misleading signals.



In its simplest form, an investment 's price can be doing only one of three things: trending up, trending down or trading sideways within a range. An uptrend is established when a security forms a series of higher highs and higher lows. A downtrend is established when a security forms a series of lower lows and lower highs. A trading range is established if a security cannot establish an uptrend or downtrend. If a security is in a trading range, an uptrend is started when the upper boundary of the range is broken and a downtrend begins when the lower boundary is broken.

In the Ford example below, it's evident that a stock can go through both trending and trading phases. The red circles indicate trading range phases that are interspersed among trending periods. It is sometimes difficult to determine when a trend will stop and a trading range will begin or when a trading range will stop and a trend will begin. The basic rules for trends and trading ranges laid out above can be applied to Ford. Notice the trading range periods, the breakouts (both up and down) and the trending periods. The moving average worked well in times of trend, but faired poorly in times of trading. Also note how the moving average lags behind the trend: it is always under the price during an uptrend and above the price during a downtrend. A 50-day simple moving average was used for this example. However, the umber of periods is optional and much will depend on the characteristics of the security as the individual's trading style.

Trend Identification/Confirmation

There are three ways to identify the direction of the trend with moving averages: direction, location and crossovers.

The first trend identification technique uses the direction of the moving average to determine the trend. If the moving average is rising, the trend is considered up. If the moving average is declining, the trend is considered down. The direction of a moving average can be determined simply by looking at a plot of the moving average or by applying an indicator to the moving average. In either case, we would not want to act on every subtle change, but rather look at general directional movement and changes.

In the case of Disney, a 100-day exponential moving average (EMA) has been used to determine the trend. We do not want to act on every little change in the moving average, but rather significant upturns and downturns. This is not a scientific study, but a number of significant turning points can be spotted just based on visual observation (red circles). A few good signals were rendered, but also a few whipsaws and late signals. Much of the performance would depend on your entry and exit points. The length of the moving average influences the number of signals and their timeliness. Moving averages are lagging indicators. Therefore, the longer the moving average is, the further behind the price movement it will be. For quicker signals, a 50-day EMA could have been used.

The second technique for trend identification is price location. The location of the price relative to the moving average can be used to determine the basic trend. If the price is above the moving average, the trend is considered up. If the price is below the moving average, the trend is considered down.

Support and Resistance Levels

Another use of moving averages is to identify support and resistance levels. This is usually accomplished with one moving average and is based on historical precedent. As with trend identification, support and resistance level identification through moving averages works best in trending markets.

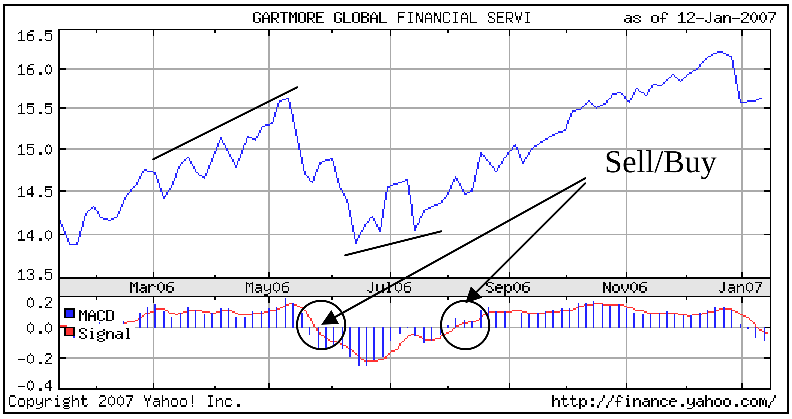
After breaking out of a trading range, Sun Microsystems (above) successfully tested moving average support in late July and early August. Also notice that the June resistance breakout near 18 turned into support. Therefore, the moving average acted as a confirmation of resistance-turned-support. After this first test, the 50-day moving average went on to 4 more successful support tests over the next several months. A break of support from the 50-day moving average would serve as a warning that the stock may move into a trading range or may be about to change the direction of the trend. Such a break occurred in Apr-00 and the 50-day SMA turned into resistance later that month. When the stock broke above the 50-day SMA in early Jun-00, it returned to a support level until the Oct-00 break. In Oct-00, the 50-day SMA became a resistance level and that held for many months.

Moving Average Convergence Divergence – MACD

One modification of the traditional Moving Average is the MACD. It is specifically used to not only help define a trend but also to measure momentum. Basically, this indicator attempts to show the relationship between two moving averages of prices. The MACD is calculated by subtracting the 26-day exponential moving average (EMA) from the 12-day EMA. A nine-day EMA of the MACD, called the "signal line", is then plotted on top of the MACD, functioning as a trigger for buy and sell signals.

There are three common methods used to interpret the MACD:

1. Crossovers - As shown in the chart below, **when the MACD *falls* below the signal line, it is a bearish signal,** which indicates that it may be time to sell. Conversely, **when the MACD *rises* above the signal line, the indicator gives a bullish signal, which suggests that the price of the asset is likely to experience upward momentum.** Many traders wait for a confirmed cross above the signal line before entering into a position to avoid getting getting "faked out" or entering into a position too early, as shown by the first arrow.
2. Divergence - When the security price diverges from the MACD. It signals the end of the current trend.
3. Dramatic rise- When the MACD rises dramatically - that is, the shorter moving average pulls away from the longer-term moving average - it is a signal that the security is overbought and will soon return to normal levels.



On Balance Volume

Developed by the once favored stock market guru, Joseph Granville, On Balance Volume is a very useful tool to help gauge sentiment about a particular stock or option by presenting a picture of what is happening between price movement and demand. If volume supports price increase, it shows a demand driven movement. However, if the price is moving up but volume is declining, this shows a divergence and may indicate a reversal.

On the flip side, if price is declining and volume is also decreasing, this may also signal a reversal to the upside. In few words, a trend needs to be fueled by volume. When the fuel runs low, the ability to sustain the trend is diminished. Use of the On Balance Volume is an excellent confirmation tool to use with other indicators.

Bollinger Bands

Bollinger Bands are the brain child of John Bollinger, a noted technical analyst. Bollinger Bands consist of a centerline and two price channels, one above the centerline and one below. The centerline is an exponential moving average, and the price channels are standard deviations of the stock the chartist is studying[3]. The bands will expand and contract as the price action of an issue becomes volatile (expansion) or becomes bound into a tight trading pattern (contraction). Thus, at a glance, the Bollinger Bands can demonstrate the amount of volatility of the price movement. When the bands contract around the moving average, trading is less volatile. When the bands expand, volatility is increasing. One could say that when the Bollinger Bands start to bulge, that means some sort of pressure is building up and some movement may push through the band indicating a significant movement. As long as prices do not move out of Bollinger Band channel, the trader can be reasonably confident that prices are moving as expected. **But when**

<u>prices start to hug close to the band, it can mean an *overbought* (upper band) or *oversold* (lower band) condition.</u> In other words, a **<u>trend reversal is possible</u>**.

As in all indicators, other indicators should provide confirmation. In the case of Bollinger Bands, the On Balance Volume indicator can provide good verification.

Relative Strength Index

The Relative Strength Index (RSI), an oscillator developed by Welles Wilder, measures the momentum strength of a stock by monitoring changes in its closing prices. RSI fluctuates between 0 and 100. **<u>RSI peaks indicate overbought</u>** levels and suggest price tops, while **<u>RSI troughs denote oversold</u>** levels and share price bottoms.

Two horizontal reference lines are normally placed at **<u>30 (indicating an oversold area</u>**) and **<u>70 (indicating an overbought area</u>**). These reference lines can be adjusted depending on the market environment. Some analysts move these lines to 40 and 80 in bull markets (raising the bar, so to speak) and lower them to 20 and 60 in bear markets.

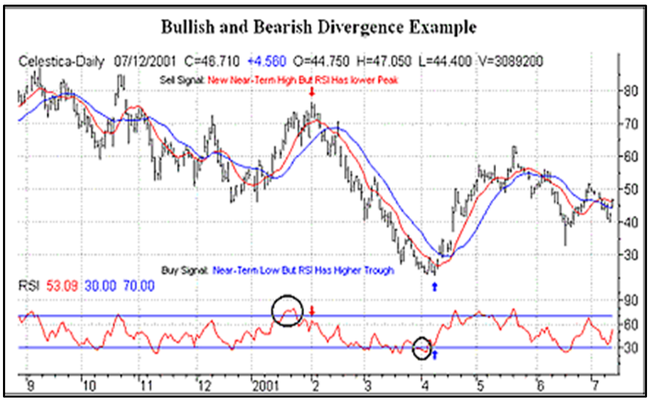
It is advised that traders use the "five-percent" rule - RSI spends less than five percent of the time beyond either reference line over a six-month period. You can adjust these reference lines every three months (once per quarter).

There is no "holy grail" level dictating guaranteed overbought or oversold readings. RSI can stay overbought in bull markets and oversold in bear markets for prolonged periods. **<u>Like most indicators, you will become accustomed to using RSI, getting a "feel" for what works best for you.</u>**

Divergence

The most significant signal is generated on "bullish" or "bearish" divergences between the RSI and the price of the underlying stock. A bullish divergence gives a "buy" or long signal and occurs **<u>when the stock price makes a new near-term low, but the RSI makes a shallower trough relative to the previous decline.</u>** **<u>You would enter a long position as soon as the RSI turns upward from this second bottom.</u>**

The buy signal is especially strong if the first RSI low drops below the oversold reference line. This indicates that selling pressure is near exhaustion and a directional change (upward) is imminent.



Note in the chart that blue arrows indicate long or buy signals. The circled trough in the RSI reading indicates the "previous decline" that did move below the lower reference line.

A higher trough in the RSI accompanied the subsequent low in the stock. The upside move was explosive. A bearish divergence that gives a "sell" or short signal occurs when prices rally to a new near-term peak but the RSI makes a lower peak than during the previous advance by the stock. This calls for selling short or purchasing a put option as soon as the RSI turns down from this second peak. Place a protective stop above the stock's latest minor high. Sell signals are especially strong if the first RSI peak is above the upper or overbought reference line.

Note in the chart that the red arrows indicate short or sell signals. The circled RSI peak coincides with the previous advance that moved above the upper reference line. A lower peak in the RSI accompanied the subsequent higher peak in the stock. Note how the substantial downside move was predicted by the RSI.

There is a lifetime of indicators and mix of indicators to use as filters in selection and to home in on the best trade. Those presented in this section represent the most common and most traders will have at least two or three of them in their trading paradigm.

It's important to understand that technical indicators are very effective in helping narrow down promising selections from the broad universe of possibilities. Once a list of candidates has been selected by computer, the next step is to focus on the fundamental analysis. Even though indicators are nice and neat, they are far from the full story. In fact, many traders have put so much faith in the technicals that many trading programs are based only on technical indicators and custom algorithms. In fact, once the parameters have been programmed into the computer, some traders just place orders as they are spit out of the program. Talk about mechanical! However, price and volume data are just a history of what has already happened and a possible indication of what the future might bring. Future information that might affect price movement are most often hidden in the fundamentals and between the lines in press releases. For this reason, traders may be well advised to not forget the importance of fundamentals.

Selection Filters

The first step in the trading paradigm is trade selection. For traders who trade in equities, each trade selection is the starting point for each trade. However, some traders become experts on just a few investments like a few currency pairs or commodities and the actual trade selection is only important when looking for alternatives when the main vehicles are not acting as they should.

A filter is usually a set of technical indicators used to help select a potential trade out of the thousands of possibilities. Each equity price and volume creates data that can be analyzed in the attempt to fathom the future; "technical entrails", if you will. Data is food for computers and programs have been developed to reach out and grab specific data that can be "screened" for its pertinence to a selection. For example, a filter can be set up to collect the data on stocks that have an RSI (Relative Strength Index) of below 30% if a trader is looking for a possible reversal in direction. Another filter might look for stocks with a low P/E and increasing cash flow. A filter can be designed for an almost unlimited number of indicators depending on what indicators the trader feels provide valuable information. As a general rule, a "high probability trade" will exist when a multiple of indicators support each other.

Two things are needed to develop a selection filter: 1) a data feed; and 2) computer program. Data service providers used to be expensive but now most trading platforms offered by brokers provide data-free of charge-to clients. In addition, most trading platforms offer a fairly wide variety of filters and charts. However, as these programs are usually "heavy", you should have a computer

with a lot of power and speed otherwise, you may find yourself nervously tapping your pencil and swearing at the computer as you wait for it to give up the information you want.

Many screening programs allow you to select the filters you want. The following is an actual screening filter developed and used by a stock option position trader. The trader is looking for a high probability trade where the stock will be reversing its short term up trend.

1. Increasing Put/Call ratio
2. RSI Above 70%
3. Price near upper Bollinger Band
4. Decreasing volume
5. Increasing Implied Volatility
6. Decreasing Detrended Price Oscillator
7. 20 day SMA starting to roll over

To this particular trader, these are important indicators which he/she feels provide a significant indication of future direction of price movement. If at least six of the seven indicators support the thesis that the trend will be reversing soon (for the position trader this would mean within the next three weeks or so), the trader will put the stock on a priority list of potential trades. Needless to say, there are probably as many filter setups as there are traders! However, these filters are not arbitrary in any sense of the word. To set up a proper selection filter, a trader needs a solid understanding of what each indicator implies and enough experience with them to feel confident that they reveal significant information.

Sample Trade Selection

To help the novice trader get an idea of what a typical screening process looks like, we present the step by step selection process in the following example.

Let's say we were taking a look at Home Depot (HD) to see if it could be a possible trading opportunity. We did an analysis of the general trend, 200 and 20 day simple moving average (SMA), and then compared the trend of the general stock market index (DJI) to the trend of HD. We noticed that there was a divergence between the two trends which could signal an opportunity for what seems to be stock in disfavor because the short term SMA is starting to move below the longer term SMA.

Now, let's take a look at some of the fundamental considerations for HD.

News about HD: We can go to www.finance.yahoo.com or many other free websites dedicated to investing and look up HD and then check out some of the recent headlines concerning the company. We find that HD has been experiencing a decline in revenue and profits due to a weak housing sector. Over 30% of HD revenue comes from commercial contractors who have fallen on hard times as the "credit crunch" continues. Moreover, we also find out that at the same time HD is experiencing falling revenues, it is under-taking a huge program of reinvesting in company

infrastructure. A double whammy. However, we also find out that HD is about 50% complete on a stock buyback plan. This should diminish the supply of HD stock available to the public and eventually drive up HD stock prices. We surmise that the short term reflects the credit problems but the long term looks promising as more people put money into fixing up their existing homes rather than selling and buying up. On the whole, the current construction market conditions are working against HD but its problems don't seem to be anything internal to the company. HD is the leader in its industry. The construction situation will change and that's what we want. The Federal Reserve has recently increased liquidity and this is the right medicine to help the troubled sector, but it will take time for the new liquidity to work its way into the system. Things will get better but when is the big question?

HD Financials: We now check the "Key Financial Indicators" and look at several things. Financial analysts go into great detail analyzing the financial data reported by companies, but we just want to make sure the company is in good financial health to weather the storm. We look for several key indicators:

1. Price Earnings Ratio (P/E). In the case of HD, it is 11 which is under the industry average.
2. Return on Equity (ROE): Over the last five years, HD has averaged 18.9% which is a strong performance.
3. Current Ratio: This is total current liabilities divided by current assets. HD is 1.4. This is OK, but nothing to get excited about. A ratio of 2.0 is considered as strong.
4. Current Price: Right now, HD is near its 12 month low; another favorable sign.

There are many other uses for the fundamental financial data but for our purposes we have made a quick check and feel that the fundamentals favor out strategy of looking for a stock ready to make a move in a new direction. Now, we will depend more on our technicals to help us make our decision. Looking at the basic fundamentals, we see a company that's not in any imminent danger and is reflecting a weak sector. We want to find companies who are out of favor but in good financial shape. HD is the leader in a very important sector and construction and home ownership are mainstays of the U.S. economy and it's a good bet that things will improve….we hope. But when is the big question. So far, our findings after doing some basic fundamental analysis is that HD could be an opportunity provided we can get a better idea of when the stock price might start moving back toward its mean.

We know from history that construction is fairly seasonal. Normally it slows during the winter time and picks up again in the spring. As we are entering the winter months, we feel that we may be entering a good time to buy to take advantage of the seasonality. To find out more about that, we turn to some technical analysis.

Now, we want to see if we can get some idea of when the stock might be reversing its current trend and start moving back to rejoin the long term stock market up trend. Remembering the old saying that a good strategy calls for buying low and selling high, we want to buy when the stock is out of favor and sell when it is all the rage. In technical analysis, we have some very powerful tools to help us get an idea of when a stock smells like a dead fish or like a perfumed gardenia. One of the more important is relative strength index. (RSI).

Relative Strength Index (RSI)

When a stock is in favor, more and more investors want to own it so there are more and more purchases of the stock. Normally, as a stock moves up, volume may also increase. This velocity and direction creates a certain momentum. The RSI measures this momentum. RSI uses a scale to show the percentage change in momentum between buying and selling. When a stock is up past 80% on the RSI, that shows that the stock has strong upward momentum. But as in the physics of gravity, what goes up must come down. If a stock's RSI moves above 80% we can say that it is moving into an *overbought* condition and it may soon move back toward equilibrium. On the other hand, if a stock's price has an RSI of 20%, we can say that the stock may be *oversold* and may soon attract buyers and move back up toward equilibrium.

We see from the chart below that RSI shows an oversold condition and the probability that buyers may come back in grows accordingly**.**

Chart of HD with 200/20 day SMA and RSI

If we were optimistic, we can visualize the buyers moving back in and pushing the stock back up towards the 20 day moving average. But there are no guarantees this will happen. We need another indicator or two to help confirm that the price has a high probability of moving back up. To do this, we introduce you to the venerable Japanese candlesticks; venerable because this technical indicator system has been around for over 400 years and is still going strong.

Candlesticks

Japanese Candlesticks is a subject in itself but we will be looking for some key reversal indicators to help our idea that HD may be reversing soon. In this case, we see a "hammer" which is one of the candlestick reversal indicators. Moreover, we see that the RSI has tested an oversold low and is moving back up. Now, we will look at another sentiment indicator:

Put/Call ratio

Put/ Call ratio which measures how stock option traders feel about the stock. More calls than puts means bullish sentiment and more puts than calls would mean bearish sentiment. We check another chart and see that the put/ call ratio shows almost twice as many calls as puts which is another very bullish signal indicating a possible reversal in short term direction.

So far, our analysis of HD has our interest. It has all the makings of a high probability trade. The next part of the process is to identify the potential entry point, profit target, stop loss price and how much resources to allocate to the trade.

Ideally, when we have selected at least five high probability trades, we will rank them and choose the best one.

The Importance of Paper Trading

As you will see, deciding on what filters to use is the end result of study and trial applications. One of the most important phases of developing the trading paradigm is paper trading.

Paper trading does several very important things. First, it allows the trader to simulate trades without the emotional fear (and reality) of losing money. This allows the trader to experiment with new and different filters until the trader sees consistent results in excess of chance. Picking the best filters and selecting good trades is a very important part of becoming a successful trader. But it's not everything.

Paper trading and experimentation with filters should take place for however long it takes to have a significant number of trials to determine with some statistical significance that the filters are correct in picking winning trades. No less than 100 trades should be used to test the validity of a filter set that will be part of your trading paradigm. In other words, if you have found a set of indicators that will give you at least a 65% win-loss ratio over 100 paper trades, you should be successful in making a profit ***if the trades are executed properly***. My friends, remember that ***paper trading is not real trading***.

When something as emotionally loaded as money comes into play, picking a high probability trade is only one of the requirements to becoming a successful trader. Proper trade execution, money management and proper trading psychology (see www.thedisciplinedtrader.com) must be maintained in a consistent and disciplined manner.

Small, frequent gains and limited losses is the basic philosophy of becoming a successful trader.

And it all begins with choosing high probability trading opportunities and this is why it is well worth the time to experiment and find a mix of effective indicators to make up a filter that will have the ability to generate a correct determination of price direction at least 65% of the time.

If a trader follows the total trading system with discipline and consistency, there is no real reason why filters will need to be changed very often.

In most cases, when the trading system is no longer providing the results expected, it is usually the trader who has strayed from the trading paradigm and trading rules that are established in the **trading plan**.

Trading System, Trading Rules and the Trading Plan

- ***Trading System*** is how a trader selects and executes trades.
- ***Trading Rules:*** how a trader implements the total Trading System
- ***Trading System:*** the total, detailed plan of how a trader plans to achieve pre-determined goals and how to measure progress toward those goals.

We've discussed the **trading system** in regards to designing selection filters, entry, exit and stop loss points and the importance of testing and experimentation with paper trading. However, we have said nothing yet about **trading rules.**

Trading rules are procedures established by the trader to help insure that the trading system is executed consistently. Traders should consider the trading system like a mathematical function in that it can only work on the input. It's the old "garbage in garbage out" and if the input is different, the function will not work as expected. For example, if you change your stop loss from 5% to 8%, this might change the win-loss ratio. Another example might be that if you run into a streak of losses, your trading rules might stipulate that you stop trading for one week. If you violate that rule, you may start to force trades that you might otherwise not enter. Trading rules are established to help build strict consistency on every trade.

Rules not only help a trader define each step in the process but also take into account any idiosyncrasies that a trader might have. For example, if you find yourself overly influenced by the opinions of others, you might make a rule that you will not subscribe to any form of trading "guidance" such as newsletters, watch investment "experts" on TV or even ask others for their opinion about a trade. Indeed, you are the expert on your own system. Or, you might find that talking about your trading with your spouse only puts more pressure on you to produce. So you might have a rule that you not discuss trading with your spouse or any other non trader.

As you can see, a trading plan is a mix of cold, hard analysis and idiosyncratic procedures customized for the individual trader. But to establish the most effective rules requires knowledge of yourself and the honesty to know and accept your weaknesses. Letting ego creep into your self appraisal will do much more harm than good.

To make all three aspects of the trading plan more effective, they should be written out in separate sections: First, the Trading Plan, next the Trading Paradigm and lastly, the Trading Rules.

It is also recommended that the trading system be used as a checklist for each trade until the procedures become so ingrained that a checklist is no longer necessary. But take note, if you have laid your trading system checklist aside, and your win-loss isn't performing like it should, one of the first thing you should do is go back to using your checklist. Chances are you have forgotten a key step in the process.

Establishing trading rules has no hard and fast format. They should be designed to make sure that you have considered all aspects of what you do in the selection and execution of a trade and when you need to step back from trading and re-evaluate. Remember, trading should be mechanical. You want to eliminate as much emotion or "human influences" (i.e., fatigue, depression, illness, etc) as possible.

As you can see, if you have the river boat gambler image of a trader you need to replace it with the image of a robot, blindly following a written program. If you find this vision to be obnoxious, you may be in love with the false image and should probably reconsider your plans to become a trader. Trading is neither glamorous nor quick riches. It is hard work, dedication and tough mental attitude. Indeed, if you have no passion for trading you will find it a most difficult way to make money.

Example of Trading Rules.

1) Do research early in the morning before trading.
2) Do not alter selection filters unless you have paper traded the filters at least 100 trades at or above an average win-loss of 65%.
3) Do not act on trading advice unless it checks with the filters and is within the scope of your expertise and trading plan.

4) Do not trade more than 5% of the account balance on any one trade.
5) Trade no more than 15% of the account balance on any one day.
6) Follow the trading system checklist on each trade.
7) If making any alteration to trading procedures, enter that into the trading journal and highlight.
8) Stop trading if:
    - If the trading account is drawn down below 35%
    - If you have lost five consecutive trades.
    - If you are tired, ill, emotionally upset, pressed for time or otherwise distracted.
    - If you are going on vacation. (smell the flowers)
    - If you are not comfortable trading in the current state of the markets.
    - If you feel that you are trying to make up for losses.

- If you feel negative or unsure.
- If you are getting bored.

9) Review each closed trade within one week and make entries in the trading journal.
10) Review the trading journal at least once each week.
11) Engage a qualified mentor or join an appropriate trading group and share information freely.
12) Take at least two online courses each year.
13) Attend a trading seminar at least once each year.
14) Do not discuss trading activities with non traders.
15) Don not discuss losing trades with your spouse or other friends or family members.
16) Get regular exercise and eat well.
17) Find a method to help keep a positive attitude. (www.thedisciplinedtrader.com).
18) Reward you and spouse with dinner at a top restaurant when you meet your monthly goals.
19) Make sure that you properly maintain all information systems and upgrade when it makes sense.
20) Make sure that all trades have an appropriate confirmation.
21) At the end of each month, cross check all trades with account balance.
22) Move 30% of profits into the taxation account at the end of each month's account audit.
23) Establish separate accounts for each trading type. (stock options, currencies, commodities).
24) Do not answer telephone during trading executions.
25) Do not monitor trades more than three times per day.
26) NEVER be without properly positioned stops.
27) NEVER back off stops once set.

Just to make sure that you understand the difference between the trading system and trading rules, the system is how to select and execute trades-from selection to Trading Journal entries. Trading rules, on the other hand, are established to minimize losses, help create a trading "gestalt" and to best match the trading environment to the preferences, personality and goals of the trader.

Of course, who is going to enforce all these rules and procedures?

The obvious answer is "you".

Chapter 6: Establishing a Trading Schedule

Are you a night owl or an early bird? Do you function better at certain hours of the day? Are you a part time trader with only limited hours you can trade? Or, are you a fulltime scalper who will spend most of your time chained to your computer? These are important questions to ask when trying to structure your trading life.

If one of your goals is to have more time with family or to play more golf or do the things you like to do, then these things should be taken into account when designing your trading plan. One of the greatest gifts of being a trader is the flexibility it offers.

In the U.S., most markets start trading at 9:30 am Eastern Time and close at around 4:00 pm Monday thru Friday. Some exceptions apply and you should find out the hours of operation for the exchanges you wish to trade. So, if you live in California, your trading times may be from 6:30 am to 1:00 pm Pacific Time. If this is not a good time for your trading activities, you could trade on one of the European Exchanges, which would open at around 2:30 pm and close around Midnight Pacific time; plenty of time to prepare and see how things have transpired in the U.S. markets. Or, you could instead trade in Japan where the markets open at about 9:00 pm Pacific Time, plenty of time to come home from work, eat dinner, watch the news and prepare for the opening of trading in Japan. Of course, not all investments trade on all markets. The best thing to do is check with your brokerage and see what foreign markets you can trade on for a specific investment.

One very important consideration when scheduling your trading is to understand how the particular investment trades. Often times, the “big players” will make their trades early in the trading day or right near closing. Before trading any specific investment, you should get an idea of how it trades. Certain commodities trade heavily at certain specific times as do currencies such as just prior to FOMC meetings.

The following is a list of exchanges located in the U.S., Canada, Europe, The United Kingdom and Japan. There are many more markets throughout the world but these nations offer execution procedures and regulations similar to those found in the U.S.and other more advanced trading nations.

U.S. National Exchanges

- American Stock Exchange (AMEX)
- Boston Options Exchange (BOX)

- Chicago Board Options Exchange (CBOE; parent company of the CBOE Futures Exchange)
- Chicago Board of Trade (CBOT; parent company of the MidAm Exchange)
- Chicago Climate Exchange (CCX; parent company of the Chicago Climate Futures Exchange and the European Climate Exchange)
- Chicago Mercantile Exchange (CME)
- Currenex (currency exchange)
- ICE (Intercontinental Exchange; incorporating the International Petroleum Exchange and the NYBOT)
- ICE Futures US (formerly the New York Board of Trade; incorporating the Coffee, Sugar & Cocoa Exchange, the New York Cotton Exchange, and the New York Futures Exchange)
- International Securities Exchange (options)
- Nasdaq Stock Market (merged with OMX to form Nasdaq OMX Group)
- National Stock Exchange (NSX - formerly Cincinnati Stock Exchange)
- New York Board of Trade, now a subsidiary of ICE, the Intercontinental Exchange)
- New York Mercantile Exchange (NYMEX; parent company of the COMEX)
- New York Stock Exchange (NYSE; parent of ARCA; merged with Euronext)
- One Chicago (OCX; joint venture of CME, CBOT, and CBOE)
- OTC Bulletin Board
- Pink Sheets (formerly the National Quotation Bureau)
- U.S. Futures Exchange (parent company of the Exchange Place Futures Exchange)

Regional U.S. Exchanges

- Arizona Stock Exchange
- Boston Stock Exchange (co-owner of the Boston Options Exchange)
- Chicago Stock Exchange (CHX)
- Iowa Electronic Markets
- Kansas City Board of Trade (KCBT)
- Minneapolis Grain Exchange (MGE)
- Pacific Futures Exchange (ceased April 08)
- Philadelphia Stock Exchange (PHLX; parent company of the Philadelphia Board of Trade; acquired by Nasdaq OMX July 08)
- San Diego Stock Exchange

Canada

- CNQ
- ICE Futures Canada (incorporating the Winnipeg Commodity Exchange)
- Montreal Exchange (Bourse de Montréal; co-owner of the Boston Options Exchange)
- Nasdaq Canada
- NGX (Natural Gas Exchange, a subsidiary of TSX)
- Toronto Stock Exchange (incorporating TSX Venture Exchange, merger of the Alberta, Vancouver, and Winnipeg exchanges)

Europe

- Chi-X: an ECN NEW
- Eurex: The European Derivatives Market (joint venture between Deutsche Börse and the Swiss Exchange
- Euronext.liffe (incorporating the London (LIFFE) derivatives market, and the French derivatives (MATIF) and options (MONEP) markets)
- European Energy Exchange (EEX)
- International Petroleum Exchange: now ICE Futures
- ICE Futures Europe (incorporating the International Petroleum Exchange)
- Nasdaq OMX Europe (will begin in late Sep 08) NEW
- Newex (Frankfurt Stock Exchange)
- NOREX (alliance between the Nordic and Baltic stock exchanges: Iceland Stock Exchange, Oslo Börs and the OMX Exchanges - Copenhagen Stock Exchange, Helsinki Stock Exchange, Riga Stock Exchange, Stockholm Stock Exchange, Tallinn Stock Exchange, and Vilnius Stock Exchange.)
- Nordic Exchange created by OMX (merger of OM [Sweden] and HEX [Finland]) - OMX merged with NASDAQ Stock Market to form NASDAQ OMX Group)
- NYSE Euronext (merger of the Amsterdam, Brussels, Lisbon, and Paris exchanges; merged with the New York Stock Exchange)
- SWX Europe (formerly virt-x and Tradepoint) NEW
- Turquoise NEW

<u>U.K.</u>

- Baltic Exchange
- EDX London (equity derivatives exchange)
- Euronext.liffe (formerly London International Financial Futures and Options Exchange)
- LCH Clearnet: an ECN
- London Metal Exchange
- London Stock Exchange
- PLUS (incorporating OFEX)

<u>Japan</u>

- Central Japan Commodity Exchange (Chubu Commodity Exchange, Nagoya Textile Exchange, Osaka Mercantile Exchange
- Kansai Commodity Exchange (incorporating the Fukuoka Futures Exchange)
- Fukuoka Stock Exchange
- Jasdaq Securities Exchange
- Kansai Commodities Exchange (Osaka Grain Exchange, Osaka Sugar Exchange, Kobe Grain Commodities Exchange, and Kobe Raw Silk Exchange)
- Nagoya Stock Exchange
- Osaka Mercantile Exchange (merger of Osaka Textile Exchange and Kobe Rubber Exchange, now merged into Central Japan Commodity Exchange)
- Osaka Securities Exchange (OSE)
- Sapporo Securities Exchange
- Tokyo Commodity Exchange
- Tokyo Financial Exchange (formerly Tokyo International Financial Futures Exchange)
- Tokyo Grain Exchange (merged with the Yokohama Commodity Exchange, 2006)
- Tokyo Stock Exchange
- Yokohama Commodity Exchange merged into Tokyo Grain Exchange, 2006

- Japan Financials (from the yuka shoken hokokusho, the Japanese equivalent of the SEC filings.)

Some companies such as E-trade now offer access to local foreign exchanges. As a matter of fact, the company recently said a poll of its customers showed that 66% of them were interested in trading foreign stocks on local exchanges, and that 70% of those would do so if it was easy.

So, if you design what your trading schedule might look like before targeting certain types of investments, this may help you decide not only on your style of trading but also the type of investments you will trade. Again, the purpose of the trading plan is to allow you to put all the pieces together *first* and see what it looks like before you risk your capital. It makes sense, doesn't In any case, the advantage of trading is that it allows you a way to make money while designing the way you want to live. Having markets available for trading 24 hours a day can help traders who plan to supplement their incomes while not conflicting with their primary interests.

Chapter 7: Setting up a Trading Journal

It's a simple but uncomfortable fact: losing trades costs money and all traders have losing trades. There is zero probability that a trader can develop a system that yields a 100% win-loss capability because the chaos factor of unknown events and the infinite permutations of variables make it so. Losing is part of trading. But consider the fact that a trader can continually strive to reduce the number of trader induced errors and that pursuit of perfection usually makes the difference between success and failure as a trader. As a trader, you are happy with a high probability trade of at least 65% but that still means a 35% loss rate.

Making miscues like not following trading procedures or misreading selection indicators will cost money that may have been avoided. By not trying to learn from past trades will cost even much more money.

Trading is a process of continuous learning. If a trader pays close attention to what was done wrong or could have been done differently in past trades, a trader can greatly improve future performance. For example, a trader may notice that there is some commonality in certain trading situations. In fact, by doing a *postmortem* on all trades, a trader may be able to identify indicators with high degrees of confidence. Likewise, a trade postmortem may reveal a flaw or omission in proper trading procedures. In any case, a trader must make every effort to limit losing trades and a thorough trade postmortem is an important part of each trade.

The trade postmortem and analysis is the final step in closing out a trade. A trade has not been completed until this vital step has been accomplished.

Capitalize on losing trades by looking for weakness in your assumptions and implementation. Don't just assume that "the market went against me" or "the market is unpredictable". Try to find out what happened in as objective a way as possible. Don't let your ego get in the way. After all, there is treasure to be found in winning and losing trades. You just need to look for it.

So, once you develop your trading system, you need to constantly monitor its performance and make certain that it's being implemented the same way, every trade. If your system isn't working the way you expect as had been established by paper trading and experience, then there are two possible reasons: 1) the system isn't valid or; 2) it's not being implemented properly and consistently.

Indeed, there are times when there may not be a clear reason and that's because of the "chaos factor" of the infinite chain of events that can subtly affect the movement of an investment. That's why traders get giddy over a 75% win ratio. However, without analyzing what happened, you pass up any opportunity for discovery and any affective alterations to your trading system.

Yes, trading is all about discipline and consistent implementation of your system. Do you follow a checklist for every trade? When you find a good trade and your heart is beating faster as you are about to click on “confirm”, have you consulted your checklist before pulling the trigger? Have you become so adept at entering your orders that you feel you don’t need to double check your procedures? Are you even aware if you’re consistent in your trading routine? As a human being, chances are you don’t do all of the things you should be doing all of the time. And my friends, it’s

the mistakes and oversights that can bring you to your knees. So, what is the best way to avoid costly mistakes and evolve as a trader? The answer is simple: The Trading Journal

The Trading Journal-your best friend

Most traders work in isolation. In fact, many seek the independence that trading offers. However, isolation can be dangerous because there is nobody else to point out mistakes or present new ideas. There is only the trader and his/her protective ego. A lone trader can become easily trapped within their own reality of how things are. Some traders realize this weakness and justify the expense of having a trading mentor who monitors every trade and provides some sort of “objectivity” to the trading experience.

However, most traders aren’t quite so pragmatic or can justify the expense even though just one good observation a month can easily pay for the mentor’s services. Luckily, the trading journal is an effective and inexpensive way to bring in much needed perspective and the ability to make self corrections. But regardless of whether or not you take on a mentor, performing the task of trade postmortem must become part of your trading procedures.

By trading, you are paying for the potential lessons provided by each trade but if you don’t take advantage of the opportunity, you don’t capitalize on that value you are paying for anyway.

Key Questions to ask yourself

Simply put, a trading journal forces the trader to analyze each trade and ask some key questions such as:

1. <u>Did I implement the system properly? If not, why not?</u> At least at the beginning of your trading career, it’s a good idea to use a checklist to walk thru the steps used in your trading system. This helps to condition yourself to the procedural flow. After a while, you will probably cut this step out, but if you find your results aren’t what you expect, go back to using the checklist to make sure you haven’t subconsciously cut out some important steps. Remember, you want to remove any variations from the implementation your system. The more mechanical, the better.

2. <u>How did I do on the trade in terms of ROI?</u> Return on your investment (ROI) is your systems performance report card. Normally, traders will already have an idea of what the potential profit might be before entering into a trade. However, the proof is in the profit or loss and when you exit the trade either your system (not you) will be validated or not.
   Another important aspect of ROI is also considering if you had your stop loss in the proper place. Are you using a support level or a percentage of estimated loss as your stop? One of

the important keys to being a successful trader is limiting losses and overcoming your ego's need to be correct.

3. <u>What could I have done differently to improve the ROI or avoid the loss?</u> This is where the growth comes. First, accept that you will not be correct a certain percentage of the time. You learn what to expect from your system by doing a significant number of paper trades-at least 100 trades. But, if things aren't going the way you want them, either the system is off key or you are doing something wrong in how you implement it. By doing everything the same way, you hope to isolate any problems to the system. If you find that you are following the procedures and not getting the results, it is time to stop trading and rework

   your system and then paper trade until you have a good feel of what to expect. (75% win-loss, for example).

   Also, as you close-out and record each trade in your journal, re-examine it to look at what happened *after you closed out the position* and if you left a lot of money on the table. If so, what could you have done differently to optimize the trade?

   If you had a losing trade, make sure to spend time dissecting what happened. Make sure to WRITE OUT IN YOUR JOURNAL WHAT ERRORS YOU MADE. UNDERLINE or HIGHLIGHT THEM so you can pick them out quickly when reviewing your journal.

   The trading journal is all about learning, looking for patterns and finding ways to optimize results.

When to make Journal entries

Of course, after you enter each trade and receive confirmation, enter the trade into your journal. Write down any observations you might have which may make the trade anything but normal.

Once the trade is closed out, this is the time to roll up your sleeves and pull out the microscope. Be honest with yourself and be as objective as you can. As a matter of fact, be hard on yourself and don't conjure up any excuses. Indeed, as a trader, you must learn to be your own harshest critic.

Let as little time as possible pass between the trade closing and your journal entry and analysis. Notice I said two things: journal entry AND analysis. Just writing things down is not enough. If you are going to take the time to fill in the journal, it only makes sense to analyze the information. Remember, your journal is your coach and the final step in closing out a trade. *So, until you have completed your review of the trade, you have not completed the implementation of your system.*

In Summary, keeping a trading journal is part of being a successful trader. Some traders don't want to know the truth but what do you think their chances of being successful are? The journal not only tells the story in black and white but also serves as a roadmap to success. Not to incorporate the zealous use of the trading journal is the mark of a lazy and unprofessional attitude. Take the time, fight the smart fight and constantly learn from each trade by journaling and analyzing all trades. No exceptions. After all, by trading, you are paying for the opportunity to learn. Not taking advantage of the opportunity is, in the words of, Forrest Gump, "just plain stupid".

Take pride in creating the chronicles of your trading activities. If done with a sense of pride and a testament for your quest for discovery and success, your journal can become one of your most treasured possessions. Remember that a journal has no hard and fast rules and can be set up in any manner that will best help you analyze and learn. The journal can also reveal what was going on in your mind and around you that may have influence on your trading. As every trader brings their own ingredients to the party, your journal will be like no other. For successful traders, a well kept journal can become the proverbial map to buried treasure worthy of a hand down to the next generation in your family.

Example of a Trading Journal

Trading Journal												
Date	**Trade**	**Symbo**	**price**	**QTY**	**Total**	**Sell Date**	**price**	**gain/loss**	**comm**	**Net Pro**	**Gain/los**	ROI
6/10/2007	buy	AAFW	0.25	5	-125.00	7/16/2007	0	-125.00	7	-132.00	-132.00	
	sell	AAFV	1.18	5	590.00	7/16/2007	0	590.00	7	583.00	583.00	129.27%
follow the system? Yes												
If not, why not?												
Comments: Bear Call Credit Spread												
OK												
6/13/2007	buy	APVFT	2.97	5	-1485.00	7/13/2008	6.5	1765.00	7	1758.00		196.00%
	sell	APVFS	4.00	5	2000.00	7/13/2008	6.5	-750.00	7	-757.00		
follow the system? No. Used an upward sloping Volatility indicator												
If not, why not?"lack of good candidates made me push												
Comments: Bear Call Credit Spread												
What would you do differently												
Short call moved contrary and had to buy out. Should have set a stop. Also, Fast volatility indicator was sloping up												
Should always set a stop on the shorted call if more than 1$ spread with buy call.												
Consider treating an upward sloping fast volatility as a potential profit on the buy call use the short just as a hedge.												
6/18/2007	buy	FCXFZ	1.10	5	-550.00	7/12/2007	0.55	-275	7	-282	-282	
	sell	FCXF\	3.02	5	1510.00	7/12/2007	5.25	-1115	7	-1122	388.00	10.70%
follow the system? Yes												
If not, why not?												
Comments: Bear Call Credit Spread												
Forgot toplace stop on short call. Need to put that in the position checklist. I got lazy and didnt check the news												

The above example is taken from the journal of an active option trader. Of course, headings can be customized for the types of trading activities, but the idea is the same.

Chapter 8: Testing your Trading System

Developing a successful trading system based upon your specific goals and a set of trading rules form the heart of your trading plan. These two documents wrap around the "fuzzy" part of your personal goals, aspirations, strengths and weaknesses and your preferred style of trading. But how do you know when you have a system that will meet your needs?

Today's trading environment makes becoming a successful trader much easier that in the past. The electronic age has not only greatly reduced transaction costs but has also mad available a wealth of information available from any place on the globe. One of the most positively impacted industries was that of the world of finance. One of the most profound effects was that of the evolution of electronic trading. Not only did it offer 24 hour trading capabilities but it changed the trading paradigm. As a result of computer to computer bid-ask matching, many of the most knowledgeable people in the industry-the market makers and floor traders-suddenly found themselves no longer needed. Indeed, the new technology forced them out of the pits and into the field of education. In the logical pursuit of putting food on the table, many former "insiders" needed to leverage their knowledge. As a result, new online trading institutions have sprung up on the net Now, the independent trader community has access to formerly closely held information on not only the mechanics of trading like a pro but also the more subtle psychological considerations of being a trader. (www.thedisciplinedtrader.com)

Part time traders and aspiring full time traders can now have access to knowledge not formerly available to the public. From online courses to full time mentoring, the internet has opened up a whole new opportunity for a person to carve out a new and potentially very rewarding career without needing to take time out from an ongoing profession or to convert free time into productive time (many "house wives and stay at home dads are exploring the possibilities of trading). Indeed, businesses of all types are entertaining the idea of using a portion of company free cash for trading purposes. In view of the low levels of returns offered by most financial institutions, if a trader can develop a fairly low risk way of generating an ROI above 10%, many capable business owners are looking at trading as part of a new way of generating additional revenues to help optimize assets. But is it possible to develop a trading system that is relatively low risk?
The answer is yes.

Given that you have put in the time to learn about investing and the types of investment vehicles that you feel are best for you to trade in, the trading plan is the first step in the process. As mentioned in Chapters 5 and 6, step by step procedures need to be developed and formalized into a document or checklist. Once you have established your procedures, the next step is to try the out. Before the advent of paper trading via an actual trading platform, aspiring traders were more or less forced to sing or swim with their money on the table. However, today, aspiring traders can build a professional trading plan and test it out before getting rolled by the pros.

When undergoing the testing of your trading system, you not only get to test your system but you also become experienced in using the trading platform and all its nuances. Moreover, you become comfortable with the trading process and how best to set up entry, exit and stops. In addition, most brokerages have seemingly come to the realization that many investors want to become educated and take a more active part in managing their investments. As a result, brokerages now make a much more serious effort to educate their clients by offering regular seminars and online webinars on trading education.

As mentioned before, the paper trading account is one of the most important tools a trader can have. Not only does it allow testing to help come up with a system that produces at least a 65% win-loss ratio over at least 100 trades, but it also provides a "safe harbor" when a system needs to be taken out of action for adjustment if production is not what it should be. Most traders will set up a trading rule whereby if the win-loss drops below its expected win-loss ratio over a certain time number of trades, the trader becomes obligated to stop trading and go back to paper trading to troubleshoot the system. Indeed, paper trading is the test bed.

Most statisticians will say that a significant sample size is about 100 test trades but this is just a rough estimate. A better way would be to test in different market conditions. For example, how does your system function during an up market with moderate volatility, in a down market with low volatility, etc, etc? However, this could take some time so as a general rule, it is probably a good idea to do at least 100 trades to develop the win-loss ratio but take into consideration that the macro economic environment of the market can have a distinct impact on how your system performs.

Over a period of differing market conditions, you will develop a feel for how your system will function. Some traders have different trading systems for different market conditions. As you can see, it is up to the trader to constantly monitor, test and tweak the system and there is no "Trading Plan for Dummies" workbook-at least not yet. Being a successful trader is just about as dynamic as the markets themselves and a trader must be ready to change what might have worked in the past. Because of this, paper trading is can be viewed as indispensible tool. For an excellent description of how to select a proper sample size go to: www.isixsigma.com/library/content/c000709a.asp

Pros and Cons of Paper Trading

According to Chuck Kowalski, a widely read financial journalist, there is a difference of opinion among many experienced traders on whether paper trading is useful or not. Some will say that it is not completely realistic since you don't have any money at risk. And once your money is at risk it is a different ball game. Emotions cloud judgment, as fear and greed become your enemies. These points are valid, but the benefits of paper trading outweigh these issues.

Paper trading offers you the opportunity to get familiar with trading and to see if you are on the right track. It also allows you the opportunity to make adjustments to your trading plan before you put money at risk. Many traders often go back to paper trading when they are struggling as a way to get back on track. Overall, it is not the complete experience, but it is an excellent training tool and almost a necessity before you put your money at risk.

Chapter 9: The Emotional Aspects of Trading

One of the least understood and most important factors trading is the emotional-psychological aspects of trading. Why is this so important? Just ask any experienced trader and they will most likely tell you straight out “you come face to face with yourself”.

Yes, that statement is a bit cryptic but what it really means is that a trader is totally and utterly accountable for his/her success. Now, that doesn’t sound too challenging but we live in an era where the word accountability has lost much of its meaning. We see it in government, business and in our personal lives. Who is to blame when things go wrong? Is it even politically correct to accuse anybody of being responsible for anything? As we speak, some school districts are even trying to do away with a grade of “F”!

Perhaps its an over reaction to a more traditional war era generation (World War II) who still believed in narrow definitions, discipline and self reliance but times seem to have moved on for most of today’s modern societies. Some may say that the decline of the Western Civilizations is a direct result of new liberal “humanistic” values. But to the trader, the trading account shrinks or grows as a direct result of their decisions. No excuses. It is what it is. The market could care less if you are a nice person or not. Trading is totally a cold Darwinian undertaking and not for the weak of heart or the grandiose of ego.

Let’s talk about ego. In most western capitalistic societies (where most traders reside), we are taught that if you want to be a success you must not fail. In some cases, if you have even the slightest blemish on your record you are automatically shoved to the side. It is indeed a paradox; a society that worships success but not accountability. How can you have success without accountability? The answer is starting to make itself apparent in the corruption and political decision making nature of our “leaders”. Nowadays, it seems to be who you know not what you know. But not for the trader. The market could care less. You make the right decisions or you are toast.

This clarity makes many people nervous. You see, as a trader, everybody is a loser at one time or another. There is no escape from this fact. No amount of schmoozing, glad handing or past history of performance shakes the market’s judgment. Either you do or you don’t. Period; end of story.

To most in our consumer societies, losing money only amplifies losing. In most modern societies, money seems to be the measure of a persons worth. With it, you are somebody. Without it, you are nobody. And what makes it worse is that most people believe it!

Not only can losing be a painful experience for most, but the loss of money equates with loss of self image and a certain standing in the world. You see yourself as a loser; not worthy. Losing money is a shameful event for many and represents some personal flaw. Not so for the trader. If they believed this tripe, they would not be traders.

A trader understands and believes that a trading system must have a fairly reliable win-loss ratio. It has been tested and tried. If a trader has a system that should yield a 70% win-loss ratio, it is expected that out of every 10 trades a trader will lose about 3 trades. **The trader expects that to happen**. It is understood that any trading system is not perfect and neither is the trader. **The trader understand that**. If the trading system's expected win-loss is not performing as expected, the first

thing a trader should do is examine what the trader is doing. You see, a trader takes the position that if a system is not working as expected it is most likely the fault of the trader. Nobody else. The trader asks the questions: are you following your trading system to the letter? Are the indicators you are using for your filter reliable? Did you lose your cool and not follow your trading rules? These are the questions that a trader usually asks after the inevitable losing trade. A trader assumes their fallibility.

"But how does a trader keep a positive attitude and good self image if they are a loser", you might ask. The answer is: "because losing is a relative thing". If a trader expects to lose a certain amount of the time, it becomes a normal event. In fact, a trader views a losing trade as a golden opportunity to learn and improve; thus, the importance of Journaling and analysis procedures. But it can still be a difficult thing for most human beings to lose money; it is the negating of things we want because of ones own doing. After all, it is our emotions that make us human and learning how to reprogram the knee jerk emotional response to losing is perhaps the most important task of becoming a successful trader.

It is one thing to talk intellectually about how to lose. It is another to neuter the pain. From the time we are small children, we are constantly conditioned about the beauty of reward and the emptiness of no reward. It becomes ingrained in our subconscious; winning or doing a good job feels good and losing feels bad. It goes way back and is reinforced almost everyday. It usually isn't until we have experienced enough losing that we learn that our infantile programming about not doing things right can be wiped away. But not all people reach that realization. It is a requirement for a trader to have emotionally-intellectually evolved to at least this point.

The importance of developing a way to cope with the emotions that are part of our makeup as humans can't be over estimated. Some traders study ancient techniques such as Yoga or Transcendental Meditation to control emotions. Others develop their own ways to cope with the stress of losing.

Holistic Trading

From the beginning of the process of developing your trading plan, the concerns for identifying your personal goals and preferences are a major factor. If you can tune your personal life with your trading activities, this can really help resolve many issues. For example, if you decided to change professions so you could spend more time with your family, you must make the effort to make that a priority. If you do that, you will see some immediate success in your decision to trade. It is not unreasonable to expect a better quality of life if you are realizing more control on how you live your life. But more is needed.

The subconscious mind has subtle influence over some of our most important characteristics. Years of programming and reinforcement can build a strong neural net akin to a knee jerk reaction when certain events happen. A trader needs to be able to reach down and change or control those conditioned responses that allow doubt, fear and anxiety to emerge and affect conscious behavior. For example, professional performers, athletes and others who depend on real time performance are turning more frequently to special psychological training programs that focus on maintaining the proper mental attitude to dominate any fears that may affect performance.

In response to the obvious dearth of any functional strategy to address the important concerns of maintaining the proper trading psyche, we started The Disciplined Trader Intensive Program.-(www.thedisciplinedtrader.com). As I am an experienced trader with over 25 years in the business I know first hand what wrestling with the proper attitude is all about. Been there….done that

But what really setup the epiphany was the suddenly obvious fact that my wife, Tisha, has provided mental training for success to many of her clients. In fact, she helped me to overcome some of my own blind spots. Indeed, once we made that obvious connection, it took us a short while to come up with our program to provide traders with the intensive training needed to help overcome the natural human weaknesses that make a trader less effective. We fully understood the need to design a methodical system to enable a trader to "train the mind" in a disciplined way to handle the stresses of trading on a daily basis.

The name "Disciplined Trader Intensive Program" exactly describes the intention of the course. As a trader, I know that having a disciplined trading methodology is paramount to success. I also know that discipline is the key word and discipline is developed through consistent application. As a result, we developed the program to rapidly provide a trader with the tools necessary to address the maintaining of the proper trading psyche. We know the system works…if applied in a consistent and conscientious manner. We also know that it requires the total buy-in of the trader to make it work. But that is up to the trader. Bottom line, The Disciplined Trader Intensive Program can provide the tools but it is up to each individual trader to use them properly.

The intensive 10 day online course presents a disciplined program of mental exercises to help program subconscious suggestions and to help traders develop the ***techniques*** to maintain the winning attitude a trader needs on a daily basis. The trader develops the techniques that can be employed in the same disciplined manner that the trader uses with the trading system.

While such a program might not be for everyone, traders must not overlook the need to develop some sort of system or techniques to help keep the proper attitude and mindset. Maybe it might be just as simple as playing golf, lighting incense and repeating a mantra or playing a musical instrument, traders need to find a way to keep a positive attitude because there will be dark trading days-and that is guaranteed. Indeed, a trader must develop a way to separate ego from the negative subconscious emotions that normally come from losing and being wrong.

Many traders feel that the lessons learned about how to stay positive and the total self acceptance of responsibility for one's life has a powerful influence on how they live their daily lives. In fact, some say that developing the proper mental attitude is even more important than the money; a very existential view but perhaps to be regarded with a bit of cynicism. Bottom line, trading is all about the bottom line and whatever it takes to get there should be considered. Having the right mental attitude is essential to becoming a consistent winner in just about anything but especially for the trader.

Characteristics of a Successful Trader

Many articles have been written about the characteristics of a successful trader. But if only it were that easy! Sit down, read an article and bingo, you are on your way to success!. It takes a program of changing attitudes deep down in your past and establishing new attitudes to take the place of those pre adolescence subconscious concepts that can hold you back.

The following was written by Paul Hedgeworth and is an example of the typical laundry list of desirable characteristics of a successful trader. But the question remains, how does a trader make these characteristics part of a trading system. However, if you at least familiar with what they are, the better, the chances are that you can develop some or all of these desirable characteristics in your own trading.

1. **Successful Traders Set Goals**

Successful traders tend to be incredibly goal-oriented. Why? Most people perform at their best when they're reaching for a *clear* goal. And there are three basic qualities that make up a clear goal:

The goal must be realistic. If your goal is to double your money every day, it sounds great – but it's not realistic.

• **The goal must be attainable.** Just like with a realistic goal, an attainable goal must be within your current capabilities. The best goals are short-term goals; make your first goal a small one, and then continue to increase your goals as you experience success. World-class sprinters don't start by thinking of winning the Olympics.

• **The goal must be measurable.** Goals that aren't precise, and can't be quantified or measured, aren't really goals at all. If your goal is to be wealthy, that's great… but what does "wealthy" mean? Our guess is that your definition of "wealth" will change as your net worth increases. If you can't define your goal, and measure your progress towards it, then you

have no way of assessing your progress or of making changes to your techniques and strategies that allow you to reach your goal.

Successful traders set goals, and they also are confident they can reach their goals. Confidence is a key to staying rational, logical, and disciplined. Starting with small, realistic goals will help build your confidence in yourself and your abilities.

2. **Success Can Come at Any Level**

Whether you're a beginning trader, a trader with some experience, or someone who makes his or her living strictly from trading, you can be successful. Many people think they have to have significant capital, or years of experience, to trade successfully. That's not true. (It's also true that if you don't stay disciplined, focused, and rational, you'll end up as a losing trader, regardless of your level of "expertise.") All successful traders started as small investors; they didn't trade more than they could safely risk, they learned from their mistakes, and they developed systems that worked for them and that fit their personal styles. We have not defined different strategies for different "levels" of traders in this e-book because the principles are the same: logical, focused, disciplined trading creates success.

3. **Successful Traders Specialize**

It's simply not possible to understand and stay in touch with everything that occurs in all the types of investment vehicles and markets across the world. While some traders have developed systems that allow them to trade in multiple venues (for instance, in different stock markets around the world), most traders specialize in a particular type of investment, and in a particular market. You may enjoy trading in commodities futures; that enjoyment will help you focus and stay in touch with market events. If you aren't interested in currency trading, for example, don't trade in it – your lack of knowledge and motivation will cause you to lose focus and make mistakes. Successful traders tend to specialize; they pick an area to gain in-depth knowledge of, and they follow it closely, learning from past trends and patterns, and from their own trades. If you're a beginning trader, we recommend focusing narrowly on a particular investment vehicle and market; learn all you can, about the market and about yourself, before you move into other investment types.

4. **Successful Traders Take Losses in Stride**

No one likes to lose. But losing is a fact of life for traders; they key is to limit your losses and maximize your successes.

A losing trade is not a failure. It isn't a reflection of you or of your overall judgment. (If it was possible to be right every time, we'd all be rich.) The only way a losing trade is truly a failure is if you aren't willing to take the loss, without hesitation, and move on to find winning trades. By accepting that they've made a losing trade, and getting out of the position, successful traders focus on making money – not on being right all the time.

Many traders feel they don't want to "lose" money on any trade, and they stay in losing positions in the hopes that it will recover to at least the break-even point. There are three problems with this approach:

1. The position may never recover to the break-even point.
2. Holding on to a losing position ties up capital that could be placed into winning trades.
3. Holding on to a losing position is an example of unfocused trading and a lack of discipline.

Successful traders are willing to take small losses. If you aren't willing to take small losses, or don't have the discipline to take small losses, don't trade.

5. **Successful Traders Stay Focused During Rapid Swings**

Most of us were raised to think that it takes years of hard work to acquire wealth. That viewpoint doesn't apply to trading in the markets; you can make thousands of dollars in minutes under the right circumstances. Successful traders understand that money can be made or lost extremely quickly, and they stay calm and rational.

Why is that attitude important? Let's say you've made several thousand dollars over the course of an hour trading futures contracts. You're thrilled and excited, and you may lose your composure and start making irrational trades. You may stay in the position longer than you should, for one of two reasons:

- You think the market will keep going up, and you don't want to limit your gains.
- The market falls, and you don't want to give up all the gains you've made, so you hold on in hopes your position will rally.

If you accept and understand that huge amounts of money can be made in a short period of time, you are less likely to become undisciplined in your trading. Successful traders take their gains in stride, no matter how large. They quickly move to protect their positions by setting stops, or covering a percentage of a short position. Successful traders stay rational and disciplined in the face of rapid gains or losses because they understand the nature of trading.

6. **Successful Traders Stay Flexible**

Staying flexible requires that you stay detached and unemotional about your trades. No matter how strongly you feel about your analysis of a position or a trade, you have to be willing to change that opinion and act quickly if necessary.

Successful traders realize that bad trades reduce the gains made from past trades and potential gains from future trades. Successful traders change their minds quickly and easily, and are not concerned about whether they were "right" or "wrong." They're concerned with maximizing their gains and minimizing their losses – and to minimize losses, they have to be willing to quickly change their minds.

Remember: the more flexible you are, the more successful you will be.

7. **Successful Traders Don't Leap Before They Look**

One of the most common mistakes inexperienced traders make is to trade when they see an opportunity they think *might* be too good to miss. Jumping into a position based on a hunch, or on the belief that you may be missing an opportunity, is no different than gambling. Almost every investor at one time or another has felt a rush of greed or enthusiasm for a trade – based solely on the desire not to miss out on a great opportunity that *might* be available.

Successful traders practice self-discipline, and apply skill and logic to their trading. They learn every day, and they use what they know to make intelligent decisions on every trade. Successful traders don't worry about missing out – they focus on making intelligent decisions.

8. **Successful Traders Don't Passively Follow "Expert" Advice**

Blindly following the investment advice of a broker or analyst is foolish and self-destructive. Oftentimes, the broker's self-interest is completely different from yours, because the broker gets paid when you make a trade, whether it's a good trade or not. He or she *wants* you to trade.

Analysts may have inside knowledge or years worth of experience, but in the end their opinions on the markets are just that – opinions.

Successful traders take responsibility for their trades and therefore their money. They learn, they stay focused and disciplined, and they make their *own* judgments about their trades.

9. **Successful Traders Aren't Affected by Mood Swings**

Many traders get excited when their positions are making money, and they increase their stake in the position. Then, when the price goes down, they panic and sell. Emotional traders are affected by the highs and lows of gains and losses, and fail to stick to their plans and their strategies.

Successful traders understand how the markets work, what to expect, and how to capitalize on trends and events. They aren't affected by the excitement or the disappointment that can come from good or bad trades.

There is your image to stick up on your mental wall. If you can model those characteristics and develop a viable trading system, and, oh yes, have the trading capital, you too may become a successful trader. But as always, the Devil is in the details. That's why you need to start with a comprehensive overall trading plan which is based upon what you want to achieve.

One of the difficult things about the nature of being an independent trader is the isolation. It's not about being a "lone wolf" but about objective input. By "objective" we refer to somebody other than yourself. You say tomato and I say tomahhto.

10 Successful Traders avoid the "blowout trade".

Arrogance and a false sense of security can cause the hubris of the "blowout trade". Within the context of being a successful trader, a "blowout trade" refers to the trade where all caution and discipline is thrown to the wind and results in trading losses that wipe out any gains made over a period of time; it is the "big Labowski", which can send a trader limping to the sidelines-with a trading account and ego in tatters.

Here is how it normally happens. The trader experiences a series of winning trades. It appears that the indicators used in selection are right on and the results are behaving with unexpected regularity. The trader begins to feel overconfident that a high probability trade becomes "easy to spot" and discards all or part of the trading system discipline used as the litmus test. Indeed, trading discipline goes out the window and money management rules violated in a fit of greed and arrogance as the trader puts a chunk of the account on just one trade. Normally, even the primal rule of placing stops will be forgotten. It is an act of trader insanity and the trading gods react with characteristic glee as they provide overwhelming hubris.

Successful traders understand the word *hubris* and honor it at all time by clinging tenaciously to their trading system.

Chapter 10: The Power of Objectivity

For many, isolation simplifies life. In fact, becoming an independent trader free from the office BS can be a powerful draw for many burned out W-2 workers. Dressed in Shorts and a T shirt, feet up on the desk and sipping coffee while watching the computer screen, can be a seductive image to some victims of the Dilbert world. In fact, it is an environment of seemingly little accountability. But is this the real world of being an independent trader?

Consider the following scenario. You have invested a lot of time studying everything you could about investments and trading. You have developed a detailed trading plan and spent over 6 months paper trading and developing your trading system. Through most of this process of preparation, you not had a two-way discussion with anybody on the complexities of trading except for a few operational questions with the trading desk of your online broker. Your spouse knows little about what you are doing and when you try to talk about it, his/her eyes glaze over as they try to pay attention to what you are saying. You are alone in your toil. You spend hours each day and can share none of it with anybody except the sleeping dogs at your feet. Indeed, you are the sum total of what you have taught yourself. But is that enough or even the wise thing to do?

Trading is a complex subject and presents many unusual events that are not found in any book or online course. Successful trading is in the details and most content on the subject deals with mostly generalities. A danger is that the independent trader can become too isolated and is cut off from valuable information found in the experience of others. It's a valid argument.

An isolated trader becomes the captive of his/her perceptions. Over time, a subtle arrogance can build up and the ideas and experiences of others are seen as rather irrelevant to the isolated trader's world. The sad truth is: how many traders may have left their trading potential unfulfilled because they hit a bump in the road and became discouraged. With nobody to turn to for help, how many potentially successful traders have given up just because they were operating in their own vacuum?

Take this to the bank: all traders hit slumps. Unless you are properly prepared to deal with losing, the chances are about 80% that you will drop out of the trading scene at the first sign of a serious losing streak.

There is no need to trade in isolation and the benefit of hooking up with other traders through various ways is strongly recommended. Some of the most popular ways to resolve this concern are the following:

- ***Hiring a trading mentor***.

This is an excellent way to get hooked up, trained and monitored. But, needless to say, it depends very much on the mentor. Some of the key questions in this regard are:

1. What type of trading is the forte of the mentor?
2. What is the trading background and level of education of the trader?
3. What is the training and mentoring syllabus like?
4. Is the amount of capital you have for trading sufficient to justify a mentor?
5. What has been the experience of current and past students?
6. Can you obtain telephone contact numbers (not e-mail) of current and past students and can you talk to them?
7. What has been the typical average win-loss ratio of students?
8. How much personal time will you get with the mentor?
9. What does the mentor see as the most important factors needed to become a successful trader?
10. What is the cost of the program and are there terms if you need them?
11. Does the mentor think there is a way to measurable return on the investment in their services?
12. Has the mentor ever had problems with regulators?

The benefits of working with a mentor who has a good reputation and record of performance is that the mentor can get to know you and your weaknesses and strengths. When you hit a wall, they will know you well enough to effectively help you technically and emotionally. They may very well be able to be proactive enough to steer you away from potholes and walls. More than anything else, working closely with a mentor can greatly accelerate the total learning process of how to become a successful trader and overcome the initial bumps in the road.

The Disciplined Trader (www.thedisciplinedtrader.com) is an online mentoring program which offers an intensive program aimed specifically at the ***psychology of trading***. What makes this program special is that they are specialists in providing proven techniques on how to maintain the proper trader attitude. Most trading mentors are experts on trading per se but may not have the training and experience to offer the best techniques for this important aspect of trading.

Do you accept the fact that an experienced set of eyes and ears can provide valuable input and if left on your own, you will miss some important observations? If you don't accept this statement, then maybe it is better to consider the next option for "hooking up".

- **Tapping into your broker resources**

On line brokerages such as ***Think or Swim*** offer a stunning array of educational services and group communications.
For example:

1. As a client, you have access to ask questions from experienced brokers and traders. The staff at Think of Swim has been taught to spend the time necessary to help trading clients because the industry understands that happy traders are revenue generators. If their clients are successful, the company benefits.
2. Some brokerages offer almost daily online webinars where company experts talk about timely subjects.
3. Trader Chat rooms where traders can establish online relationships and the exchange of experiences and information.

4. Some brokerage offer special guest speakers and market experts.
5. If you use a “brick and mortar brokerage”, you can develop trading relationships with other by hanging out at the brokerage and finding out who else is trading.

The main idea is that there is a less intense but low cost way to make connections with others who share your unique occupation. They may not offer the talent of a good mentor, but it is a way to get outside of yourself. It is not uncommon to see online traders form very important professional relationships that carry very little baggage and are based on total sharing and a commitment to success of all in the communications” loop”. Not only that but everybody knows it’s a lot easier to be honest and straight forward with someone you don’t really know. Just ask the stranger at the bar.

As a rule, it is best not to discuss your trading activities with those who have a limited understanding of what you are doing. This holds especially true for those close to you yet a trader is only human and more than likely has the need to communicate on something as important as what they do. Indeed, most traders make an extra effort to separate professional from personal life, mainly because it is a complex subject and most spouses want to fully understand where the money is going. (Not so much about where it is coming from….just as long as it keeps coming!)

Give and receive

Trading markets are huge and it is easy to imagine it is just you, the trader, against the world. You know that there are vast sums of money being managed by a relatively few fund managers who are out there trying to suck the little guy, you, into surrendering their audacity to “swim with the sharks”. There are some who feel that it is not beyond the realm of possibility that some large fund managers might be communicating with each other and indeed, there is nothing illegal about discussing business.

There is no dispute that more heads are better than one and this is particularly true with trading. Often times, the markets are not rational and at times” off the wall views” (call it contrarian) can have merit. Many traders read continuously about trading and the markets and there is little doubt that the many can absorb much more information than the isolated trader. You may see something that appears to be clear but you have no input to persuade you otherwise. You may only learn the truth about your perceptions only after a losing trade. By operating in isolation, a trader loses the advantage of talking and listening to other traders. It may be only occasionally that the words of others play an important role in your trading but that one time will pay off handsomely. If you are isolated off from other traders, you may miss the ability to look objectively at your perceptions and ideas and those of others. Isolation has its price and a trader should reach out and try to develop the powerful resource of the minds of others.

You may think you are right but throw it out there and your view may not be shared by others. If you are flexible in your attitude about sharing information, you will benefit not only yourself but others like you. The market is huge and a few traders talking shop is not illegal; in fact not to collaborate with others is a perhaps an unhealthy sign of arrogance and self destructive insecurity.

By keeping an open mind and not letting your ego get in the way, other traders can become your mentor and vice versa

There is no doubt that being open to the ideas of others and using others to test your ideas is a superior strategy to that of just listening only to your own counsel. If you really want to be successful as an independent trader, you must reach out and share openly and honestly with other traders. In today's digital world, there is no excuse not to tap into this marvelous resource.

Chapter 11: Putting it all Together-a sample Trading Plan

We have come full circle and now it is time to put it all together. The following trading plan was developed by Jody Samuels, a professional currency trader and mentor[4]. Please understand that the trading plan is an example only and you should develop your own plan depending on your level of understanding and experience. Most of the technical rules used in this plan are for currency trading and were developed by an experienced trader to fit her specific goals and style of trading.

Section 1

A Trading Strategy Description
- 1) What markets am I going to trade?
- 2) What is my trading style and time frame for trading these markets?
- 3) What specific trading strategies and indicators will I use?

B. Trading Strategy Rules
- 1) What are my trading criteria for entering trades?
- 2) What are my exit strategies/rules for profit taking and stop losses?
- 3) What are my profit and drawdown rules?

C. Trade and Performance Monitoring
- 1) How will I use the trading plan to look for high probability trade setups?
- 2) How am I going to track and rank my trades in my trading journal so that I can learn from my mistakes?
- 3) How am I going to use the Performance Summary to monitor my performance and money management?

D. Trading Psychology
- 1) List 10 positive trading beliefs that support successful trading.
- 2) List 10 general trading rules to keep me out of trouble.
- 3) How am I going to model other successful traders?

E. Defined Goals
- 1) What is my Mission Statement?

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[4] fxtradersedge.com

Answer: To be an intuitive swing trader, using Elliott Wave analysis for the roadmap, combined with specific indicators for trade entry and exit.

a. I will focus on the components of the plan to be successful and continue to grow my account. These factors include proper mindset, strict money management, and trading with a predefined game plan.

b. I will be prompt in making any updates to my trading system.

c. I will track my results on a weekly and monthly basis through my Performance Summary.

2) To trade, teach and help others achieve their trading goals.

a. I will continue as an Entrepreneur to explore new trading methodologies and share anything I find worthy of passing on.

b. I will continue to make myself available to answer

3) Profitability

a. For swing trades, make 50 - 100 pips per week or 200 - 400 pips a month consistently for the first 6 months, using 3% of the capital for a given trade. If goals are met, use 5% of the capital for next 6 months. Once I make my weekly goals, I will trade on my paper trading account unless there is another high probability setup. (This is for a currency trader. Substitute appropriate metrics)

b. For day and momentum trades, make 50 pips per week or 200 pips per month consistently, using 5% of the capital or a given trade.

4) Number of trades per week – take no more than 5 trades per week for swing and no more than 1 currency at a time on the live account. Keep demo accounts for all other trading. For day trades, take no more than 1 trade a day on one currency.

5) Personal Habits – exercise 3-5 times per week; eat healthy; meditate 3-5 times per week.

F. What is my time commitment to the business?

1) I am committed to trading 4 hours per day this year.

2) I will make contact with trading chat group prior to trading.

3) In the morning, I'll take the necessary time to look for set

4) Once I enter my trade, I will walk away and let the market do its thing.

G. Holistic Approach

1) How does my trading fit into my life?

a. I have many other activities going on in my life besides trading. Because of this, I have decided to trade only 4 hours a day, and to be present to my family the rest of the time. By trading only 4 hours a day, I also have time to look after myself in the way of exercise, diet and meditation.

b. I will make time to work on my trading courses on do research.

2) What are my plans to simplify my life?

a. This year I plan to hire a statistics grad student to help me do some statistical analysis using my trading Journal data.

3) I plan to hire someone to manage my other investments, which will free me up to focus on my trading business.

4) I will arrange a meeting with a trading coach to talk about my overall trading plan.

5) What are my rewards if my trading is on target?

a. After 6 months, if I meet my profit target, I will take my family to New York or Las Vegas for a long weekend

b. After 1 year, if I meet my profit target I will take my family to the Atlantis in the Bahamas for a week.

Note: This is all about establishing vacation goals that motivate me to stick to my Trading Plan. If I stick to my plan, I have a better chance of meeting my profit goals. I do not focus on the profit goals when I trade however. I focus on executing my trade plan. If I focus on the money, I will lose. If I focus on executing the trade plan and high probability setups, I will win.).

H. Continued Growth and Success

1) How am I going to stay on target to meet my trading goals?

a. To make sure that my plan is implemented and stays on target, I will take 2 hours every month to reread and review the plan and see what needs improving.

2) I will ask myself questions such as “Did I update my trading journal daily?” “Did I stick to my personal habits of exercising, good diet, and meditation?”

3) I will review my Performance Summary and see if I am on target. If yes, then great. If not, then I will take measures to improve it.

4) I will make a list of tasks that need to be completed and make sure that I have someone that I am accountable to (assistant ?).

5) What professional development seminars do I plan to attend this year?

a. The FOREX Traders Conference is a reward for meeting my 6 month target and it will be combined with a family vacation.

6) How do I plan to give back what I have freely been given?

a. I will continue to be active in my participation in the traders group and share honestly and openly. I will make an effort to thank those who contribute their ideas.

b. I will donate 10% of my trading profits to a charity of my choice, not yet decided.

Section 2

A. Trading Strategy Description

1) What markets am I going to trade?

a. For swing trades, I am going to look for setups in 15 different currency pairs, all of the major currencies and crosses. I have a live account only for swing trades (using 3-lot setup).

2) For day trades, I am only going to trade the 6 major currency pairs. These positions will be momentum and day trades which include the wavy tunnel setup, bracket or channel trading during quiet times. I have a separate live account for these trades.

Note:
Beginning traders should focus on only a few currencies, even one at first. Take the next 6 months and focus exclusively on one or two currencies before diversifying into other currency pairs.

3) What is my trading style and time frame for trading these markets?

a. For swing trades, I will take positions based on the hourly charts, but I will use 15 minute charts to fine tune my entries. I will review the 4 hour and the daily charts first and note the trend of the current candle.

b. For day and momentum trades, I will enter positions based on the 15 minute charts and will look at the 5 minute chart to fine tune my entries. I will make sure that the hourly is in sync with my positions and note the trend of the current hourly candle.

4) What specific trading strategies and indicators will I use?

a. FOREX swing trades on the hourly chart: chart patterns, trend lines, Elliott Wave analysis, Awesome Oscillator/MACD, 1-2-3 reversal patterns, Wavy tunnel trades, Fibo retracements and projections, Fibo grid lines (barriers) and FX lines. I will look for 2-3 confirmations of trend before entering a trade on the wavy tunnel.

b. FOREX day trades on the 15 minute chart: chart patterns, trend lines, wavy tunnel trades, Elliott Wave Analysis, 1-2-3 reversal patterns, bracket or channel breakout trades and FX lines. I will look for short-term setups such as channel breakout trades and chart pattern breakouts. For each trading setup I will prepare trading rules which I will follow consistently and track.

Note:
(There are many other trading strategies which can be used such as the K.I.S.S. method, pivot points, MA crossovers, Bollinger bands, RSI, Stochastic, Parabolic, etc. Choose what works for you!)

B. Trading Strategy Rules for Wavy Tunnel trades

1) What are my trading criteria for entering trades?

a. Wavy Tunnel Trades on the hourly and 15-minute charts. Set up the wave on the hourly and 15 minute charts which includes 34 EMAs on the high, low, and close prices. Set up the Vegas tunnel moving averages of 144 and 169 and 12 EMAs. Draw trend lines connecting tops and bottoms to see chart patterns such as consolidation and reversal patterns.

b. Entry Strategy Guidelines.

i. Buy when the wave and the tunnel are close together – either the wave is crossing above the tunnel or the wave is approaching the tunnel from above and ready to separate up from the tunnel again.

ii. Buy when the candle moves above the wave tunnel and 12 EMA as long as the wave and tunnel are together.

iii. For confirmation, look for a trend line break at the same time.

iv. For further confirmation, determine the Elliott Wave count to see where the next major trend move will be.

v. After entering the trade, look at the awesome oscillator to spot bullish/bearish divergences.

vi. Watch for the angularity of the 34 EMAs for uptrends, you want to see the MAs moving from the sideways position to a 12 –2 pm angle.

vii. For high percentage trades, take the trade during a high volume time of day.

viii. Note the major barriers and FIBO grid lines if we are close to a major barrier, then use the barrier as the confirmed entry point.

ix. Make sure the candlestick exhaustion point is not reached for the daily trading range.

2) Wavy Tunnel Execution Procedure

a. If at the computer, use the market order to enter the position. I must be at the computer for all 15 minute day trades.

b. If not at the computer for hourly setups, use limit orders for entry.

c. Take full position at entry which is 3 lots or any multiple of 3 lots.

d. If price has already broken through the wavy tunnel, leave orders to buy on the pullback to the wave (using Fibo retracements to confirm levels).

3) Channel Breakout Trades on 15 minute and hourly charts

a. Setup

i. Channel breakouts are momentum plays. Search through various currencies and time frames for setups. Look for a flat consolidation. Draw a horizontal line across the tops and bottoms. Make sure there are 2 touches on either side before a trade is triggered.

b. Entry strategy guidelines.

i. Place 2 orders once the 4th test is complete and the price moves back within the channel. Place a buy stop 3 pips above the high and a sell stop 3 pips below the low. Whichever way the market breaks, I am sitting there with my order waiting to get filled.

C What are my exit strategies/rules for profit taking and stop losses?

1) Wavy Tunnel Trades

a. Stop Loss guidelines

i. Place the initial stop loss on the other side of the tunnel.

ii. Keep moving the stop up once in profit to below the wave for buys and above the wave for sells.

b. Profit guidelines

i. Hourly trades: With 3 lots or multiples of 3 lots, use Fibonacci sequence numbers to take profits. For trades taken off the hourly charts, exit the first position at 34 pips profit and the second position at 55 pips profit. Trail the third lot until the stop gets triggered.

ii. 15 minute trades: Exit the first position at 13 or 21 pips and the second position at 21 or 34 pips profit. Trail the third lot until the stop gets triggered.

D. Channel Breakout Trades

1) Stop Loss guidelines

a. If the buy gets triggered, the stop loss is the stop sell order. If the sell gets triggered, the stop loss is the stop buy order.

b. The stop loss is the width of the channel. Make sure to cancel the stop sell once the profit target is met.

2) Profit guidelines

a. Measure the width of the channel and set your profit target the same distance as the width of the channel. Take a 3 lot position or any multiple and take your profit all at once or at 3 Fibonacci sequence numbers such as 13, 21, 34, 55, or 89 pips.

E What are my profit and drawdown rules?

1) Wavy Tunnel Trades and Bracket Trades

a. Profit rules

i. My weekly trading goal on swing trades is to make 50 - 100 pips a week. (10 - 20 pips a day). Once I make my 50 - 100 pips for the week, I will stop trading in that account. I will take all other trades in my second live account or in a demo account.

ii. My weekly trading goal for day trades is to make 50 pips per week. (10 pips per day).Once I make my goal, I will stop trading for the week.

b. Drawdown rules

i. Daily drawdown maximum is 5%. If I exceed this level on a given day, I will not trade the following day. If I exceed this level in a week, I will stop trading for the rest of the week. If I am down to a 20% total drawdown, it is time for a 2-week trading break until I can figure out what I am doing wrong. I will trade on the paper trading account instead.

F. Trade and Performance Monitoring

1) How will I use the Trading Plan to look for high probability trade setups?

a. On Sunday evenings I will look at all the currencies and pick one currency to focus on for swing trades.

b. On a daily basis, I will fill out the trading blotter for one currency that has a high probability trade setup for day trading.

c. I will print out the chart with the actual trade plan parameters on it and keep it out until the trade plays itself out for both the swing trade and the day trade.

2) How am I going to track and rank my trades in my trading journal so that I can learn from my mistakes? Each trade will be tracked on performance and execution.

a. Performance scoring

i. Profit target hit on all 3 lots.

ii. Out at a different price from target, but trade is profitable.

iii. Breakeven trade.

iv. Out at a different price from stop, but a losing trade.

v. Stop is hit.

b. Execution scoring

i. Executed the trade as dictated in the trading plan.

ii. Followed the trade entry, but closed out the position before the predetermined target was met.

iii. Followed the trade entry, but changed stop and target levels.

iv. Entered the trade late by chasing it and didn't set target or stop loss.

v. Impulse trade.

3) How am I going to use the Performance Summary to monitor my performance and money management?

a. Every week on Sunday, I will prepare the performance summary for the week prior and review my trading journal for feedback. This will prepare me mentally for the coming week.

b. I will keep my trading blotters, journals and performance summaries in a 3-ring notebook.

G. Trading Psychology

1) List 10 positive trading beliefs that support successful trading.

a. I learn through my mistakes and my successes.

b. There will be other opportunities besides this one.

c. The market provides me with oceans of opportunity and profits.

d. Risk is essential to reward.

e. My emotions are balanced on the fulcrum between fear and greed.

d. I love trading as it is a privilege to trade.

e. I will do the necessary planning and journaling to be a superior trader.

f. I know my rules and I follow my rules.

g. I don't trade on other analysts' advice.

h. My trading rules are rigid but my expectations are flexible.

2) List 10 general trading rules to keep me out of trouble.

a. Avoid buying or selling after a large move in the market.

b. Avoid impulse trades that do not follow the trading plan.

c. Do not change the trade parameters once they are entered. Define the profit target and stop before the trade is executed and do not tamper with it.

d. If I miss the trade, wait for the pullback or FIBO retracement.

e. After a 5-wave sequence, determine the potential retracement and print out the chart to wait for the level to buy (or sell) so that you don't miss the trade.

f. Trade with the trend. If the daily and general trends are up, look for buys unless you see the end of a 5-wave sequence and divergence in the oscillators.

g. Be happy taking losses and profits – don't focus on the money but focus on the set up instead.

h. Avoid buying in an uptrend if price is way above the wave – wait until price comes back to neutral and then look to buy. Think of a rubber band analogy and the need for price to snap back to the wave before continuing in the direction of the trend.

i The best way to minimize risk is not to trade. Do not feel obligated to be in a position all the time.

j Don't overtrade and take small losses and big profits. Take one setup per market per day.

3) How am I going to model other successful traders?

a. There are many books on the market about successful traders such as Market Wizards, by Jack Schwager, Market Masters by Jake Bernstein, and Entries and Exits: Visits to Sixteen Trading Rooms, by Dr. Alexander Elder. I will continue to read these books on an ongoing basis.

b I understand that many traders have successful lives and important lessons to teach. I will read so that I can learn those lessons and model the successful qualities.

As mentioned, the example Trading Plan was provided by a veteran FOREX trader, Jody Samuels. She offers FOREX trading education and mentoring and can be contacted at www.fxtradersedge.com.

In Closing

The purpose of the trading plan is to come up with realistic trading goals and objectives as well as trading tactics which are the proposed methods of action to meet your clearly stated goals. The plan must also be a holistic approach to trading. You must think about incorporating the plan into your daily life to really make it work. Otherwise, trading can easily begin to dominate your life and take it over. By recognizing this, and being well balanced, you will be able to stay in the game for the long haul.

It is also important to keep in mind that successful trading is a blend of technical and mental skills. Much has been printed about investing and how to go about it; however, rarely is it discussed about the importance of developing the psychological-spiritual knowledge as well. Acquiring the intellectual skills to become a trader is reachable for most but the inner struggle to reach self understanding and control requires something more.

Before you make the commitment to become a trader, take some time and go through all the steps discussed in this book. Carefully draw up your plan and step back and take a look when you are done. Does it feel right? Is it really for you? What is the worst that can happen? If you are honest with yourself, the answer will be obvious.

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