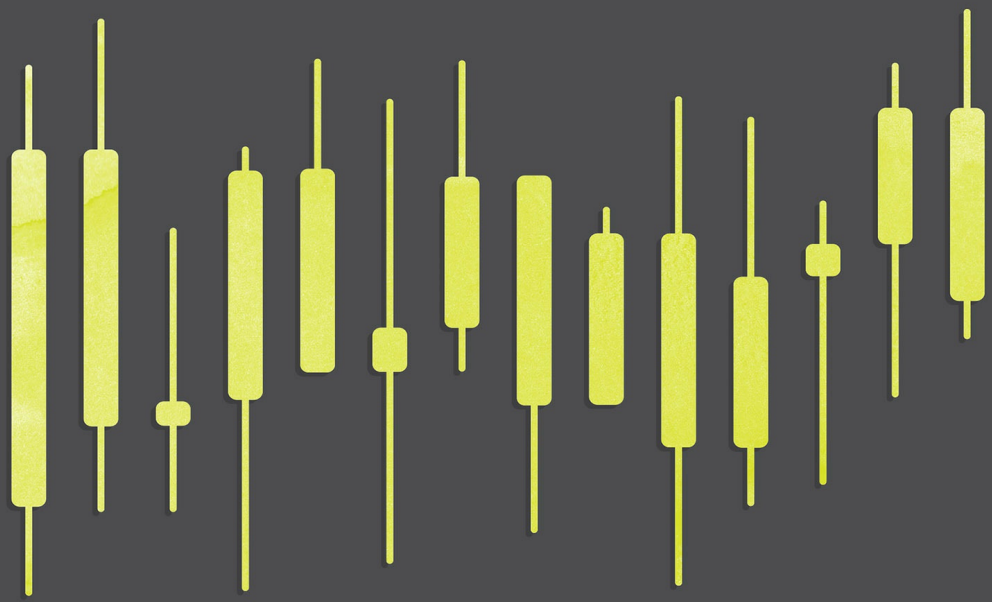
DAY TRADING

QuickStart Guide™



THE *Simplified* BEGINNER'S GUIDE TO WINNING TRADE PLANS, CONQUERING THE MARKETS, AND BECOMING A SUCCESSFUL DAY TRADER

Troy Noonan

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ClydeBank FINANCE

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Introduction

When you think about day trading, what comes to mind? How do you envision yourself day trading? Are you looking at multiple computer screens, clicking on a chart here, reading a news story there, and watching financial markets all day and night? Are you day trading full time or is it just a side gig? Are you simply learning, exploring, satisfying your curiosity, or are you ready to go all-in? If you have more questions than answers, this book is the guide you are seeking.

Day trading, to me, is not just a thing that I do each day. It's a series of decisions that I make over time. The first decision is whether to day trade at all. How do you know day trading is right for you?

If you think you're ready to dive into day trading, the next question is, *Why are you day trading?* From there, you face decisions, big decisions—about your overall trading approach, how to fit trading into your existing lifestyle, and what goals you seek to accomplish—and a myriad of smaller decisions about when, what, and how much to buy and sell.

I wrote this book to help you make those decisions. More important, I want to help you ask the right questions and come up with the best answers, beginning with the most important question of all. *Why? Why do you want to trade?*

You have probably seen other day trading books that tell you about chart patterns and what types of instruments (stocks, forex, futures) to trade. They might tell you about the mechanics of day trading, like chart reading, order entries, and various indicators.

But I have yet to find a book that offers the correct answers to the critical questions, the vital issues that determine success or failure in day trading.

Until now, there have been no day trading books that encourage the reader to ask the right questions. I wrote this book to fill the void.

Before I give you more details, let me tell you one reason I am so committed to day trading and why it has become such a huge part of my life. Rewind to the early 1990s: I was backpacking across Europe, taking in the sights and meeting new people.

It was in 1992 when George Soros became famous for "breaking the Bank of England." The Hungarian-born hedge fund manager is known for placing large trades in the currency markets. He's what you call a *whale* in the foreign exchange (forex) market.

By building a substantial (short) position, Soros began betting that the British pound would fall. For those of you who are brand-new to the trading world, a "short" position means you are betting that the value of the asset—the British pound in this case—will decline. The year before, Britain had joined the European Exchange Rate Mechanism, or ERM, and pledged to keep its currency within a certain band or range relative to the German mark. This was done by keeping interest rates high relative to Germany.

Believing that the pound had become overvalued relative to the mark, Soros held a $1.5 billion short position through the summer of 1992 and then, according to unconfirmed reports, increased it to $10 billion through September. If the pound stayed in the predefined range, the trade would make a little profit or maybe lose some. But if Soros was correct, a decline in the pound could yield hefty profits.

It was on September 16, 1992, that the British government realized it could no longer prop up its currency and abandoned the ERM. The next day, the British pound suffered a 15% drop against the German mark, and it is estimated that Soros banked $1 billion in profits.

It was considered the greatest currency, or forex, trade ever made, but it also highlights how a combination of skill, luck and guts can lead to large profits in trading. Was Soros expecting to bank some of the biggest profits in the history of trading, or was this merely a stroke of good fortune? My guess is that he had confidence in the approach and was willing to take a substantial risk. Soros was probably lucky in the sense that the realized profits were massive, but it was his skill—and probably a fair amount of research—that put him in a situation to achieve the $1 billion gain.

As day traders, that is all we can reasonably do. That is, we can develop positive expectations about potential outcomes, but only after we do the necessary work—which I call ditch digging—to build confidence in our approach or point of view. Will we always be right? No. Will we always be wrong? Not likely. Will we possibly hit one out of the park like Soros did and make a substantial profit? Yes, when we have the right mix of skill, luck, and the necessary preproduction work under our belt.

Speaking of luck, I was betting against the British pound at the same time as Soros. However, rather than shorting it against the German mark, my play was against the US dollar. This was when I was just beginning to recognize common chart patterns that could lead to good trades and I noticed a shorting opportunity.

Prior to that, I (like most investors at the time) used a full-service broker who would take my orders over the phone. We would discuss various ideas and scenarios. Then he would place the trades in my account for me. I did really well with this full-service broker. Until I lost it all in one day!

After the pain of wiping out my account with my full-service broker (a horror story that many traders suffer at some point in their trading careers), I decided to start using my own strategies. I had no idea what Soros was trading at the time, but we were on the same page when it came to the

British pound, and when the currency lost 15% in one day, I scored my biggest win as a trader.

I took some of the profits to fund a long backpacking trip through Europe. While I was there, I bought a set of bongos and, as I traveled around to various cities, I played with other musicians in parks, bars, and cafés. One of the other musicians—a mandolin player from Venezuela—became a close friend, and later, in 1995, invited me to visit him in Caracas. I did that, and, within 24 hours of my arrival, I met my wife of 25 years.

So, while Soros made his billions, I made a wife. I like to say that finding her, in the way that it happened, was the best trade of my life.

During my second backpacking trip around Europe in the late 1990s, the world was changing fast and internet cafés were popping up all over European cities. Even the smallest towns in remote locations seemed to have a café with internet access. This was also the infancy of online trading, when brokers started leveraging new technologies and the internet to develop innovative platforms for day traders like me.

As I moved from one city to the next across Europe, it was striking just how easy it was to log in to my account and trade from anywhere in the world. More important, my account balance was growing, and I felt empowered because, while I was traveling the world and seeing beautiful places, I was also making money using computers and the internet. *It can't get any better than this*, I thought.

At this time, I started to fully appreciate that I could have the lifestyle I wanted, thanks to day trading. I was never one for a nine-to-five office job and had always had an entrepreneurial mindset. Day trading gave me what I really wanted in terms of flexibility, freedom, and lifestyle.

One of my first businesses was selling food products to restaurants. My

profits came from buying at wholesale prices and selling at retail prices—simple. I found that the profit margins were the highest when I found canned goods that were slightly damaged, because they were the cheapest, and my restaurant customers had no problem paying almost full retail price because their customers would never see the dented cans. I was able to undercut the big distributors and save my customers money, and they loved me for it. While my peers were struggling making $4.25 an hour, I was banking some real money, more than 25 times that, while spending about one tenth the amount of time.

One time, I had a large order for cases of canned pizza sauce, and my customer refused to pay me upon delivery, as we had agreed. My solution: I barricaded his front door with the cases of pizza sauce I had just delivered, so that nobody could get in or out. He was an Old-World Greek and World War II vet who loved to show off scars of the bullet-entry wounds given him by the Germans. He was a real hard-nosed tough cookie, to say the least.

He stood behind his counter and watched as I stacked up the cases to block his restaurant entrance. Then, with a gleam in his eye, he signaled for me to come over to him. He pulled from his pocket a softball-sized wad of cash. He then peeled off a few grand from this preposterous money ball and paid me what he owed. Then he said, "Bring me the same order in two weeks!" I scooted the cases over just enough so I could squeeze through to exit his restaurant and was gone.

Two weeks later, I delivered his order and he paid me immediately. We later became good friends, and he even invited my girlfriend and me to visit his villa in the Greek islands.

There are a few lessons in this story. First, don't let anything (or anyone) derail a business transaction that has already been agreed upon—the ability of a trader to stick to his or her guns under pressure is crucial.

In addition, day trading requires confidence, because even with the best strategies or approaches you will experience losing trades and even losing streaks. Belief and conviction are essential when these losses occur. The idea is to navigate these difficult periods in a businesslike manner and then be sure to also experience the winning streaks that typically follow.

Another lesson is that successful businesses, like my food delivery service, have an edge that allows them to profit over their competitors—whether it's getting dented cans at reduced wholesale prices or making trades with the aid of a tested and proven tradeplan. I had an edge in my food business because I could buy canned goods at deeply discounted prices and deliver them to customers at slightly discounted prices. Successful day trading requires an edge as well. The edge that I am talking about cannot be attained by learning a few chart patterns or indicators, opening a brokerage account, and jumping right into trading. In fact, going in underprepared is a recipe for disaster and one of the main reasons why most traders fail.

You are reading this book because you want to be a successful day trader and, to that end, I will teach you the techniques needed to put you in the most advantageous position you can possibly be in, greatly improving your odds for success.

In this book, I have crystallized the most important lessons I learned over the course of nearly 30 years of day trading:

- What are the best markets for day trading?
- How much do I need to day trade?
- What are the best times to trade?
- What tradeable patterns have the highest success rates? How do I identify them and how do I trade them?
- How do I prevent large losses?

- What types of trading systems work?
- How do I avoid the pitfalls that cause so many traders to give up?
- How much money can I make?
- When can I start paying myself from my trading account?

After reading the entire book, you will understand what is necessary to become a successful day trader. Like all things in life that are worthwhile, it requires some work on your part and a commitment to the process.

The financial industry is extremely competitive today, which has both advantages and disadvantages. On the plus side, competition among brokers is intense and, as a result, many firms offer state-of-the-art trading platforms at no cost and execute buy and sell orders for rock-bottom commissions. Simply put, while the technology is advanced, the costs of trading for the individual trader are lower than they have ever been and are falling still. When I started trading, my commission (which was discounted by my broker) was over $50 ***round turn*** (round turn refers to a complete trade, including entering and exiting). Today, the same trade would cost $5 or less!

On the downside, because the cost of admission to the day trading scene is so low, the participation level is high. As a day trader, you compete against some of the smartest people in the world, from all walks of life. It is a zero-sum game where money that is lost by one trader is the profit gained by another. In other words, if you are consistently successful as a day trader, you are taking money out of the market that once belonged to somebody else—that's no easy feat.

Just as you probably wouldn't step onto a football field without practice and protective equipment, you do not want to move into the world of trading without preparation and the weapons needed to survive. That is why I also include sections on charting, order entry techniques, and specific methods for

testing your strategies.

I say "your strategies" because you own them. When I was a kid, I had a drum teacher who used to tell me, "Practice like a wimp, play like a wimp." Good practice involves hard work and repetition, repetition, repetition. Repetition is how one masters technique. You want your trading techniques to be natural and reflexive, not something you have to think about.

Just like accomplished drummers, day traders seek to build muscle memory. Doing so, however, can only be accomplished through something I call "ditch digging," which is essentially preproduction work that involves the careful analysis of patterns with high-probability outcomes and the identification of unique situations that provide an edge.

Any gambler can learn some random strategy, dive into the game, and hope for the best. This is not the ideal approach of the day trader, at least not for those who wish to keep trading and to make money. If you view day trading as gambling, then the best advice I can give you is to go to Vegas. It is a lot more entertaining to throw dice at a craps table than to sit in front of your computer screen trading gold futures. But in the latter case, if you know what you are doing, you can put the odds in your favor, a feat unheard of at the casino. Unless, of course, you *are* the casino. When we trade, we always want to have the house odds on *our* side.

If you are not yet day trading, I encourage you to wait until you finish the entire book and understand the whole process. It can be tempting to see patterns on charts and assume they will repeat—that you found the holy grail of day trading indicators—but I teach my students to avoid the temptation of trading too soon. Only by thoroughly testing an approach is it possible to really believe in a system. And I will explain why belief and confidence are so vital to day trading success when I talk about the psychological aspects of trading: handling losses, keeping emotions in check, and maintaining

reasonable expectations.

That said, I wanted to give readers real trading examples. If you are tired of books that use hypothetical (XYZ) examples or outdated trades, you will like chapter 10, which walks you through real trading scenarios and shows you how to execute trades like a professional.

It is, after all, your money. I hope that, after reading through this book and doing the exercises, you believe in the power of day trading and the advantages of using a viable tradeplan. If you put in the effort, the payback can be exponential. Day trading can give you the freedom and lifestyle that you deserve.

One day you too might be backpacking around Europe, trading from internet cafés in the French Alps, and stumble upon something that you never expected, something that forever changes your life for the better. Of course, it will never happen if you do not take a chance and give it a try.

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» Chapter 1, "Challenges and Rewards," lays the foundation for part I, "Is Day Trading Right for You?" All aspiring day traders must come to terms with the fact that they are attempting to accomplish something that has a high failure rate. The biggest obstacle to success is human emotions. The fact is, human beings make terrible traders, and the road to successful trading often involves changing the way we think.

Day trading in today's market requires some technology, including real-time access to the markets, a trading platform, and charts. I also use spreadsheets to log all trades. I have provided access to these spreadsheets and other tools in the "download" sections throughout the book. So be sure to watch my training videos and download the other tools available in your digital asset vault at www.clydebankmedia.com/trading-assets.

» Chapter 2, "Why Most Day Traders Lose," continues the conversation from chapter 1 and provides a complete list of the characteristics possessed by winning traders and the traits of many losing traders. Two characters are introduced: Harvey the engineer and Trisha the truck driver. Only one of them has the characteristics needed to win at day trading.

» Chapter 3, "You Must Have an Edge," begins with a discussion of the ins and outs of today's financial markets, which some people consider to be random and impossible to beat. However, there are many examples of investors and traders that have consistently achieved positive results. The key to success is almost always a process of finding a statistical advantage or, as many call it, an *edge.*

» Chapter 4, "Getting Started: Self-Evaluation," encourages readers to look at their own personal situation and determine if day trading makes sense given their specific lifestyle, objectives, and longer-term goals. It also seeks to help answer the question about how much money is needed to day trade. The chapter concludes with the quintessential question, *Why do you trade?* Although the answer might seem obvious, for many people it is not.

» Chapter 5, "Choosing What to Trade," explores the various investment types: futures, forex, stocks, options, and ETFs. It is a primer for those without a lot of prior knowledge or experience in

trading. Key futures markets are highlighted and explained, along with the ticker symbols and sizes of the optimal contracts to trade. The chapter also explains how forex positions—another interesting market for day traders—can be traded in various sizes, from small to large.

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- Chapter 6, "How Markets Work," begins part II, "The Foundations of Day Trading," by looking at the market from a technical viewpoint: market cycles, trends, and trading ranges. The chapter concludes with a look at chart patterns for day traders and reveals the best times of day to trade various markets.
- Chapter 7, "Charting," offers a primer on basic techniques that fall under the umbrella of technical analysis. The various chart types—bar, candlestick, range bar—are explained in detail. The reader will learn how to identify potential trading opportunities using tools like support/resistance, trendlines, and Fibonacci numbers. The final section of the chapter explains how to analyze markets over different time frames and which time frames are most appropriate for day traders.
- The discussion of technical analysis continues in chapter 8, "Technical Indicators." Here, the reader is introduced to charting platforms—which are essential to day trading—and a variety of indicators that are available with almost all charting packages today. Examples include MACD, Bollinger Bands®, and the Relative Strength Index.
- Chapter 9, "Types of Trades," offers examples of trading opportunities that present themselves based on the previously described technical tools and goes one step further by explaining

what day trading strategies are best suited for different setups. Here the reader gets a taste of what is involved in trading real markets, including the ins and outs of order entry.

» Chapter 10, "The Big Chapter – Trading in Action!" offers a series of examples of real trades based on my playbook. How do I trade a market that has been moving higher, but seems ripe for a move lower? What if a market has been rallying hard and I expect the move to continue; what are my best day trading strategies? How do I set targets for each of my trades and how do I limit my potential losses?

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» Chapter 11, "To Be or Not to Be a Winning Trader," begins to answer the key question *why trade?* by taking a deep dive into the Power of Why. Another key question, *how do I make money?* is partly answered by the Power of the Tradeplan. Then the reader is introduced to the idea of the Power of Foundation; just as they would not build their house on a pile of sand, the day trader needs to build a sturdy infrastructure before risking real money.

» Chapter 12, "Wait! Stop What You're Doing," covers the next three powers. The Power of Quitting explains how to avoid losses by staying true to the tradeplan. The Power of Numbers explores further the idea of building a system with a statistical advantage or edge. The Power of Compounding is critical in achieving longer-term goals, because it is through this concept that day trading accounts can grow from small to massive.

» Chapter 13, "Plan Your Trade and Trade Your Plan," walks through the different approaches to the markets. The Power of Mechanical Rules explains how some trading systems are developed with hard

rules that must be followed to the letter. The Power of Dynamic Setups adds an element of flexibility that allows day traders to adjust to changing market conditions. And the Power of Structure emphasizes the importance of using tools that visually present the trades in a clear and concise way.

» The remaining three powers are covered in detail in chapter 14, "Taking Control," but it's more about learning how to let go of the things that we cannot control. That's the Power of Surrender. The Power of Lifestyle holds important lessons on structuring your day trading so that it is balanced with the other things that are important in your life: family, free time, and other goals. Finally, the Power of CEO helps to give aspiring day traders a sense of the big picture—it's not one or two transactions or trades that matter, but rather how you run your business.

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» Chapter 15, "Looking Inward and Moving Forward," begins part IV, "A Step-by-Step Guide to Trading Success," by outlining a 10-step action plan that can be followed to move from using "practice" money to trading with real money. I introduce a metaphor called the three-legged stool, which outlines the first three steps of the 10-step action plan: methodology, money management, and psychology. The chapter concludes with the most important step for day traders: commit to making money.

» Chapter 16, "Proof of Concept," moves the 10-step action plan forward by explaining *proof of concept*, which is the key element in determining if a trading approach will succeed. Creating a tradeplan is an essential aspect of establishing proof of concept. Readers learn how to create and backtest the trading strategies that are used within

the tradeplan. The importance of properly using a trading simulator—a process not unlike when a pilot learns to fly in a virtual environment—is explained as well.

» Chapter 17, "From JV to Varsity and Beyond," is required reading for anyone who wants to trade real money, because, as it happens, "Trade with Real Money" is step 8 of the 10-step action plan. Once you know how to trade in smaller sizes, you can graduate to trading full-risk positions (typically around 2% of available trading capital). As you build your business, the next step is to promote yourself to CEO, and that's when you begin paying yourself from trading profits. It doesn't end there, however, because successful day trading over the long term involves steady investments in research and development—that is step 10 and how you stay ahead of the competition.

PART I - Is Day Trading Right for You?

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- The real reason to day trade
- Day trading and freedom
- Against the odds
- Dedication, perseverance, and emotional discipline
- Cycles of emotions

Success in trading can lead to independence, freedom, and financial prosperity. Those are compelling reasons to try to beat the odds. The truth is that most traders fail because day trading is challenging. Many aspiring traders quit after a series of losses.

Why is day trading so challenging? There are many reasons, but what I have found is that most traders' failure can be attributed to just a few. First and foremost, trading is unnatural. Human beings are just not wired for trading. From the very beginning, the odds are stacked against us because of the way we think.

We have a primal need, as a species, to simply survive. In the trading world, we grapple with the risk of becoming extinct. Losses are experienced as painful, and, like any living creature, we feel that pain is something to be avoided, and for good reason. It typically signifies that something is very

wrong. We often experience pain to avoid things that threaten our existence. Inexperienced traders then will do whatever they can to avoid losing trades, regardless of whether it is the correct decision or not. This behavior is not something that always happens consciously, of course, which makes it all the more difficult to resolve.

When someone is in a trade, they must surrender control to what the markets will do next. Humans have a hard time surrendering control. They want to control the outcome because their very survival often depends on it. If they win, their odds of survival increase. If they lose, they experience pain and suffering, which means they are at risk of becoming extinct. Only the strong survive. So, the tendency for the inexperienced trader is to try to control the outcome of their trade, which has the opposite effect of what they intended. It is not possible to control the markets.

Of course, all this happens deep inside a person's subconscious mind, and as a result, most would-be traders are not aware that it is happening. Therefore, they might not even be in conscious control of their own behaviors when trading.

Luckily, psychological and emotional roadblocks can be removed. Of course, understanding financial markets is certainly important too. But that's the easy part. Anyone can learn that. Learning how to harness and control the deep-rooted primal need to survive is much more challenging.

To become a successful trader, as a human being, you need to recalibrate your internal thinking and become that strange and unnatural creature/animal/species we call a trader. You need to do the necessary work to actually transform yourself from a person trying to trade into a trader—or better yet, the CEO of your trading business. This makes all the difference to the potential for success in trading. It is also what makes this book a lot different from other books on day trading. This book gives you a plan, the

steps to take to recalibrate your "internals" so that you can transform into a trader.

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Why day trade? Isn't it risky? Don't most people fail? What inspires people to take up day trading? If you ask experienced traders what motivates them, their responses might include one or more of the following:

- Unlimited income potential
- Owning a business with no employees, no clients, no inventory
- Creating your own schedule
- Freedom to travel and see the world
- Lifelong learning

In fact, there is just one reason to trade. I will talk about this later. Have a guess? Write down your answer to the question *Why trade?* and compare it with mine at the end of chapter 4.

It is true: trading can give you a great life. Imagine being independent, free, and prosperous—with no boss, no employees to manage, and no one to answer to but yourself.

Want to buy a round-trip ticket for you and your wife to visit Paris for a couple of weeks? No problem. How about taking a day off to ski a foot of fresh powder? You got it. Maybe you want to volunteer your time and energy to help others in your community or promote a cause that is very important to you. Yes, it is all possible. Success in trading can give you freedom and the

life of your dreams.

Consider John Henry, principal owner of the Boston Red Sox. He grew up on a soybean farm in Illinois and took it upon himself to learn the ins and outs of trading the futures market so that he could help his parents manage the price fluctuations in the soybean market. His goal: maximize their profits.

Henry learned so much about trading that he opened his own trading firm and became fabulously wealthy managing money for other people. He purchased the Red Sox in 2002 and helped build the team that won the 2004 World Series, the first Series triumph for the Red Sox in 86 years.

Or how about Paul Tudor Jones? A billionaire from trading, Jones got his start as a mere clerk on the New York Cotton Exchange. He later used his wealth to start the Robin Hood Foundation, a philanthropic group that battles problems associated with poverty in New York City.

Henry and Jones are two of today's best-known traders, but there are scores of others quietly trading for a living in the financial markets. They typically trade smaller amounts, control their risk, and are able to consistently make money despite occasional losing streaks and bad days.

Can you live the dream of day trading? What exactly is the dream? Monitor the market for a few hours (maybe even minutes) every day and make a few trades? Watch your account grow and have time left over for whatever else you want to do on any given day? Set your own schedule and live life on your own terms?

The good news is that getting started in day trading is easier than ever before. Trading commissions and fees have come down over the years. At the same time, electronic trade execution via computer allows individual traders to buy and sell faster than ever before.

Today we have a huge advantage. Brokers charge a tiny commission. As I stated in the introduction, the same trade that cost me $50 (round turn) when I started trading could now cost $5 or less. In fact, some brokers now offer no-commission trading for active traders or certain products.

The bad news: trading profitably is hard, darn hard. Here is why.

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Several successful traders I have talked to over the years compare learning to trade with learning to diet.

Millions of people want to lose weight. Many need to lose weight for health reasons. Others simply want to look and feel better about themselves.

The problem is not lack of knowledge. Sure, there are complex issues involved in the biology and psychology of food consumption. But if you consume more calories than you burn, you'll gain weight. And if you burn more calories than you consume, you'll lose weight. Pretty simple.

Although the process is very straightforward, there is an entire industry devoted to weight loss. Bookstores have stacks and stacks on dieting and weight loss. There are websites, seminars, herbal concoctions, and packaged foods. Yet more than 60% of American women and almost 75% of men are overweight, according to a study conducted at the University of Washington.

The problem is behavioral. For too many people, the short-term pleasure of opening a carton of ice cream or a bag of chips after dinner overrides the long-term benefits and satisfaction of weight loss and better health. It's really that simple. Call it a lack of discipline, bad wiring in the brain, or poor coping skills. Whatever the root cause, the results are the same—the person

continues to make bad decisions and to gain weight.

Trading is not that much different from dieting. Trading education and other resources are not lacking. Just like for dieting, there are reams of books, seminars, and websites to teach you how to trade. While I admit that developing a trading method that beats the market is tougher than constructing a diet to lose weight, there are time-tested trading approaches that make money when applied with discipline and consistency.

Having worked with and coached hundreds of traders in my career, I am confident in making this statement: Most traders do not fail because of a faulty method. They almost always fail because the psychological pressures of trading cause them to make bad decisions.

An important aim of this book is to discuss the psychological and emotional aspects of trading. It really begins with knowing why you are trading in the first place, which is a point that we will drive home as we go. For now, keep in mind that the psychological pressures are the root of all evil. Here are the critical questions to ask: Why am I trading? Do my actions agree with why I am trading or not? Am I keeping things in the right perspective?

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Here is what happens to the typical new trader. Let's call him Herb.

Herb is a graphic designer. After several years of working for a very successful website, Herb developed the financial security to leave the corporate grind behind and become a freelance contractor. Working from home, he began

watching the daily ups and downs of the stocks he owned, along with other financial markets.

At the end of the trading day, Herb liked to examine the price charts and plot where it seemed to make sense to buy and sell. Even though he had only a smattering of knowledge about the financial markets, he seemed to intuitively spot recurring chart patterns.

His brokerage firm had a robust charting platform with a wide range of tools and indicators. Herb began experimenting and noticed that many of the indicators correlated closely with changes in the direction of the markets.

Herb was hooked. He began calculating how much money he could make by trading the stock market every day. Some days had big moves in one direction. Other days were filled with ups and downs like a roller coaster. No matter. He figured he could catch the turning points and make several hundred dollars each day. Easy. And then if he started trading larger amounts, well, the sky's the limit!

Herb had not placed any trades or risked any money, yet he was already thinking about how he could make a million dollars a year by buying and selling stocks.

Herb read more on trading and started to build his trading system. Along the way, he came across several websites that promised to teach him how to trade. Some of the sites promised almost instant wealth and aggressively hyped their systems and seminars. Others were more informative and educational.

A book reader by nature, Herb purchased one of the better-reviewed day trading books online one day. The cost was modest compared to most online trading programs. He skimmed some of the chapters and focused on one of

the trading strategies that reminded him of the trade opportunities he had noticed when he looked at his stock charts.

Herb spent a couple of weeks checking in on the market during the course of the day and identifying where his newly crafted system spotted buying and selling opportunities. Every time his system generated a profitable trade, he imagined himself buying or selling, and he calculated how much money he would have made on it.

Paper trading simply means practice trading. Also called "sim" trading (short for simulated trading), it is a way to get a feel for the markets without risking real money. Some brokerage firms today have practice trading platforms that allow you to buy and sell as if you are using real money. It's like a flight simulator that pilots would use before flying real airplanes.

Herb read in his book that traders should keep good records of all their trades and analyze their results over time. He created a spreadsheet to catalog all his hypothetical trades. At the close of every trading day, he recorded where he entered the market, where he sold, and the profit or loss that was generated by each trade.

A "trade" typically refers to a buy or sell order for a stock, futures contract, option, or other investment product. If I purchase (or sell) 100 shares of

XYZ stock, or buy (or sell) 10 gold futures contracts, or buy (or sell) $1,000 worth of British pounds, then I have "placed" or "put on" a trade.

If he was objective and honest with himself, Herb would have recorded all the instances where his system led him into an unprofitable trade. Instead, over a two-week period, he recorded only two losing trades. He rationalized this omission after adding a new technical indicator to his system. In his mind, had he had the benefit of the technical indicator beforehand, then he would not have suffered any losses; therefore, it was not important that he record his losing trades.

After two weeks, Herb's spreadsheet showed 14 winning trades and two losing trades, for a net profit of $3,512.50.

Many newcomers to trading think a profitable trade means buying low and selling high, but, as you may know, money can also be made when prices fall. In chapter 4, we discuss "shorting" or "going short" on a trade.

Herb felt he was ready to roll and start trading real money. His vehicle of choice: futures contracts on the S&P 500 (more on these later).

He figured he would start trading two contracts, and after building up his account he would graduate to five contracts. In five or six months, he would start trading 10 contracts. He anticipated having enough money and experience after a year to trade 20 or 25 contracts.

Herb calculated that, if all went according to plan, he could make $500,000

in his second full year of trading.

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Herb's first day of trading went quite well. He was surprised by how nervous he felt as he watched the market unfold early in the morning. The indicators in his system moved up and down rapidly. It was far different watching the indicators live, in real time, as opposed to evaluating them on the daily chart after the close of trading.

Herb was anxious to make a trade and almost jumped the gun before his system indicated a buy or sell signal. About 45 minutes into the trading day, the market surged higher, and his system unmistakably flashed a buy signal. With his pulse racing a bit, Herb executed the buy order on his computer with the click of a mouse.

The market stalled and then dropped a little bit. Herb wondered if he had made a mistake and even thought about liquidating the trade at a small loss. Suddenly, the market jumped sharply higher and continued to climb for the next 30 minutes. The trade was now profitable! As soon as the market paused, Herb sold his position.

On his two contracts, Herb made a profit of $625. Not bad for 90 minutes of work. The anxiety Herb felt when he was watching the market disappeared and was replaced by a feeling of elation. In the quiet of his home office, he pumped his fist in celebration. The system worked! I am on my way, he thought.

When he was contemplating day trading, Herb had assumed he would watch the market all day long and make all the trades his system dictated. But after the first trade that morning, he found it difficult to concentrate on the market. He gave up and took care of some chores around the house.

Herb returned to his computer after lunch. Near the end of the trading day, all the indicators in his system flashed a sell signal. Herb knew he should put in an order to sell, but he did not feel up to the anxiety of watching the market go up and down with real money at stake.

The market continued to go down, validating his system's sell signal. Herb congratulated himself for spotting the trade and being right, even though he could not bring himself to enter the market. All in all, Herb felt great about his first day of trading.

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Herb was eager to replicate his success and the feeling of elation he experienced on day one. He watched the market carefully the next morning and jumped in with a buy order when his indicators turned positive.

This time, things didn't go so well. The market quickly turned against him and he exited the position, taking a $250 loss. He felt terrible. He blamed himself for jumping into the trade too quickly and not looking at other indicators that were not a formal part of his system.

Fixing a losing trade is a slippery slope that often leads to sliding into razor-sharp rocks at the bottom. That is what happened to our friend Herb. He was trying to fix a losing trade, even though he believed his trading method was solid. Seasoned traders know that there are losing trades inside of winning tradeplans and strategies. If you try to fix a losing trade, you might break something else within an already successful and effective tradeplan!

After about 30 minutes of directionless action, the market started to trend downward. All of Herb's indicators flashed a sell signal—but Herb didn't even look at them. He was so hurt from the loss that he didn't want to follow the market and risk the possibility of losing more money.

Over the next several days, Herb toyed with his system. He adjusted the parameters of two of his indicators and added another indicator which he hoped would keep him from getting into trades before a definite trend was established.

A couple of weeks later, he tried trading again. He had mixed results. Some of his trades made money, but he grabbed profits too quickly and left money on the table on the few occasions when the market moved strongly in his direction.

Unlike many new traders, Herb was good at getting out of losing trades. He always put in a stop-loss order (which, we will see later, is a way to automatically close a losing trade) near to where he entered the market. That way, when the market went against him, he could exit the trade with a relatively small loss.

But despite his ability to handle losses, Herb became increasingly frustrated. On two consecutive occasions, Herb's stop-loss orders were triggered within 10 minutes of when he entered trades—producing a total of $525 in losses. Both times, after he exited his position, the market reversed course and surged strongly in the direction of his original trade. Had he stayed with the positions, he would have made $1,850.

By now, Herb understood that trading was much harder and more stressful than he imagined when he was making hypothetical trades on static charts. For one thing, he found monitoring the market all day to be tedious and boring. Then, when he was considering putting on a trade, he became

nervous and agitated. To escape the uncomfortable feelings, many times he stepped away from his computer and let potential trades go by.

After all the losses he experienced, Herb was reluctant to pull the trigger when his system called for a trade.

Herb's trading account was down more than 30%. More important, his confidence in his system and in his ability to make good trading decisions was pretty much shot. He was tempted to quit.

After taking a hiatus of several days, Herb found himself with nothing pressing to do one morning. He opened his computer and started watching the market. The market tried to go up early in the session but then retreated quickly and began to look very weak. All of Herb's indicators were flashing a sell signal. It was as clear as day. Almost reluctantly, Herb entered his sell order.

The rain was pouring outside. A bit of water was leaking through the windowsill in Herb's home office and he fetched a towel, placing it strategically to absorb the water.

Back at his computer, Herb fretted as the market moved up and down, but without a lot of direction one way or the other. Twice, the market almost hit his protective stop—which would have taken him out of the market at a loss of $300. He felt a sense of dread that he was about to experience another losing trade.

The rain continued to seep through the window and was now dripping through the towel onto the floor. Looking back and forth from the leaky window to his computer screen, Herb became increasingly agitated and began swearing out loud.

This is too much to deal with at once, he finally decided. He closed his

position at a loss of $125 and focused on fixing the source of the leaky window.

Five minutes later, the market broke very fast in the direction of Herb's original position. He lost out on a $1,600 trade. The pain of losing was hard enough, but the pain of missing out on a winning trade, knowing his trade decision had been correct, felt even worse! Herb had enough. He quit trading.

Real trading does not have the benefit of hindsight. Sure, you can look at a chart and see what happened in the past. But when you navigate to the right edge of the chart, and you keep looking to the right, all you see is nothingness. You are looking into the invisible veil of the future and something you have absolutely zero control over.

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Of course, every trader's experience is different. Some are far more aggressive and impulsive than Herb and lose large amounts of money very quickly. Others are more careful and studious—they can suffer from "paralysis by analysis" as they attempt to create the perfect trading system but never place any actual trades.

Paralysis by analysis is something many new traders experience. It often

occurs when too much information (often contradictory information) comes in from all directions. One indicator might suggest going long (buy the market) while another suggests the opposite (sell the market short). The result is the deer-caught-in-the-headlights syndrome, because confusion leads to one outcome: doing nothing at all.

But though the specifics differ among individuals, almost all new traders experience the same types of intense emotions as Herb did. And, in most cases, those strong emotions cause new traders to make bad trading decisions. A typical cycle might go from hope to greed to euphoria, then to disappointment, anger, and even despair. Let's break down the emotional cycle of our friend Herb:

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When he first began looking at price charts and calculating where he would buy or sell, Herb started daydreaming about how much money he could make and how much he would enjoy the independence of the trading lifestyle.

I know many traders who start off the same way. They become entranced by what looks like an obvious way to make money. What they fail to grasp is that trading in real time, in live markets, is far more challenging than looking at yesterday's price charts and seeing where to buy or sell.

N wu xp

Herb's first success in the markets was thrilling and extremely fulfilling. He wanted to recreate that feeling on his second day of trading. As a result, he overrode his system and jumped into the market prematurely.

It is fine to feel good about making money in the markets. The problem is you can't let the emotions—good or bad—that are generated from one trade impact your next trade.

P tts

In my view, greed takes two forms in trading. First, there are some traders who are focused on making a great deal of money very fast. They take on too much risk and trade too frequently. While they may have some short-term success if they happen to get on the right side of a trend, they usually blow through their trading account very quickly once things turn bad.

Like bad gamblers, greedy traders are wishful thinkers. But Lady Luck is a schizophrenic and I urge you not to put your faith in her! Trading as a gambler is not part of my approach and not the correct reason to trade. If you want to gamble, you will have a lot more fun losing your money in Las Vegas, where you will at least get free drinks, entertainment, and tons of food.

Second, there are many traders like Herb who cannot stand to lose money—which, to me, is a form of greed. Because you never know whether any given trade will be a win or a loss, you must be willing to lose money in the short term to make money in the long term. As the old saying goes, it takes money to make money.

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New traders tend to take losses too hard. To a large degree, depression over losses—or a series of losses—reflects an unrealistic view of what trading is all about. For new traders a loss is not just a loss—it is a shattering of their dreams of easy money and an independent lifestyle.

If you decide to trade, understand that losses are inevitable. If you are

faithfully executing a proven trading plan, there is no reason to bemoan an unprofitable trade. It is part of the business.

Tradeplan and trade methodology are often used interchangeably, but in the context of this book, they are different. A tradeplan is a set of rules. It typically has a specific market (crude oil, stocks, forex), a start time, a stop time, and set goals. It can be tested and proven to create measurable results. A method, on the other hand, is an overall strategy used to trade a market or price pattern. The tradeplan exists within the method or strategy.

Ot p

I believe fear is the single most powerful emotion in the financial markets. Even experienced traders will make fear-based decisions at times. As human beings, we are genetically wired to run away from threats. And the financial markets frequently seem threatening—to our trading accounts and our financial well-being!

New traders typically are anxious and nervous when they enter a trade. Their emotions rise and fall with every small move in support of or against their position. And once they suffer a few disappointments in the market, new traders are often afraid to get back into the game. They worry their system might be wrong again—or they do not trust themselves to manage the trade properly.

If I were to say to you, "Reach out and touch that hot burning stove," you would look at me like I had lost my marbles. But let's say that because I am

your mentor and you trust me, in the end you do what you are told, and you touch the hot stove. You quickly recoil with burnt fingers. Ouch!

You look at me expecting a nod of approval, but instead I tell you to reach out and touch it again. You are confused, hesitant, fearful. You do not want to do it but you trust me, so you do it again. This time it hurts twice as bad.

When I tell you to touch it a third time, you punch me in the nose and run out the door, never to be heard from again! And who could blame you? A losing trade is like the hot burning stove. It hurts! Most traders quit after a series of losing trades. They have taken on more pain than they can handle. If they do not quit trading entirely, they at least quit the method that they are trying to learn or win with.

The thing is, after such a limited, albeit negative, span of experience, how do they really know the method they are quitting is a bad method? It might be the greatest method ever created for trading success.

A few losing trades does not mean anything to a real trader. It happens all the time. There are losing trades inside of winning tradeplans. Learning to handle the fear of losing money is part of the process of becoming a successful trader. Your emotions will tug at you to do things that run counter to your system and trading rules. Good traders make the right decisions consistently despite their fears.

Ki tsi–

To many people, day trading seems interesting and exciting. Sure, making a good trade and managing it in a way that maximizes profits is a fun and engaging challenge.

The question is, what are you doing between trades? After two, three, or four hours of studying a computer screen hoping that your indicators will signal a

buy or sell opportunity, you are likely to become bored and your mind will wander. For many I have worked with, keeping their attention on something for just three or four minutes is a real challenge.

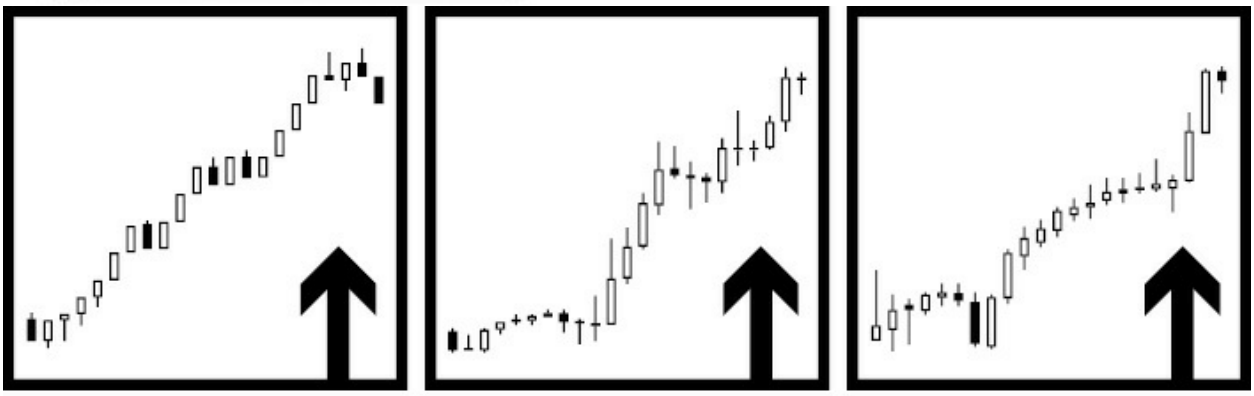
Time is one of the great challenges, and dream killers, of would-be traders. The market can bore you to tears because it is moving so painfully slow, and then, just as you are about to fall asleep, it slaps you in the face with a flurry of activity and energy, causing your heart to race out of your chest.

Your nervous, twitching fingers accidentally hit the wrong keys on your keyboard; the trade you were waiting for came and went, and you accidentally got in on the wrong side of the market. Oh, no!

Looking at a chart was so much easier, but the element of time was not there. In real trading, dealing with time is critical and nonnegotiable. The passing of time does not show up on the charts. The trade that you were so excited about might take many hours. Or it could happen in the blink of an eye.

Consider the three charts in figure 1. The ***price action*** is similar, moving higher in all three instances. But what we do not see is the element of time. In this case, the charts are 5-minute, 60-minute, and one-week charts. Moves can happen very suddenly or unfold over longer periods that stretch for days or even weeks. Yet it takes no time at all to look at each of these charts and see that prices are trending upward.

GRAPHIC fig. 1



5-minute 60-minute one-week

NOTE

The charts featured in figure 1 are known as "candlestick charts." They will be explained in more detail in chapter 7.

It is easy to look at charts and see all the great trades that took place in the past, allowing this to stoke the fires of your imagination of a burgeoning trading account.

What is not so apparent is the time factor. A trade that you see on a chart (the one that causes you to salivate with excitement and keeps you tossing and turning at night in anticipation of tomorrow's trade session) is far different than the one that happens in a matter of seconds in live trading. You might spend hours waiting for a trade, or you might not. Markets sometimes move fast, and that is not a bad thing.

In day trading, our philosophy is that we want to spend as little time as

possible in front of our charts. Our techniques, our way of thinking and trading, are designed to give us the kind of lifestyle we have always imagined. We never want to adjust our lifestyle to cater to the needs of our trading. We can have our cake and eat it too, which is a concept covered in more detail in the 12 Powers section in part III of this book.

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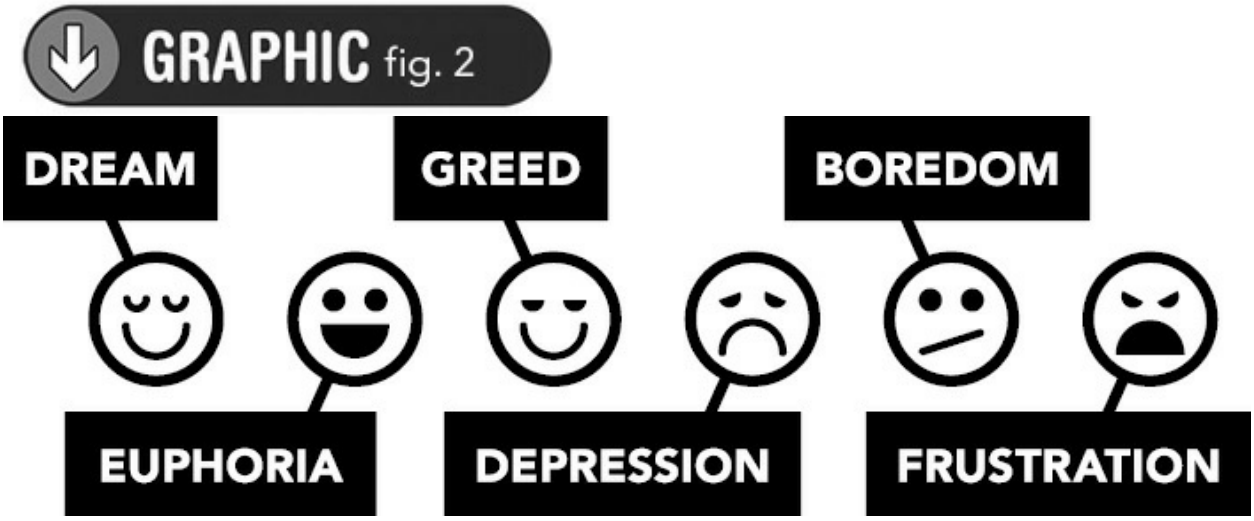
New traders frequently become frustrated because their systems produce unprofitable trades and because they have a hard time executing trades properly. As we can see in figure 2, this emotional cycle often occurs toward the end of the emotional trading roller coaster.



Remember, no one has ever produced a perfect trading system. The best you can do is build a system that produces consistent profits over large numbers of trades.

Regarding difficulties in execution, this is the challenge all traders face. When you make a mistake, the only thing you can do is acknowledge what you did wrong, figure out why you did it, and do better next time. Learn from your mistakes.

I teach my students to practice executing trades until they are almost perfect: practice placing trades, canceling trades, moving stops, and setting targets, repeatedly, until it's as easy as riding a bike. You can get the repetition in a practice or simulated account without putting real money at risk. What you do not want to do is make execution errors with real money on the line. You have the chance to practice as much as you need to in a sim account, and any broker worth his salt will give that to you at no charge.

If you are unclear about what is meant by "execution" in the world of trading, it is not as horrible as it sounds. Execution refers to placing your trade properly, in full accordance with your analysis and your intentions. If you do not know how to properly use your trading platform and you do not practice your trading maneuvers prior to trading with real money, then it is easy to make costly and highly frustrating errors when placing trades.

Tom Traderman intends to "go long" and buy the market, but due to making an execution error he "goes short" instead, selling the market by mistake. Tom's analysis was correct. The market spikes high. Tom's misplaced trade loses money, and he experiences a maddening level of frustration.

What does "do better next time" actually mean? What does it mean to learn from your mistakes? Were they execution mistakes that caused the losing trade? Were they trades that weren't even part of a proven trade method? Did you turn your head to answer your daughter, who suddenly barged in to ask if she could borrow the car, right when you were about to place a trade? Did

you trip and fall and spill your coffee on the computer keyboard, racing back from the kitchen so you would not miss your trade, only to short out your computer and crash your entire trading desk?

Or was it the correct trade, the next trade per the rules of your proven tradeplan, that just happened to lose?

These are not frivolous questions. If we are honest with ourselves, the answers point us in the right direction and tell us what it is we need to work on next.

In short, frustration caused by improperly executed trades is emotional baggage that you cannot afford to carry. The good news is that you can safely practice your trade executions over and over again without ever risking one penny of hard-earned cash. We will show you how in Chapter 16.

Every decision we make in life is some sort of a trade. We must give up something to get something. If I go left instead of right, it might save 20 minutes, but if I'm wrong it will cost five minutes more for sure. Is it worth risking an extra five minutes for a good chance of saving 20? I know I should not order that second slice of hot, delicious pepperoni pizza, but it smells so good. I want it! What if I tell myself that I will eat nothing but salads for the next three days? Hmmm. In that case, I will take two more slices now, please! Make it three! If you understand that you always give something to get something and vice versa, then you will begin to respect the risks in the markets and learn how to focus only on trades where the reward justifies the risk.

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The last thing I want to do is discourage anyone from trading. I love the challenge and rewards of navigating financial markets. There is nothing else I would rather do. At the same time, I have seen too many aspiring traders come into the markets with unrealistic expectations and a lack of knowledge about what it takes to succeed.

It is important for new traders to understand both the technical issues in developing a solid trading approach and the psychological challenges involved in managing their emotions and executing their system amid the unpredictable ups and downs of ever-changing market price action.

In the chapters that follow, I will explore these issues and provide a foundation of knowledge along with a plan of action to put you in the strongest position possible to become a successful day trader.

How do you measure success? The only true measure of success is profitability and seeing your account grow.

Every trade is like a tree in your forest. The forest itself is the value of your trading account, or, as we like to call it, your ***equity curve***; equity refers to the value of your trading account, and the curve shows the account balance growth rate in terms of profits and losses. And good traders understand that their trading pursuits are in fact a business, an endeavor in which they are the CEO with the singular mission of making money. Is your forest (equity curve) expanding or shrinking?

Most would-be traders are in the trees with no perception of the overall forest. Trading losses are painful, so they spend their time running around the forest floor, trying to avoid getting crushed by falling trees. In the end, their fears materialize, and they end up getting crushed by the same falling trees they are trying to avoid. This is the unfortunate vantage point from the forest floor, but there is an alternative.

Successful traders enjoy a different vantage point. They learn how to grow a pair of wings, like an eagle, and ultimately soar above the trees, high enough to see the entire forest. While above, from that higher point of view, the successful trader can look down and be at peace with one-third of the trees falling, because they can also see the forest growing two-thirds larger as a result.

As a beginning trader, it is normal to feel like a little grunt, just running around the forest floor, trying to dodge random falling trees. But keep in mind that if you truly want to find success in trading, then you must embrace a dramatic personal metamorphosis. Are you ready to begin?

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» Day trading is a challenging way to make a living. Most people fail.

» The potential payoffs, if successful, are enormous and include the potential for high income, the ability to work only hours (maybe minutes) per day, and the freedom to live a life most people only dream of.

» There are many pitfalls to be wary of; most are emotional or psychological.

» The first takeaway of the book is this: be real, truthful, and objective with yourself, your expectations, and your trading results.

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- Against the odds
- Winners and losers
- Trading plans, resilience, and long-term goals
- Benefits of boring

Most day traders lose money. Industry estimates suggest that the failure rate among day traders ranges from about 80% to 95%, and about 80% quit within their first two years. Stated differently, the success rate is probably under 20%. If you are a new trader, it’s important to recognize and understand the challenge in front of you.

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A zero-sum game is the concept in the field of mathematics that says one person’s gain (or loss) is a loss (or gain) for somebody else. In the world of trading, the idea is that one trader’s loss is a profit for another trader. For every winner, there’s a loser. In the real world, there’s more to it than that, because other market participants are getting a piece of the action as well, so the true odds of success are even lower than 50/50.

I do not know who took the other side of my trade, but I think they made a mistake. I know I have stacked the odds in my favor, and they will end up on the losing end. Think of trading like war. There will be a winner and a loser in each trade. You want to be the winner. If a trade goes against you, regardless of who is on the other side, it is you who suffers the loss. If it goes your way, it is you who enjoys the win.

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When I "trade" something, I am exchanging one thing for another. In the context of this book, trading refers to the buying and selling of forex, futures, options, stocks, or ***exchange-traded funds*** (ETFs).

The basics of placing a trade are the same regardless of the product. Either I buy into the market to "go long" or I sell into the market and "go short." If I am long, I want the price to increase, but if I am short, the goal is to make profits when the price falls.

- **Go Long:** Open a new position with a purchase (of a stock, option, futures, forex, or ETF) in anticipation of a price increase.
- **Go Short:** Open a new position with a sale (of a stock, option, futures, forex, or ETF) in anticipation of a price decrease.

After I enter a long position, I can exit it through a sale. For example, if I buy shares of stock, I sell the stock when I want to exit the position. The difference between the price I pay and the price I receive is my profit or loss. You exit long futures, forex, or options positions the same way.

On the other hand, if I short the stock (futures, forex, option, stock, or ETF), I exit the position by purchasing the same number of shares of the same

stock. Shorting is not something that the average investor does, but it is quite normal for day traders to take short positions.

Prepare to encounter much untamed and unstandardized terminology as you begin to participate in the trading community and marketplace. In this book, most terms are defined or explained as the book moves along, and you can also find definitions of key terms in the glossary.

Often, the key to successful trades is not just the purchase and sale prices, but how the entries and exits are managed. For instance, after I enter a position, I know how much I have at risk because I have an exit plan that includes a ***stop-loss*** order and a price target. The stop-loss (which is sent as an open order when I enter my position) is triggered if the trade turns against me. At that point, the position is exited at the stop-loss price.

My price target, which is also an open order, is my goal for the trade. Therefore, several elements define the anatomy of a trade:

- **Entry Price:** The price where a long or short trade is actually placed.
- **Exit Price:** The price where the trade is concluded, whether it be at the target or the stop-loss.
- **Target Price:** A predetermined profit objective for a given trade.
- **Stop-loss:** The predetermined price level for exiting a losing trade.

The mechanics of placing orders is discussed in greater detail in chapter 9.

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Commissions are the fees that brokerage firms charge customers to buy and

sell. While commissions have come down over the years (some brokerages even offer no-commission trading to some customers), you still must cover the costs of trading before you can claim profitability. And as a day trader making several trades a day, you will find a larger percentage of your profits eaten up by commissions than will a longer-term trader who may trade only once or twice a month.

In addition to commissions, your trading profits must also cover any other costs associated with your trading, such as software, advisory services, exchange fees, and data fees.

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Finally, there is the issue of ***slippage***—a term for when you get a worse price than you expected on your entry or exit from a trade. There may not be another trader willing to take the other side of your trade at the price you want. The problem is that you never know at what exact price your requested order will be filled. Thinly traded markets exacerbate this issue.

Slippage can also be influenced by the “bid-ask spread.” Trading stocks, futures, or a foreign exchange is not like buying something from a store where there is one price. Prices in the financial markets are always quoted in two parts: the bid, or the price at which someone is willing to buy from you, and the ask, the price at which someone is willing to sell to you.

Let’s say you’re looking at a stock and the bid-ask spread is $31.50 and $31.51. If you’re looking to buy 100 shares, you would expect to purchase, or get “filled,” at $31.51. If the bid-ask spread stays the same and you decide to sell 10 minutes later, you would expect to get filled at

$31.50. That means you would actually lose one penny per share–even though the market price didn't change.

You can eliminate slippage by using orders that specify that you will only buy or sell at a specific price. The problem with this approach is that your trade may never be executed if the market moves quickly. That is the reason many traders—particularly those who try to catch the beginning of big moves—will place an order which guarantees their trade will be executed at the best available price. Market orders and other order types are discussed in more detail in chapter 9.

When markets are moving extremely fast in reaction to an economic report or some other important news, there can be a substantial difference between the bid-ask spread displayed on your computer and the actual price at which your trade will be executed. If your strategy requires you to enter fast-moving markets, you'll need to factor slippage into your profit/loss calculations.

Slippage can also occur in markets where there simply isn't much activity or trading volume (something we discuss in more detail in chapter 5). You will find that to be the case with many smaller stocks and even some futures contracts, such as coffee or cocoa. That is why, as a day trader, it is usually better to focus on major markets with tight bid-ask spreads throughout the entire trading day. We refer to these markets as liquid, as opposed to thin or illiquid markets.

In any case, you cannot totally escape slippage. It is a cost of trading that you need to take into account when you develop your trading strategies and profit/loss expectations.

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In addition to covering the costs of trading, as a day trader, you are also

battling against institutional traders that have access to more sophisticated technology, better information, and faster trade execution. Professional traders at hedge funds, banks, or major investment houses have a good idea when other traders are going to buy or sell and how they are likely to react to major news events.

As individual traders, our guesses might not be as good as those of professionals who have better information, but in today's world we have access to many of the same tools. Thanks to advances in technology, brokerage platforms, and online news services, the information gap between the pro and the individual trader has narrowed substantially. It's not a totally level playing field, but it has never been better.

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It is important that you enter the day trading arena with a clear idea of what you are up against. You have to be profitable just to break even, and you are competing against some of the brightest minds in the world. To make matters worse, the trader's worst enemy is usually the person in the mirror. Most people become their own biggest impediment to consistent success. Is it no wonder that a large percentage of day traders fail?

The good news is that you can succeed. Here is why: you do not have to play the same game as a professional trader. You can solve the issues that are preventing you from finding success. There is a pathway to follow.

One of the reasons most large mutual funds and money managers have trouble beating the overall market is that—to a significant degree—they *are* the market. They hold billions of dollars in assets. They simply cannot move in and out of the market as easily as you can.

You have probably read a lot about high-frequency traders. They use

automated trading programs to execute trades in microseconds in order to take advantage of very small price changes. That is not a game you can play.

Quantitative trading firms have armies of PhDs scouring mathematical relationships between markets all over the world. They construct trading strategies to take advantage of pricing discrepancies and unusual patterns. Again, such an approach does not make sense for most individuals. There is no need for you to try to compete against these people.

It is important to realize that as an independent trader, you do have advantages. Unlike these professional traders, you have complete discretion over when, what, and how you trade. You have no mandate that must be fulfilled every day. You can stay on the sidelines and patiently wait for an opportunity. You call all the shots. That is your advantage. But you must also avoid some of the pitfalls that many failed traders face.

Lwp pr t x xr ıuUı x"v c pst

Harvey is a brilliant engineer with an advanced degree from an Ivy League university. He has a lot of confidence because his career has been marked with great success and he is highly respected in his field. However, it would be a mistake to assume that his success in engineering will automatically translate into a profitable career as a day trader, because the two endeavors require different skill sets. Success requires going through a learning phase.

There is nothing wrong with being confident. In fact, confidence and belief in a trading plan are essential to longer-term success. The problem occurs when an individual becomes so intent on perfection and controlling everything that they do not use common sense. In fact, if a trader feels a need to consistently self-validate how smart they are, they are setting themselves up for disappointment.

In other words, big egos can be advantageous in day-to-day living and

when trying to climb the corporate ladder, but when dealing with financial markets, a big ego is usually a ticket to a quick exit.

Successful trading comes from managing imperfection and surrendering to what we cannot control. It is not possible to control where prices are heading next or how the market—the unruly beast—will react from one day to the next. The winning trader focuses attention on the things that can be controlled.

Harvey is not coachable, because he thinks he is smarter than his coaches. He cannot accept being wrong, and, since he cannot concede defeat, he holds losing positions too long. Harvey does everything in his power to control the outcome of the trade. In the end, he cannot get out of his own way to transform into something different: a winning trader.

What Harvey is really doing is asserting his over-embellished ego to validate how smart he is, which is not going to end well, because trading to prove your self-worth is not the right reason to trade.

Trading is hard, very hard. That is why losing traders far outnumber winning traders. Harvey fails because his ego gets in the way. Losing traders fail for a multitude of other reasons, including (but not limited to) the following:

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Most new traders dream about making large amounts of money in a short amount of time. When that does not happen, frustration sets in. They have a choice: work hard to grow and develop their trading skills, or quit. Most quit.

A third choice is to throw the baby out with the bathwater and begin chasing down a new trade strategy. We call that ***chasing performance***. They might have a winning tradeplan or strategy, but they cannot see the forest for the trees. They are trying not to get crushed by a few falling trees and are unable

to elevate high enough to see that their plan can and will grow their forest larger.

They actually do possess the keys to the kingdom, but they do not know how to use them to open the door, or they do not even recognize the door that is right there in front of them. Just put the key in the lock, open the door, and walk through it.

In trying to survive as humans, we often do the wrong things as traders. Losses hurt and represent a risk to our survival (in trading). So we do what humans would do to avoid the pain: we try to fix the losing trade. But the losing trade does not represent a risk to our survival as traders if it is part of a winning tradeplan, which will accomplish our goals if we stay the course.

We have instincts, as humans, to want to survive and not become extinct. Understanding that survival is your first goal is probably the best way to approach trading.

That does not mean trying to avoid the random losing trade. But it does mean not taking random trades at all. Any trade should have the odds stacked on your side and be within the context of a proven tradeplan. The trade could still lose, but within such a context it is not going to threaten your survival as a trader. Let the odds do the heavy lifting for you. It is a pure numbers game.

Your account will grow over time. But even then, it will not grow in a straight line. You will have periods of wins and losses. Your account will go up, go down, go up again, and go down again. To succeed, upswings must be

larger than downswings.

I will show you how to prove your trade methodology and help you achieve your goals before you ever risk any real money. Once you prove it to yourself, you can begin to solve the emotional and psychological issues that haunt all would-be traders.

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Losing traders tend to get excited or fearful when a trading situation develops. The excited ones often get in prematurely and the fearful ones often miss the trade entirely.

If the trade is profitable, the excited trader may hold on to it too long in hopes of a greater profit—only to see the market reverse course and erase much of the original profit.

The fearful trader, after missing out on what would have been a winner, will pull the trigger too quickly on the next trade. Often, that second trade will be a loser.

Trading objectively and without emotion is the hallmark of good traders, and trading emotionally is the hallmark of poor traders. Which do you want to be?

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After a few unprofitable trades, the average trader becomes hesitant about entering the market again, because he or she fears the next trade will be a loser too.

Often these traders will try to find a new indicator that they can add to their system that would have prevented them from getting into those losing trades. This can become a continuous cycle that ultimately leads to "paralysis by analysis." They are looking at so many indicators that they are unable to make

a decision about whether to trade.

R’pst p t c psx”v Y“p”

Unsuccessful traders usually don’t think through their trading plan. Or, worse, they don’t have one at all! They take a haphazard approach to the markets they trade, the hours they devote to trading, and their daily preparation.

Often, they keep no records of their trades and never ask themselves what they did right or wrong at the end of the trading day.

Proper planning and preparation provide a solid foundation that allows traders to exercise the necessary patience and discipline to trade well.

There is an old saying: “Failure to plan is planning to fail.” That is absolutely true in trading.

d” ı t”b p tv

Unsuccessful traders usually do not thoroughly test a trading system, whether it is a system they developed on their own or a system they picked up from another trader. As a result, they lack conviction in implementing the system and are prone to making a variety of trading errors.

Building a trading system that works in the real-world markets over long periods is no simple matter. I devote considerable space later in this book to the subject of constructing solid trading systems, because it is one of the critical components of success. We go through the building blocks together, step by step. In chapters 15 to 17, I give you a process that you can test and deploy with confidence. If you execute this system consistently and correctly, it will put you in the best position for success as a trader.

Yıı Vı”t Vp”pvt–t”

Money management is probably the most underappreciated part of successful

trading. For every trade you enter, you should know exactly where you will get out for a profit and where you will get out for a loss. If you choose instead to play it by ear, you will probably end up losing more on your losers than you win on your winners. That is a recipe for failure.

Unsuccessful traders frequently will risk too much on a single trade. Sure, you may win big the first time. But eventually some of those big trades will go against you and you will have a very tough time coming back. Simply put, minimizing losses is critical to successful trading.

Let's say you have a $100,000 account and you lose 20%. You now have $80,000. You'll need to grow the account by 25% to get back to $100,000. If you lose 50% and have $50,000 left in the account, you'll need to grow the account by 100% to get back to where you started. Growing your account by 100% just to get to the break-even point is a lot harder than it sounds.

Figure 3 shows other examples of how difficult it is to get back to break-even after a loss has been suffered. For example, if you lose 20% in day one, you need to make 25% in day two to get back to break-even, and it will take 2.34 trading days to get back to break-even if you make 10% per day.

Money management is a foundation for trading success. There are different levels of money management and techniques that need to be learned. For example, we will see later how to use stop-loss orders to manage risk and why I typically do not risk more than 2% on one trade.

GRAPHIC fig. 3

A LONG WAY BACK TO EVEN

Day 1 return:	Day 2 return required to get back to even:	Number of days at 10% return to get back to even:
- 10%	11.1%	1.11
- 20%	25.0%	2.34
- 30%	42.9%	3.74
- 40%	66.7%	5.36
- 50%	100.0%	7.28
- 60%	150.0%	9.62
- 70%	233.3%	12.64
- 80%	400.0%	16.89
- 90%	900.0%	24.16

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Trading is a business where, much of the time, the best thing to do is sit tight and wait patiently for an opportunity. It is not the wild ride you see depicted in the movies, with a crowd of traders on the trading floor screaming and waving their hands. More often than not, day traders sit at a desk and monitor charts on computer screens for the next buy or sell signal. Is that

what you signed up for?

Why are you trading? That is an important question to ask yourself and one that I address at the end of chapter 4. The short answer can be stated as follows: *the only reason to trade is to make money*. If you are trading for fun and excitement, stop trading and take up skydiving or bungee jumping as a hobby.

There are certain personality types that migrate to trading because they crave an adrenaline rush. These types often risk too much money and their trading accounts drop substantially, eventually getting wiped out. They will make one last, high-risk trade—kind of like a Hail Mary pass at the end of a football game—and when the pass falls incomplete, they are done with the markets.

Well, at least they got what they wanted: excitement. And probably a story to tell their therapist.

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Harvey, the engineer, is a losing trader because his ego gets in his way and he will not surrender to what he cannot control. Winning traders manage imperfections and do not try to control everything.

Trisha is a truck driver who makes a living driving a big rig. She was not interested in going to college; maybe she could not afford it. Trisha learned other life lessons, and some of them apply to day trading. Somewhere along her journey, she developed the ability to go with the flow. She knows it would be silly and unproductive to sit in her rig and honk her horn all day while stuck in gridlocked traffic. She learned she cannot control weather patterns or where the next road construction will delay her delivery. She has learned that when she is stuck it is beyond her power to control. She resigns herself to the reality of her current situation.

At the risk of being a spoiler, I can tell you that Trisha will be far a more successful trader than Harvey.

The market is the unruly, unpredictable thing I call "Mr. Beast." Mr. Beast does not care how smart you are. Wisdom and intelligence do not walk hand in hand in trading. Trisha has learned how to let Mr. Beast take control. Her ego is not going to stand in the way—Mr. Beast leads the great dance of ever-changing price action. By contrast, Harvey, the brilliant engineer, is in a constant fight with Mr. Beast over leading the dance.

Trisha will let Mr. Beast lead and focus more on not letting her toes get stepped on, nimbly going with the flow of Mr. Beast's constantly changing fickle mood swings, the ever-changing ups and downs of price action.

Successful day traders develop certain behaviors and attitudes that allow them to implement a strategy effectively, thoughtfully, and with a minimum of stress. Trisha the truck driver is patient, flexible, and able to go with the flow. There are other characteristics that winning traders seem to share as well:

Yıt"b ptv

There are many different ways to trade. Good traders find a strategy that corresponds to their own unique situation in life—their abilities and skill level, their available trade capital, their available time to trade, and their personality. Most important, they rigorously test their approach until they are convinced that they have an edge that will enable them to win over the long term. They stack the odds in their favor like a casino.

As aspiring traders, we must begin somewhere. I remember one trader telling me he won before he even began. He had devoted so much time and effort to perfecting a trading approach that he came into the markets with supreme confidence that he would win over time. How did he know? He thoroughly

and methodically backtested his trading approach before risking any real money.

He understood that he would have a few losing trades in a row at various times, but he knew with certainty that if he rigorously implemented his system, he would hardly ever have a losing month. That is what I call a proven strategy. The winners come.

b ı”v c pst “p”

Having a good trading plan and the discipline to implement it is vital to trading success. You must be able to patiently wait for a tradeable situation to develop and then execute the trade quickly and efficiently (with no second-guessing) once it is staring you in the face from your computer screen.

Then, once you are in the market, you must adhere to your plan for managing the trade. Do you move your stop-loss up as the trade becomes profitable? Do you take profits at a predetermined price point or do you wait for a technical indicator to flash a signal? Do you follow your tradeplan rules? Whatever your trading plan, you must implement it religiously—every single time.

A common challenge for day traders is developing the ability to sit in front of their computer hour after hour waiting for a trade to unfold. It can get boring. It is very easy to become distracted and miss a trade. To overcome this problem, we focus on tradeplans that have predefined start times and stop times, a maximum number of trades, and achievable goals.

Do not neglect the preproduction work. It is essential that you establish a trading strategy and tradeplan that you can prove to yourself will win over

time. How do you prove it will win over time? We'll get into that soon.

at x%t"rt

Losing trades are part of the business. If you cannot bounce back from a tough loss or a series of losing trades, you will not make it as a day trader.

Paul Tudor Jones, one of today's most successful traders, put it succinctly: "You have to be able to handle getting your butt kicked. No matter how you cut it, there are enormous emotional ups and downs involved."

The difference between successful and unsuccessful traders is that successful ones win at least a little bit more on their winners than they lose on their losers. Some traders win on less than half their trades, but because they make much more money on their winners, they end up ahead. Other traders may win on 75% of their trades, but generate roughly equal dollar gains/losses on their average trade. They too end up ahead.

My experience suggests that the typical sweet spot for day trading is often at the mid-60% win rate. That would be represented by the "two steps forward, one step back, two steps forward, one step back" concept. Remember, you can sacrifice one-third of your trees if it means you can grow your forest two-thirds larger as a result. In other words, you can learn to live with the one step back if you are confident enough that the two steps forward will consistently follow.

That does not mean you cannot do better and find an even sweeter spot. There are good tradeplans and strategies that consistently win three steps forward and one step back, for example, but such a high ratio is not necessary to achieve your financial goals with day trading. If you can consistently win two-thirds of your trades and keep your losses small, you have a money-making trading formula for success.

That is why it is so important to test your system in a variety of market conditions—so you have a sense of why your system is performing poorly at any point in time and how bad it is likely to get before things turn positive again.

You need to know the worst-case scenario.

At the same time, you need to have a high level of trust and a positive attitude about your strategy in the face of losses, and you must be ready to move forward despite inevitable setbacks.

Yt x t”rt

In a sense, the first goal of any trader should be survival.

Successful traders must train themselves to transcend the “extinction threats” that arise from taking on financial risk. They must learn how to confidently and calmly embrace risk as a tool that must be wisely wielded. Simply put, traders must learn how to assess, accept, and use the proper amount of risk: not too much, but not too little either.

Traders need to respect the risks associated with exposure to the market. Poor preparation for risk exposure is yet another reason would-be traders fail to survive. The remedy, and perhaps the trader’s most important survival tool, is a proven trading plan. Trading without a tradeplan is like charting a course of travel without a map. At its worst it is like driving a car blindfolded.

Everything becomes easier and the odds of survival as a day trader increase dramatically when you can prove that a tradeplan will work. Equipped with a full-fledged one-hundred-percent belief in a trading plan, success becomes just a matter of executing the trades per the plan rules and putting on the proper risk size, based on smart and safe money management techniques.

Even the most inspired and finely tuned trading plans have one of only three outcomes: win, lose, or break even.

Experience and persistence go hand in hand. To succeed, a trader must execute trades and vividly experience both winning and losing. These emotional experiences and the skill development that accompanies them must be allowed to mature before the trader either a) runs out of money or b) becomes excessively frustrated by the ruthlessness of the markets. The quitters fail and the failures quit. Therefore, persistence is essential for success.

Make no mistake, the markets have a way of teaching you lessons. If there is a weakness in your system, your money management tactics, or your own psychology, the markets will bring it to the fore.

Good traders review their trades every day and ask themselves important questions: did they prepare well, did they make the right decisions getting in and out of the trade, and did they handle themselves and their own reaction to the trade properly? More important, did they follow their proven tradeplan rules and execute the proper trades per the rules without mistakes? You should do the same.

Good traders also stay open-minded about new approaches in discovering tradeable opportunities. While it is important to adhere to your system, no approach is perfect, and you may find other ways to trade that work as well or better than your original system. I know a professional trader who uses four different systems. The bottom line is that the traders who succeed are those who stay in the game, hone their skills, persist and evolve, intelligently, as if

their very survival were at stake.

When you find a winning way to trade, it is critical that you protect it and not be tempted to chase perfection. Doing so can have the opposite effect and wind up breaking your money-making approach. Let it do its job and make you money. That is why you are trading. Mission accomplished!

V p”pvt b t p”s c pst x” p Lı – u i ı ”t

Good traders know themselves and understand how to handle the anxiety and stress that are an unavoidable part of the job.

How would you answer these questions: If your trade wins, did you make money? If your trade loses, did you lose money? My guess is that you answered yes to both questions. But the correct answer, if you want to succeed as a trader, is no. A winning trade does not make money. A losing trade does not lose money. Why? Well, what about the next trade? The one after that? We are traders. What do traders do? They trade. There will always be another trade! Trades win and trades lose. It is never the result of a random trade or series of trades that matters, but the net sum of all your trades that will determine your success or failure.

Some traders are not comfortable implementing a system that requires them to make mental judgments about patterns and indicators as they unfold on their live trading screens. It is too much stress. Instead, they develop completely automated systems that get them in and out of the market without their having to make decisions during market hours.

Other traders, even though they may have a large account, find having too much money at risk raises their stress to an uncomfortable level. As a result,

they trade relatively small amounts and know exactly the maximum they will allow themselves to lose on any single trade.

For most day traders, good preparation and trade planning before the market opens helps to reduce the anxiety of trying to figure out a trade strategy as the market is moving up and down very rapidly. There is an old adage: “Plan your trades and trade your plan.” I couldn’t agree more. Prove a tradeplan first, then execute it according to its rule set.

If you know exactly what you are looking for going into the trading day, you will experience much less stress than a trader who takes a more “seat of the pants” approach and is likely to overreact to each market swing.

Lı pvt

Trading is not for the fainthearted. As I mentioned above, you will feel the sting of losses, your own trading mistakes, and confounding market conditions. At some point, you are likely to have doubts about your approach and your ability to function effectively in unpredictable and volatile markets.

It takes courage to stare into the cold, yet chaotic eyes of Mr. Beast (the market) and stand by your convictions (your trading plan). Mr. Beast is ever changing, ever evolving, and ever confounding, and if you are sufficiently impressionable, he will lead you to continuously second-guess yourself.

> **NOTE**
>
> The first time you have doubts about your trading method is the first sign that you need to spend more time and effort building a strong “trader foundation” for yourself. The Power of Foundation will be explored in detail in chapter 11.

Just know that inexperienced traders, since they are human beings, typically have an emotional investment in the outcome of any trade. Great traders do not. They are more concerned about properly executing their proven, winning tradeplan and do not overly concern themselves with the outcome of any given trade. Sure, they want to win, but they are more intent on growing the equity in their accounts and achieving their financial goals, which is not the same as worrying about whether any given trade will win or lose.

It is easy to look at a chart at the end of the day and see a trade you could have and should have made. It takes courage to look at the hard right edge of your chart, though, and put on a trade in a live market—especially if your last trade lost money.

It takes courage to keep trading when you have lost 25% of your account, and you, the market, and your system seem completely out of sync with each other.

Ultimately, good trading is about the appropriate use of risk. The question is, will you take trades based on calculated risks where you already know the odds are in your favor, or on unknown risk where you have no idea if it's a trade that will win more times than it will lose?

M")X t tpr ıf x" ı Ul t

"Market sentiment" refers to the human emotion that moves prices. At times, traders in one market can get too excited or bullish and send prices to unsustainable levels. Other times, fear, panic, and bearish sentiment send prices sharply lower, and may even cause market crashes.

While bubbles and crashes happen due to changes in sentiment among groups of traders or "the crowd," individual day traders can experience dramatic swings in emotion as well. Simply put, making money makes us feel good, and losing money is painful.

The day trader's objective is to be profitable over the long term. It is like any business. You want consistent profits and minimal losses.

Since wins and losses happen daily, but day trading is ultimately a longer-term endeavor, there is really no need to overreact to the short-term wins and losses. Winning big on one trade is great, but what is important is figuring out how to do it again, and again. Nevertheless, sometimes things go unexpectedly wrong and you lose a chunk more than you expected.

The question is, how do you avoid making the same mistake in the future?

Also ask yourself: was it a mistake? Maybe it was not a mistake, because wins and losses come at random. Some wins and losses are bound to be larger than others. In fact, they will often cluster together in a series of wins or a series of losses. You will see losing streaks and, if the tradeplan is a good one, even larger winning streaks.

Losing trades exist inside of winning tradeplans.

If you execute your tradeplan properly, per the rules of a proven method, then losing trades are not mistakes. The normal human reaction to the pain of losing money is to quit trading and run away in search of safer pastures. Traders, however, are not normal humans, as you will soon discover. The trader knows that after the one step back, he can look forward to the next two steps forward, which will lift the value of his account while putting the losses in the rearview mirror.

Lwp t atrp

- Day trading is difficult, and many people fail.
- Successful traders often share similar characteristics or traits, which can be learned.
- Unsuccessful traders often fail because they lack discipline and fail to learn what really matters.
- Having a solid trading plan can increase the odds of success in day trading.

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Lwp t X t xt

- The theory of efficient markets
- No holy grails
- Finding an edge
- Singles and doubles, not home runs

What separates a successful and profitable business from a losing one that fails? Does the profitable business have an edge? What advantage does it have over its competition? While a handful of gas stations may struggle to turn a profit, a similar gas station, when positioned in a strategic location at a busy intersection, may do a booming business. A blog might see millions of daily visitors because it has unique content and the company hired experts in search engine optimization. A local veterinarian is enjoying large profit margins because she aggressively deploys marketing strategies that target certain affluent zip codes, where pet owners are more likely to spend top dollar for veterinary services.

As a day trader, your competitors are not just a few, or a few dozen. There are millions of them, each trying to make profits in their own trading accounts. Some are day traders. Others are longer-term investors, big institutions, electronic trading systems, asset managers, or pension funds.

Unquestionably, many smart people try to make money in the financial markets, and, just like the profitable business owner, the most successful traders have an edge.

J t V p z t ap”sı – H

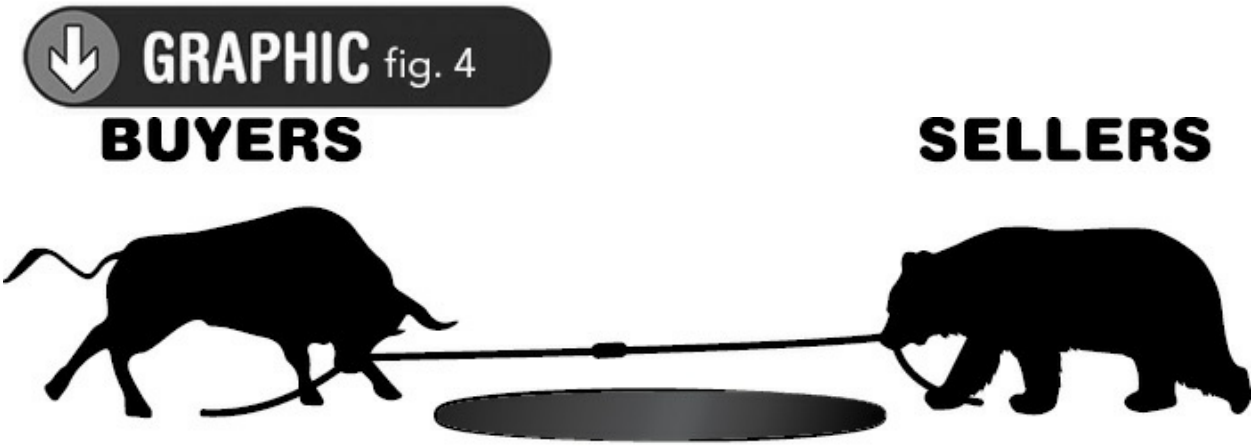
Some people argue that it is impossible to gain an edge or beat the market. Every day, millions of investors buy and sell investments based on their assessments of supply and demand, the strength (or weakness) of the economy, profits, interest rates, and other factors. Because of the massive number of transactions and participants, market prices change quickly as investors react to the latest news and events. Therefore, prices move in a random fashion that cannot be predicted with absolute certainty.

Price discovery is the process of setting the price of an asset (stock, commodity, currency) based on factors such as supply and demand, economic data, and expectations about the future. The right price is discovered when a buyer and a seller reach a deal and a transaction takes place. Consider an auction with 500 people bidding for a herd of cattle; if the crowd consists of well-informed ranchers and farmers, the selling price will probably be a reliable gauge of what the herd is worth. When the buyers and sellers agree on a deal, the price has been discovered.

In day trading, price discovery is constantly changing before our very eyes. It is the ever-flowing movement of price action on a real-time chart. It is the price that a buyer is willing to pay for the asset and the price that a seller is willing to accept. Price discovery represents the perceived value that both

sides of the trade agree to, at an exact moment in time.

I like to think of the flow of price action as a giant tug-of-war, with buyers on one side and sellers on the other, as in figure 4. As prices rise, the buyers are pulling the sellers into the great crocodile pit that separates the two sides.



When the buyers have pulled all the sellers into the pit, there is no one left to pull on the sellers' side of the rope, and all the buyers fall backward because of the lack of tension. The buyers have become exhausted in the process, because what gives them energy is having someone to buy from. A new batch of sellers senses the weakness in the buyers and steps up with newfound energy and begins pulling on the rope. The buyers will either gather their strength and overcome the sellers again (which gives us a pullback and then a resumption of the uptrend) or the sellers will bring far more energy than the buyers can withstand, and the buyers will find themselves falling into the mouths of the ever-hungry snapping crocodiles below. (This is what a reversal of price action looks like—a continuous process of price discovery.) Sometimes the two sides will face off with equal power and the price action will move sideways until one side finally concedes to the other.

The tug-of-war between buyers and sellers is an endless cycle that continues in all markets, in all time frames. Our job as traders is to avoid becoming crocodile food by learning how to be on the right side of the rope.

Jrpst-xr cwtı xt

The random walk hypothesis gained traction in the early 1970s after a Princeton economist named Burton Malkiel wrote the book *A Random Walk Down Wall Street*. Malkiel argued that asset prices follow random patterns and the next step cannot be predicted. He studied a multitude of popular theories on how to make money in the markets and concluded that over the longer term it is nearly impossible to consistently maintain a portfolio of investments that outperform the overall market.

Believers in efficient markets often cite the random walk hypothesis when suggesting that asset prices quickly incorporate all available public (and sometimes nonpublic) information. Accordingly, the efficient market hypothesis (EMH) argues that analyzing charts or other data is an exercise in futility—an individual trader simply cannot outsmart the overall market.

"It is not hard to make money in the market. What is hard to avoid is the alluring temptation to throw your money away on short, get-rich-quick speculative binges. It is an obvious lesson, but one frequently ignored."

- **BURTON MALKIEL,** *A Random Walk Down Wall Street*

Qı Mı bı-t c pst f x"H

Many exceptions seem to disprove the theory of efficient markets. Consider Warren Buffett, for example. The so-called Oracle of Omaha has consistently posted returns superior to stock market averages. In 1984, Buffett directly challenged the EMH, citing the performance of nine successful funds that had superior longer-term returns. He argued that their ability to beat the market refutes the idea that markets are totally random and efficient. Malkiel never responded to Buffett's critique.

R' t x'v 2c psx'v

Warren Buffett is not a trader, however. He is a long-term investor. Investing and day trading are as different as apples and oranges. Buffett, like many value investors, is looking for strategic longer-term opportunities based on company variables like earnings, assets, and liabilities. The idea is to buy shares of a company that have longer-term potential and that are trading at reasonable prices. The value of the company's shares increases and the portfolio increases in value over longer periods of time—years and even decades.

Day traders are also buying and selling, but the time frames are typically minutes (or maybe an hour or two, depending on the approach). The goal is to increase the account balance by generating profits from one day to the next. Day traders are not really focused on factors that drive prices over years, but are interested in key areas on the charts (chart patterns) that can help forecast where prices will move in the next few minutes or hours.

Day traders finish the day flat, which means that they are in a one-hundred-percent cash position. This is a far cry from Warren Buffett's approach—his Berkshire Hathaway conglomerate held nearly 50 companies worth more than $200 billion in mid-2019, and some of his holdings date back to purchases from the 1960s.

R'v tsxt" ıupc psx'v Nsvt

How does Warren Buffett beat the market? He credits his success to a stock selection process known as value investing. By analyzing financial statements and ratios, Buffett computes an estimated value for the company, and, if shares seem attractive relative to the estimated value, he is a buyer. Entire books have been written about his approach (*The Warren Buffett Way* is probably the most well-known). The point is, Buffett has found a competitive edge. Is it easy? No. Does it take a lot of work and effort? Yes.

Rst" xux'v bx px" ,cwp J t Ut ap"sı--

Finding a niche or edge will increase the odds of success, but it is not easy. It takes time to identify patterns that have worked in the past. This is sometimes known as ***backtesting*** and is something that we will cover in more detail in parts III and IV of this book when I talk about system development (as well as my unique approach that I call *fast-testing*).

The key to a successful backtest is that it delivers measurably positive results. Warren Buffett's results are easy to measure and verify—it's a simple matter of looking at the performance of his investment funds. For day traders, the backtests are usually done in a spreadsheet and using charting software that has historical data. The good news is that we can do all this risk free, with our hard-earned cash parked on the sidelines.

The concept of measurable results is critical and goes right into our foundation. We can prove our method works and achieve our financial goals when we can get the positive measurable results from our proof of concept efforts, our "preproduction" work.

For now, the key point is that beating the market, which is efficient in many ways, requires an edge and positive measurable results. It is easy to think that we can simply outsmart the market with a little research. That is very difficult to do. That's why I encourage people to develop a solid trading plan with measurable results that have been backtested before trading with real money.

Qxwf x" apt bx px"

We all know that most gamblers lose money. That is because casinos are smart—they know how to compute odds and probabilities. From there, it is a numbers game. The more people that come and play, the more money the casino can make. Sure, they will pay out some hefty jackpots from time to time, but the steady flow of losing gamblers that come in and out of the doors ensures that the casino continues to make profits.

Q: As a trader, would you rather be the gambler who has to rely on Lady Luck (and probably does not know when to quit, even when he is lucky enough to be in a profitable position) or would you rather be the casino, with all the odds stacked in your favor, where you don't even care if you win or lose on any given trade?

Answer: Consider a simple coin toss. What are the odds of it landing on heads or tails? There's a 50% probability that it will land on heads and a 50% probability that it will land on tails. Does that mean that if you toss a coin 10 times it will land on

heads five times and tails five times? Does it mean that if you flip nine heads in a row, the next flip is more likely to be tails? No.

Probabilities play out and become more visible over longer periods of time. Therefore, if you flip a coin one thousand times, there is a chance that it will land on heads 50% of the time, and, if you toss it one million times, there is an even greater probability that it will fall on heads 50% of the time. This is basic statistics—over time, averages and probabilities rule the day.

It is better to have the house odds on your side, and that is accomplished through preproduction work, foundation building, and generating measurable results. In the end, you will have a tradeplan where, like the casino, the odds are stacked on your side.

N rt“t” ax z3at p s bx p x”

In day trading, we can use backtests to estimate the potential probabilities associated with an approach and, from there, compare it to the potential rewards of the strategy. A casino might have just a 2% edge over its customers and still come out ahead. In day trading, a 2% edge is probably not enough.

A well-tested trade approach should give far better odds than 2%. My tradeplans often have a 15-20% edge or better. If you can win on two-thirds of your trades, you win 66.66% of the time, and that gives you the two steps forward. When you lose (which happens 33.33% of the time), you experience the one step back.

The thing is, the losses can come at any time. It is not as orderly as a simple stair-stepping action. Losses tend to come in clusters. So do winners. My experience is that, with a proven trading method, winning streaks happen, typically, after the worst losing trades.

Survive the one step back so that you are still standing to enjoy the two steps forward again. With correct money management, we can get kicked in the shins but not lose our legs.

How much can we expect to make on each trade? That is another important factor to consider. Say you bet a friend $1 on the next coin toss—you are risking $1 to make $1. Is that a good risk/reward ratio in day trading? It might be. For example, if the probability of winning is 80%, then it makes sense to risk $1 on a trade in order to make $1 in profits—over time, you will make $8 (80%) for every $2 (the other 20%) that you lose.

In futures trading, the risk/reward ratio is often expressed in ***ticks***, which are the minimum price movement in a futures contract. For example, a trader might exit a position if the price drops 20 ticks and take profits if it moves 30 ticks higher. The risk/reward ratio is 20:30, or 2:3 (risk $2 to make $3, in other words).

Some traders only enter trades when the risk/reward ratio is much higher. For example, they will risk one for the opportunity to make three. In that case, they can lose on two trades for every one that wins and still come out ahead. Simply put, your probability of winning can be lower when your risk/reward ratio is greater.

What about risking $1 to make 80 cents on a trade? Is that a bad idea? Not necessarily. If you have an approach that has an 80% success rate, for example, then it makes total sense to risk more than your potential profits.

An appropriate ***risk/reward*** ratio needs to be looked at in conjunction with other key metrics like ***profit factor***, ***winning percentage***, average ***net profit per trade***, and some other factors that are determined during preproduction work.

- **Risk/Reward**: A ratio of how much money is being put at risk compared to potential profit. If, for example, I buy a $1 stock and my profit target is $3, my risk is $1 (if shares fall to zero) and my potential profit is $2 if the stock reaches $3. My risk/reward ratio is 1:2. Of course, risks and rewards can be adjusted using precise exit and entry prices, and by using order techniques like stop-losses, stop market orders, and stop-limit orders (covered in detail in chapter 9).
- **Winning Percentage**: Out of 100 trades, how many are winners and how many are losers? If 60 win and 40 lose, the winning percentage, or win rate, is 60%.
- **Net Profit (or Loss) Per Trade**: How much is won or lost, on average, on each trade. The goal is to have a net positive profit per trade, on average and over time. The net profit per trade will increase as position size is increased.
- **Profit Factor ($ won/$ lost)**: The ratio of dollars won to every dollar lost. A PF of 1.0 suggests that the system broke even, with no profits or losses. A profit factor greater than 1 indicates that the system is winning more than it loses. Day trading plans with a PF of 2.0 or more are outstanding.

The metrics can be narrowed down further by things like products traded, time of day, and length of time the position is held. There are no limits or

rules on what metrics to watch. The more information and data used to analyze trading results, the more you can make sense of why your account is growing or shrinking.

cwt t R W Qı " P px"

Playing the lottery is an example of ignoring the odds and hoping dumb luck will deliver a huge payout. It is tempting to buy a ticket when the jackpot gets into the hundreds of millions, even when the odds of winning are almost zero. Winning the lottery is a holy grail, something illusive and impossible to find. In the world of trading, that search for a big payout often leads down the path of defeat. In other words, the probabilities are stacked against the trader looking for the big win.

A solid trading plan, on the other hand, doesn't shoot for the stars. To use the familiar baseball metaphor, some people say that it is better to hit singles and doubles than to swing for the fences.

I prefer to think that the best trading systems generate singles and doubles, but occasionally the home run too. Is it really possible to do both—have your cake and eat it too? I say that we can safely do both by putting on steady trades but with the creative and strategic use of position size, money management, and stop-losses.

Still, though, even the best strategies are dangerous in the hands of the ill-prepared trader. If a trader does not invest the time and effort to do their own preproduction work and derive their own proof of concept, they will probably end up losing anyway and then blame the vendor of the strategy without even knowing if the methods are good or bad.

Think of an effective strategy like you would think of a power tool. Imagine you were a carpenter who was excellent at swinging a hammer. You could pound nails five times faster than any other carpenter. One day,

though, a carpenter shows up with a hydraulic nail gun. Try as you may, you cannot possibly pound nails fast enough to keep up with *this* competitor, who in your mind is cheating.

You decide to level the playing field by investing in a new hydraulic nail gun of your own.

But you are so excited that you fail to read the instructions or learn how to properly use it. You see your competition building structures much faster than you can. You are determined to catch up, immediately.

Because you failed to read the instructions and learn how to use your new power tool, you end up with a nail sticking out of your big toe. Or worse! Was it the fault of the nail gun?

A trading strategy is a power tool that must be learned to be effectively used. If you do not take the time to do so, the only person to blame is the one staring back at you from the mirror.

Mt t‘ı x”v hı Yt ı”p“c psx”v Nsvt

By this point, you have probably been asking yourself: how do I get a trading edge? What can I do better than other traders? How can I increase my odds of success? In the second half of this book I cover the specifics of setting up a trading system. But first let’s talk about how we turn ideas into action.

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Great ideas lead to big innovations. Every breakthrough, from the light bulb to vaccines, emerged after someone had a great idea. Just think about how much the world changed in 2007 after Apple unveiled the touchscreen iPhone.

All great trading systems begin as an idea as well. The inspiration for the idea can come from another trader, a book, a chart pattern, or an indicator. Then,

with the help of backtesting, the idea can become an actionable trading system.

- **Backtesting**: The study of past data and charts to determine if a trading style or approach can deliver acceptably profitable and measurable results.
- **Fast-Testing**: I have developed a technique to help you zero in on the best trade ideas before you commit effort to the time-consuming task of backtesting. Preproduction work is time-intensive and we do not want to waste a lot of effort on ideas that have no chance of success. While it is true that learning what not to trade is quite valuable, our time is valuable as well, so quickly figuring out what not to trade is preferable to learning those lessons slowly. As the name implies, fast-testing, which we cover in more detail in Chapter 16 of part IV, is a time-saving and efficient method that filters out the potential winning systems from the ones that have a low probability of success. It is one step in the backtesting process.

Nsvt Lwp”vt p Vp zt Lwp”vt

Brokers sometimes warn customers in their disclaimers that “markets can and do change,” and just because an approach has worked in the past does not mean it will work again in the future. That is certainly true of day trading.

As traders all try to find an edge based on past data and experiences, edges that have existed in the past sometimes evaporate. Does that mean it is time to throw away the trading system and start from scratch? Perhaps, but not necessarily. Maybe the plan can be tweaked a bit or applied to a different market. The important thing is that trading edges can change, and if one approach stops working, it might be time to change the plan a bit.

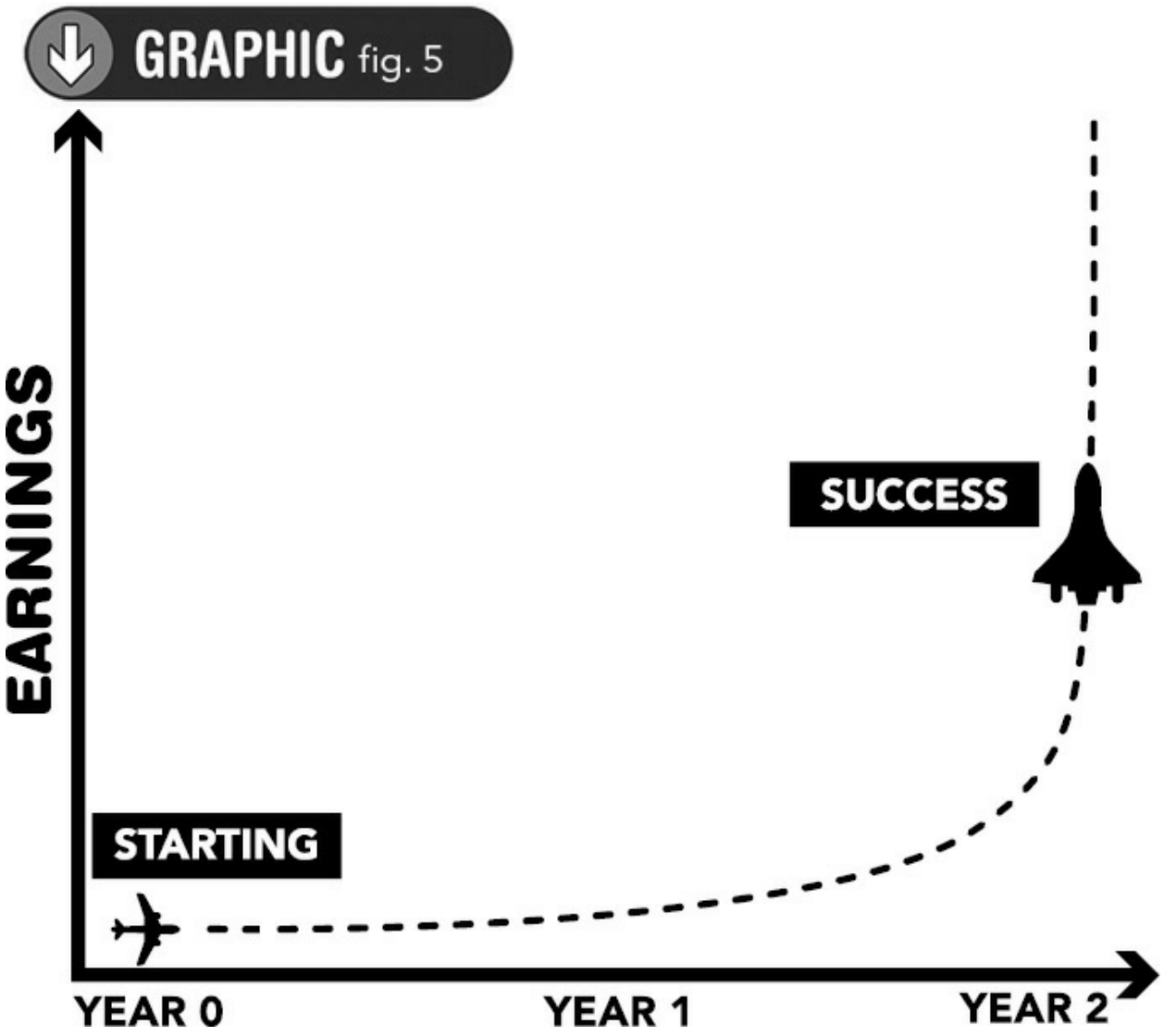
In the aftermath of a failed trade, it is easy to be fooled into thinking that the strategy you are using does not work when it actually does still work. This error is often made when traders forget that winning tradeplans often follow a trajectory of two steps forward, one step back. However, once you establish a well-founded belief in your approach, be careful not to fall prey to chasing performance. You might end up quitting your perfectly good approach right before it launches into the two or four steps forward.

b– p“‘c pst Lp” V pzt V ı ”t

People often ask me: how much do I need to trade? I do not have one answer. Some people trade with as little as $500 and others with as much as $5 million. We will see in chapter 4 that brokers have account minimums and some markets are better suited for small traders. Fortunately, with so much information available online today, you do not need a large budget to start testing strategies and ideas. Chapter 5 outlines some markets—particularly forex—that are easily accessible to smaller traders.

A successful career as a day trader can be like the flight of a jumbo jet. The plane is heavy and barrels down the runway. It is slow at first. There might be a few bumps before it gets off the ground. Then, once airborne, it begins to gradually ascend, little by little. As it continues to climb in altitude, the rate of ascension increases. The nose begins to tip upward faster and faster as well. Eventually, the tip of the airplane becomes like the tip of a rocket ship.

Like a jumbo jet, a day trader will experience some bumps or turbulence early in the trading career. The goal is to persist, survive the turbulence, and become the rocket ship.



A jet makes a gradual ascent and levels off, but if done right, a successful trading career blasts off like a rocket. That is because, as you increase your position size for each trade, the rate of growth increases exponentially, thanks to the Power of Compounding, which is covered in Chapter 12 of part III. It is like a snowball turning into an avalanche—it starts small and then grows into an unstoppable giant force.

Your equity curve is your stake in your trading business.

If you think of a three-year trajectory for your newfound and fledgling (albeit maturing) trading business, 80% of your trading profits will materialize in the latter 20% of your three-year journey. This is due to the exponential growth of your trade results—you will be using larger and larger position sizes as you go forward (figure 6).

You must put forth great amounts of energy up front, and the rewards may not seem worth the effort. But it is important to understand that most of the rewards will probably come later rather than sooner. You want to stay the course and resist the temptation to quit when you could very well be on the brink of success.

GRAPHIC fig. 6

Lwp t atrp

» While it's difficult to gain an edge in random and efficient markets, there are many examples of successful investors and traders who consistently make profits.

» Day traders look for an edge or advantage by backtesting systems and looking for situations with favorable risk/reward scenarios.

» It does not take a lot of money to succeed, but success doesn't come overnight.

| 4 |

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Lwp t X t xt

- How much is enough?
- Account minimums
- Why trade?

Getting started in day trading is a big decision and one that can change your life. Your day trading efforts can grow into a small business where you are the chief executive officer and the company’s profits flow directly into your pockets.

As with any business, success can take some time and effort. Success requires a road map and the discipline to follow the instructions, even when the map seems to be leading in the wrong direction.

There are also basic steps in the early stages of the process, which we discuss in this chapter: determining how much money to start trading with, finding the right broker, and answering the one simple question, *Why trade?*

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Many people do not think that day trading is an option for them because they think it requires a lot of money to get started. That is not true today. Not only do brokerage firms offer opportunities to open accounts with relatively

small cash deposits, but it is also possible to trade forex or options with relatively small accounts.

Q: How much do you have to day trade?

Answer: It is an obvious question, but nevertheless an important one. Moreover, it is a question that only you can answer. Is it $500, $5,000, or $5 million?

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While many brokerage firms set account minimums, they do not tell you how much to risk on one trade or one trading plan. That decision is up to you and is really a personal matter. It is also very important! We all know the old saying, "It takes money to make money." That is certainly true in day trading. If you do not risk anything, you will not make anything.

At the same time, risking too much can have negative consequences. You might lose money that you need for other life necessities like emergency savings or retirement funds. Too much risk can cause stress, sleepless nights, and general feelings of unhappiness. The business of day trading should lead to an improvement in one's life; if you are experiencing many adverse effects, things are not heading in the right direction!

I always say that the most important indicator a trader has is not a chart indicator, but how they feel and react when they are in a trade. If you ever find yourself in a trade that causes you to feel uncomfortable in any way, this

is usually an "indicator" that you are overtrading your account—that is, exposing yourself to too much risk—and/or that you have not invested enough time and effort into building your "trader foundation," which we cover in greater detail in part III of this book.

In short, *you* are the most important indicator. Pay attention to yourself. Doing so will reveal what you may be doing wrong and what you need to focus on to get firmly on the right pathway to trading success.

The amount of money to put at risk is a subjective matter. As a general guideline, I tell people that they probably should not risk more than 2% of their capital on one trade and should only risk 2% if they have a proven trading plan. The 2% threshold is not set in stone. It may be a little more or a little less, depending on other factors.

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Day trading is all about managing risk while attempting to make short-term profits. In that sense, money is simply a tool that allows one to buy and sell. *What does money mean to me?* is an important question to ask before you open an account and begin taking risks as a day trader. If money is a source of pride or something you absolutely cannot put at risk, day trading might not be the right pursuit.

J Wı t Jqı K ı zt

At some point, you will open an account with a brokerage firm to begin day trading.

There is no one-size-fits-all when it comes to brokerage firms. The process is like buying a car: sure, your two-seater Porsche is great for driving to work, but Stanley down the street with six kids needs something bigger.

Yet, while picking the right broker is a matter of personal preference, all day traders need to find a firm with three important features: low commissions, reliable data feeds, and advanced charting platforms. Low commissions are now normal throughout the industry, and day traders should not be paying more than a couple of dollars per trade.

Your data feed is your lifeline and one of the most important tools for success. You need accurate, real-time data.

As for charting, in my opinion, some of the best charts for day trading are tick and range bar charts, which are covered in much more detail in chapter 7. To use charts like these you need a data feed that is not available through every broker. Be sure that the broker you choose offers tick and range bar style charts. That being said, third-party charting platforms and data feeds are available if you look around.

Before I do business with any broker I always ask whether they take the opposite sides of their clients' trades. I'd rather have a broker that puts me in the market against another trader rather than the broker itself. The broker should have my best interests at heart. How can they do that when they're holding the opposite end of my trade?

It is also important to understand that not every broker offers every type of investment product. For example, one firm might provide traditional stock

brokerage services, but not futures or forex. Another might provide only forex. Some firms cater to options traders and have tools for advanced strategies.

It is important to look at the pros and cons of a few good brokerage options to choose the solution that's right for you. For the remainder of this book, we will use examples from TradeStation, which is a brokerage firm that I really like for my day trading. NinjaTrader is another popular charting platform that I frequently use. NinjaTrader interfaces with various other brokers and gives you more choices and better flexibility.

Many brokerage firms, though not all, set account minimums. The minimum is the smallest amount required to open an account. Prior to the emergence of discount brokers and online trading platforms, brokerage firms—often called full-service brokers—would require larger amounts, such as $25,000, to start trading. Discount and online brokers cater to smaller, do-it-yourself traders. They generally do not require a lot of cash to get started. Some even offer perks, like a certain number of free trades or accounts with no minimum requirement.

There are no one-hundred-percent perfect solutions regarding broker, charting, data, and what products to trade. If you are not sure what type of investments a company offers or what their account minimums are, check their website, or simply call customer service and ask.

f w M hı c pstH

Q: Remember the question at the beginning of the book, *Why trade?*

Answer: It's simple—the only reason to trade is to make money! This question, why do you trade, is important and something to think about as we conclude this chapter.

While the answer "to make money" might seem obvious—a no-brainer—most losing traders actually trade for other reasons (remember Harvey the engineer?). They may *think* they are trading to make money, but their actions indicate that other motivations are driving their decisions. Remember, the most important indicator is you.

If you are truly trading to make money, then the next logical question to ask is *How?* How does a trader achieve that objective?

The answer is by trading within the context and rules of a proven tradeplan. A proven tradeplan grows equity in your account, despite the random distribution of wins and losses. It includes rules to follow that you can prove to yourself.

Taking random trades that are not within the context of a proven tradeplan is not trading to make money. It is something else. Why? Because we are traders. It is what we do. We take trades. If you win on a random trade, now what? There is still another trade to take, right? Making money comes from the edge that your proven tradeplan gives you over time. Random trades are not going to reveal whether or not you have an edge—they're random—until

after the fact, when you will most likely learn that the answer is no, you did not have an edge. And then it will be too late. This is how accounts get blown up.

If you are truly trading to make money, then your actions should reflect that. If they do not, then you are most likely trading for other reasons that you don't quite understand. You will need to address that if you truly want to internalize the correct reason to trade—to make money. Otherwise, the market will give you something else and you probably will not like it.

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- Getting started in day trading is an important decision.
- One of the first steps is to open an account, which usually requires a minimum deposit.
- When selecting brokers, look at their commissions, data feeds, and charting packages.
- Why do you trade? The real answer might surprise you.

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Lwp t X t xt

- The stock market
- Ins and outs of ETFs
- Futures
- Options
- Foreign exchange

Day traders are not all the same. Some focus on just one investment vehicle or product. Others trade many different markets. One trader might place just one or two trades per day. Another might try to make quick short-term profits by trading in and out of the market dozens of times in just a few hours.

While there are many ways to day trade, I teach specific methods designed to help overcome some of the biggest mistakes I see traders make. A step-by-step guide to building trading systems is detailed in part IV of this book. This chapter deals mostly with specific tools for day traders; if you already know the difference between stock, forex, and futures markets, you might want to skim these pages and breeze through

to part II.

Also, many different markets are accessible to day traders. We simply cannot cover all the available products in just one book. Instead, this chapter focuses on some of the best vehicles for day trading, including actively traded stocks, futures, options, and foreign exchange (forex). We also cover the pros and cons of each type.

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If there is one iconic symbol of the US stock market, it is the New York Stock Exchange (NYSE). It traces its origins to 1792 when a group of stockbrokers signed an agreement under a buttonwood tree on Wall Street. The so-called Buttonwood Agreement paved the way for the first organized trading of stocks among investors. At that point, a centralized stock market with a physical trading floor became a reality.

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The stock market is a place where investors buy and sell shares of individual companies. The shares trade on exchanges like the NYSE, but also on electronic networks such as Nasdaq. In fact, few exchanges have actual trading floors where human beings facilitate transactions—most are electronic networks. Even the NYSE now has an advanced electronic order-routing system.

The path from idea to execution is straightforward. After a trader decides to buy or sell a position in shares, the buy and sell orders are sent to the exchanges through a broker or electronically through a brokerage platform. Some brokerage firms allow traders to specify where to send orders (direct order brokers), but most traders simply leave that task to the broker. In other

words, the broker determines where to route the order, and it is the broker's responsibility to obtain the best prices possible on customer orders.

Some brokerage firms keep customer orders and execute them in-house, which is referred to as internalization, and others sell customer orders to large wholesalers. It doesn't really matter for the individual trader, so long as the prices on trades are consistent with the best market prices at the time.

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A stock represents a share of ownership in a company. The price of a stock changes for a variety of reasons. For example, a start-up biotechnology company's stock might see little price movement as it invests heavily in research and development. The stock might fall in value if the company begins losing too much money. Then, one day, the company discovers a breakthrough drug that it can sell to millions of people. The stock price shoots higher overnight.

Obviously, not all companies have the same potential for big wins and losses that a biotech firm does. More often, the price of a stock is driven by the activity in the overall market and other news flow: quarterly earnings announcements, new product developments, changes in the industry.

Day traders typically focus on some of the more actively traded stocks where there are sufficient amounts of volume, or ***liquidity***. An investment is liquid when there are many traders actively buying and selling. There is depth to the market and traders can be reasonably confident that they can enter and exit

positions in an instant. Examples of highly liquid stocks include Apple (AAPL), Facebook (FB), and Bank of America (BAC).

Indexes offer traders a gauge, or snapshot, of how a group of stocks changes from one day to the next. The most well-known index is probably the Dow Jones Industrial Average. Charles Dow created the index in 1896, and today the Dow includes 30 of the largest companies with shares trading on the US exchanges.

You have probably heard people say that information is already priced into a stock's value. Stocks are typically priced and valued on the potential of future earnings and a multiple that the general market views as a correct value. That's why markets often turn down before a recession—because investors begin to discount or price in the possibility of slower earnings growth across the entire market.

News reports flash that the Dow Jones Industrial Average dropped 500 points today. What does this mean? It simply means stocks had a bad day. For example, if the Dow dropped from 25,000 to 24,500, the average share of the 30 companies in the index lost 2%.

R' p"s X ıuR'st t

For traders, the S&P 500 Index is more popular than the Dow Jones Industrial Average. It tracks 500 companies, rather than just 30. In addition, the S&P 500 has a variety of investments tied to its performance (including ETFs, futures, and options, which I discuss later). In addition, many traders consider the S&P 500 to be the best gauge of the stock market—when they

talk about beating the market, it is usually in reference to this index.

- **Dow Jones Industrial Average**: 30 of the largest names trading on US stock exchanges
- **S&P 500 Index**: Top 500 companies trading on US stock exchanges
- **Nasdaq 100**: Top 100 nonfinancial companies trading on the Nasdaq Stock Market
- **Russell 2000 Small Cap Index**: 2,000 of the smaller companies with shares listed on US stock exchanges
- **CBOE Volatility Index (VIX)**: Tracks the volatility of the S&P 500, based on the latest readings from an options-pricing model

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While indexes track the performance of various markets, exchange-traded funds are investments that allow you to buy or sell entire markets or other portfolios. Like a mutual fund, an ETF is simply a pool of money invested in specific assets or themes. The most popular is the SPDR 500 Trust (SPY), which holds the same companies as the S&P 500 Index. SPY is among the most popular investments today; in 2019, the fund held nearly $300 billion in assets.

Q: What is the difference between an ETF and a mutual fund?

Answer: Both ETFs and mutual funds are pools of money with a portfolio manager making decisions regarding buy and sell transactions. Both are offered in shares. The key difference is that an ETF trades on an exchange like a stock and can be

bought and sold in real time when markets are open. The prices of mutual funds are only updated once per day, and they typically have more management fees as well.

Like stocks, ETF shares can be bought and sold throughout the trading day, but ETFs represent baskets of stocks rather than shares of individual companies. For example, the iShares Small Cap ETF (IWM) holds the same names as the Russell 2000 Small Cap Index. The Dow Jones Industrial Average ETF (DIA), the Nasdaq 100 Fund (QQQ), and the iShares Emerging Markets Fund (EEM) are also among the more actively traded ETFs.

- **SPDR 500 Trust (SPY)**: Holds the same 500 companies as the S&P 500 Index
- **Dow Jones Industrial ETF (DIA)**: Also called the Diamonds, this fund includes the Dow 30
- **iShares Russell 2000 Small Cap Fund (IWM)**: An ETF that holds 2,000 pint-sized companies
- **Invesco QQQ ETF (QQQ)**: Formerly called the PowerShares QQQ and sometimes just the Qs, the fund holds 100 top companies listed on the Nasdaq Stock Market
- **iShares Emerging Markets (EEM)**: One of the most actively traded and liquid funds that holds shares of companies outside of the US

Several popular exchange-traded funds track specific market sectors or countries. The Financial Select Sector SPDR Fund (XLF), for instance, includes the banking and brokerage names from the S&P 500. The Nasdaq Biotechnology ETF (IBB) holds only biotechnology companies with shares listed for trading on the Nasdaq. The VanEck Vectors Gold Miners ETF

(GDX) is a portfolio of companies involved in mining for gold and other metals. Other actively traded sector ETFs include the following:

- **Energy Select Sector SPDR (XLE)**: A fund of energy-related companies from the S&P 500
- **VanEck Vectors Semiconductor ETF (SMH)**: A portfolio of chip and chip equipment companies
- **Technology Select Sector SPDR Fund (XLK)**: A fund holding the technology components of the S&P 500

And ETFs for specific countries:

- **iShares MSCI Brazil Fund (EWZ)**: The biggest names in Brazil
- **iShares China Large-Cap ETF (FXI)**: Leading names listed on China's equities markets
- **iShares MSCI Germany Fund (EWG)**: A portfolio of equities from Germany's stock market

Some ETFs offer exposure to asset classes like commodities and bonds. For instance, the United States Oil Fund (USO) tracks crude oil, and the SPDR Gold Trust (GLD) owns gold. The iShares 20+ Year Treasury Bond (TLT) holds US Treasury bonds that mature in 20 years or more.

The US Oil Fund holds crude oil and the SPDR Gold Fund represents gold, but the funds are very different. Namely, while the gold fund holds actual metal (stored in bank vaults), the US Oil Fund attempts to track crude oil with futures contracts. The oil fund doesn't always achieve its objective and, in fact, the longer-term chart of the ETF is very different from the longer-term trend in crude oil.

Leveraged ETFs can offer opportunities for day traders as well. These funds are designed to track the performance of specific indexes and are considered leveraged because daily moves are multiplied by two or three times. A leveraged ETF is like a regular ETF, but on steroids.

The triple-leveraged UltraPro Short S&P 500 ETF (SPXU), for instance, is designed to move opposite to the SPDR 500 Trust, but three times as fast. Meanwhile, the ProShares Ultra S&P500 (SSO) will move in the same direction as the S&P 500, only twice as much. Other examples include the following:

- **ProShares UltraPro QQQ (TQQQ)**: 3X the QQQ
- **ProShares Ultra QQQ (QLD)**: 2X the QQQ
- **Direxion Daily Financial Bull Shares (FAS)**: 3X the XLF
- **Direxion Daily Gold Miners Bull Shares (NUGT)**: 3X GDX
- **Direxion Daily S&P 500 Bull Shares (SPXL)**: 3X SPY

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Other than account minimums, there are no requirements for trading stocks and ETFs. Brokerage firms simply require that you complete a new account application and deposit money. Then you can begin buying and selling shares of stocks or ETFs.

Trading hours for the regular trading session of the NYSE are 9:30 to 4:00 ET, Monday through Friday, but there are also extended trading periods before and after the market opens. Typically, day traders are most active during the regular trading session, since volume and liquidity drop off notably during extended trading hours.

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The stock market has several attractive attributes when it comes to day trading. For one, it is massive, with billions of shares traded each day. Single

companies, like Apple (AAPL), have reached $1 trillion in market value (shares outstanding multiplied by stock price). Market participants are in the millions, from the large institutions to the small day traders. There is no shortage of buyers or sellers in the stock market today.

There are large numbers of stocks and ETFs available for day trading as well. Whether the goal is to profit from the move in one company, one sector, or an entire market, there is probably a stock or ETF out there to match that objective.

Stocks and ETFs can often be purchased on margin, and that is helpful when day trading. ***Margin*** is a loan from the brokerage firm to the customer for a down payment on a stock purchase. Current rules, which are subject to change, allow borrowing of up to 50% of the purchase price, after the account holder signs a margin agreement.

Therefore, you can buy two times more stock with a margin account than you can with a regular trading account. You pay interest on the loan and can pay back the loan at any time, typically when the stock is sold.

The term margin can have very different definitions depending on the financial market. If you want to buy a stock, bond, or ETF "on margin," you are borrowing money as a down payment–the margin is typically up to 50% of the purchase price. A futures margin, on the other hand, is money that is deposited in order to open a position. I will explain the details of the futures margin later in this chapter.

Here is an example to illustrate the concept of 50% margin for a stock

purchase. Say you have $10,000 in a non-margin account and use the money to buy 100 shares at $100 per share. You are a savvy trader and the stock is worth $120 one year later. Your profit on 100 shares is $20 per share, or $2,000 on the 100-lot. Twenty percent is not too shabby.

Suppose that, instead, you buy 200 shares with a margin account. The investment is $20,000, but $10,000 was borrowed from the broker.

Then:

$10,000 is paid for 100 shares of stock	-10,000
Another 100 shares are bought for zero	0
Stock price increases to	$120 x 200
Shares sold	+24,000
Repay margin loan	-10,000
Pay interest	-500
Profit	+3,500

Trading in a margin account results in a profit, after interest is paid, of $3,500, or 35% on a $10,000 investment. That's quite a bit more than the $2,000 profit in the non-margin account.

Obviously, the opposite holds true if the stock takes a turn for the worse. If, for instance, the stock falls to $80, the loss in the regular account is $2,000, but in the margin account it is $4,000 plus the interest paid.

Trading on margin can boost returns from day trading, but the stock market is not necessarily the best place to day trade, for a few important reasons. For one, while there are thousands of names to choose from, most of the best

opportunities are in the most liquid stocks, and those names represent just a fraction of the total universe. And, as noted earlier, the volume and activity tend to fall off significantly outside of the regular trading session hours. Stock markets are also closed on weekends and holidays.

Furthermore, it is not always possible to sell a stock short or bet against it. When a trader sells stock short, they are borrowing shares from their broker and selling them in the marketplace. If the share price falls, they can buy them back (a process known as short covering) and then return the shares to their broker, netting a profit equal to the difference between the short sale price and the purchase price.

There are important drawbacks to selling stock short (as opposed to futures and forex, which we will see later). One is that brokers charge interest when lending stock for short-selling purposes. Also, not all stocks can be sold short, because they sometimes become hard to borrow (HTB). A stock can become HTB when many other people are trying to sell it short or because the company simply does not have a lot of shares trading in the market. Finally, exchanges can put restrictions on short sellers if the stock or market has seen a sharp and volatile downward move.

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The biggest problem with buying and selling stocks as a day trader is a set of rules called ***Pattern Day Trader (PDT) rules***. According to PDT rules, traders with less than $25,000 in their account can only initiate three day trades within a five-day time period. While the goal is to prevent traders from overtrading and paying their brokerage firms too much in commissions, the rules also make it nearly impossible to day trade the stock market in smaller accounts. PDT rules are set by FINRA, the Financial Industry Regulatory Authority.

PDT rules apply only to equity accounts that use margin, which is the account type preferred by day traders. Cash accounts are immune to the PDT rules but are not favored by day traders, because they require too much capital for acceptable ROI (return on investment).

Given PDT rules and other factors, the stock market is probably better for swing trading than for day trading. A swing trade is one that lasts two or three days, or longer. For instance, the trader might buy shares Tuesday morning with a target to exit the position no later than the next day, or sometimes days or weeks later. Swing trading can be very profitable and is something that day traders should consider mixing into their overall trading portfolio, but it is not the topic of this book.

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Trading in derivatives known as ***futures contracts*** dates back centuries. The first commodities exchange was the Dojima Rice Exchange in Japan beginning in 1697. Commodities futures were traded in England during the sixteenth century and on the London Metal Exchange by the late 1800s. The Chicago Board of Trade (CBOT) was the first commodities exchange in the United States, formed in 1848.

The futures market today is a large, mostly electronic set of exchanges where traders can go to buy or sell contracts. Popular products include futures on stock indexes, energy, currencies, bonds, metals, and agricultural commodities. Players in the futures market include hedgers, who are the people looking to manage risk for existing assets such as inventories of crude

oil, silos full of soybeans, or portfolios of stocks. Speculators, on the other hand, attempt to generate profits from the price moves of the futures contract and do not intend to take delivery of (or to deliver, in the case of a short trade) the physical commodity. Most brokers won't let you take delivery anyway. They will close out your trade before expiration of the contract, which is good, except they won't care if you are in a winning or losing position. They will liquidate your position rather than let 1,000 barrels of crude oil end up on your doorstep.

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Although there are still a handful of trading pits, the days of traders screaming out orders and throwing up hand signals are mostly a thing of the past. Instead, the bulk of futures transactions are done electronically. Buying and selling happens in milliseconds, with a trader taking the short side of every long position and vice versa.

Each contract is ***standardized***, which means that the specific terms (expirations, quantities, quality standards, and symbols) are clearly spelled out in the contract. Standardizing makes it easier for market participants to understand the nuances of each specific contract.

All futures are contracts, agreements to buy or sell an underlying asset at a set price and at a specific time. An underlying asset can be crude oil futures, gold, a stock market index, or a number of other financial instruments. Futures contracts trade up and down in the market, just like stocks.

For the sake of day trading, you might buy a gold futures contract and

hope to benefit from short-term price fluctuations in the value of the contract. If you are selling the contract (going short), then you want its price go down. You will then close out the trade profitably by buying a contract (an offsetting contract) at the lower price.

Futures contracts are not typically held through the expiration, however, and a trader can close or cover a long contract at any time by selling the same contract. Conversely, futures contracts can be sold when the price is expected to fall. A short futures position is covered with a purchase or buy order, which is sometimes called an offsetting purchase.

Prices for futures are often different from the price of the underlying asset. On the one hand, there is the cash price, or ***spot price***, which is the actual price of the commodity or financial instrument and the price of the physical commodity or investment today. On the other hand, there is the futures price, which reflects expectations about the future and consideration of other costs like storage, transportation, and interest.

Futures can be traded at a discount or a premium on the cash price, depending on the underlying asset and market conditions. A complete discussion of futures pricing is beyond the scope of this book, but many have already been written on the topic. For day traders, the important thing to understand is that futures prices fluctuate and move all day long. We can move in and out of leveraged positions quickly and easily, which is far more profitable and efficient than buying the underlying asset with cash.

Futures contracts are bought and sold using margin. That is, the trader must

provide a deposit and maintain a certain level of funds for each long or short futures position. The deposit is called the ***initial margin*** and is typically 5% to 15% of the value of the contract size. After that, the account must meet the ***maintenance margin*** or face a ***margin call***.

- **Initial Margin**: The initial deposit made when buying or selling a futures contract; ranges between 5% and 15% of the value of the futures contract size.
- **Maintenance Margin**: A specific amount of funds, less than the initial margin, needed to maintain an open futures position
- **Margin Call**: A request from the broker for the customer to deposit additional funds to reestablish initial margin levels, or to liquidate a position after the value of the position drops below the maintenance margin threshold

Margin levels are set by the exchanges, but brokers can add to the minimum requirements in order to manage their own risk. In day trading, margin calls are rare, because the idea is to close positions before the end of the trading day and end each day flat (with no open positions). Nevertheless, let's work through a hypothetical example to see how a margin call might look.

The initial margin for one crude oil futures contract is $4,000. Since the value is $54 per barrel and 1,000 barrels underlie one contract, the contract size is $54,000, and $4,000 represents roughly 7% of the value of the contract size. The maintenance margin is $3,250.

A trader takes a long position in one contract and, to their dismay, crude oil drops 5% the next day to $51.30. They have an unrealized loss of $2,700 ($54,000 – $51,300). Subtract that from the $4,000 initial margin and the position has dropped to $1,300, below the $3,250 maintenance margin. A margin call is sent, and the trader must deposit more money (to restore the

$4,000 initial margin) or potentially see the position liquidated.

Margin requirements vary greatly by futures contract and are largely determined by the volatility of the underlying asset. For example, the initial margin on a Treasury note contract is a much smaller percentage of contract size than that on a crude oil contract because, on a daily percentage basis, crude oil moves a lot faster, with bigger daily percentage moves, than Treasury notes.

In terms of specific products, futures contracts can be compartmentalized into a handful of groups: metals, grains, stock indexes, financials, currencies, livestock, and energies. The following is not a complete list of all tradeable products, but it covers many of the most popular ones:

Market	Instrument	Symbol	Value/ Point	Value/ Tick	Tick Increment	Exchange
Energies	Crude Oil	(CL)	$1000	$10	.01	NYMEX
Energies	Natural Gas	(NG)	$10,000	$10	.001	NYMEX
Energies	Unleaded Gasoline	(RB)	$42,000	$4.20	.0001	NYMEX
Energies	Heating Oil	(HO)	$42,000	$4.20	.0001	NYMEX
Stock Indexes (E-mini)	S&P 500	(ES)	$50.00	$12.50	.25	CME
Stock Indexes (E-mini)	Dow Jones Industrials	(YM)	$5.00	$5.00	1	CBOT
Stock Indexes (E-mini)	Nasdaq	(NQ)	$20.00	$5.00	.25	CME
Stock Indexes (E-mini)	Russell 2000	(RTY)	$50.00	$5.00	.1	CME

Market	Instrument	Symbol	Value/ Point	Value/ Tick	Tick Increment	Exchange
Stock Indexes						

(micro)	S&P 500	(MES)	$5.00	$1.25	.25	CME
Stock Indexes (micro)	Dow Jones Industrials	(MYM)	$0.50	$0.50	1	CBOT
Stock Indexes (micro)	Nasdaq	(MNQ)	$2.00	$0.50	.25	CME
Stock Indexes (micro)	Russell 2000	(M2K)	$5.00	$0.50	.1	CME
Grains	Corn	(C)	$50.00	$12.50	.25	CBOT
Grains	Wheat	(W)	$50.00	$12.50	.25	CBOT
Grains	Soybeans	(S)	$50.00	$12.50	.25	CBOT
Financials	10-Year Treasury Note	(ZN)	$1,000	$15.63	1/64 of a point	CME
Financials	5-Year Treasury Note	(ZF)	$1,000	$7.8125	1/128 of a point	CME
Financials	30-Year Treasury Note	(ZB)	$1,000	$31.25	1/32 of a point	CME
Currencies	Euro	(EC) or “6E”	$125,000	$6.25	.00005	CME
Currencies	British Pound	(BP) or “6B”	$65,500	$6.25	.0001	CME
Metals	Gold	(GC)	$100	$10.00	.10	COMEX
Metals	Silver	(SI)	$5,000	$25.00	.005	COMEX
Metals	Copper	(HG)	$25,000	$12.50	.0005	COMEX
Softs	Cocoa	(CC)	$10/unit	$10.00	1	ICE
Softs	Coffee	(KC)	$375/unit	$18.75	.05	ICE

Individual contracts within each group can trade very differently from others.

For example, crude oil is by far the most interesting (in terms of liquidity and day trading opportunities) within the energy group, and the Nasdaq futures contract is a lot more volatile than the S&P 500 in the stock index group. Not many day traders are focused on things like live cattle or soybeans.

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Other than account minimums set by the broker and margin deposits, there are no requirements for trading futures contracts. The exchanges have even created contracts to appeal to smaller investors and day traders. An example is the S&P E-mini, which is by far the most popular among the stock index futures contracts (but not one that I like to trade; I'll explain later).

While not required, it is important for traders to understand key dates for futures and to trade the correct expiration months. In other words, you never want to find yourself in a position where you need to take ***delivery*** of 5,000 barrels of crude oil! Here are some key dates:

- **Expiration Day**: The day the futures contract expires and ceases to exist
- **First Notice Day**: The first day the exchange can assign delivery on accounts with open positions
- **Rollover Day**: The day that traders begin trading the new contract
- **Last Trading Day**: The last day that a futures contract can be closed before delivery

The expiration month with the greatest volume is typically the best one to day trade.

The rollover day is important as well. It is the day traders begin trading the new contract, and there is usually a migration where you see volume reducing in the soon-to-expire contract and volume increasing in the new contract. Once I see that the new contract has more volume than the old, I begin trading the new contract.

For crude oil and the other energy futures, rollover typically takes place on or around the 18th of each month. For example, from approximately July 18 through August 17, the September contract is traded. Around August 18, we

begin trading the October contract. This can vary depending on how the days fall on the calendar, and at times I've seen the majority of the volume migrate to the new contract as early as the 15th.

On the other hand, E-minis and currencies have contracts that trade for the entire calendar quarter (March, June, September, and December). They typically roll over by the second Friday of the new quarter. So, for trading purposes, when the September contract ends, the December contract begins, on the second Friday of September.

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The futures market has been around for centuries for one simple reason: it works. Farmers, portfolio managers, metal producers, and large manufacturers find a lot of value in futures because these contracts allow them to do things like lock in prices, hedge risk, and manage inventories. There are large pools of liquidity in many contracts, and that is great for day traders.

The trading hours for futures are longer than for most other markets, and, while I prefer trading for a few hours (or, ideally, minutes) in the morning, there are opportunities well beyond that. At the very moment I was writing this section, I shorted some crude oil contracts and exited with a .12 profit, making a quick $120 per contract. The entire trade took about two minutes. Such is the life of an experienced day trader. The S&P E-mini, for example, trades almost all day during the week and is open for trading Sunday evenings at 6:00 p.m. ET.

Tick size is another important factor to consider when looking at a futures contract. It is the minimum price fluctuation for a given instrument. In our crude oil example, one contract is 1,000 barrels, and therefore a $1 move in the crude oil price per barrel represents a $1,000 change in the value of the

contract. Each move can be as small as $10 because the minimum tick size is .01 per barrel. In other words, each one-cent change in crude oil results in a $10 change in the value of the position.

Having smaller tick sizes is a boon for day traders because it creates a lot of potential price levels for entries and exits. For instance, you can buy at $54.06 with a target at $54.21 and a stop-loss at $53.99. There are endless possibilities. (This is in no way an actual trading suggestion, because all trades should be placed within the context of a proven tradeplan.)

The costs of trading futures have come down a lot, thanks to advances in electronic platforms and competition among futures brokerages. Some brokers charge only a few of dollars for trades (including exchange fees). In the most liquid markets, like crude oil and stock indexes, the bid–ask spreads are narrow, which minimizes slippage as well.

One disadvantage of trading S&P E-mini (ES) futures is that the contract trades in one-quarter-point ticks. Each point is worth $50 and each tick is worth $12.50. That is quite expensive, especially when you consider that it is so widely traded that you have a lot of other traders waiting to get filled at specific prices. It can feel like standing in line at the DMV.

Many times I have put on a trade that actually hits a target exactly, and my order does not get filled. I am literally waiting to exit my position. Then the price backs off the target price and I am faced with a tough decision: Should I just get out as the price backs off my target, paying another tick or two in slippage? Or should I wait to see if the price comes back up and returns to my price target?

With ES, it generally has to trade through my target (move to the target price and beyond) to get filled. For instance, if my target is 2,879.25, it must trade to 2,879.50 to assure a fill. On the other hand, if I wait and hold the position

(rather than exiting it immediately), I risk the price continuing in the opposite direction, in which case all my hard work to trade up to my projected target was for naught. $12.50 per tick is expensive, and I risk giving back a larger percentage of my profit objective, on average.

Other markets are less costly and it's easier to get filled at specific price targets. Crude oil is $10 per tick. I usually get filled right when I hit my target, but even if for some reason I do not, I can quickly exit the position and pay a much smaller percentage in slippage. Or, for stock indexes, the Russell E-mini (RTY) trades in ticks of one-tenth of a point. A tick is only worth $5. The percentage of my slippage costs is a much smaller percentage of my overall trade objective. Keeping costs down is essential to long-term success.

Price action is the ebb and flow—higher, lower, and sideways—of the price of an investment security. The same tradeable patterns occur over and over again. It is just a matter of identifying good trading opportunities where we can assure the odds are stacked in our favor. After that, it's just a numbers game. Regardless of the ebb and flow of prices, there will always be fixed costs with every trade you take.

Futures represent some of the best day trade opportunities. You can get in and out of a trade with a significant profit or loss in a matter of minutes, or less, and for very little trade cost.

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Options have been around for a long time, but trading of standardized contracts on organized exchanges did not begin until the 1970s. At that time, with the help of academic research and new models for pricing options, the ***Chicago Board Options Exchange (CBOE)*** listed the first stock option contracts.

More than a dozen exchanges exist today and most are electronic. CBOE still maintains a couple of physical trading pits (S&P 500 Index and CBOE Volatility Index options), but the bulk of the trading takes place electronically, as most newer exchanges are fully automated venues.

Like futures, options are agreements between two parties to buy or sell an investment, known as the ***underlying asset*** or security, at a specific price through a period of time. There are two types of options: puts and calls. The holder of a call has the option to buy the underlying asset, and a put holder has the right to sell the underlying asset.

Options are available on many different financial instruments, including futures, forex, indexes, ETFs, and stocks. We do not cover index, futures, or forex options in this book. Instead, we consider options on stocks and exchange-traded funds.

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Options are listed on thousands of different stocks, ETFs, and indexes, but a handful of tickers see the bulk of the trading activity. Large companies like Apple (AAPL), Bank of America (BAC), and Facebook (FB) dominate the activity in stock options. SPDR 500 Trust (SPY), Invesco QQQ (QQQ), and iShares Russell 2000 (IWM) are heavily traded ETF contracts. The S&P 500 Index (SPX) is the most active in the world of index options.

Prices for options are quoted in dollars and cents, multiplied by 100. Therefore, if the quote is $1.90 (***bid***) to $2.00 (***ask***), the cost for one contract

(if bought at the ask) is $200 because the ***multiplier*** is 100.

All options are standardized with respect to contract size, expiration date, and ***strike price***. The strike price is easy to understand—it is the price at which shares are bought or sold if the contract is ***exercised***—and will vary depending on the price of the underlying asset. For example, if a stock is trading near $200, the strike prices might be (in 10-point increments) 170, 180, 190, 200, 210, and 220, but for a stock that is at $20, strike prices might be 1 or 2.5 points apart, like 18, 19, 20, and 21 or 17.50, 20, 22.5, and 25. The popularity of the underlying asset often determines what strike prices are listed, with the most active names having the greatest number of strike prices available.

The size of an option contract is easy to understand as well. One stock or ETF option represents the right to buy or sell 100 shares of the underlying asset. For example, a call option gives its owner the right to buy 100 shares for every contract at the strike price, and a put option represents the right to sell 100 shares at a specified strike price.

The option owner is not obligated to buy or sell the stock or ETF. They simply have the choice, or option, to do so. Buying a call option is similar to putting down a good faith deposit on a home. Once you have deposited the money, from that point forward you have the choice to buy the home, and the seller has an obligation to sell it to you; but you also have the choice not to buy it. If you don't, you lose your deposit. In the world of options, the investor pays a ***premium*** for the option contract.

If the investor chooses to buy the stock or ETF under the terms of the contract, the option has been exercised, and a seller of the option will be assigned. Once assignment happens, the seller of the option must deliver the shares under the terms of the contract (or buy the shares if assigned on a

short put option).

Day traders in the options market typically close positions before the expiration (as with futures) and therefore exercise or assignment of the option contract rarely comes into play for them. Once an option position is opened (either long or short, put or call), it can be closed with an offsetting transaction, at any time prior to the expiration.

Profits are made when options are bought at one price and sold at a higher price or when sold at a high price and bought back (through an offsetting transaction) at a lower price. As when trading stocks, the option buyer wants to buy low, sell high.

For example, when XYZ calls are trading for $1.00 and move up in price to $1.50, I can sell (or cover) the call to bank the profit of 50 cents. On the other hand, if I sell XYZ calls at $1.00 and cover at $1.50, the loss is 50 cents per contract. Fifty cents x 100 shares = $50. The main point is that an option contract can be covered or closed at any time through an offsetting trade. It does not need to be held until the expiration, which is typically on a Friday.

Expiration dates vary from one week to two years. Maybe you've heard that options expire on the third Friday of every month. While that is true of many contracts with monthly expirations, a lot of the activity in some of the more popular names is in weekly contracts. Weeklies were launched in 2005 and are available on actively traded underlying assets like SPY, QQQ, and equities such as Facebook and Apple.

Weekly contracts are listed on Thursday and expire on the following Friday. Compared to the standard monthly contracts for which trading often begins several months before their expiration dates, the weeklies only have eight days of trading life. These contracts are highly popular among short-term traders and represent large liquidity pools for day traders.

To recap, the following are the key components of an options contract:

- **Underlying ticker symbol**: AAPL, SPY, SPX, etc.
- **Type:** Put or call
- **Expiration Date:** Can vary from one week to two years; most have a monthly expiration cycle
- **Strike Price:** The price at which an option can be exercised

Players take positions in options with "opening transactions" and offset them with "closing transactions." For instance, buying "one Apple June 150 put" gives the investor the right to sell 100 shares of Apple at $150 per share through the June expiration. This buying of the put option is the opening transaction in this trade. The long put position can be offset, or covered, at any time by "selling to close" one Apple June 150 put.

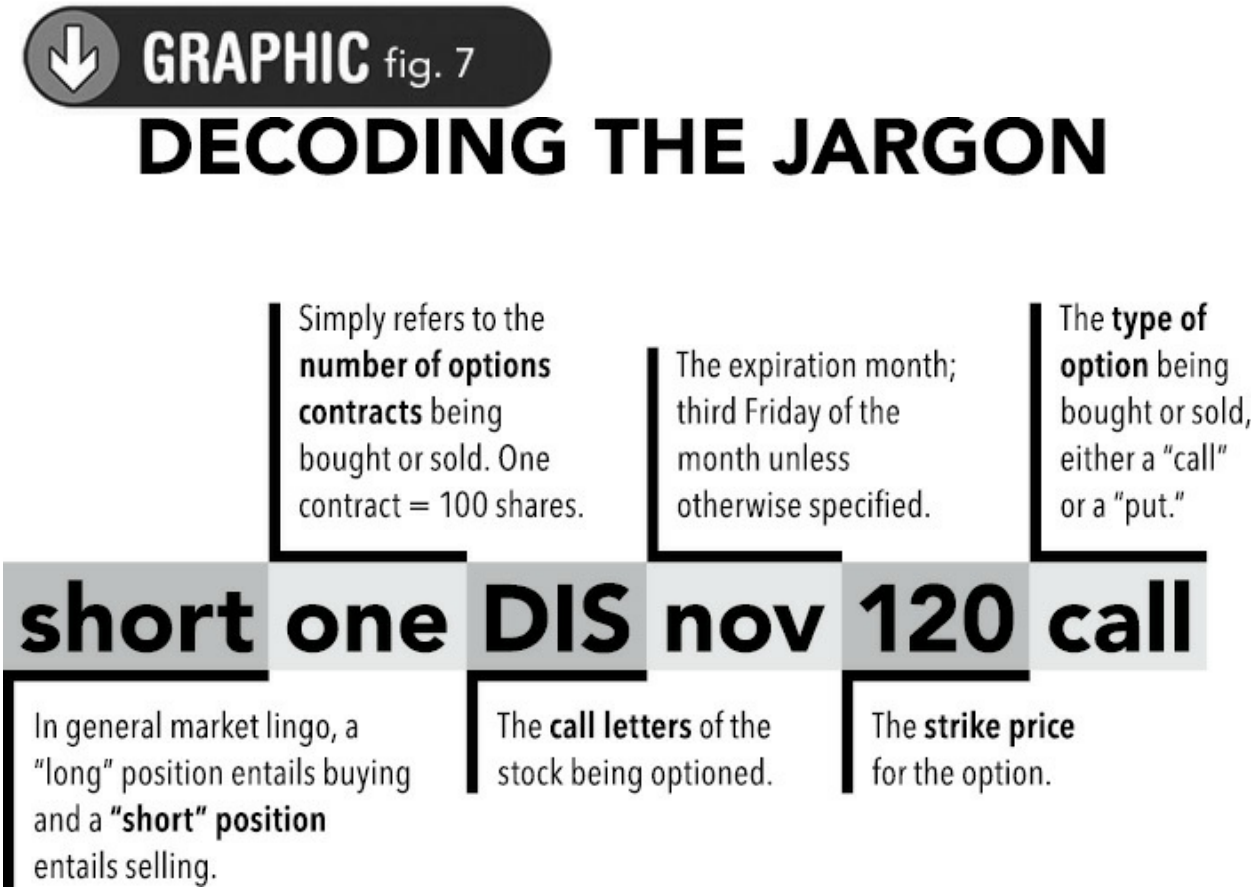
Options trades may also transpire in the opposite direction. The option is sold via the opening transaction and then covered through the offsetting closing transaction, which closes out the position via the purchase of an offsetting option. This approach to exiting a position is known as "buy to close."

- Buy to open → Sell to close
- Sell to open → Buy to close

Here is an example. Apple June 150 calls that expire in five days trade for $1.00 per contract ($0.95 bid and $1.05 ask) and, since Bob thinks the stock will rally over the next few hours, he places a buy-to-open order for 10 contracts of AAPL Jun 150 calls for $1.00 each. The order is filled for a total investment of $1,000 (10 contracts x $1.00 x 100 multiplier). Bob's assumption is correct and Apple shares shoot higher—the calls now trade at $1.50 to $1.60. He wants to bank the profit, so he sells to close the calls at $1.50, for a profit of 50 cents per contract, or $500 on the 10 contracts.

Figure 7 breaks down a call option into its many components. In this case, the investor sold the calls, and so the position is "short" the call. The position size is one contract, which represents 100 shares of stock per contract. The ticker symbol is DIS for Disney shares. The expiration month is November, and the strike price is $120. These variables are used to describe any options contract.

GRAPHIC fig. 7



Options prices will change depending on price movements in the underlying asset and changes in volatility. Also, since options have fixed expiration dates, the passage of time will have an important impact on their value. A family of metrics known as the "Greeks" helps us understand how the various factors come into play and affect options prices:

- » **Delta**: The price change in an option for every one-point move in the underlying asset
- » **Vega**: The price move in the option for every point of change in implied volatility
- » **Theta**: The loss in the value of an option that is due to time decay

Delta, theta, and vega are estimates based on options-pricing models (rho measures changes in interest rates and gamma tracks changes in delta, but these are subjects for more advanced books on options, like Sheldon Natenberg's *Option Volatility and Pricing* or ClydeBank Media's *Options Trading QuickStart Guide*). Delta is straightforward. It estimates the change in the value of an option for every point move in the underlying asset. So, if an Apple June 150 call has a delta of .75, it will increase in value by 75 cents for every one-dollar move in shares. Puts have negative deltas; the value of a put option will *decrease* when the underlying asset's value increases.

Volatility is essential when determining the value of an options contract. To keep it simple, let's say volatility equals speed. A fast stock (one that is seeing large percentage moves from one day to the next) has a greater chance of moving during the life of an options contract than a slow stock does. Since each contract has a fixed strike price, the fast stock should be worth more than the slow one. For example, if both a fast and a slow stock are trading at $80 and the strike price is $100, there is a greater probability that the fast stock will move beyond that level through the expiration date. Therefore, the call option on the fast stock should be worth more.

Options contracts, even the ones on the same ticker, can have very different prices due to volatility. Within an option pricing model, the measure is called implied volatility (IV) and is constantly in a state of flux. The CBOE Volatility Index (VIX), which was mentioned earlier, is an index tracking the

short-term implied volatility of S&P 500 Index options.

Vega is the Greek that measures how IV affects an option's price. It is always a positive number, meaning that the value of an option will increase as implied volatility moves higher and will decrease as implied volatility moves lower.

Finally, all traders should understand that options are "wasting" assets and the rate of decay increases as expiration approaches. That's because a contract with 12 months remaining until expiration should be worth a lot more than an equivalent option with only 10 days remaining. Theta measures the amount an option can be expected to lose on each given day. Theta is always expressed as a negative number.

So, options prices can be tricky. Sometimes a stock can move modestly higher, but the price of a call option declines in value. That might be a sign that vega and theta are offsetting delta. Keeping an eye on the Greeks can help day traders understand why a contract is trading for $X on Tuesday, but $Y on Friday, even if the price of the underlying stock did not change much.

It is also very important to understand that options can lose value quickly due to theta, especially during the second half of trading on expiration Friday. That is, theta really picks up heading into the option's expiration. Therefore, everything else being the same, a weekly contract that expires in two days will have a faster rate of time decay than a contract with two months of life remaining.

Also note that there are no extended trading hours for options (except some index contracts) and no trading on the weekends. This means day traders will typically close positions no later than 4:00 p.m. ET. The opening for options is 9:30 a.m. ET.

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Options are either out-of-the-money (OTM), at-the-money (ATM), or in-the-money (ITM). An ATM option has a strike price equal to the stock price, and the delta will be near .50. An OTM call has a strike price above the stock price, and an OTM put has a strike price below the stock price. The opposite is true for ITM options, and the delta of a call option will increase as the contract goes from OTM to ITM. So-called deep-in-the-money options, where a call strike is well below the stock price (or above the stock price for puts), will have a delta approaching 1.0 (-1.0 for puts).

The best way to see where an option strike price sits relative to the share price is with an option chain. Most brokerage firms and a number of financial websites provide chains, which are tables with rows of calls and puts ranked by strike price. As the strike prices increase, the premiums for the call options decrease and the prices of the puts increase.

Figure 8 shows an option chain with call options with strike prices ranging from $120 to $170. The first four rows are shaded because these contracts are in-the-money. The chain also shows the change, bid–asks, and volume statistics. Some chains can be customized to include other data such as delta, vega, and theta.

GRAPHIC fig. 8

a Strike Price	b Price of Options Contract	c Change	d Bid	e Ask	f Volume
120	34.12	+0.30	33.80	33.95	29
130	24.27	+0.42	23.80	24.00	79
140	14.25	0.00	13.85	19.00	110
150	4.39	+0.12	4.35	4.45	238
160	0.21	+0.01	0.21	0.22	2059
170	0.01	-0.01	0.01	0.03	12

g

a The buyer of the call option buys the **right to purchase** the stock at a given "strike price."

b **Option chains** list the last price paid (per share) for the option at the given strike price. The price of a call option always **increases in inverse proportion** to the strike price.

c The **Change column** shows the recent increase or decrease in the price of the options.

d The **Bid column** shows available offers (bids) to buy options.

e The **Ask column** shows available offers to sell options.

f The **Volume column** shows the quantity of options recently traded at the given strike price.

g These four call options are "in-the-money" because their strike prices are **lower** than the stock price (153.80). Option chains will usually highlight the options contracts that are "in-the-money."

Day traders want to focus on contracts with narrow bid–ask spreads, which are typically contracts that see high volume as well. Since a 10-cent spread (difference between bid and ask) represents $10 in the world of options trading, trading contracts frequently can result in a lot of slippage. Option chains are a handy way to view bid–ask spreads and see which contracts are

eliciting a lot of interest among other traders.

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Approval for trading options varies among brokerage firms, but most follow a system of levels. New traders are limited to certain low-risk option plays, and experienced traders with sufficient account sizes can pursue the most advanced and riskiest strategies. The levels, which are assigned by the brokerage firm after they review the account application, correspond to the amount of risk associated with each strategy. Level 1 strategies are the least risky.

LEVEL 1

- Covered calls: Selling calls against long stock
- Protective puts: Buying puts to hedge long stock

LEVEL 2

- Long puts and long calls: Simply buying puts and calls
- Cash-secured puts: Selling puts with enough cash in the account to buy the underlying stock if the puts are assigned

LEVEL 3

- More advanced strategies like butterflies, condors, and calendar spreads, which are not covered in this book (see the *Options Trading QuickStart Guide*)
- Straddles and strangles: Simultaneously buying puts and calls (can be level 2 approval)

LEVEL 4

- Naked option writing: Short straddles, short strangles, short puts, short calls
- Short index contracts

Day trading, which mostly involves buying puts and calls, typically requires

Level 2 approval. That's usually not a problem for traders with experience in buying stocks, ETFs, or futures. More experience and more capital translate into higher approval levels.

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As with individual stocks, options accounts are subject to Pattern Day Trader (PDT) rules, and therefore it is not possible to place many consecutive day trades in small accounts. That is obviously a major negative. In addition, unlike with futures, the price of the option does not move one-for-one with the price of the underlying asset. That is, the delta of an option is often less than 1.0.

On the plus side, some options see a lot of action, and, with the recent popularity of weekly contracts, there is a lot of liquidity in the more popular names, especially when nearing expiration. In addition, the costs of trading options have come down significantly in recent years, and some brokerage firms offer advanced trading platforms that cater specifically to options traders. We will discuss examples of option day trades in later chapters.

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Though options are not perfect, puts and calls are often preferred to stocks and ETFs in accounts that are well-capitalized and not subject to PDT rules. The main reason: leverage. Let's consider an example.

Let's say a popular stock like Facebook trades for $100 per share and the purchase of 100 shares represents a $10,000 investment, or $5,000 in a margin account. Looking at the various options available, we find a weekly 105 call on Facebook that expires in five days, and it trades for $1.50. Since the multiplier is 100, one contract costs just $150, and that amount is at risk if the stock fails to rally beyond $105 and the contract expires worthless at the expiration.

What if the stock moves to $106.50? At that point, the contract is worth $1.50 at expiration because the call will be exercised and shares will be bought for $105.00, then sold in the market at $106.50. The trade breaks even because the cost is $1.50 and the profit is $1.50 per contract.

On a move to $110, the trader is making money. In fact, the contract is $5.00 in-the-money at expiration, and, subtracting the $1.50 paid to enter the contract, the profit is $3.50. Therefore, the risk was $1.50 and the profit $3.50. On a percentage basis, the stock gained just 10%, but the call option increased 133%. That's the leverage.

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When you hear the term *foreign exchange* you might imagine landing in an airport overseas and stepping up to a kiosk to exchange your US dollars for something else, like a peso or euro. That is one way to exchange currencies.

But the foreign exchange market, which is also called ***forex*** or FX, is much more than that. It is a massive network of global institutions in financial centers like London, Tokyo, New York, and Hong Kong. The foreign exchange market never sleeps because it spans so many time zones.

In contrast to traders of futures and options, forex day traders are trading the "spot market"; their focus is on the current (not future) valuations of the assets being traded. Although there is a vibrant market for foreign exchange futures contracts and options, the real action is in "pairs trading," such as the euro versus the dollar or the dollar versus the yen. There is no exercise, settlement, delivery, or anything like that. Trading FX is the buying or selling of one currency against another.

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Each currency pair represents the numeric relationship between the two

currencies. For example, the euro was launched in 1999 and in the year that followed approached .99 against the dollar. When the EUR/USD pair was .99, it suggested that one euro could buy almost one US dollar. The euro strengthened through 2008-2009 and rose to more than 1.40, which meant it could buy more dollars (1.4) with the same number (1.0) of euros. It then turned lower and fell back toward 1.00 until 2016, before rebounding back to 1.15, which means that one euro can buy 1.15 US dollars.

Currencies will see a lot of up and down price action based on international, political, and economic news. Interest rates play an important role, as countries with higher rates typically attract greater investment flows and appreciating currencies. Countries with unstable outlooks often see their currencies come under fire. On the other hand, countries with booming economic conditions and attractive investment opportunities can easily see their currencies do quite well.

In addition to EUR/USD, other popular pairs for day traders include the US dollar versus the Japanese yen, the British pound versus the US dollar, and the euro versus the yen.

GRAPHIC fig. 9

POPULAR CURRENCY PAIRS AMONG DAY TRADERS	
Symbol	**Pair**
EUR/USD	Euro/US Dollar
USD/JPY	US Dollar/Japanese Yen
GBP/USD	British Pound/US Dollar
GBP/JPY	British Pound/Japanese Yen
EUR/JPY	Euro/Japanese Yen
USD/CHF	US Dollar/Swiss Franc

Each pair has a numerator and a denominator—it is a fraction—and one currency appears first, followed by a diagonal line, then the other currency. Some brokers actually quote the pairs without the diagonal line, like EURUSD or AUDGBP. Both are correct and commonly used. The pair expresses the amount of the numerator currency per each single unit of the denominator currency.

In a EUR/USD pair, for example, the US dollar is the second, or denominator, currency, but in USD/JPY the US dollar is the numerator currency. Therefore, if reports suggest that the dollar is seeing strength across all major currencies, EUR/USD will decrease in value and USD/JPY will move up.

MY TAKE

Not all currency pairs are created equal with regard to day trading. While some are more popular than others and receive more media coverage, there are also "under the radar" currency pairs, which are excellent for day trading. One of my favorites is the British pound versus the Australian dollar, GBP/AUD.

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In forex day trading, currencies are bought and sold in position sizes called *units* or *lots*. A standard unit or lot size is 100,000 and, in dollar-based trading accounts, equals $100,000. Forex brokers also make available smaller sizes. These smaller units—appropriately called micros and minis—represent 1,000 units and 10,000 units, respectively, of currency (or $1,000 and $10,000 when the forex account is funded with US dollars).

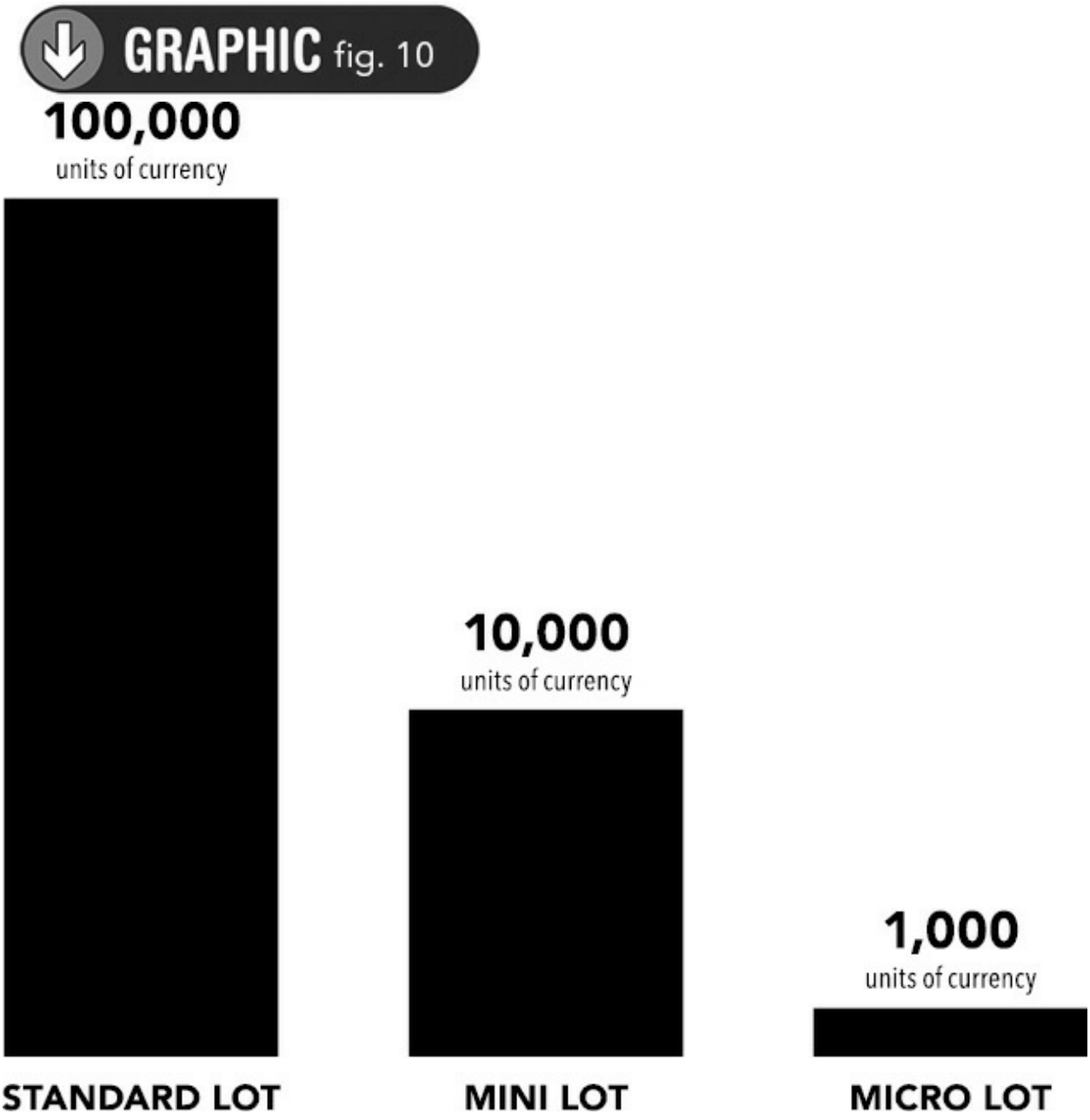
- **Standard:** 100,000 units
- **Mini:** 10,000 units
- **Micro:** 1,000 units

Many forex brokers allow traders to buy currency with margins like 10:1 or 50:1. Some foreign brokers will allow for even greater levels of margin. For example, in a 50:1 forex margin account, for every $1 in your account, you can trade $50 worth of currency. With $2,000, you can trade a standard unit of $100,000 of any currency pair.

The amount of margin varies by broker, but for this example, let's say the margin is 100:1. Therefore, to trade one standard unit of EUR/USD ($100,000 worth of euros), you only need to deposit $1,000 and the rest is borrowed from the broker.

If EUR/USD moves up, the position increases in value, but it if moves lower, the difference is deducted from the $1,000. The trader must maintain the account value above the $1,000 deposit amount or the broker will close the

position.



My trading approach does not focus on leverage, but on the relative size of each trade and how much can be won or lost on each trade based on my tradeplan. There is no reason to trade 100,000 standard units with a ton of leverage when there are smaller micro and mini units available. In other

words, with the ability to trade micro lots, traders with small trade accounts can still day trade forex while keeping their position sizes at reasonable levels relative to their overall account.

Foreign currency price changes are measured in ***pips***. For most currencies, a pip is the fourth decimal place. For example, if EUR/USD moves from 1.1200 to 1.1205, it has moved five pips.

In recent years, some currency pairs have started trading in one-tenth-of-a-pip increments.

If you hold a standard lot ($100,000) of EUR/USD and the pair moves two pips, from 1.1203 to 1.1205, the profit is $20 (.0002 x 100,000). On a $10,000 mini lot, the gain is $2. And on a $1,000 micro lot it equals $.20, twenty cents.

The extent to which each pip affects the value of a forex position varies depending on the lot size used when trading. A move of 50 pips on a small trade will be felt far less than a 50-pip move on a large trade. Specifically, each pip changes the value of a position in the following way:

- $10 for $100,000 standard lot
- $1 for $10,000 mini lot
- 10 cents for $1,000 micro lot

The pip values (as described in the preceding list) are common when the US dollar is listed second (as the denominator currency). When USD is listed first (as the numerator currency) then each pip is computed using the

following simple method: divide our standard pip values ($10, $1, or $.10) by the current USD/[OTHER CURRENCY] exchange rate.

The USD/CAD is trading at a rate of 1.25; therefore, one pip on a standard $100,000 lot is $8 rather than $10 ($10/1.25=$8).

If you are having trouble getting your head around some of these concepts, do not worry. It takes a while to warm up to the terminologies and dynamics in play, but you will learn the ropes faster than you think. The best way to understand how pips and FX margin trading work, without risking real money, is to use a simulated trading platform. Many brokerage firms and other websites offer free or fee-based platforms that let you practice trading with real or delayed data. For now, have fun, learn the ropes, and try not to worry too much about making mistakes.

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There are no stringent requirements for trading forex. The market is open to small and large traders alike. The first step is to find a good forex broker, one that provides a free trading and charting platform, like MetaTrader 4 (MT4).

My personal preference for forex trading is to use TradeStation's charting but to place my trades with another forex broker. TradeStation is not a forex broker despite having great forex charts. Go figure. Another great

choice is NinjaTrader; they have excellent charts and they integrate with a variety of forex brokers. You can literally trade directly from your NinjaTrader charts.

Please be sure you open an account with a reputable broker, as the forex market is not regulated as stringently as other markets, and there are some unscrupulous firms out there.

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Forex is the largest market and is open for business all day, every day. The top pairs, like GDP/USD and EUR/USD, are among the most liquid in the world. These large liquidity pools are great for day traders.

In addition, with the ability to trade micro lots, traders with small accounts can still day trade forex while keeping their position size at a safe level. In fact, forex gives you the greatest flexibility in adjusting position size correctly. For example, if you want to risk 2% of your account on a trade, you can use any combination of micro, mini, and full-size lots to get your position size just right. Compare that to a futures contract where you cannot trade less than one contract (you cannot trade 1/100 of a contract, for example).

Finally, there are no expiration dates, risks of delivery, PDT rules, or interest charges on margin accounts in forex trading. For those reasons, forex is often a great choice for day traders.

Ultimately, regardless of what markets or symbols you are trading, success depends on keeping more of your money than you give back to the market. Simple, right?

Yet I see so many traders hung up on what instruments they are trading. Some traders are actually committed to a particular market or symbol. Being married to a product is silly. From my point of view, all stocks or contracts

are just bars on a chart: buyers, sellers, and price action going up, down, and sideways.

I often teach my students to cover up or ignore the symbol—just listen to what the price action is telling you. In the end, it is all about your proven tradeplan and the positive trade results that it will produce over time.

Just grasp the general concepts so that you learn to remain neutral and not become emotionally involved with a particular market. Yes, price action can differ among asset classes, but all are driven by supply and demand, and, if there is sufficient liquidity, almost any market can be suitable for day trading.

In the end, there are certain markets that you should not trade (because liquidity is poor) and other markets that would be advisable for you. Everyone is different, and the only way to figure out what is best is to focus on your personal situation and your tradeplan.

Lwp t atrp

- The stock market is just one place people day trade.
- Other markets include futures, currencies, and options.
- Futures and forex markets have pros and cons but are typically the best for day traders.
- Forex provides a unique degree of position sizing flexibility through micro, mini, and full-size lots.

PART II

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| 6 |

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Lwp t X t xt

- Markets and cycles
- Supply and demand
- Daily patterns
- Beyond theories
- Best times to trade

Part I of this book emphasized the importance of understanding how our psychology can affect our day trading. By now you understand that some of our basic instincts, like our inherent need to avoid pain and extinction, can negatively impact our decision-making when day trading.

For example, because we want to survive and avoid extinction, we might ditch a solid tradeplan too soon. We might sabotage a good approach by throwing in the towel when the plan takes one step back, just before it takes two steps forward. Unfortunately, that is far too common and what most losing traders end up doing. However, each trader must understand that there are losers within winning tradeplans and not let the natural fight-or-flight instincts govern buy or sell decisions.

This chapter is also about psychology, in a way, but of a different sort. It deals with the mass psychology of crowds that drive financial markets

through cycles. We will provide an overview of basic technical analysis tools that help make sense of the daily tug-of-wars between buyers and sellers. After this chapter, the focus turns to charting and some of the more advanced indicators that can be added to charts. Part II, which concludes with a series of real day trading examples (chapter 10), is all about uncovering the tools that can be used later when creating trading plans and systems.

V p zt L r‘t

Understanding the broader cycles that drive financial markets can help you make better sense of market moves from one day to the next. Recall that technical analysis is the study of charts, patterns, and indicators. The goal is to understand how price patterns have behaved in the past in order to anticipate what might happen in the future.

Richard Wyckoff was one of the pioneers in the field and developed the idea of market cycles. In the 1930s he founded a school for traders called the Stock Market Institute. Many of his insights are still relevant today.

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A market cycle has specific characteristics, according to ***Wyckoff Market Cycle*** rules. Although no markets behave the same way twice, cycles evolve through a series of similar price patterns or phases that can be understood through the study of supply and demand, which are in turn measured by price action, volume, and time.

NOTE

The method by which volume is measured varies by financial instrument. For stocks and ETFs, volume is measured in shares traded (over specific

time frames like minutes, days, weeks, or months). Futures and options volumes are measured by the number of contracts traded over specific time frames. Volume in the forex market is typically measured in terms of lots, but there are no centralized or standardized sources of such data, and therefore no volume statistics are available for forex markets.

A market cycle typically begins with a period of ***accumulation***. During this initial phase (left-hand side of figure 11), prices have stopped falling, marking the end of a downtrend. Prior to that, supply had been weighing on prices, but then the decline ends—sometimes in dramatic fashion on heavy volume and sometimes simply with a period of sideways trading after a big decline—and this is the accumulation phase before the second phase begins.

In the second phase, institutions, professionals, and other smart-money types are driving demand, scooping up positions at discounted prices. The buying interest—demand—begins to absorb supply. Thus begins the ***markup*** phase, where prices move higher on increasing volume.

In the third phase, ***distribution***, bulls and bears battle for dominance, with some profit taking (or selling of positions to book gains), resulting in increased supply—but demand also remains strong after the sustained move higher. The result is often a period of sideways action. This phase is called distribution because some of the players from the accumulation and markup phases begin selling, or distributing, their positions in order to take profits. The distribution phase often reflects mass uncertainty about the market's next direction. Of the four phases, it is the hardest to identify.

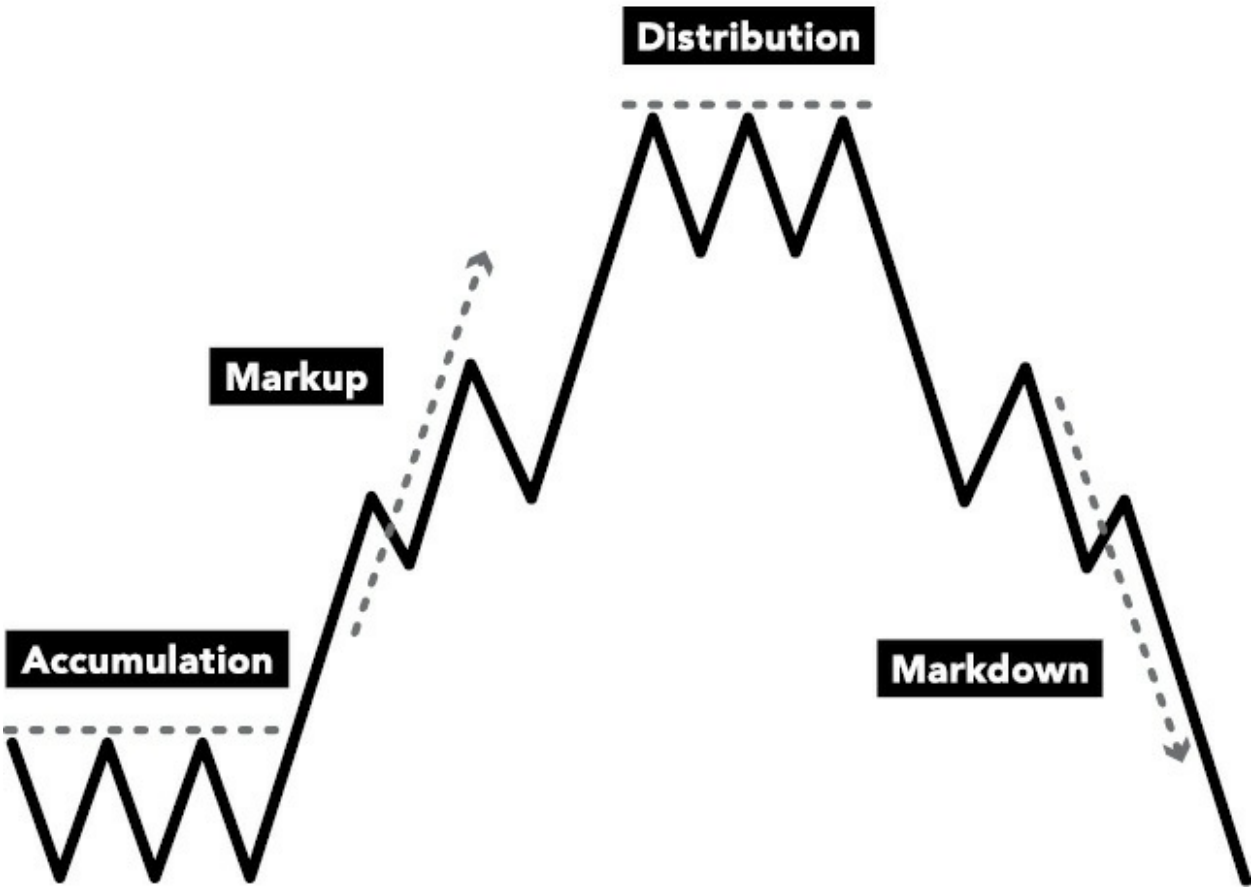
In the fourth phase, *markdown*, bulls are becoming more cautious because the uptrend no longer seems to have legs, and demand begins to wane. A final leg to new highs on high volume sometimes occurs, as seen in the spike in figure 11, before sellers take control and the market enters the bearish markdown

period. Profit taking and additional selling continue, along with increased supply from the weaker long position holders. A period of falling prices is underway.

Then the entire cycle repeats.

GRAPHIC fig. 11

WYCKOFF MARKET CYCLE



MY TAKE

Day traders are focused on the happenings of one day or even a few hours. Therefore, market cycles are not of utmost importance but are worth understanding, because they reflect some of the mass psychology that moves prices through bull and bear phases.

c t”s

The markup and markdown phases of Wyckoff's market cycle theory are examples of uptrends and downtrends. In fact, markets typically trade in trends that can be represented by lines on charts. Markets that are trending higher are bullish and better for taking long positions. Bearish downtrends are moves lower that are better for shorting.

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A market that is in a bullish uptrend is typically characterized by a series of higher highs and higher lows. Think of it as a flight of stairs or an escalator, with each step moving to higher ground.

Bearish markets are easy to spot as well. The market moves downward, setting a series of lower lows and lower highs. With each rebound attempt, the advance fails to move beyond previous highs.

The candlestick chart in figure 12 representing the gold market (SPDR Gold ETF, “GLD”) shows examples of both bullish trends with higher highs and higher lows and a bearish trend with lower highs and lower lows. There is a clear downtrend from April through September, followed by an uptrend from October through March.

Candlestick charts, such as those featured in figure 12, will be explained in more detail in chapter 7.

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I like to think of it as two types of moves: action moves and reaction moves. When you consider the stair-stepping pattern of an uptrend or downtrend, the first major move of the trend is an ***action move***. “Major” is the key word.

If it is an uptrend move, the bulls are in charge. When they finally pause to catch their breath, the bears take over and send the market lower. The move lower is counter to the uptrend and is what I call a ***reaction move***. A typical

reaction move might be approximately one- to two-thirds of the action move, in the opposite direction or sideways in some cases. Some traders call the reaction move a *pullback* if it's part a larger trend. Of course, nothing is exact with price action; some reactions can be very weak and others can be deeper. In fact, a move that seems like it could be a reaction may end up being a new action move in the opposite direction.

It is always best to trade the action moves and the main trend. Trading the reaction move is a recipe for losing money. Typically, the ***subsequent action*** move that follows the reaction move is predictable and tends, to some extent, to mirror the first action move. Again, nothing is ever perfect, but the subsequent action move is the most predictable and tradeable.

Moreover, action and reaction price movement can happen in any time frame, and sometimes you can see smaller action–reaction price behavior inside of a larger move higher. It is possible that what appears to be an action move in one direction is merely part of a bigger reaction move on a longer time frame.

For example, an action move up on a five-minute chart might be the final leg of a larger reaction move on a 60-minute chart. When you can get the smaller action move to line up with the larger time frame action move, you really begin to stack the odds in your favor.

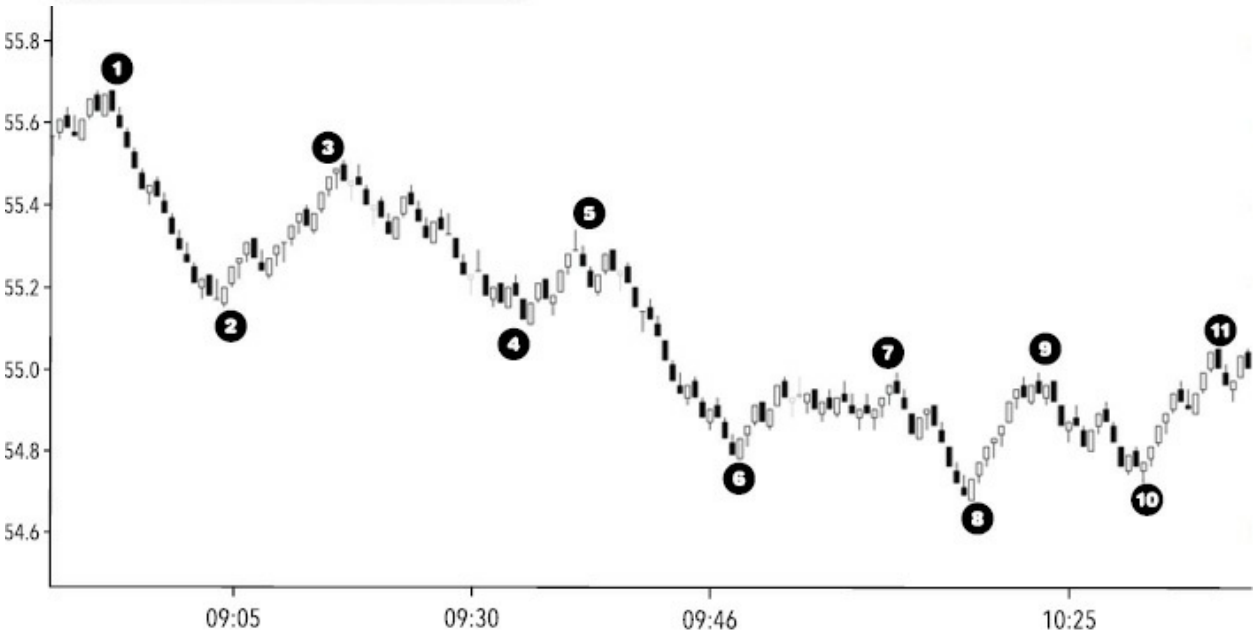
I first learned of this multi-time-frame action-reaction concept in a trading book I read many years ago by Charles Lindsay, called *Trident: A Trading Strategy*, which shows how to take advantage of this repetitive and predictable price pattern. I have since developed my own ways to take

advantage of action moves that occur every day in the markets.

When you look at ripples of water in a pond, you often see smaller ones inside of larger ones. Price action behaves the same way. Action, reaction, and subsequent action are like waves in the water, with smaller ones existing inside of larger ones. Much depends on our point of view and the time frame of the chart.

The example in figure 13 shows actual price action on a chart of crude oil futures over a one-and-a-half-hour period. Notice the action moves and the reaction moves. You will see that when the trend has energy to the downside, each action move tends to mirror the prior action move. Points 1 to 2 show the first action move, followed by a reaction from 2 to 3. Notice how the next action move from 3 to 4 is similar in length to the first action move. Then comes the 4 to 5 reaction move, followed by the 5 to 6 action move.

GRAPHIC fig. 13



1 → 2 is an **action move**.

2 → 3 is a **reaction**.

3 → 4 is a **subsequent action** and later becomes a new first action.

4 → 5 is a **new reaction**.

5 → 6 is a new **subsequent tradeable action move**.

6 → 7 is a **new reaction**.

7 → 8 is a **new subsequent action** but is weaker and sets up a possible new action in the opposite direction.

8 → 9 is **not a reaction move** because it is too long. The move extends beyond the two-thirds retracement that defines a reaction move. In other words, when considering the prior action move (from 7 to 8) were the downtrend likely to continue, then the reaction move would need to be one-third to two-thirds the length of the prior action move. The actual price action from 8 to 9 looks more like a 100% retracement. It may in fact be an action move in the opposite direction, which would be confirmed by an appropriate new reaction move (9 to 10) or it may not be.

9 → 10 **is unclear**; by eye it appears to go beyond the two-thirds reaction limit. It could be a bottoming of the trend or a consolidation, especially since it failed to make a new low. It made a higher low, when compared to the lowest swing level at 8. The market seems poised at 10 to start moving higher, and it does with the next action move upward (10 to11).

10 → 11 seems to be **a new action move up**. Will it continue up or come back down to test the lows again? No one really knows what will happen next, but if I were looking to trade this pattern I would first look for a new reaction move. If it occurred, then I would consider trading the anticipated subsequent action move. I know that there is a good chance the subsequent action move would be similar to the prior action move, which provides a tradeable opportunity.

Figure 14 is the exact same chart as figure 13, but instead of numbers, lowercase letters show key chart levels. Notice the smaller ripples inside the circled larger movements: action (a to b), reaction (b to c), subsequent action (c to d). The letters mark the ripples within the waves—the smaller action/reaction moves that exist inside the larger ones (shown on figure 13 as 3 to 4, 7 to 8, and 9 to 10).

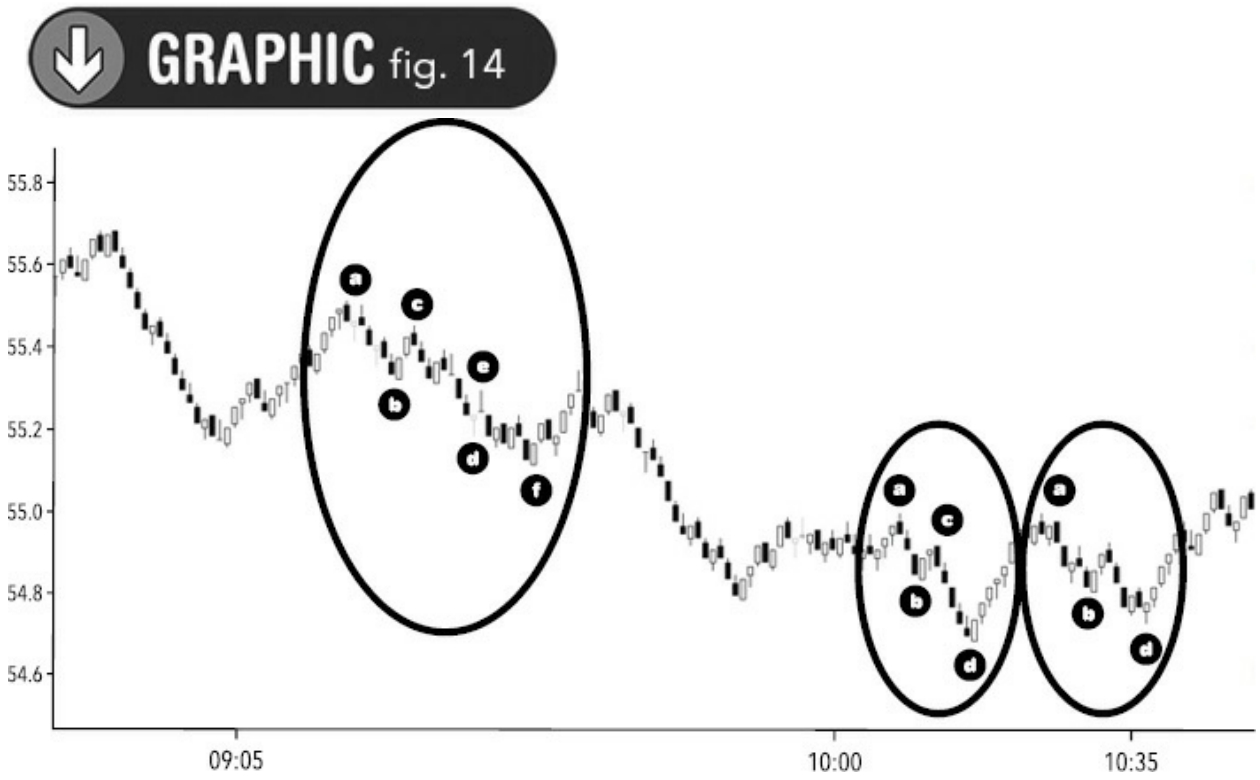


Figure 15 shows a "slower" chart than the ones shown in figures 13 and 14. It is considered slower because each bar represents a longer period of time. Notice the same price action waves as in figures 13 and 14, but from an entirely different perspective. You can clearly see the larger action/reaction moves, such as the dramatic movement from 1 to 2, followed by the movement from 2 to 3. But it becomes more difficult to see the smaller "ripple" moves, which are quite visible in the faster charts (figures 13 and 14), because they have been smoothed out by the slower time frame.

In figure 15 notice how the 10 to 11 move higher never was followed with a legitimate reaction move and, in fact, the price ended up moving lower to test the prior lows established at point 8. Some price moves are just too

unclear to be referred to as action or reaction moves. This happens during consolidations, when the market is balanced and the buyers and sellers are exerting similar levels of pressure—these indecisive periods of price action essentially represent the market's effort at determining whether it wants to resume the trend or reverse direction.

Looking at this chart (figure 15) you may wonder if we are heading for new lows or whether we are just going through a long consolidation. As with many things in trading, the truth is not entirely clear. We make our decisions on the right edge of the chart based on what the price action is telling us. If the long setup doesn't come as we predict, then we stay on the sidelines. If the fickle beast of the market changes its mind and breaks lower, then we would adapt by looking for a new short trade opportunity, perhaps one predicated on a new action/reaction sequence to the downside.

This chart contains the same price action as figures 13 and 14, but the time frame is extended, so we can see what ends up actually happening next.

Prices trend and prices consolidate. Consolidations are typically reaction moves on a slower time frame and represent a period on the chart where the market is balanced between buyers and sellers. There is equal power as the tug-of-war rages between bulls and bears; the market cannot find a direction higher or lower.

These ***consolidation*** periods are synonymous with sideways price action, choppiness, or directionless price action. In other words, consolidation is a pause of some sort and can happen on any time frame. However, the best trading opportunities are when a market is out of balance, due to one side or the other taking control, pushing the market up or down. For example, in an uptrend, the market is out of balance because the bulls have all the power.

When a trader learns to identify patterns, recognize the action moves on the chart, and begin trading the larger-time-frame action moves, then they are

stacking greater odds in their favor and the trade has a better chance of succeeding.

c psx”v ap”vt

Whether the market is in an uptrend, downtrend, or moving sideways, it often moves in a range or channel that can be viewed on a chart as a set of parallel lines (like in figure 12). A range can be bullish, as in an uptrend with higher lows and higher highs, or a downtrend, with a series of lower lows and lower highs. A sideways or trendless market can also have highs and lows that define its trading range.

b ı Oat x p”rtOp”s Tt Ut t“

Prices sometimes fall sharply and, at a certain level, attract a lot of demand and buying interest. The sudden burst of buying sends prices higher and tends to happen at a round number, like 3,000 on the S&P 500, $50 per barrel for crude oil, or $100 per share for Facebook.

When I trade in one of my favorite markets, crude oil futures, the .25 levels (like $51.25, $52.75, or $55.50) can also put up a fight, meaning that price action can stall or reverse when these levels are approached. I call these quarter-century levels.

Prices that end with .00 or .50 (also quarter-century levels) are apt to form support or resistance points (which we cover in a lot more detail in chapter 7). Even prices that end with .05 and .10 can be suspect, though to a smaller extent. Nevertheless, in my trading I find myself adjusting my entry levels and stops so they do not fall squarely on—or even one tick in front of—these numbers. This is how I lean on support and resistance areas to plan key elements of my trade:

- **Entry**: The entry price where I want the initial trade executed. For example, if my plan says to sell crude oil at $55.23, then I would place an order to go short at $55.23.
- **Setup Bar**: A (candlestick) bar on the chart that serves as a critical reference point with the potential to determine where a position is opened, where the stop is placed, and where other important elements of a trade are defined.
- **Profit target ("target")**: A target is a trade's goal and is where I exit some or all of the position to take profits.
- **Stop (stop-loss)**: A stop is the price where I exit the trade if it makes a turn in the wrong direction. A stop's price represents the place on the chart where I have to admit the trade failed.
- **Key level**: The key level is the technical level (such as support or resistance or key price points like the quarter-century numbers, multiples of fives or tens, etc.) that represent significant price points on the chart that I would want to adjust around.
- **Key level adjustment**: An adjustment to the entry, the stop, or both after the price reaches a key level is called a key level adjustment.

For example, rather than set an ***entry*** at $56.34 or $56.35, I will set an entry at $56.36, because I want confirmation that crude has enough energy to push through $56.35. We refer to some support and resistance points as ***key levels*** and we make ***key level adjustments*** to ***stops*** and entries around those price points. Some traders also adjust their ***profit targets*** around (in front of) key support or resistance levels as well, making the targets a little easier to reach. Rather than force the price to push through a key level, which it might not be able to do, some traders will place their target objective in front of the key level by a tick or two.

Day trading is like fishing; we throw our hook in the water at a strategic spot

and hope to catch something going our way. At the rightmost edge of a chart, we identify the tradeable pattern where the odds favor a healthy catch. We are fishing blind, meaning we do not know for sure that we will catch a big beautiful trout—maybe we will pull up an ugly suckerfish from the bottom. There is no way to know what lurks beyond the rightmost edge of the chart.

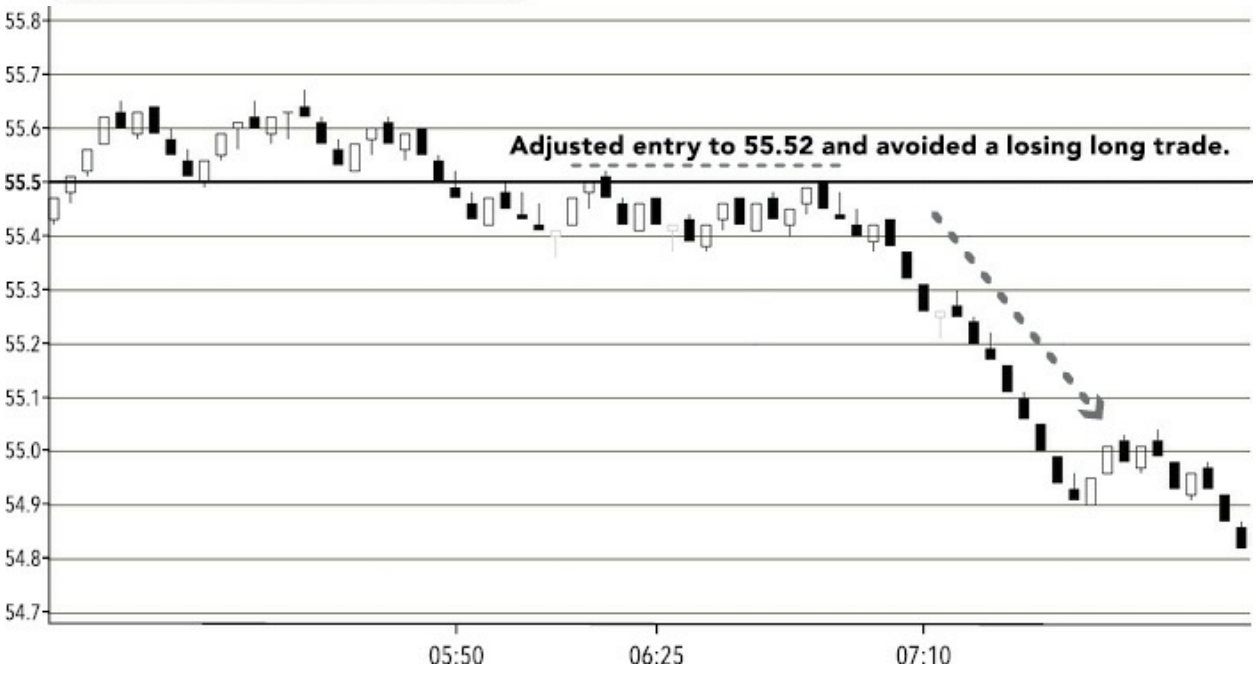
Look at the chart in figure 16. My trading system issued a signal to go long at $55.50, right at the bar indicated by the arrow. I have learned through years of experience that a number like .50, a big round number, can often serve as a psychological barrier. I want to enter the trade only after this barrier is overcome. Therefore, I adjust my entry up to $55.52, asking the price action to give me a little more confirmation that it has the necessary buyer strength to push through the .50 level.

The price hit $55.50 but did not break through that level. Thus, the trade's

$55.52 entry was never reached, and I did not enter the trade. When the market turned lower, I remained safely on the sidelines and avoided a losing trade. Look what happened next (figure 17). Crude oil tanked to less than $55.

Resistance is the opposite of support. When prices rise to a certain level, sellers come out of the woodwork and flood the market with supply. Again, resistance often occurs near round numbers and prices where a lot of people were anticipating exiting positions, or along key technical areas like swing levels, pivot points, trendlines, channels, and moving averages (which will be discussed in chapter 8).

GRAPHIC fig. 17



MY TAKE

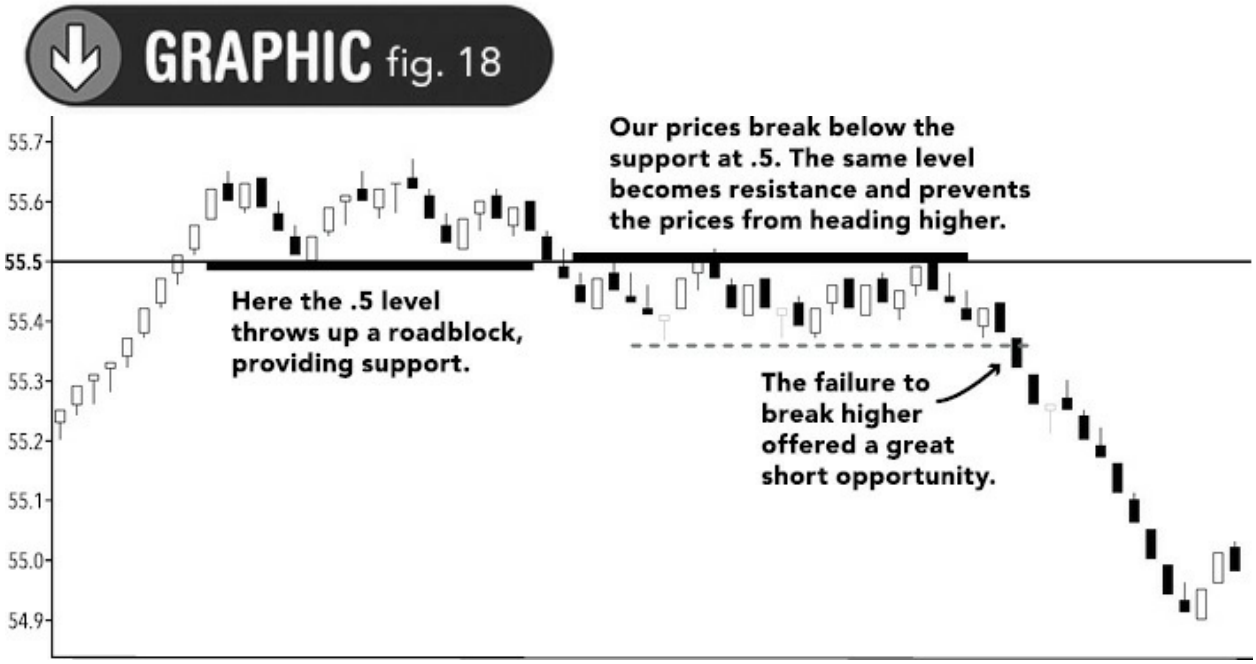
Being nimble as a trader can help you make profits when most others do not. Remember, it is all about being the passive dance partner and surrendering to what we cannot control, and we cannot control price action. We want to let the market speak to us and tell us what it wants to do next. The trader needs to be flexible, open-minded, and not "married" to any one idea. For example, stubborn buyers will hang on to positions until they have taken on more pain than they can handle, then bail out of the trade and sell their long positions, thus experiencing "capitulation." That is why sudden moves to the upside, which quickly lose steam, are often followed by a strong move lower. In other words, fake breakouts through support or resistance (breakouts that fail to follow through) will often lead to strong moves in the opposite direction. It is possible that a person can learn to specialize in just this one repetitive market dynamic, learn to trade a frequent occurrence, and ultimately achieve financial goals with this one type of trade alone.

Kizt"b ı Ktrı–t at x p"rt

Markets are interesting because sometimes price levels attract sellers, but later draw in buyers (or vice versa). For instance, a stock might try to break above $100 per share many times and fail, because that is a price where many holders are eager to sell shares. It is said to have resistance at $100. Finally, demand pressure builds and the price explodes beyond that key $100 level. Several weeks go by and the stock has trended lower. As it approaches $100 again, this time from above, buyers begin showing interest, and the stock rebounds. A previous resistance level has turned into a support area. The opposite can happen as well, where a support area from the past becomes a source of resistance.

Figure 18 is the same chart used in previous examples showing how the bad long trade was avoided by adjusting the entry a couple of ticks above the key level of $50. Here we can see that prior to that setup, the $55.50 level offered some short-term support. When the sellers finally mustered enough strength to push the price below the $50 level, the price came back up and "tested"

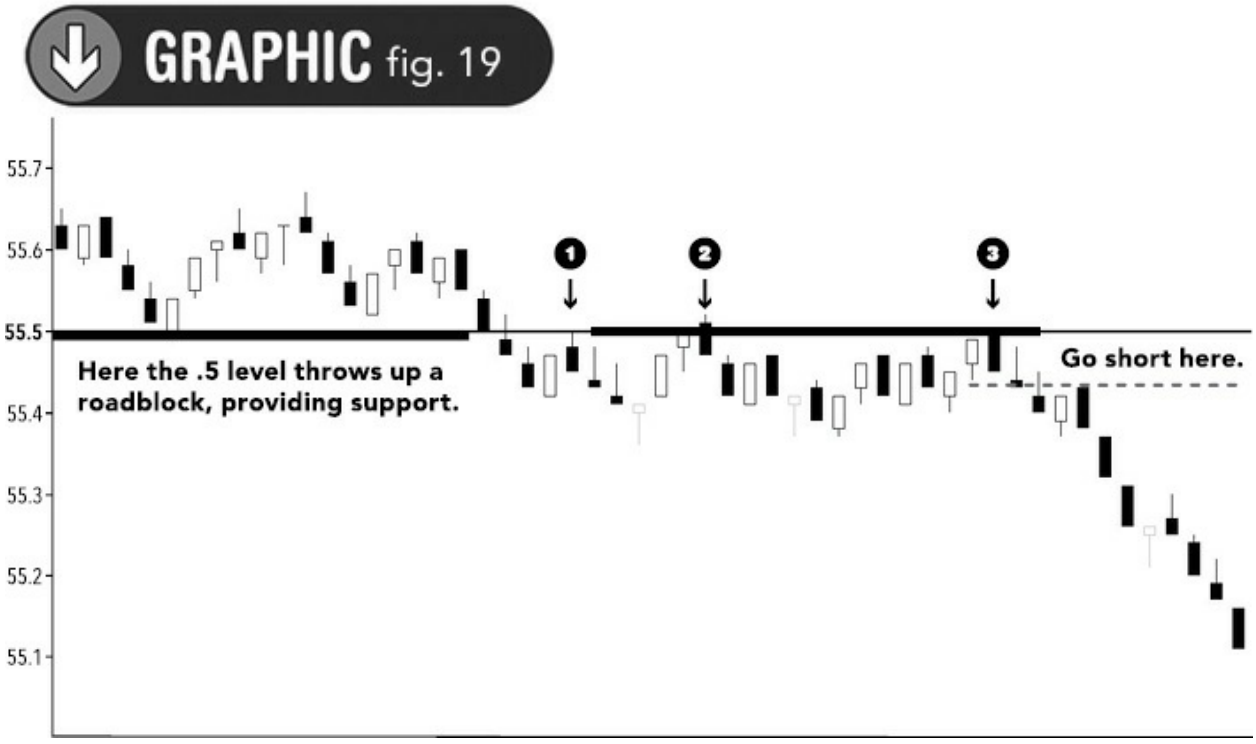
that level again. The broken support at the .50 then became resistance at the same price level. Try as they might, the buyers could not bring to task enough buying power to push through the new resistance level. Instead, they capitulated and the market broke lower with a strong and profitable move.



One could have traded this move short in a couple of different ways. Above, you see the solid line showing the bottom of the consolidation as the price kept trying to get above the key $55.50 level. An order to go short could have been placed a couple of ticks below the line marking $55.50 (see the down arrows in figure 19), with a stop being put a few ticks above $55.50.

More aggressive traders could have entered this trade with an even smaller ***risk profile***. Once the price failed to get through the $55.50 level at either point 2 or point 3 (on figure 19), an entry to short the market could have been placed at 2 to 3 ticks below the low of those same bars, once they closed lower.

A trade at point 2 would have been riskier, since this point is only the second attempt to break through the key level to the upside. But when



it tries and fails again at point 3, the odds are greatly increased that the sellers are most likely in charge. A stop could be placed a few ticks above the $55.50 level so even if the buyers gathered their strength and ended up sending the price higher, short traders would have stopped out with a minimal loss.

That's not what happened, though, and for a very small "risk profile," large rewards were won as the price broke lower with an explosive move. *The failure to break resistance higher led to a strong move in the opposite direction.*

Mpx" Yp t " p"s Kt cx-t ı c pst

To be an effective day trader, you need to have a tradeplan that gives you rules for when to start trading, guidance on what types of trade setups to look

for, goals to achieve, and a time to quit. That's it. Everything else just makes things too complicated, too time-consuming, and too confusing.

X t”x”v

Trading hours vary by market, and the best time to day trade is usually when markets are at their most active. For that reason, an ideal time is often right when the markets open.

For futures, there are different start times, but typically the E-minis see an uptick in activity when the US stock markets open at 9:30 a.m. ET. There can be other good start times for the E-minis later in the morning as well. Things tend to slow down with the stock exchange's close at 4:00 p.m., but futures continue trading overnight (with a one-hour pause between 5:00 and 6:00 p.m. ET). I generally do not recommend trading during the overnight session, as volumes tend to be too thin.

I like compartmentalizing trading sessions into smaller periods. With crude oil, for example, I have four mini sessions each day. One begins at 9:00 a.m. ET, then one at 10:00, one at 11:00, and one more at 1:00 p.m. I set goals for each mini session: typically, a winner for one of my predefined targets and a positive result, with a maximum of two losses or three trades total. Using mini sessions is ideal because it provides great flexibility. Every one-hour session can be tested in advance, so that a trader can get the all-important "proof of concept" by seeing measurably favorable results before risking their hard-earned cash.

I find that 9:00 a.m. ET is a good start time for crude oil. Some traders start earlier, but much depends on where you are located and if it is realistic for

you to start earlier. I am on the West Coast, and if I wanted to start sooner, I would need to get up way too early—it is just not realistic for me personally to pursue such an early start time on a consistent, sustainable basis.

Determine what is best for you based on your own personal situation, but realize also that the best trading times are when the markets are most active. Therefore, what is convenient for you might not be the best time to trade certain markets. You must be realistic. Perhaps the market you thought you wanted to trade is just not active enough when you want to trade it. You should probably keep looking for a market that is better for you, given your specific situation.

Some markets, like forex, are almost always open for trading, but that does not mean we want to trade them day and night. I have broken the forex market down into three windows of time that are best for day trading. This is not set in stone, but it is a good basic framework to begin with.

1. The Asian session is good for certain pairs, mainly the JPY, AUD, and NZD pairs. Activity is less reliable in this session, but with patience, discipline, and the right tradeplan you can do well. I suggest the best time window is from 3:00 or 4:00 p.m. until about 1:00 a.m. ET.
2. For the European session, I find that most of my tradeplans are successful in the window beginning at 2:00 a.m. and ending at 5:00 a.m. ET, for day trading forex and active currency futures.
3. The North American session that I recommend begins at 8:30 a.m. ET and ends at either 11:00 or noon, depending on the currency pair and the tradeplan. This is the time frame that works best with my trading schedule. Trading into the evening hours is unreliable, but if there's a major economic event, such as a Federal Open Market Committee (FOMC) announcement, or random headline news events, currencies

can really move, both the "spot" market (cash market) and currency futures. If I am in a position, I will hold it through the evening hours and let the trade play out the way it is supposed to, but I will not initiate new positions, except if there is a major event moving the markets.

One could try testing what I call the bridge session, which is the time between the European and the North American sessions, and it is sometimes possible to find decent opportunities. However, over time, I find the bridge session to be less reliable, so I stay away from it. (Equally important, as I just mentioned, I live on the West Coast, and getting up early enough to trade the bridge session day after day can't compete with staying in bed a few hours longer.) The same is true of the afternoon session, which I find to be too slow and unreliable most of the time. Therefore, the morning hours seem to be the best for trading forex as well as futures, at least during the North American session.

The best trading sessions have enough volume, price action, and, hence, opportunities. They provide the price action necessary for high-probability patterns to stack the odds in our favor. This is what we want to focus our attention on. With good price action we can build a large enough sample to adequately test a tradeplan to get the proof that our plan will win most of the time.

Without evidence that the plan will work, there is no reason to believe in what we're doing. Many traders, because of a few random losing trades, ditch a perfectly good tradeplan that could grow their equity and even achieve their financial goals. They don't understand that this is just part of the random distribution of wins and losses. Nothing wins one hundred percent of the time, and there are losing trades inside of winning tradeplans.

But if a trader doesn't make the effort to test their plan and get the all-

important measurable results that the plan is likely to produce, they will not have the necessary point of view to even recognize a good trading approach when they have one. This, in my opinion, is one of the biggest reasons most traders fail.

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Economic reports move markets. Crude oil reacts to the latest inventory data, which comes out every week, but also to many other economic reports. Stocks, bonds, and currencies often see big moves around the monthly jobs report, for example, which comes out the first Friday of each month. Forex pairs can see heavy trading when an important central bank, like the Federal Reserve or the European Central Bank (ECB), makes an interest rate announcement. But, in fact, currencies are super-sensitive and react to nearly everything, including headline news.

Some markets are super-sensitive to *most* economic data, like currencies, and in fact many markets are correlated with one another. Crude oil is priced in dollars and is therefore tied to the value of the dollar. The dollar, of course, is tied to the value of all other currencies. In short, both crude oil and currencies are extremely sensitive to changes in economic data, and surprises in the results of a news release can cause major moves in the market.

I usually stop trading in the minutes leading up to economic reports. I wait for two to five minutes after the release of the report and then begin trading again. Trying to trade through or immediately following an important report is a bad idea, because markets trade fast—you can easily lose control of your trade, and losing control of a trade is never a good thing. The reactions happen so fast that if you try to trade into the release of a major report, you might find that your entry gets filled at the price at which you had hoped to exit with a profit. Not good! Don't do it!

There are many sources that can give you a heads-up about important economic data:

- Forex Factory
- Briefing
- Econoday
- MarketWatch
- Yahoo Finance

I have used the Forex Factory (forexfactory.com) event calendar for many years. Reports are labeled by color (red, orange, and yellow). It is on a scale, with red indicating the most significant report and yellow the least important. Their labels are based on how these reports are expected to affect the forex markets, but I find they can affect the futures markets as well, since all markets tend to be correlated to some extent.

I look for red and some orange label reports. If they occur during my tradeplan times, I remain flat (wait) five minutes in front of a red or orange label event. In other words, I do not initiate any new positions just before the release of a red or orange economic report. I continue waiting until two minutes after the report is released, giving the markets time to react, and then I resume trading.

The question is often asked, *What should I do if I'm already in a live position, leading into a news release?* There is no black-and-white answer. If my tradeplan has me taking a trade 20 minutes prior to the report, for example, and I'm still in that trade when the report is about to be released, most of the time I will hold the position (most of the time) because the trade I would take has good odds of winning.

There are exceptions, though. For instance, I would never hold a crude oil position going into the weekly crude oil inventory report.

And I would never trade in front of the monthly jobs report from the US Labor Department, either. This is the granddaddy of all economic reports. The data, usually released on the first Friday of every month, is considered a leading indicator of inflation—if the job market tightens and unemployment drops, it can put pressure on wages. If there are fewer workers available for hire, then companies have to offer higher wages to attract them, and that can be inflationary. All markets react to that kind of information, with currencies and crude oil often reacting with the most extreme price swings.

Lwp t atrp

- Prices move because there is an ongoing tug-of-war between buyers and sellers.
- Trading ranges often exist in trends and consolidations.
- Trends can move up, down, or include periods of sideways action (consolidation).
- Some periods of the trading day are more favorable than others, and the morning hours are typically the best for day traders.

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- » Day traders and charts
- » Charting history
- » Pros and cons of charting
- » Charts and crystal balls

A picture is worth a thousand words. You have heard that before, right? In the day trader's world, a chart is often worth a lot more than a thousand words. It not only tells us what happened in the past but what a market might do in the future. Will it continue to trend higher or lower? Is it in a range? Maybe a major change of direction or reversal is in the cards. Is there an easy-to-spot pattern that usually resolves a certain way, enough to provide us with an opportunity to place a trade with the odds on our side?

When we state that a pattern "typically" resolves in a certain way, we do not mean one hundred percent of the time. Nothing is ever one hundred percent when it comes to trading the markets, but the good news is that profitable traders do not need one-hundred-percent certainty. Profitable traders only need to be right *most* of the time. From there it is a matter of

smart risk and money management techniques.

c t ıuLwp

Technical analysis is the study of price, volume, and time to identify patterns that have happened in the past and that might repeat again in the future. Technical analysts (sometimes called technicians) have many tools available to them today, and one of the most basic is the chart. Day traders can find charts from a variety of sources and service providers.

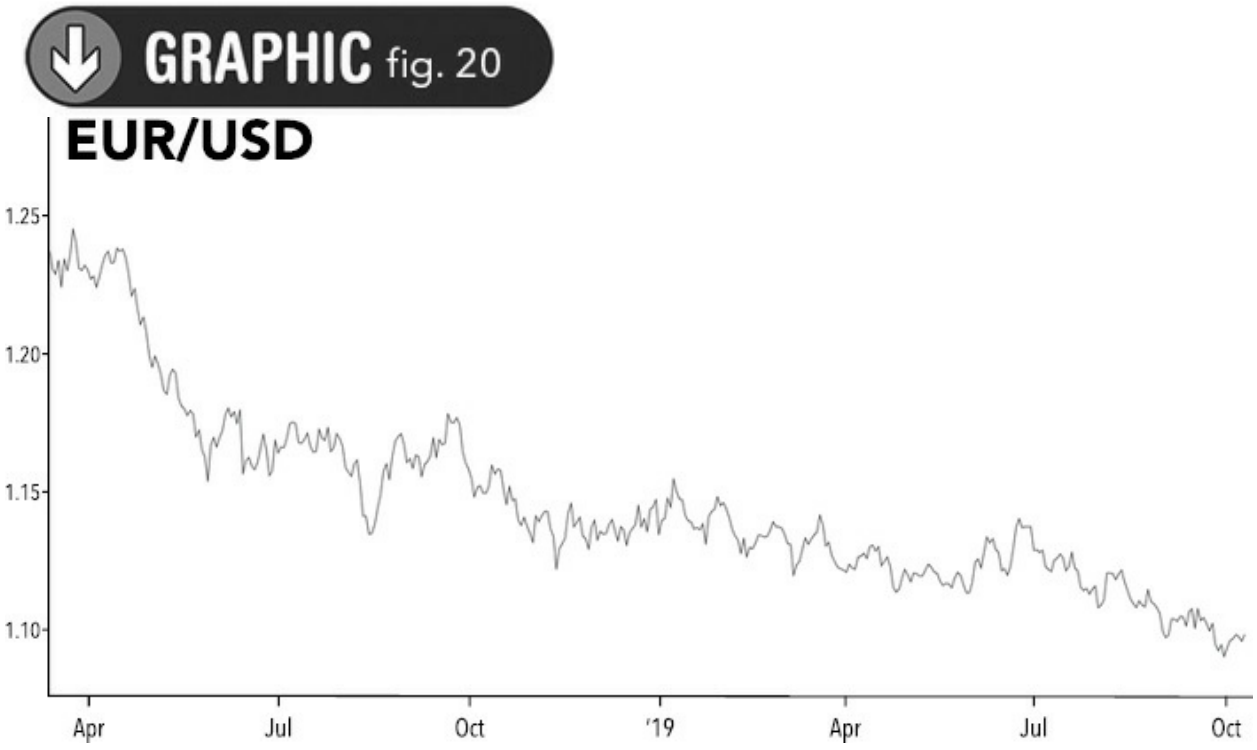
For instance, the examples used in this book are from the TradeStation platform. The company is a brokerage firm that offers access to stocks, futures, options, and forex charts. Traders can access their account with a web browser, but the more powerful features are in the stand-alone platform, which can be downloaded after an account is opened and funded. It has valuable components such as charts, indicators, automation, chart trading (the ability to place trades directly from the chart) and the ability to practice trading in a simulated environment.

Ux"t Lwp

A chart plots price on the vertical *y* axis and time on the horizontal *x* axis. The right side of the chart represents the most recent data, and beyond that, there is nothing—it is the future. The line chart is the simplest type of price chart. It can be plotted for any time frame, such as intraday (5, 10, 20 minutes), hourly, daily, weekly, or monthly.

For example, a simple line chart for EUR/USD is plotted in figure 20. It is a daily chart, meaning the chart updates with each new trading day, and the most recent trading day is on the far right. The euro has not performed well against the dollar during this period, and this daily line chart shows a notable decline, or downtrend. Time to book that dream trip to the Amalfi coast

you've always dreamed about.



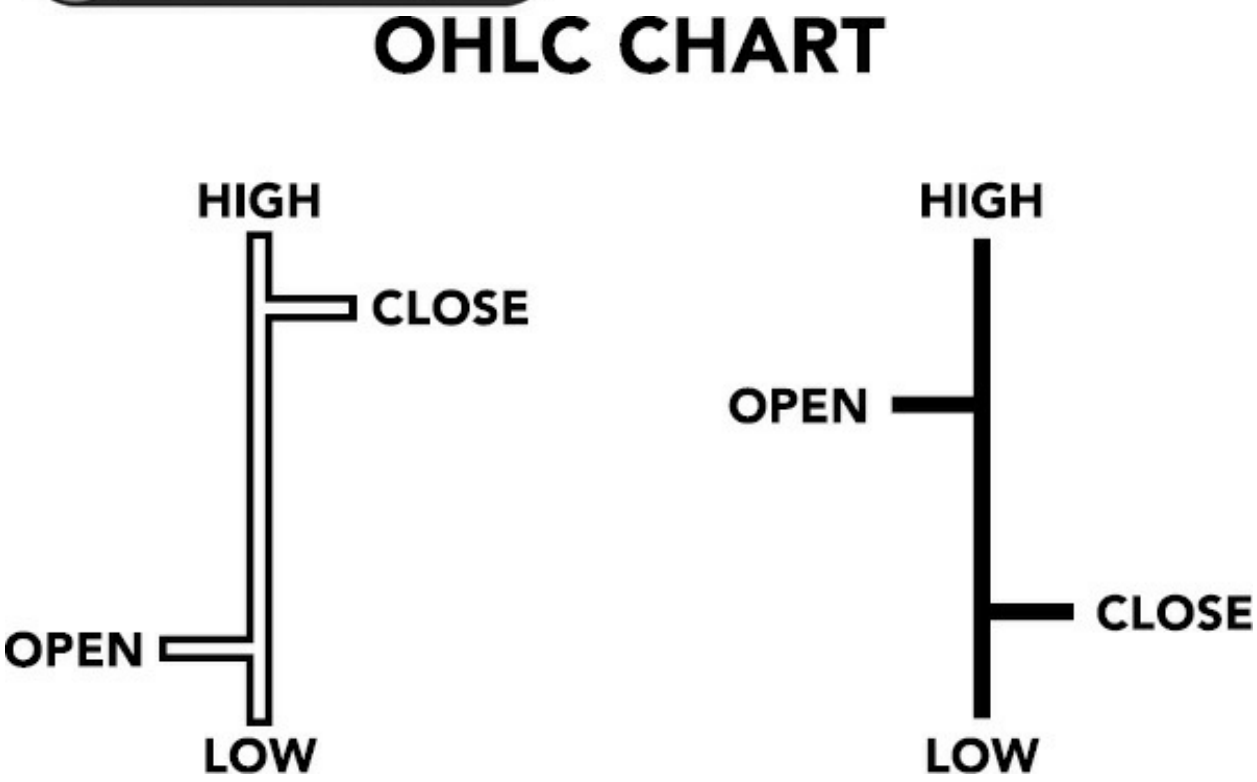
Kp Lwp

Line charts plot only the most recent (last or closing) price, but bar charts include several other pieces of price information. These charts are sometimes called OHLC charts—for Open, High, Low, Close—and they capture four different prices of the day (or of any time frame selected), as shown in figure 21.

- **Open:** This is the first price within the period defined by the bar, and is a small horizontal line on the left side of the bar.
- **High:** The top of the bar is the highest price of the day.
- **Low:** The lowest point on the bar is the lowest price of the day.
- **Close:** The final or last price of the day (or the most recent price if the market is open) is the little horizontal line on the right side of

the bar.

GRAPHIC fig. 21



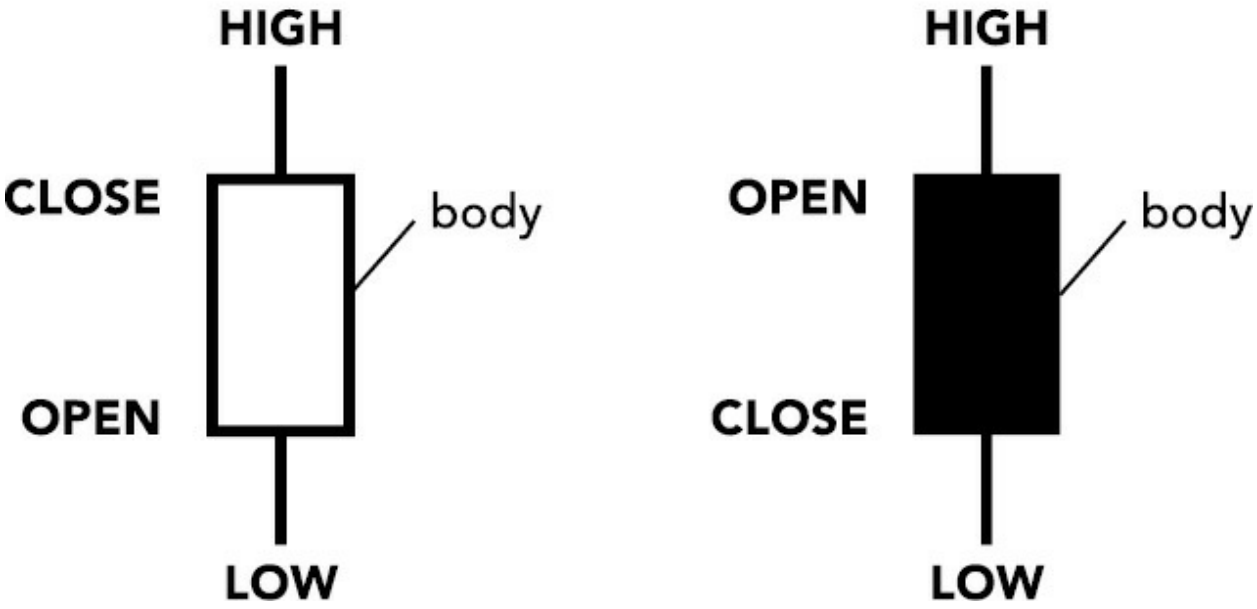
Since each bar captures the high and low price, its length gives us a sense of the range of price movement (see figure 22). Longer bars reveal that the trading range (difference between high and low) is greater than in periods when the bars are shorter in length. Figure 22 shows the OHLC for the EUR/USD currency pair over a period of several months.

Lp”s‘t xrz Lwp

Many examples in this book use candlestick charts, which are centuries-old tools first used by Japanese rice farmers. A daily candlestick chart captures the open, high, low, and close prices of the day. The main difference between a bar chart and a candlestick chart is that there is a rectangular “body” on the candlestick created by the open and close of the bar.

GRAPHIC fig. 23

CANDLESTICK CHARTS



The lines above and below the body on a candlestick bar, which look like candle wicks (figure 23), represent the highs and lows of the bar. The length of each candlestick will vary based on the bar's highs and lows, and the body will be bigger or smaller depending on the difference between the open and close prices, with a large body indicating a wider range between the first price and the last price of the bar.

Also, the color of the bar matters. Red (or dark, in black and white charts) on a daily chart means the market opened higher and closed lower—it was a down day (or down bar). Green (or lighter color) suggests the market closed higher than where it opened—it was an up day (or up bar). In other words, candlestick charts typically use lighter colors, like green, to indicate that the bar closed higher than where it opened. Darker colors like red are used to

indicate the opposite.

Like line charts, bar and candlestick charts can be plotted for any time frame. Daily charts are the most common, with each bar representing one trading day. Weekly and monthly charts give a glimpse of longer-term trends. Day traders usually focus on short-term charts. In some charts each bar represents 5, 10, 15, or some other amount of minutes of data. In other charts, each bar represents a certain number of ticks, such as 233, 377, or 610 ticks. Another type of chart has bars that represent the spanning of a particular price range. This latter group, which I find particularly useful, will be explained in more depth later on in this chapter.

The main reason I rely on candlestick charts, and why you will see them used throughout the book, is that I find them more visually appealing than line or bar charts. Also, candlesticks reveal a lot of useful information about price changes. They are easy on the eyes and quite simple to understand once you get the basics. I also use OHLC charts for day trading at times, because you can fit far more price bars on OHLC charts than on candlestick charts, which gives you a larger and longer-term perspective.

Mp c psx”v Lwp c t

Some of the best charts for day trading are based on ranges, number of ticks, or volume. These charts are a bit different than the traditional price charts we have discussed so far, which merely plot price over time. Let’s look at six examples of short-term charts of the Russell E-mini to better understand what kind of charts are ideal for day trading.

cx-t1Kp ts Lwp

We have already looked at examples of daily time-based charts, but day traders typically want to focus on intraday charts with intervals like two, five, or 10 minutes. Figure 24, for instance, is a two-minute chart, which simply means that after two minutes a bar closes and a new one opens. The concept is the same as with a daily or weekly chart, but the time interval is only two minutes. I call this a fast-time-frame chart (as opposed to a daily chart, which would be a slower chart). It is a perfect tool for watching price action and trading different setups intraday.

The vertical lines on this two-minute chart of the Russell E-mini (RTY) denote about 25 minutes (≈12 bars) of activity between 8:30 and 8:54 a.m. For purposes of comparison, a similar time demarcation has been made on several of the other charts featured in this chapter.

cxrz Lwp

A tick chart does not consider time. Instead, the chart updates based on the

number of ticks traded for a given instrument. The simplest example is a one-tick chart, which updates with every trade. Figure 25, on the other hand, is a 377-tick candlestick chart. Therefore, it updates after 377 trades have occurred. In an active market, 377 ticks can happen in seconds, but in a slow market it can seem like a lifetime. Since I trade only the most active and liquid markets, I really like charts like this—233, 377, or 610 ticks—because I can get a better sense of how fast or slow the market is moving.

V ı – t ” – ap ”vt Kp Lwp

The momentum range bar chart, or momentum bar chart, is one of several types of range bar charts that we introduce in this chapter. ***Range bar charts*** are unique in that price action (rather than time) determines when the next bar is added to the chart. A range bar chart plots a new bar each time a specified range of price action (8 ticks, for instance) occurs. Every bar on the chart would be 8 ticks, from high to low (or low to high).

Compare that with time-based charts that don't take price range into account. They plot a new bar based on a designated time period (every 15 seconds, one minute, 17 minutes, 195 minutes, one day, a week, a month, etc.). Range bar charts ignore time and are based on the range of price that occurs. They use a varying number of bars that are all the same length, according to the range selected. A 5-pip range bar on a forex chart, for example, will plot every bar with a 5-pip range from high to low. As long as the price trades within that range, that bar will remain open at the right edge of the chart. Once the price exceeds that range, the bar will close and a new bar will open. When trading is slow, a bar can remain open for long periods of time. In contrast, when a fast market occurs and price range expands quickly, dozens of bars can print in the blink of an eye.

For our first foray into the world of range bar charts, let's focus on the momentum bar chart. This chart type is unique, because it only creates a new bar when the specified range is not only met but exceeded by 1 tick. For example, let's say we plot a gold futures chart with a 5-tick momentum bar. A gold futures tick is .1 and represents $10 per contract. When the price goes up from 1568.6 to 1569.1, even though the specified range has been met, a new bar will not form until the price breaks 1 tick beyond the range—in this case, 1569.2. In a normal range bar chart, a new bar would automatically form as soon as the 5-tick range was established, 1568.6 to 1569.1.

The purpose of a momentum bar chart is to provide the trader with one extra (and often valuable) degree of "price action confirmation." The price has to exceed the range of the bar by one tick before that bar can close and a new bar can open. ***Price action confirmation*** is a concept used by traders whereby they wait for a price move to push through a certain level and offer more evidence that the intention of the market is to move in a particular direction.

Let's say the chart we are trading is an 8-tick momentum bar, and the market is heading lower. We decide to look for a short trade on the hunch that the downward movement will persist. If we know the high of the current bar is 1492.2, and we are looking to enter a trade 2 ticks below the low of the same bar, then we can quickly do the math in our heads to calculate where the low of the bar will be if the downward movement continues: 1492.2 – .8 = 1491.4. Next, before the bar has even finished forming, we are able to place our trade to go short at 1491.2. We now have a trade setup ready to go, should the price action continue lower.

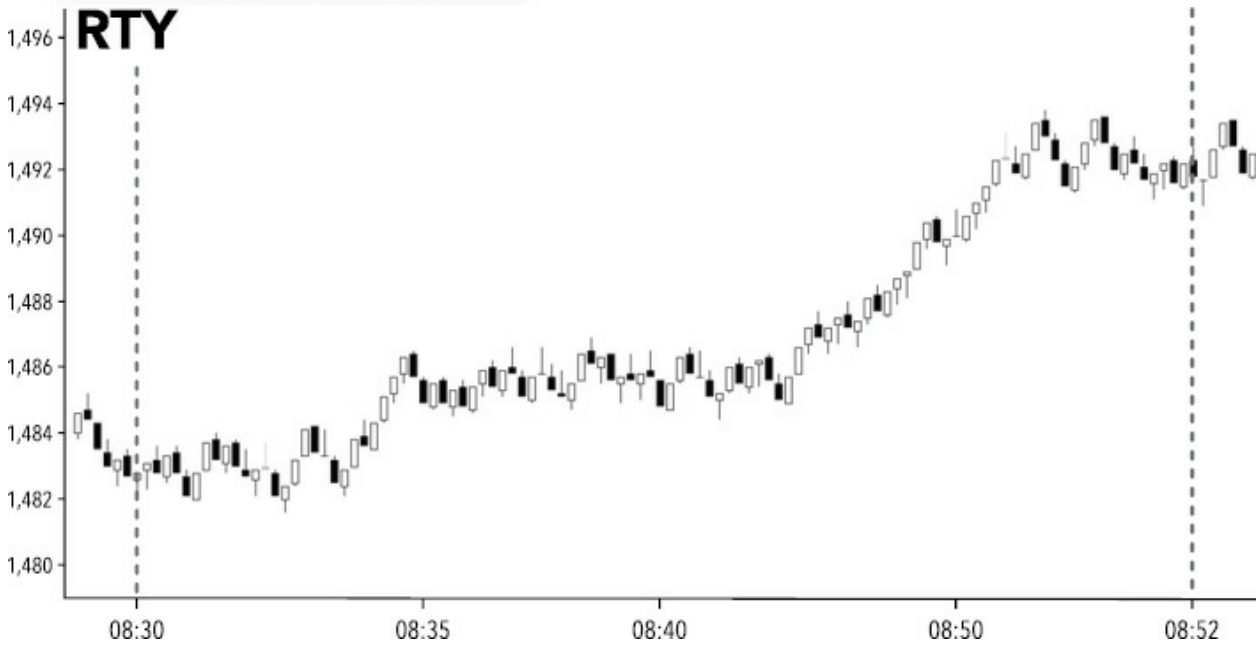
Be careful, though, because if the bar happens to make a new high prior to pushing lower, we will need to recalculate our entry. If the price moves up to 1492.3, for example, we'll have to adjust our entry to two ticks below the new low. Our new low is 1492.3 – .8 = 1491.5. So, our new entry is 1491.3.

Unless you want to experience demoralizing frustration, don't go out and try this approach until you have at least finished reading and studying this book. As I've said before, nothing is ever perfect in trading, and various steps taken by traders, such as the use of momentum bar charts, require practice and becoming familiar with how these charts work.

Range bars are very dynamic because they only consider price range, and we make our living by trading price *action*. For that reason, range bar charts are one of my favorite chart types. They can be tricky to understand at first, because the chart's horizontal axis does not correlate with time and we are not accustomed to that. Range bar charts can move fast, slow, or somewhere in between. I typically choose charts that move at a pace that suits my trading approach.

Notice that, in our momentum range bar chart in figure 26, if you include the wicks, all the candlesticks are the same length from high to low. Each bar is created when the price achieves a specified range, so the uniform length of each bar reflects that range. Notice also how each new bar opens either 1 tick above or 1 tick below the prior bar. In a normal range bar chart, you would see the price of each bar open on (at the same price as) the high or low of the prior bar.

GRAPHIC fig. 26

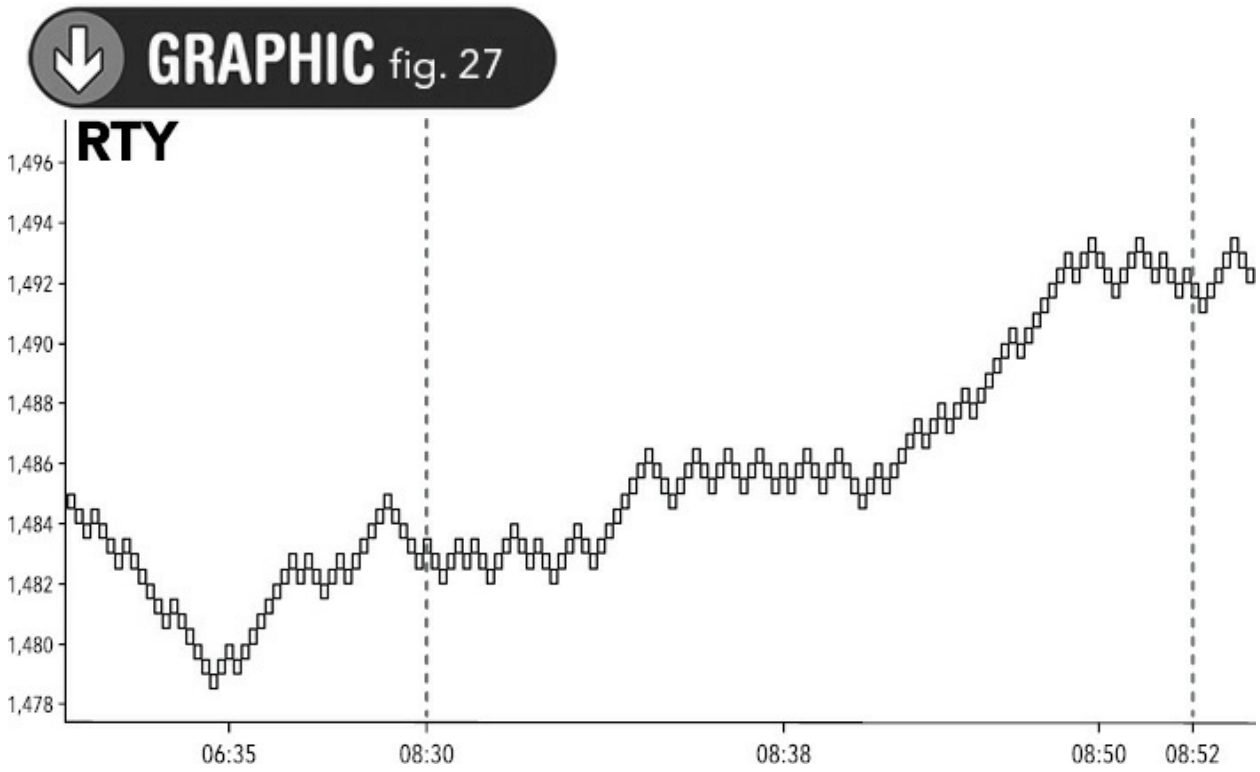


Some charting platforms, such as TradeStation, allow you to choose between a momentum bar chart and a standard range bar chart. Other platforms offer only one or the other.

Some charting platforms allow access only to momentum bars, but they refer to them simply as "range bars." Since you now know the difference between the two, you should be able to easily distinguish them when you look at a chart. Just ask yourself, "Does the new bar open on the closing high or low of the prior bar (range bar) or does it open one tick beyond the high or low of the prior bar (momentum bar)?"

at"zı Kp

The Renko bar is another type of range bar chart. The word "renga" means brick in Japanese, and, given that the Renko chart has Japanese origins, it's commonly believed that the word "Renko" is derived from the word "renga."



The chart's unique appearance is its defining feature, with each bar resembling a brick. Otherwise it behaves just like a standard range bar chart with each bar opening exactly on the high or low of the previous bar.

In figure 27, we see the price action in the Russell E-mini. All the Renko bars are the same size, equal to a 5 tick. Each brick must achieve the 5 ticks of range either above or below the prior bar in order to close.

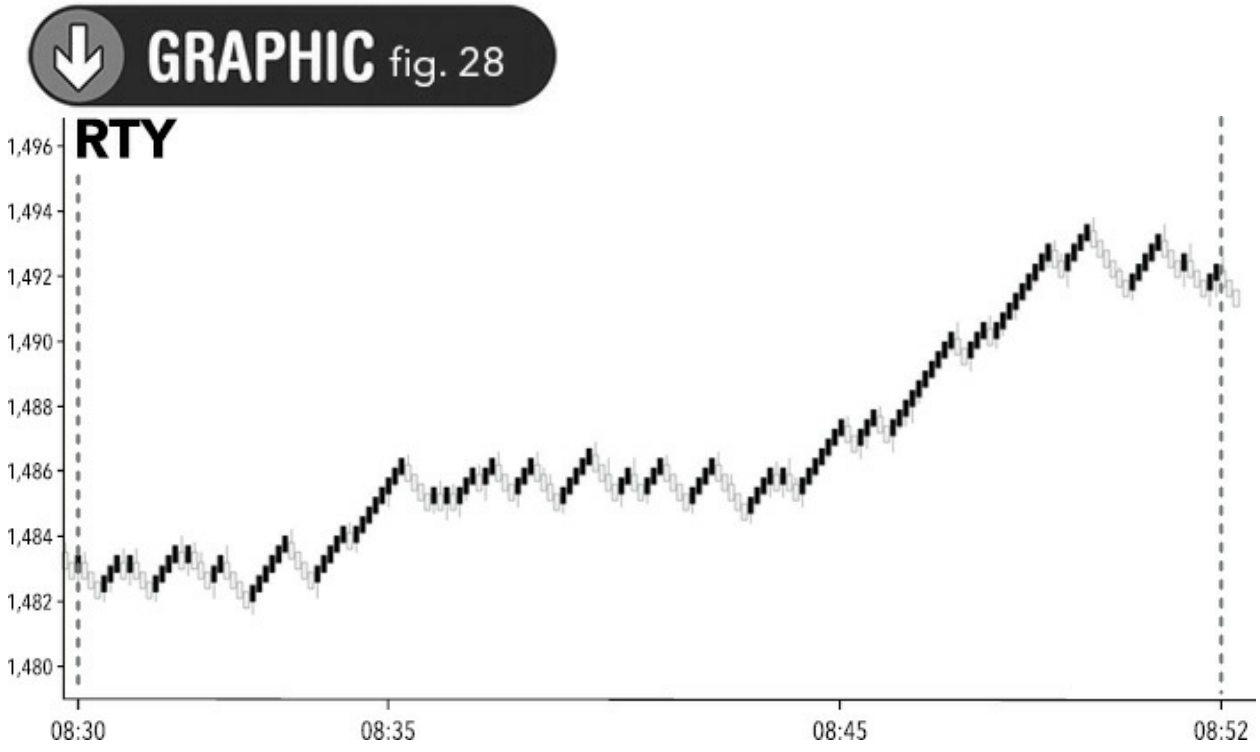
NOTE

Price points are reached beyond each bar that we will never know about, as they will not show up on the standard Renko chart. The price must travel the range of the bar for the bar to close. For example, the current price could move 4 ticks higher than the previously closed Renko bar, then move 2 ticks lower than the low of the prior bar, then back up again,

back down again, etc. Not until the bar moves 5 ticks above or below the prior bar will the current bar close, beginning the same process all over again. We would never know where the price had traveled prior to the bar closing. We only know that in the end it either moved up 5 ticks or down 5 ticks to finally close that bar. Mean Renko and custom Renko bars do show you these unseen price points, as they have wicks attached to the bar.

Vtp" at"zı Kp Lwp

Mean refers to the statistical average, and the Mean Renko chart is the same as the Renko chart in every way except that the opening price used to compute a new bar is not at the high or low point of the range. Once the range bar reaches the necessary range to create a new bar (whether at the high or low of the range), the new bar opens at the average or middle of the range.



Notice in figure 28 that with the Mean Renko set at .50 (meaning halfway

between the high and low of the range), each brick is the same size and opens at a price that is the average of the range of the previous bar. Moreover, these bars have wicks that show where the price traveled prior to the bar's closing. Standard Renko bars do not. That's a lot different than the previous chart, which shows the new bars opening at the previous bars' highs or lows. Many traders love these types of charts, because consolidation periods, breakouts, and trending moves are represented in a very clear and concise way.

ei“–t Kp Lwp

Some traders watch volume bar charts rather than time- or price-based charts. A volume-based chart (also referred to as a share bar chart) is set so that a certain level of volume (shares or contracts) triggers a new bar. The range of the bar (from high to low) represents price, but the chart does not update until volume reaches or exceeds a set threshold. In figure 29, the chart updates with every 500 contracts of Russell E-mini traded.

As a day trader, I focus mostly on momentum bars and tick charts, with some time-based charts thrown into the mix as well. Renko charts, being a specific type of range bar, also interest me, but they are more complicated to understand and require more effort. I like to keep things simple. In most cases, I'm more interested in price action than time. Most traders still use time-based charts, like a five-minute chart, for example. The thing is, a lot or very little can happen in five minutes. With a price bar, only the clock is considered, and the bar is always going to close after five minutes, regardless of price action or order flow. That can offer certain advantages. Imagine if you have to go to the bathroom and you are waiting for a setup on a five-minute chart. You can wait for the current bar to close and know that you have five minutes until the next bar closes. With a range or tick chart, you wouldn't have that luxury. In the end it's all about the tradeplan and what will give you winning results.

b ı p"s at x p"rt

Charts are used to plot prices over time, and, for that reason, they are useful for identifying support and resistance areas. Recall that support is a price level where buyers step into the market and begin buying, and resistance is a price that attracts sellers.

ct ıub ı p"s at x p"rt

A price level is not really a support or resistance area until it has been tested several times. A stock might rally up to $100 per share two, three, or maybe even four times before moving beyond that level. In that case, $100 is a resistance level. When it rises above $100, it is perhaps "breaking out" from resistance.

On the other hand, a stock might find support at $50 per share and break out

to the downside when it falls below that level. The more times support or resistance levels are tested, the greater the significance of the breakout move.

Figure 30 shows the S&P E-mini (ES) daily price action. Notice the resistance area forming around the 2,950 level. There are several other key levels, such as 2,900 and 3,000, that served as support/resistance areas as well. See how 2,900 was a source of support in April, but then resistance in June. When it rallied above that level in late June, it signaled that a breakout move to the upside was underway.

Y xrt atyr x" Yix"

If prices move higher and turn away from resistance, a price rejection point has been met. On moves lower, price rejection points happen around areas of support. For instance, in figure 30, the level 2,925 was a price rejection point for ES. Day traders want to focus on support and resistance levels because

they are often ***price rejection points***, or levels where prices stop moving in one direction and begin heading in another.

Support and resistance sometimes occur around congestion areas on charts. A congestion area is where the price has bounced around some but has not violated any trends or support/resistance areas. For example, on a chart of crude oil, prices might close at $55.02, $55.05, $55.01, $54.99, $54.98. In that case, the support (congestion area) is around $55 per barrel. In general, we draw support and resistance lines around congestion areas, like the support and resistance levels on the ES futures chart in figure 30.

Li”vt x” J tp p”s Lw

A ***congestion area*** is a place on a chart where the price trades in a tight range. It signifies indecision and a balanced market. The power between buyers and sellers is balanced. We often call this “chop” or a “choppy” market, and it is the worst time to try to trade because there’s no way to determine the best odds. The market can resolve in either direction, or it can “head fake” one way and then turn and go the other. This type of price action tends to give traders problems.

Traders often ask me for ideas on a trade strategy that deals with chop. Everyone wants some magic indicator that will help them avoid choppy markets. Trading in this type of market can lead to being whipsawed or, as I like to say, “getting chopped up.”

The best way to deal with choppy markets is to realize that markets trend and markets consolidate. If we can get to our trading goals, then we can quit for

the day and not even be in the market when it later consolidates. But sometimes we begin our session while the market is still in a consolidation, which is not always easy to see. You can see it after the fact, but not necessarily when it is about to occur.

A good tradeplan considers that markets are not always trending. Traders should be cognizant of choppy price action and learn to look for signs and clues to effectively trade through it, but they should not fear it. Remember, some trades are going to lose, especially in a choppy market. Losing trades are a fact of trading that we must learn to deal with. On the bright side, great trading opportunities do emerge when buyers or sellers finally take control and the price begins to move out of these congestion patterns. Some trading strategies are excellent at identifying when these breakout moves are likely to occur and can help identify setups that put you in front of them with a high likelihood of success.

d x"v b ı p"s at x p"rt x" Mp c psx"v

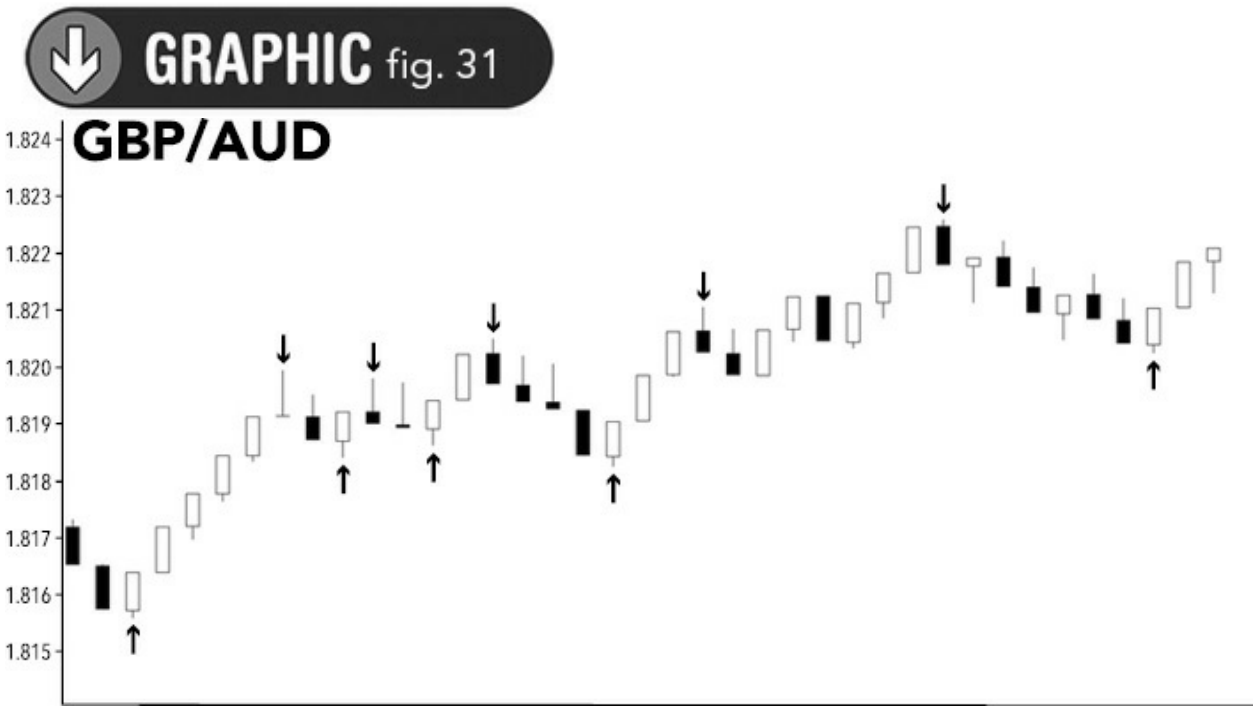
Day traders watch support and resistance areas to identify price rejection points and potential breakout moves during the trading day. This is helpful in determining potential entry points, stop-loss levels, and price targets. If I know ES has support at 2,900, I might wait for a dip to that level before entering a long position. Stop-losses can be set below the support area and we might go short rather than long if prices violate the support, signaling a breakout move to the downside. We may even start out in a long position but quickly change our mind and then stop and reverse into a short position. It all depends on the rules of the tradeplan.

In fact, it is my experience that false breakouts are more common than actual breakouts. For that reason, I often wait for the price to break out below the support (or above resistance), but I watch for a failure to follow through on

the downside, which sets up the potential for a strong move higher. The long trade is what I would be interested in if this happens. Of course, each situation is unique.

In addition, there are a few other guidelines to consider when drawing support and resistance areas:

- Support and resistance levels are drawn as horizontal lines on the charts and should highlight prices that have been touched numerous times in the past.
- The greater the number of times a price serves as a support or resistance, the greater its significance if that level is eventually broken.
- Draw support and resistance lines around round numbers but also along key congestion areas that prices have revisited over time.
- Sometimes near-term support and resistance areas are marked by the price bar itself. A price bar that makes a higher high than the two bars to its left and the two bars to its right often marks a near-term resistance level. The same is true of a bar that makes a lower low than the two bars to its left and to its right; it can mark near-term support levels. These levels are referred to as "swing levels," "pivot levels," "pivot points," or just "chart levels," and when you learn how to observe and listen to them, they can help you fine-tune your trading. I adjust my entries and stops around pivot levels, much like I would do with a key level adjustment around price levels, as described earlier.



In figure 31, the arrows of the GBP/AUD chart show the key pivot points revealed by the price action itself. Notice how the down arrows show price bars that have higher highs than the two bars to their left and right. The up arrows show bars with lows that are lower than the two bars to their left and right. Adjusting trade entries and stops above or below these "chart levels" is always a good idea.

MY TAKE

When observing pivot levels, it is good to remember that some are more significant than others. The extent to which a pivot level is significant is determined after the fact. When the market pivots and completely reverses its direction, as opposed to just pausing for a few bars before resuming its direction, then we can usually note that significant support and resistance levels have formed. If you want to zero in on the most significant support and resistance levels, try looking at a slower, higher-

time-frame chart.

c t”s“X”t

Trendlines can be sources of support and resistance. Recall that uptrends are defined as steady moves with a series of higher highs and higher lows. Downtrends are simply periods characterized by a series of lower lows and lower highs. Many traders use lines to depict the trends, and the process is really simple, especially with some of the charting software packages that include trendlines and the tools you can use to draw them.

Mp x”v c t”s“X”t

In an uptrend, the trendline is drawn across the series of higher lows; in a downtrend, the trendline is plotted across the lower highs. For example, figure 32 shows the longer-term trend in EUR/USD. The euro has been experiencing a longer-term downtrend that can be depicted as a trendline across the lower highs.

Many traders (including me) draw trendlines along the opens or closes of the body on candlestick charts, and not the highs and lows shown by the wicks. The wicks often represent where the price attempts to break the trendline but fails.

Drawing trendlines is more of an art than a science, though. Ideally, we want to mark where the support and resistance areas are that represent the trendline, and there really is no exact way to do it.

Yp p“t “c t”s‘X”t

Trading channels are often formed on charts when two trendlines run together. For instance, if an uptrend channel is defined by a series of higher highs and higher lows, then the trendline is drawn against the series of higher lows, and sometimes a parallel line can be drawn along the higher highs. The trading channel is thus defined by the space between the two trendlines. A daily chart of the Invesco QQQ ETF (figure 33) shows a powerful trading channel with parallel lines on the daily chart. Prices fell sharply once the trend gave way.

d x”v c t”s‘X”t x” Mp c psx”v

Day traders typically want to ride the trend—going long into bullish markets and short into bearish ones. If it is unfolding in orderly fashion, as with an upward-sloping channel, look for opportunities to go long (a good entry point is the pullback to the lower trendline). Each leg higher in the move (or lower in a downtrend) extends the range of the trend and is therefore commonly called a ***range extension***.

ap”vt N t” x”

Usually, the first stage of a trending move is where you find the best range extensions for new positions. As the trend continues, it will begin to wane, with each subsequent leg losing energy compared to the prior leg. This is a warning that the trend is weakening, and the odds of success by trading the direction of said trend is lessening as well. In other words, the earlier you can get in on an unfolding trend, the better. This may seem obvious, but it is often overlooked.

There are a few generally accepted rules for drawing trendlines on charts:

- In uptrends, draw the line across the series of higher lows (so that the price levels are above the trendline) and in a downtrend, draw the lines across the series of lower highs.
- Trendlines on longer-term charts are of greater importance than trendlines on shorter-term charts. For example, with respect to price action, the break of a trend on a monthly chart would be a more significant development than the break of a trend on a five-minute chart (although the five-minute chart is probably going to be more important in the eyes of the day trader).
- Draw trendlines along congestion areas on the price chart so that the line captures the true longer-term trend.

Opxts Vit

Markets are full of hazards and booby traps. I usually think of a failed move as one of those hazards or traps. The failed move is a breakout above resistance or below support that does not follow through, turning back into a major reversal instead. That is, it looks like a move through resistance (or support), and people get duped and drawn into the move.

I have found that one of the best trading opportunities is recognizing a "head fake," or failed move, and then trading in the opposite direction of the initial move, because a fake breakout in one direction often leads to large moves in the opposing direction. Let's consider a real example.

Our real examples often benefit from hindsight, but real trading does not.

We are always looking at the far-right side of the chart and hoping to understand what will happen next. That is where we make the real decisions—on the right side of the chart.

One of my favorite trading sessions is on the day when the weekly crude oil inventory report is released. The report, which shows how much stockpiles have changed over the past week, typically comes out on Wednesday morning at 10:30 a.m. ET. When there is a three-day weekend and a shortened trading week, the report is released Thursday at 11:00 a.m. The results of the report do not matter to me and, in fact, I do not even pay attention to the actual numbers. I just watch the price action and trade the subsequent move in crude oil.

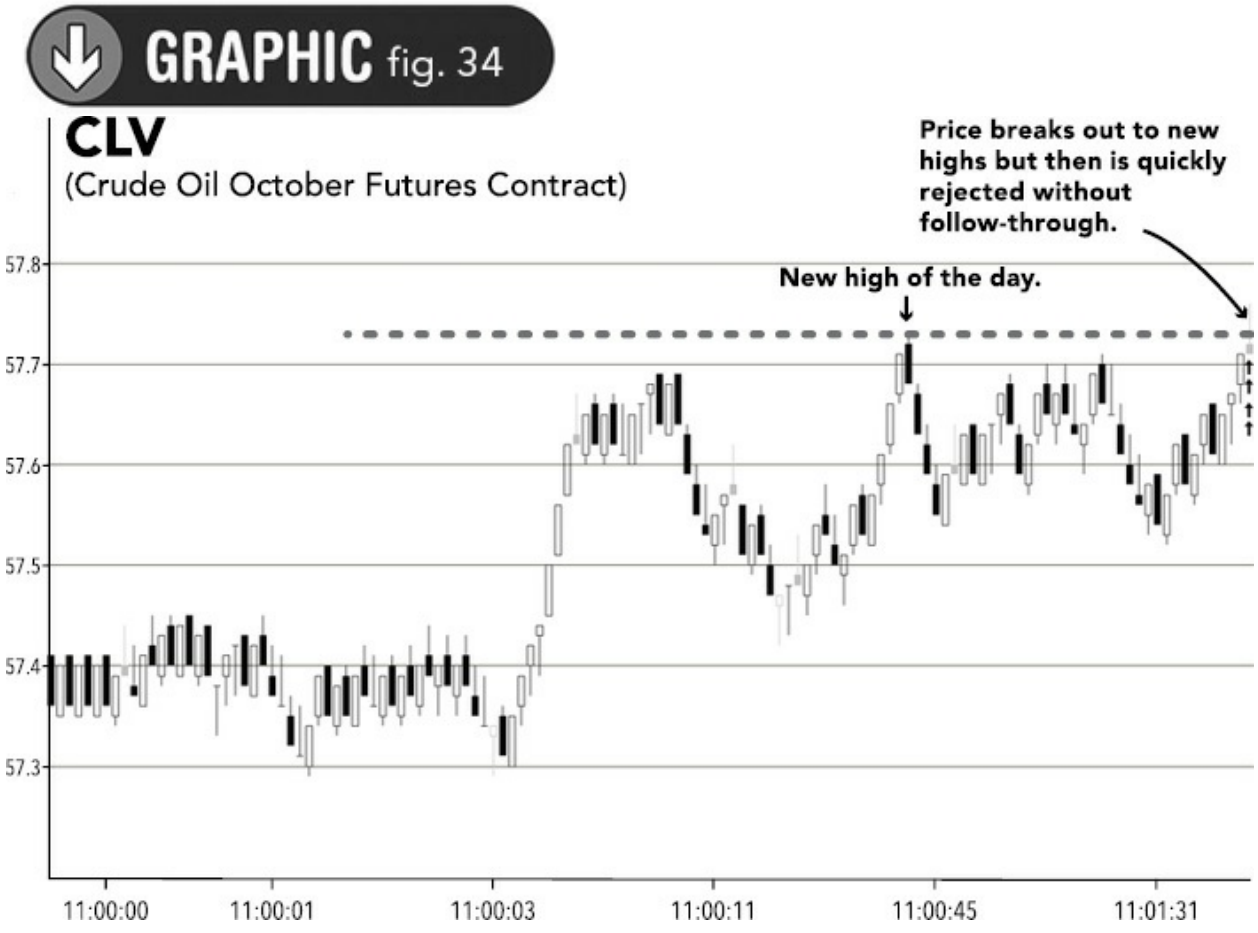
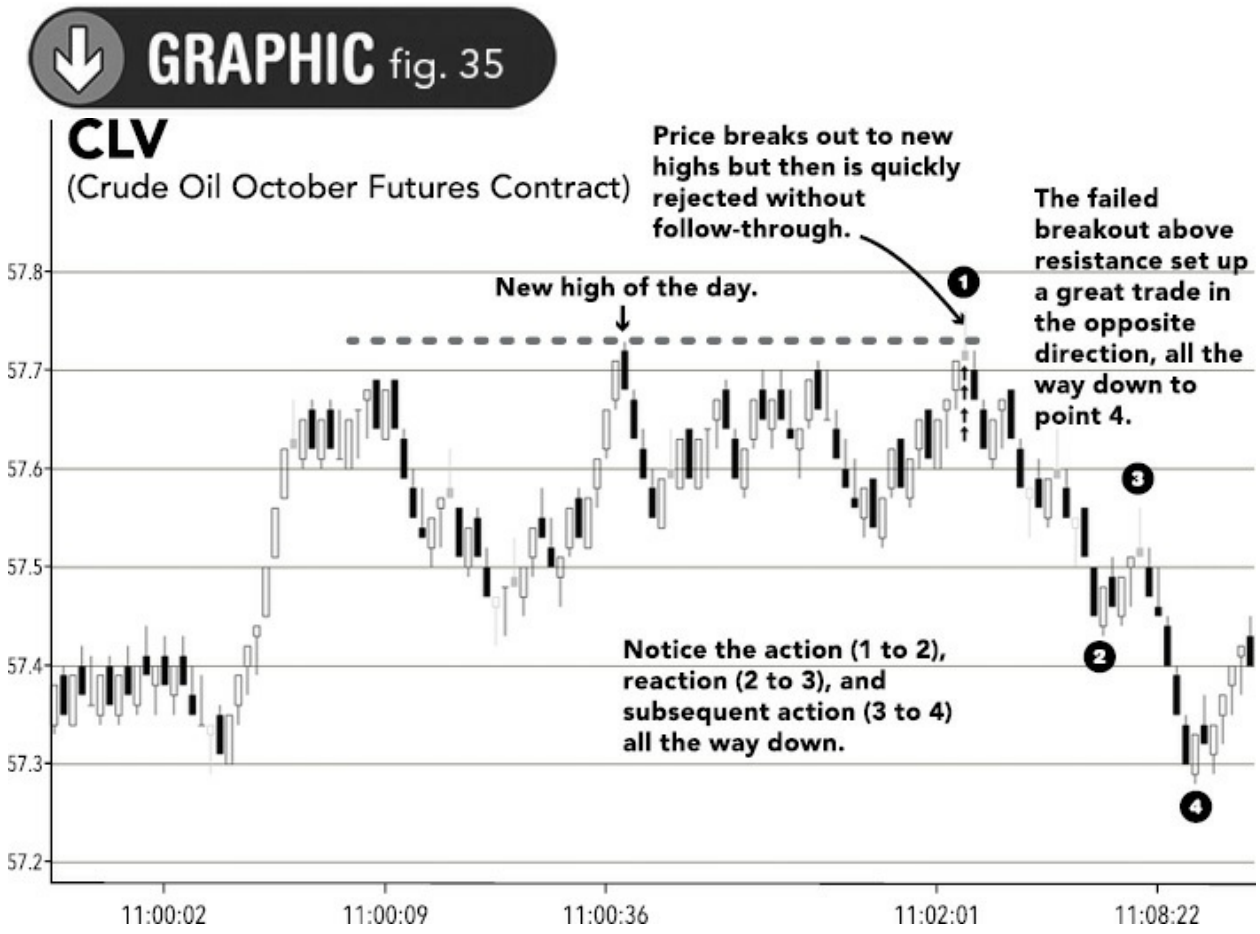


Figure 34 is a 5-tick momentum bar candlestick chart of crude oil futures. This chart occurred on the day of a weekly crude oil inventory report. It is very dynamic. As described earlier, each price bar represents five ticks of range. When the range is exceeded by one tick, either above or below, the bar closes and a new bar is created, or "plotted" as we say. The range bar chart does not consider time, only price range.

My tradeplan's rule tells me to wait two minutes after the inventory report is released and then begin looking for trades based on my "Spotlight Power Trader" strategy. In this example (see figure 35), the report was released on a Thursday at 11:00 a.m. (one day delayed due to a holiday) and the high of the day was established about 30 seconds after the inventory report was released.

What happened next? Prices dipped but then broke through the high of the day to make new highs (see point 1 in figure 35). When trading a breakout move, perhaps the obvious thing to do is to buy the market at that point. The problem with "obvious things to do" is that the market does not care and will often do what is not so obvious. Many traders were trapped getting long on this breakout, which set up a strong move in the opposite direction, as seen in figure 35.



In a classic "fake breakout" to new highs, as in this example (figure 35), buyers quickly became exhausted and the sellers took over, creating a very strong move in the opposite direction. Notice the stair-stepping nature of the move lower: action, reaction, subsequent action, reaction. You can also see ripples, smaller waves inside of the larger waves, which also exhibit the action, reaction, subsequent action phenomenon. This is how price action works and, fortunately, my tradeplan called for playing the failed breakout and trading the move down.

For a chance to check out more in-depth tutorials featuring my custom strategies, like Counter Punch Xpress and Spotlight Master Suite (which includes Spotlight Power Trader), be sure to access your digital assets at www.clydebankmedia.com/trading-assets.

Trade the action moves.

Oxqı ”prrxW – qt

Leonardo Fibonacci was an Italian mathematician (born in 1170 in Pisa, Italy) who observed a recurring natural phenomenon present in the currency exchanges of thirteenth century Italy as well as in the birth rate of rabbit populations. This phenomenon is best described by a numerical sequence where each number in the sequence is the sum of the two preceding numbers, when starting from zero (0+1 = 1, 1+1 = 2, 1+2 = 3, 2+3 = 5, 3+5 = 8, etc.) The sequence is 0, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, 233, 377, 610, 987…

Traders also use Fibonacci retracement levels to identify important price points that might serve as support or resistance, entry and exit levels, and potential price targets or stop-losses. Using our previous terminology, a retracement is the reaction move to an action move, such as a pullback in an uptrend or downtrend.

When identifying ***Fibonacci retracement levels***, it is the ratios between the numbers in the Fibonacci sequence that are important. The key ratios you need to know, expressed here as percentages, are 23.5%, 38.2%, 50%, and 61.8%. These ratios are based on observed relationships between the numbers

in the Fibonacci sequence. For example, if you divide one number by the next number (immediately to its right), such as 21 divided by 34 or 55 by 89, the result is 61.8%. Or if you divide one number by the number that is found three places to the right—such as 8/34 or 21/89—you get 23.5%. In short, the Fibonacci retracement levels are continuously observed ratios between numbers in the Fibonacci sequence.

In addition to the retracement levels mentioned, some traders also view 66.7%, or a two-thirds retracement, as significant because 2 divided by 3 is 66.7%.

Let's say the main action in crude oil takes the price from $51 to $53, a two-dollar advance. The first key "Fib" level to watch is the 23.5% retracement of that advance and, since 23.5% of $2 is 47 cents, crude might see support at $53 – $0.47, or $51.53 per barrel. A 50% retracement takes the price down one dollar to $52. The 61.8% Fib level moves us to $51.75, and, on a move below that, the main action trend would be officially negated, at least according to followers of Fibonacci levels. In other words, after a retracement greater than 61.8%, the decline no longer appears as a reaction move and is more likely to be the beginning of a new action move to the downside.

Fibonacci retracements are excellent for finding pullback zones that could be the end of reaction moves. This is critical information to know so we can trade the subsequent action moves. However, I believe there are simpler approaches to identifying the ends of reaction moves. I don't use Fibonacci retracements in my own trading (at least not directly). Instead, I simply look for reaction moves that span about one-third to two-thirds the distance of the action move, which I can easily see with my eyes—no calculator necessary. In chapter 10 I will show you how to use a simpler tool to mark the end of these retracements.

Fortunately, there is no need to compute Fibonacci levels by hand anymore, as they are now standard indicators in most charting packages.

L‘p xr Lwp Yp t ”

Sometimes a market is trending, sometimes it is in a range, and sometimes it is about to reverse direction. Chart patterns can help identify likely scenarios. For example, “flags” and “triangles” often occur during a trending market, while “double tops” (or bottoms) and “head and shoulders” happen before major trend reversals. Trends are usually easy to identify. ***Reversals*** are not.

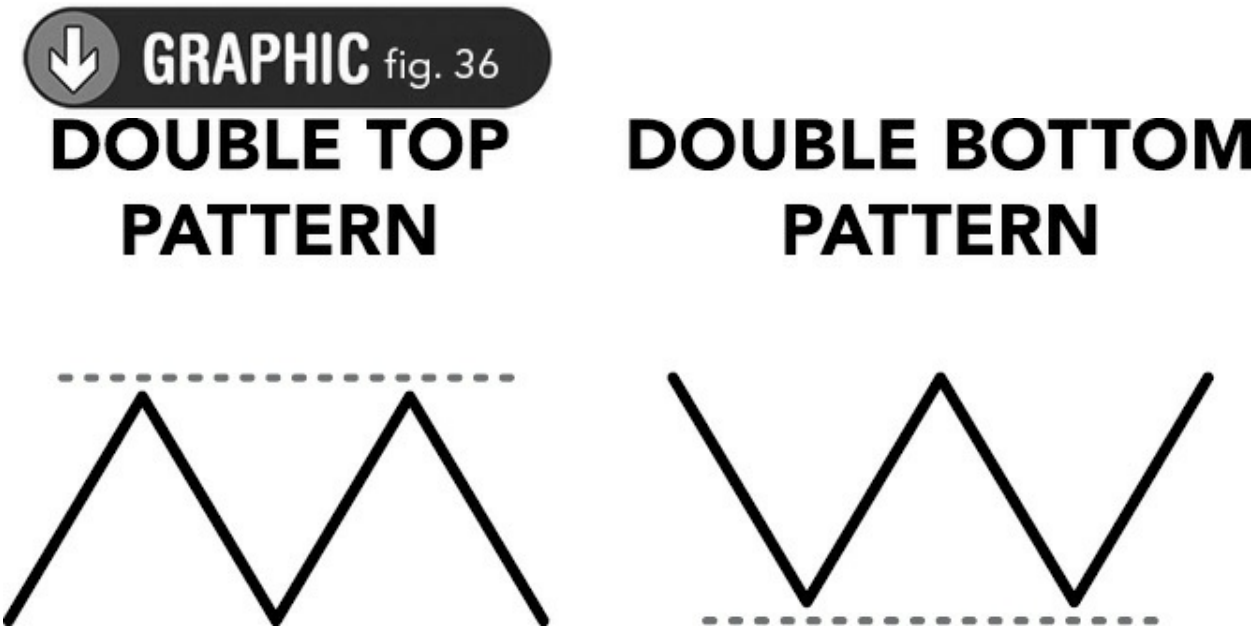
M q‘t c ı p”s Kı ı –

The trend is your friend, until the end. Every bullish or bearish move eventually reaches an end and sometimes changes direction completely. While it is impossible to predict the future, certain chart patterns can hint that the market is ready to reverse direction, crushing traders that have piled in on the wrong side of a trend that's about to end.

The double top is an example of a reversal pattern. It occurs at the end of an

uptrend. Prices have risen sharply, then they pull back (into a reaction phase), then there is another advance, followed by another decline below the previous reaction low. When prices fall below the previous low, support has been violated and a reversal is possibly underway.

The opposite is true in a double bottom, where prices are falling, rebound, then drop back toward recent lows before rebounding through previous resistance and reversing direction. Figure 36 shows how the typical double top looks like the letter M and the double bottom is more like a W.



The double top pattern shows that demand is outpacing supply (buyers dominate), as prices rise, up to the first top. Price reaches the first peak with increased volume, then falls down to a price area on lower volume where it finds support. If a double top is forming, another rally attempt to make new highs, passing the second peak, will likely be on a lower volume and will be unable to do so. It will fail to make new highs, in other words.

When a trend reaches the end point of its move, you may see a large volume spike, often accompanied by a spike in the price bar as well. These spikes are known as *blowouts*, and they can often signal an imminent reversal. If you are able to catch one, you can short the market at or near the end of the blowout move up (or down), while also placing a stop-loss just above the high (or below the low) of the bar that spikes. This is a very low-risk trade with very high reward possibilities.

If the end of a trend features a large candle with much higher volume than other recent bars, then watch out! You may be looking at a blowout (top or bottom). If so, the trend is likely to be over in the short term and may even reverse soon. Your chances of success in trading the "action" move are therefore lower, as a reversal is underway and the new trend is developing in the other direction.

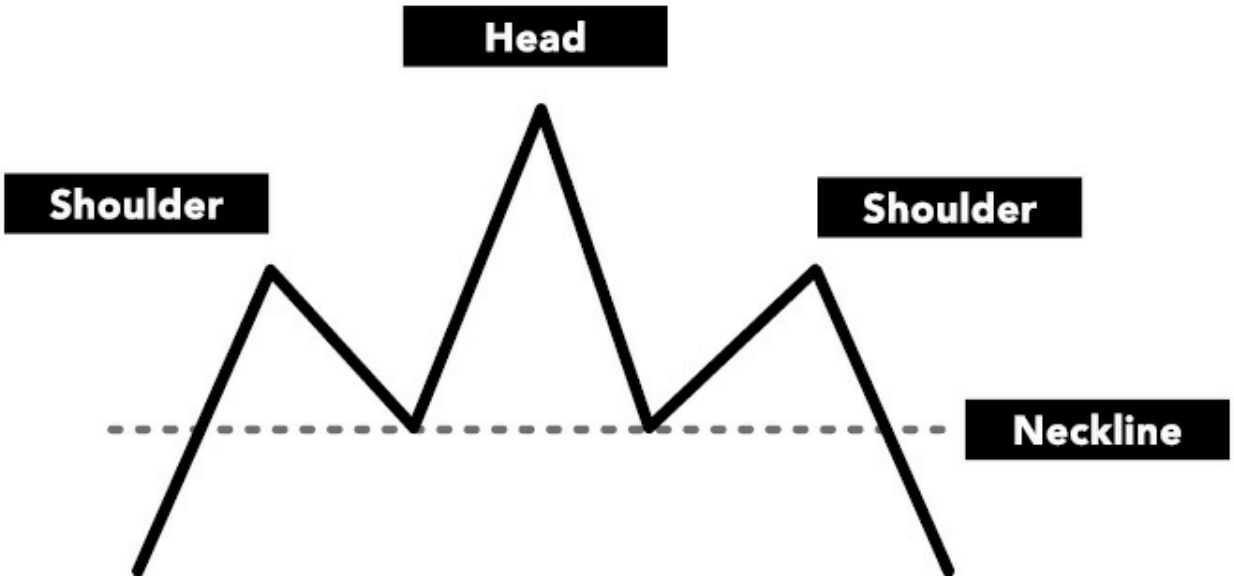
Qtps p"s bw "st

A healthy move higher is characterized by a steady advance with higher lows and higher highs. As we saw with the double top, sometimes an uptrend reaches an end when prices take a stab at new highs, fail, and then head south like a flock of Canadian geese in October. The head and shoulders pattern is a variation of the double top and, I would argue, more reliable.

The classic head and shoulders goes like this: 1) prices are trending higher and setting a series of higher highs and higher lows; 2) a surge pushes prices to new highs, and the down move that follows does not set a higher low; 3) another advance takes place, this time on diminishing volume, and prices do not set new highs. Then prices falter below the previous reaction low (support) and a downtrend begins.

GRAPHIC fig. 37

HEAD & SHOULDERS PATTERN



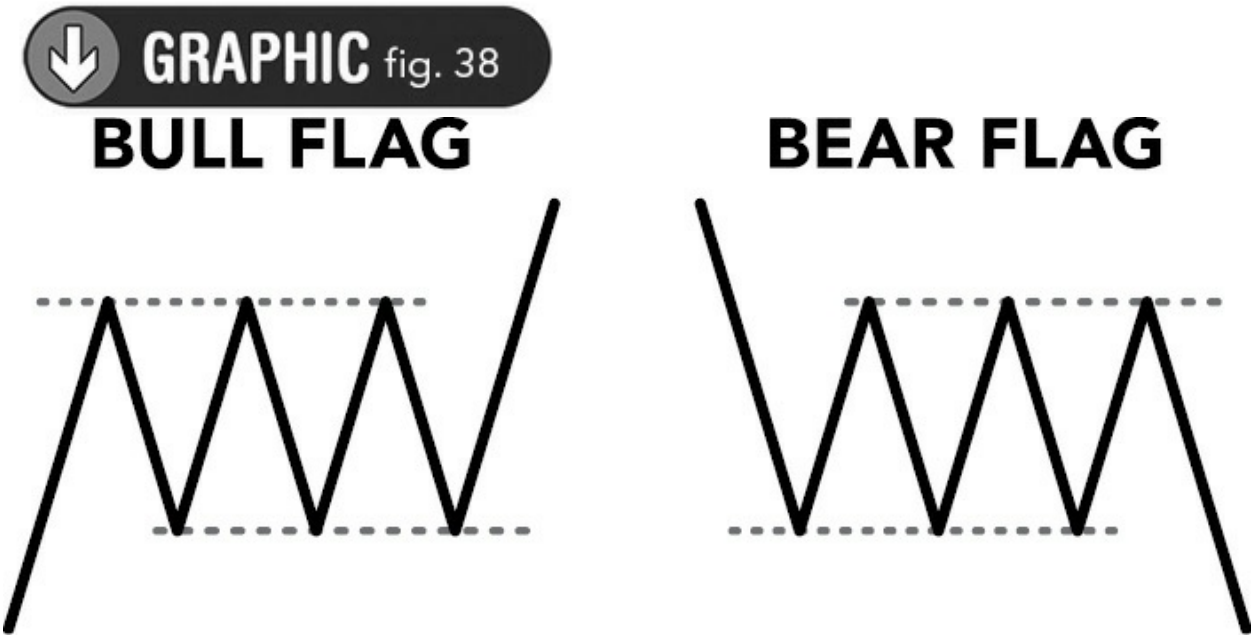
As we can see in figure 37, the price action creates a left shoulder, a head, a right shoulder, and a support area called the neckline. Once prices violate the neckline support, the trend has broken down and (as with the double tops and bottoms) is at risk of changing direction. In chapter 10, I provide specific trading examples using both double tops/bottoms and head and shoulders patterns.

O‘þv

While head and shoulders formations are reversal patterns, flags and triangles are ***continuation patterns***—they represent momentary pauses in an up or down trend. Sometimes called a rectangle because of its shape, a flag appears on a chart during a trending move as prices consolidate their recent gains or losses. It typically represents a sideways move or a modest pullback in an

uptrend or a pause in a downtrend. It is a reaction to the action move.

Figure 38 shows what bull and bear flags look like. In the bull variety, prices trend higher, trade sideways inside of clear support and resistance levels, then break above resistance to resume the uptrend. In a downtrend, the bear flag forms in a similar fashion and represents a pause in the trend. For that reason, it is commonly known as a continuation pattern and represents low-risk, high-probability trading opportunities.



c xp”v‘t

Triangle formations are very similar to flags, but they are shaped like circles. Just kidding—they are shaped like triangles, which makes them distinct from the rectangular shape of flag formations. The triangle formation results from a pause in an underlying trend and is typically followed by resumption of the trend. In some cases, however, the formation of a triangle leads to a trend reversal.

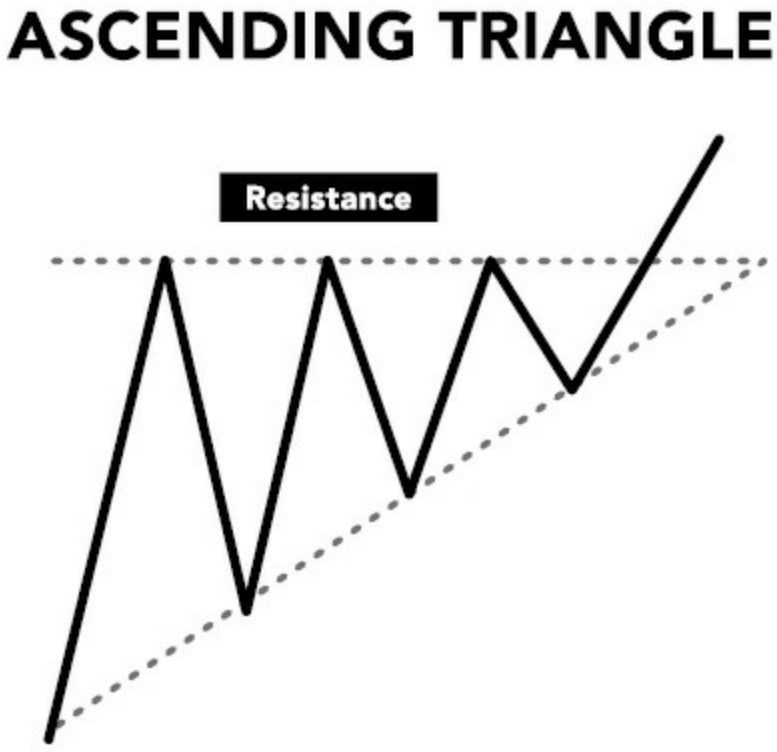
There are three types of triangles:

» **Ascending triangle**: Prices move to a series of higher lows, but there is a period of resistance, which forms a horizontal line across recent highs (figure 39). These patterns offer excellent trade opportunities when trading with the trend. They often win.

» **Descending triangle**: Prices set a series of lower highs and then reach a support level, which creates a horizontal line along the recent lows (figure 40).

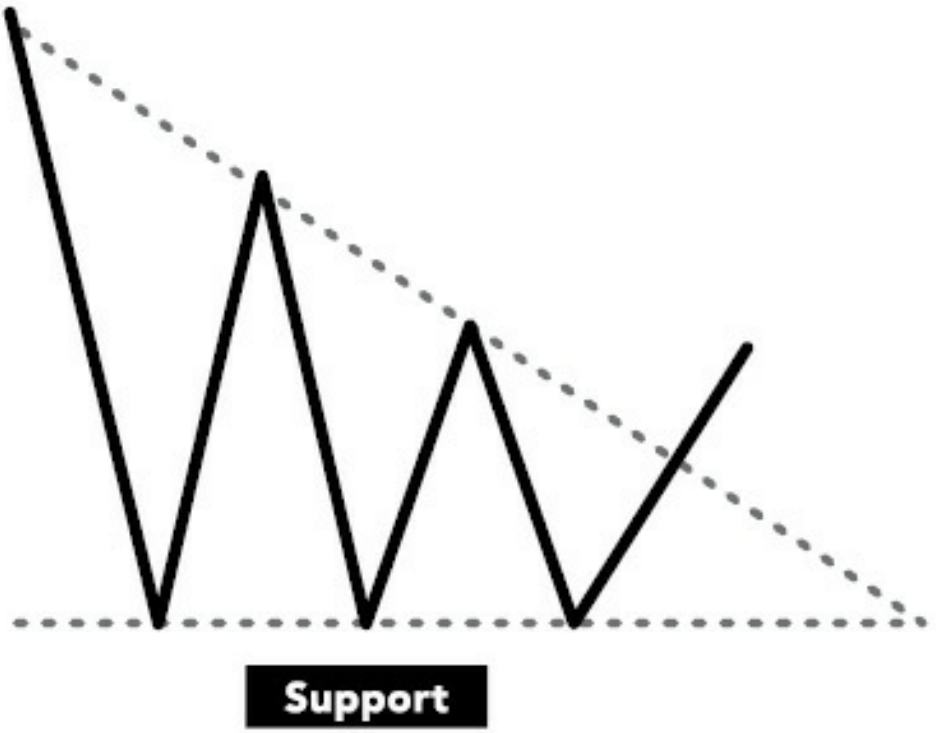
» **Symmetrical triangle**: A period of consolidation, reflecting uncertainty, as prices tighten or "coil" toward a specific price point (figure 41).

GRAPHIC fig. 39



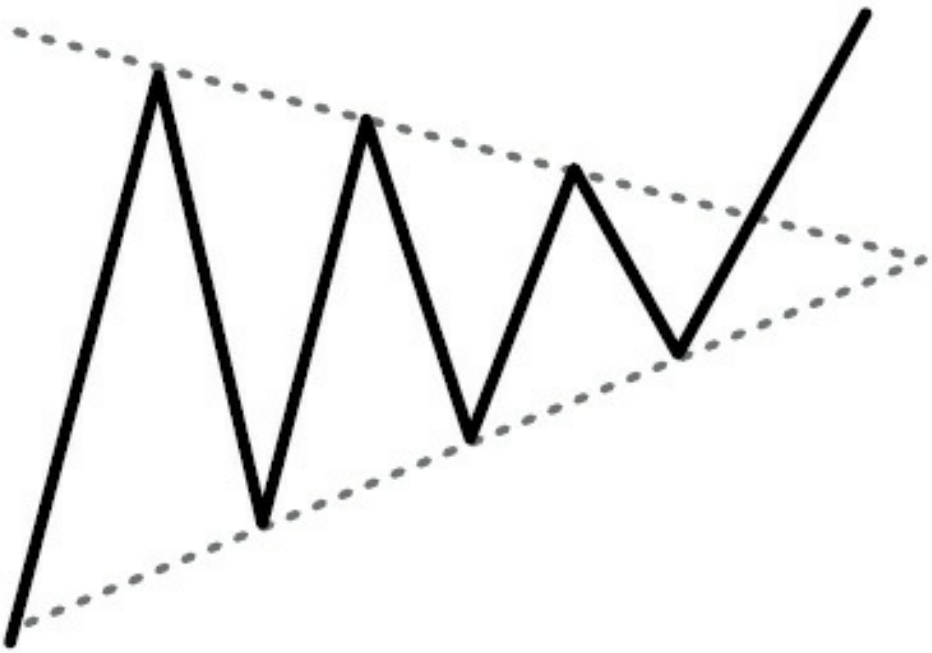
GRAPHIC fig. 40

DESCENDING TRIANGLE



GRAPHIC fig. 41

SYMMETRICAL TRIANGLE



Like flags, triangles are typically continuation patterns, which means that they happen during a larger uptrend or downtrend. I provide specific trading examples using both patterns in chapter 10.

V “x ‘t cx–t O p–t J”p“ x

Day traders often look at charts with short-term time frames—five or ten minutes—but longer-term charts can give a sense about trends that last weeks, months, or even years. Longer-term trends that last years or decades

are like the huge tides of the seas. Intermediate trends, lasting weeks or months, are the waves within tides. The intraday time frames, like five or ten minutes, are the ripples on top of the waves. Though the ripples are the source of most of the profits for day traders, you might not want to set sail unless you have some perspective broader than just the ripples.

If we know the immediate trend on a chart five times higher than what we're currently trading (think of a 25-minute chart vs. a 5-minute chart), then we can stack the odds in our favor by going with the greater flow, riding the current of the higher-time-frame chart. What tends to complicate this approach is when you have to take your eye off of the chart you're trading (the 5-minute chart in this case) and look at a higher chart (the 25-minute chart), especially if you are trying to set up a trade quickly in real time. You either need an additional monitor or a third set of eyes, or your name is Marty Feldman and you have eyes that point every which way.

Even better than multiple monitors or Marty Feldman's unique set of skills would be the ability to see the direction of the higher trend on the same chart you're trading. Wouldn't that simplify things, to be able to stay focused on the chart you're trading without distraction? We have just the solution for you. It's called the High Trend Chop Indicator (HT CHOP), and you can find it with your digital assets at www.clydebankmedia.com/trading-assets.

Lwi x"v cx-t Op-t

Time frames in charts can vary, from tick bars to weekly charts. The shortest time periods (ripples) are called "lower time frames" and the longer ones (tides) are known as "higher time frames."

- **300-tick**: updates with every 300 trades that pass through the market
- **5-minute bar**: updates every five minutes
- **15-minute bar**: updates every 15 minutes
- **60-minute bar**: updates on the hour
- **Daily chart**: updates with every trading day (weekends excluded when markets are closed)
- **Weekly chart**: updates with each new trading week

The term "tick" can be confusing because it is used to describe several unrelated things. A tick is very different than a "tick chart" that we use in day trading. Take, for example, the 377-tick chart that I use for trading the crude oil report. This type of chart counts the number of trades that take place in the market. After 377 trades, regardless of the size of the trade, the bar closes and a new bar opens. Tick charts are ideal for day trading. The word *tick* also refers to the minimum price movement of a particular instrument. A tick in crude oil is .01 and equals $10 per contract of value. Gold futures use a tick increment of .1, also representing $10 of value. A tick in the ES is .25 and equals $12.50 of value per contract. Refer to appendix I for a complete list of instruments and their tick increments and values.

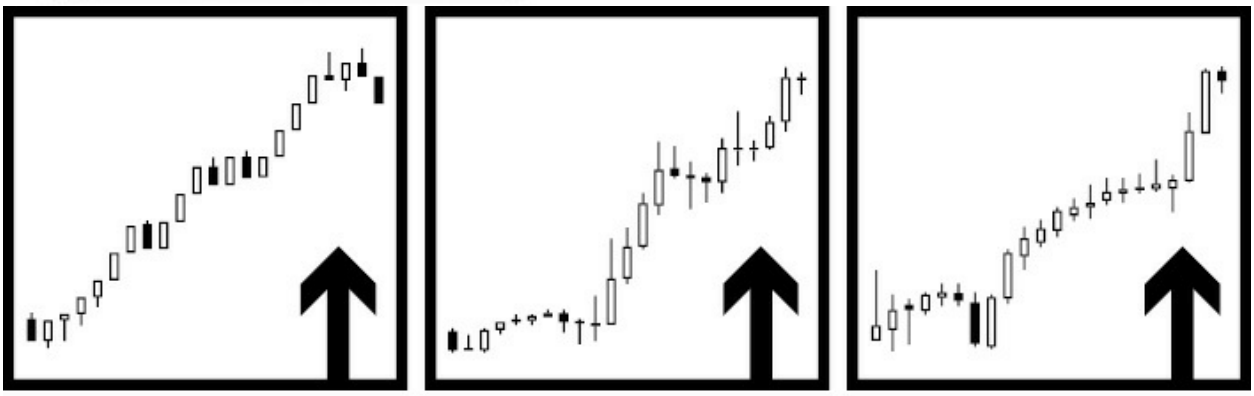
Li"ux-px" J"i"v cx-t Op-t

When a higher time frame is trending, look for patterns in a lower time frame that set up trades in the same trending direction for higher-percentage winning outcomes. Unless you are following specific rules of a trading method or tradeplan, it is often better to avoid trades where the higher and lower time frames are in conflict. Ride the main trend.

As you learn about charting and trade setups, you might be tempted to start trading with real money. Wait! I recommend that you read the entire book from front to back before you begin, because many of the key lessons are in part IV, which provides the step-by-step guide to trading success.

Recall our example from chapter 1, shown again in figure 42. We showed three charts with three different time frames (5-minute, 15-minute, and one-hour). The price action is similar, with prices moving higher in all three instances.

GRAPHIC fig. 42



In an ideal world, all three time frames would move in the same direction and confirm the move. The perfect setup for day traders is when prices are trending intraday in the same direction as the longer-term charts. In the three-charts example, the trader wants to lean on the bullish side of the trade and look for opportunities to get into long positions. Of course, the opposite is true if multiple time frames show downtrends.

Lwp t atrp

- The three basic chart types are line, bar, and candlestick.
- Day traders use charts to find opportunities by identifying areas of support and resistance and specific patterns.
- Markets trend, move sideways, or reverse direction.
- Repetitive common patterns help day traders spot trends and potential reversals.
- Looking across different time frames gives us a better sense of market direction and can help improve our odds.

18

ctrw"xrp"R"sxrp

Lwp t X t xt

- » Price-derived indicators
- » Indicators and trends
- » Reversals
- » Reading the markets

You already have a lot of tools at your disposal, tools that will assist you greatly in building an effective trading plan. Basic technical analysis features, like trendlines and support/resistance areas, are relatively easy to identify and profit from in real day trading situations. In this chapter we want to focus on technical indicators that are more advanced, yet widely available in most charting software packages today.

The most common charting indicator is the moving average, and from there we advance to momentum indicators and oscillators. A few definitions are in order before we begin:

The most important indicator of all is the person staring back at you in the mirror. Many traders know intellectually what they should do as traders

but then actually do entirely different things. Their walk is not consistent with their talk. Pay attention to the things you do, not the things you say, think, or feel. What you do will actually "indicate" what you need to work on to improve your trading. It is a unique concept but a very important one, much more important than any technical analysis indicator.

- **Momentum**: Momentum merely refers to the strength of price action moving in a given direction. Momentum is typically measured with some type of ranking methodology.
- **Oversold**: Sometimes markets fall too far and are due to bounce. In such a situation, like sometimes after a market crash, the market is referred to as "oversold" and ripe for a reversal to the upside.
- **Overbought**: When prices rise too far, bulls are possibly too bullish, and the market may have risen too much. "Overbought" markets typically turn lower to correct the excess.

Just because a market is oversold or overbought does not mean the price will suddenly reverse direction. Markets can continue to trend and remain overbought or oversold for quite some time. For that reason, overbought/oversold indicators are usually used as a confirming indicator teamed with other indicators and trading rules.

- **Oscillator**: Sometimes it is hard to tell if a market is overbought or oversold, and that is where oscillators can help. These technical indicators typically move up and down within a range (such as zero to 100) as prices move up and down. When oscillators produce

extreme (very high or low) readings, it often indicates that markets are overbought or oversold. Stochastics are examples of oscillators and are discussed in more detail in this chapter.

» **Divergence**: Sometimes indicators and price charts do not tell the same tale—they diverge. For instance, when price makes new lows and a certain indicator(s) makes a higher low, there has been divergence. Divergence can signal that an uptrend or downtrend may be coming to an end.

V ı x'v J t pvt

The ***moving average*** is the most popular charting indicator. It is easy to compute and understand. It can be a powerful visual aid for spotting trends and potential reversals on stock charts. Moving averages can also be deployed quickly over different time frames and used to identify key areas of support and resistance, changes in trend direction, areas of congestion, and a variety of trade setups that can form the basis of many effective trading approaches.

Q ı ı L ı – t V ı x'v J t pvt

An average, or mean, is the sum of all observations divided by the number of observations. For example, if I pay $3.00 for gas in January, $3.25 in February, and $3.50 in March, my average cost for gas for the first three months of the year is $3.25, or ($3.00 + $3.25 + 3.50) ÷ 3.

Moving averages are used quite a bit in trading. They are called "moving" because prices are always updating, and the averages change with each new piece of data—every day, the average is updated by removing the oldest number and adding the most recent.

Many of the examples in this chapter use daily time-based charts to explain the ins and outs of the indicator. Day traders want to apply the same logic to intraday and range bar charts, which we will show in more detail in live trading examples in chapter 10.

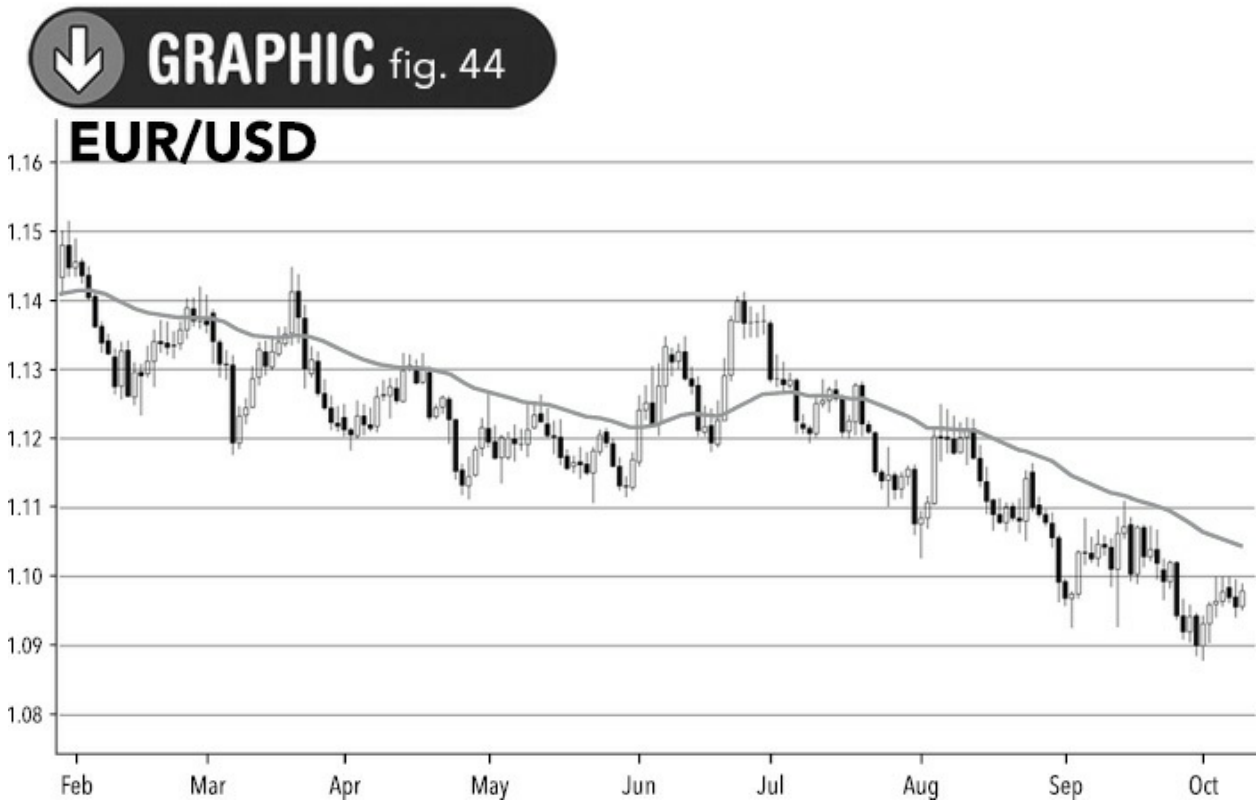
The most basic moving average is called the simple moving average (SMA). Figure 43 shows an SMA plotted on the ES Futures five-minute chart. The latest value of an SMA is simply the average price for a market over a certain number of bars, such as 9, 17, 50, etc.

I use a 20-day SMA often. I have found it to be an excellent line to mark likely pullback zones that show where a reaction move is likely to end, which in turn helps set up a subsequent action move for high-probability trades. I also like to use 50- and 200-day EMAs (explained next) to mark areas on the chart where resistance and support levels are stronger.

N ı”t” xp“V ı x”v J t pvt

The exponential moving average (EMA) is a variation of the SMA. The EMA is calculated so as to give greater weight to the most recent data. It is viewed as superior to the SMA by some traders because it does not react as much to old data but can move quickly in response to the latest price action. For example, in a 10-day SMA, the latest trading day is weighted equally with the most distant trading day, but in an EMA the most recent day is responsible for almost 20% of the EMA value.

Figure 44 shows a downtrend in EUR/USD. In this daily candlestick chart, the 50-day exponential moving average is moving in the same direction as the trend. Also note that, while price bounces around the moving average, there are times when it rises to the MA but then turns away. This is an example of a moving average serving as resistance during a downtrend. Of course, sometimes prices find support along moving averages as well.



Lwi x"v pcx-t Op-t

Today's trading software allows traders to plot multiple moving averages across a variety of different time frames, all with a few mouse clicks. For example, a trader might compare a 50-day and a 200-day moving average to identify bullish or bearish markets and spot potential changes in longer-term trends. The 9-day moving average is a popular one among day traders and swing traders.

Using two moving averages together, for certain things, can be more powerful than using one alone. It is also very easy to do. The daily price action of silver, along with 50- and 200-day moving averages, is plotted in figure 45. The first half of the chart shows the metal with sideways, choppy, and uninspired action. Then see what happens in July: the 50-day moving average (darker line) turns higher along with the price. There is some coiling action

(symmetrical triangle) and then the 50-day moving average crosses over the 200-day. From there, prices explode to the upside. By the end of the chart, the 200-day moving average has moved higher as well, and prices have dipped back to the 50-day moving average, which became a notable support area.

Crossovers between two averages are sometimes significant as well. For instance, when the 50-day MA rises from below the 200-day MA and crosses over it, and both turn higher, it is a bullish sign. On the other hand, when the 50-day MA is above the 200-day but then crosses over it to the downside (sometimes known as the "death cross"), the signal turns bearish.

GRAPHIC fig. 45

MY TAKE

There are many effective trading strategies that primarily use the idea of one moving average crossing over the other. The weakness in such strategies is that when prices are consolidating and moving sideways with tight price action (low range), the fast MA will cross over the slower MA and go up, down, up, and down again, giving undependable signals that do not offer legitimate trading opportunities. Moving averages are lagging indicators, and, when viewed after the fact, it is easy to see how they react to price movement. But when you are on the right edge of the chart looking to make a trade, with the future unknown, what appears to be one thing unfolding may end up being something entirely different. Moving averages are useful in many ways, but they are still just puzzle pieces that can never tell the whole story in a dependable way, at least not by themselves.

V ı x”v J t pvt axqqı”

The moving average ribbon indicator gives a look at multiple moving averages at the same time. It consists of eight EMAs that can be set at various lengths; the shortest one is known as the base length. For instance, the base length might be set at 10 bars, with line 2 as a 20-bar MA and line 3 as a 30-bar MA.

The base and the increments within a ribbon are easily adjusted in the charting software. Short time frames result in faster changes in the indicator, and larger numbers react more slowly. Most traders look for confirmation across the EMAs within the ribbon to determine the strength, or conviction, behind the trend. However, the ribbon can also indicate a change of trend—as it does in March on the USD/JPY chart in figure 46—when the short-term moving averages cross over the longer-term EMAs.

Moving averages and ribbons can also be applied to intraday charts, daily charts, or longer-term charts. In a 15-minute chart, for instance, the average updates every 15 minutes as each bar closes. A weekly chart updates every Friday, because that's when the latest bar closes. Regardless of the time frame, there are a few general guidelines to follow when using moving averages:

- Use moving averages to identify the longer-term, intermediate, and short-term trends.
- Look for areas of support and resistance around key moving averages like the 50 MA and 200 MA.
- When there is a crossover between two important moving averages, a major trend might be unfolding. It is wise, however, to use additional confirming indicators, because what appears to be a trend

may also be a fake breakout or false move. The price could easily turn back and head in the other direction.

A final note about moving average crossovers: I consider them to be lagging indicators, meaning they react *after* price action, not before. Sometimes when a fast MA crosses over a slow MA, it can indicate the beginning of a larger, more significant move, where trades can be quite profitable.

Often though, in my experience, the move has already happened and due to the lagging nature of the MA, the crossover occurs too late, and this is what gives traders problems. There are other mitigating factors too, like where one MA is in relationship to another. When, for example, the 50 EMA and the 200 EMA are close together, price action is very tight, moving sideways. When price begins to break out and show signs of a move in a specific direction, up or down, then the moving averages will begin to spread apart as the faster one begins to move away from the slower one. These patterns can signal some of the best trading opportunities.

I get the most reliable information from the MAs when I use them to mark support and resistance levels on the chart. In this particular application, the lagging nature doesn't even come into play, as they are just being used to show lines in the sand where buyers and sellers are more likely to face off and battle each other.

V ı – t ” – R ’ s ✗ r p ı

Momentum refers to the velocity, or speed, of price changes. Many indicators have been created to provide a visual representation of how much momentum is behind an underlying trend. These indicators are often used to gauge strength or weakness on daily and weekly charts but can be applied intraday as well. Momentum indicators can also help identify potential reversals or

turning points before important trend changes.

Kı “X”vt Kp”s

John Bollinger is a well-known market technician and is credited with developing the widely used charting tool called Bollinger Bands. This indicator takes a moving average and creates two bands around it. These bands are plotted on the chart along with the price action, as in figure 47 showing the daily price action in gold.

The center line within the Bollinger Band is an EMA. The default setting is typically a 20 MA, but there are many variations for shorter-term or longer-term charts. The two bands around the moving average are standard deviations, which is simply a statistical term describing the amount of variation from an average. If prices are clustered around the average, the deviation is small, and when prices vary wildly above and below the average, the deviation is large.

The upper band in a Bollinger Band is the moving average plus a standard deviation, and the lower band is the EMA minus the standard deviation.

The daily chart in figure 47 uses 20-day Bollinger Bands (plus and minus 2 standard deviations). During that time, gold is rallying, and when the prices move above the upper band, it signals short-term overbought conditions that are often followed by a pullback. Significant moves below the lower band are often followed by sharp upticks, indicating that gold is oversold.

Traders also watch the width of the bands—sometimes the two bands get close together after a period of sideways price action and the table is set for an explosive move higher or lower. This is like the coiling action of a triangle pattern just before prices break out in one direction or another. Notice in figure 47 that right before a major break in a downtrend in gold, the chart coiled into a triangle, just as the Bollinger Bands squeezed together, which set the scene for a major break to the upside.

Bollinger Bands can be applied to any time frame and any investment type. There are a few general guidelines to follow when applying the indicator:

- Look for penetration of the upper or lower bands to signal overbought or oversold conditions.
- Use the center line as you use any moving average: to identify the trend and to spot areas of support or resistance.

» Be careful not to assume that a strong trending market is overbought or oversold—look over multiple time frames to get true insight regarding overbought and oversold conditions.

V JLM

The moving average convergence/divergence indicator is popular among traders and available in most charting software packages and platforms. Created by money manager Gerald Appel and simply called MACD (pronounced Mack-D), it consists of three (exponential) moving averages and is displayed as two lines (a signal line and a MACD line) along with a histogram (the small vertical bars at the bottom of the chart), as we see at the bottom of figure 48 on a USD/CHF daily chart.

MACD is typically computed using 9-day, 12-day, and 26-day moving averages. The signal line (lighter color) is simply the 9-day EMA. The MACD line (darker color) is the difference between the 12-day and the 26-day (subtract the 26-day from the 12-day and, voilà, MACD line).

The histogram is computed as the difference between the signal line and the MACD line—for instance, if the two lines are equal, the histogram will be zero. If the signal line moves above the MACD line, the histogram turns negative, and it is positive when the MACD line is above the signal line. Notice in the chart that the histogram gets bigger as the gap between the two lines gets wider.

The signal line reacts more slowly to price moves (as compared to the MACD line) and reflects trends over a longer period. The MACD line is considered the fast line because it reacts more quickly to new data. Traders look for crossovers between the two lines to identify bullish/bearish trend shifts. If, for example, MACD rises above the signal line—as it does in mid-August in figure 48—it signals bulls are taking control of the trend. On the other hand, when the fast line crosses over the slow line from high levels, it could be a sign that the trend is about to shift to the downside.

NOTE

Trendlines can do more than just track obvious price action. They can also

be drawn along indicators like the RSI (which we explain next) and MACD. This is done by drawing upward-sloping lines along the higher lows in an uptrend or along the lower highs in a downtrend. When a trendline is broken, pay attention; it can signal that a reversal is underway!

In addition, if prices set new highs or new lows but the histogram does not—as in mid-August on the USD/CHF chart when prices set a new low but the histogram failed to make a new low—it sends a signal that a reversal might be in the cards. This is referred to as *divergence*, where price action is doing something different from the indicator, like when one makes a new low and the other makes a higher low. In the end, there are several general events to watch for when using MACD:

- If the MACD line moves above the signal line, the market may be turning bullish. A word of caution, though: the MACD is a lagging indicator. Oftentimes, the market has already turned bullish and the move might be over or nearing its end by the time the MACD gives you the signal. Experienced traders use the MACD as just another piece of the puzzle.
- A sell signal is triggered when the fast line drops below the signal line. But observe the same caveat regarding the lagging nature of this indicator.
- Divergences between the histogram and the price action signal that a reversal might be at hand.
- Plot MACD across different time frames to identify both long-term and short-term trends.
- The breaking of trend lines drawn on this indicator can give excellent information as well.

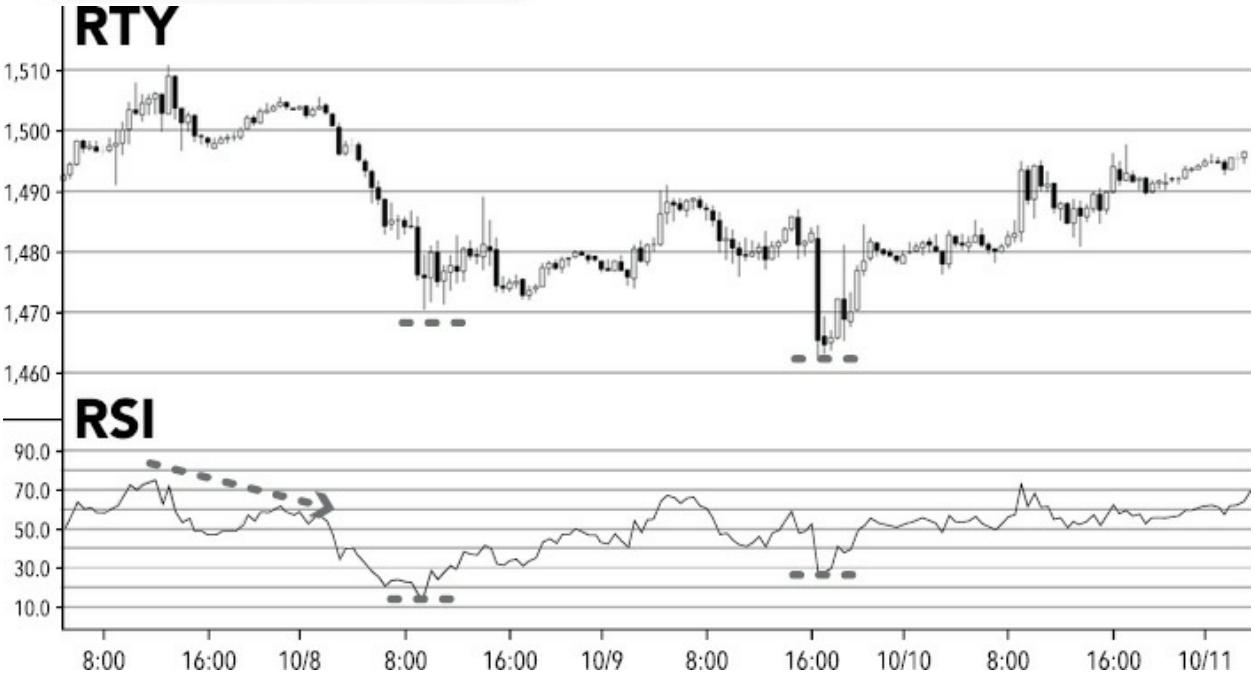
at“p x t b t”v wR’st

In the 1970s, J. Welles Wilder Jr. developed the momentum indicator called the Relative Strength Index (RSI). The details were outlined in his 1978 book called *New Concepts in Technical Trading Systems*, and now RSI is available with most charting software. It tracks closing prices to gauge the strength of trends, with a value ranging between zero and 100.

When RSI reaches a high level and turns lower, it can be a sign that a reversal is at hand. But if the indicator is at lower levels and then turns up, the market is possibly making a bottom and about to turn higher. In that sense, RSI is used as an overbought/oversold indicator, and, as we can see with the 60-minute chart of the Russell E-mini (RTY) in figure 49, RSI indicates overbought conditions when it rises above 70 and oversold when it goes below 30.

RSI can also suggest, when it diverges from price action, that a reversal is coming. Look at the chart as prices reach high on the far left, then dip, after RSI had indicated overbought levels. The market then falls to oversold levels (according to RSI below 30) before chopping around. Then there is another sharp drop to new lows and RSI is again oversold, but not below the previous low. In this case, the indicator hinted that the market was oversold, and the divergence (not falling to new lows along with price) suggested a reversal might be in the works.

GRAPHIC fig. 49



Traders use RSI in different ways, but there are a few general guidelines to follow:

- » RSI should move higher and lower along with price action to confirm trends.
- » When the indicator reaches high or low levels, the market is overbought or oversold.
- » A market can remain overbought and oversold for quite some time before price action reverses.
- » Look for divergences between price action and RSI, then wait for RSI to turn and signal a possible reversal.

MY TAKE

These types of indicators, like so many others, MACD included, are lagging indicators. It is often easier to see the signals after the fact. It is much harder and requires far more experience to use potential signals in real time, at the right edge of the chart. I typically do not rely on these commonly used indicators unless I define a very specific role for them to play, in conjunction with other pieces of information—perhaps other complementary indicators, specific price patterns, or price action itself.

X rx“p ı p”s V p zt L r‘t

Overbought markets are risky to buy into because they can reverse direction and head lower at any time. Oversold markets are dangerous to short because prices have fallen sharply and can be due to bounce higher at any moment. So how do we know if a market is overbought or oversold? Indicators like oscillators can help.

I look at oscillators as merely tools that need to be used in conjunction with other pieces of information. An OB (overbought) condition, as indicated by an oscillator, is not necessarily indicative of a good short opportunity, and an OS (oversold) condition does not always mean that going long is the right move.

The market is in the early stages of a strong uptrend, indicated by a strong action move up. An oscillator signals OB, and a pullback ensues, bringing the asset back into a 20 SMA. Despite the OB signal, the right trade to

look for here may be the long one. The pullback following the OB could be the reaction move and the subsequent tradeable action move may be due to follow. A strong uptrend can remain in an OB condition for quite some time.

Oscillators can be valuable tools in a comprehensive, researched, and proven tradeplan. So long as you accept their limitations, knowing that they are not crystal balls, and so long as you keep your wits about you when trading and recognize strong trends that could persist despite an oscillator's OB or OS signals, then oscillators will help you further finesse your trading.

As is true with virtually all technical indicators, oscillators can be counterproductive and even dangerous in the hands of an ill-prepared trader.

f x"Xp– ' a

Also known as the Williams Percent Range, %R is a basic oscillator that was popularized by Larry Williams in the 1970s and is used to confirm trends, while also identifying situations that are ripe for a reversal. Like RSI, %R moves in a range between zero and 100.

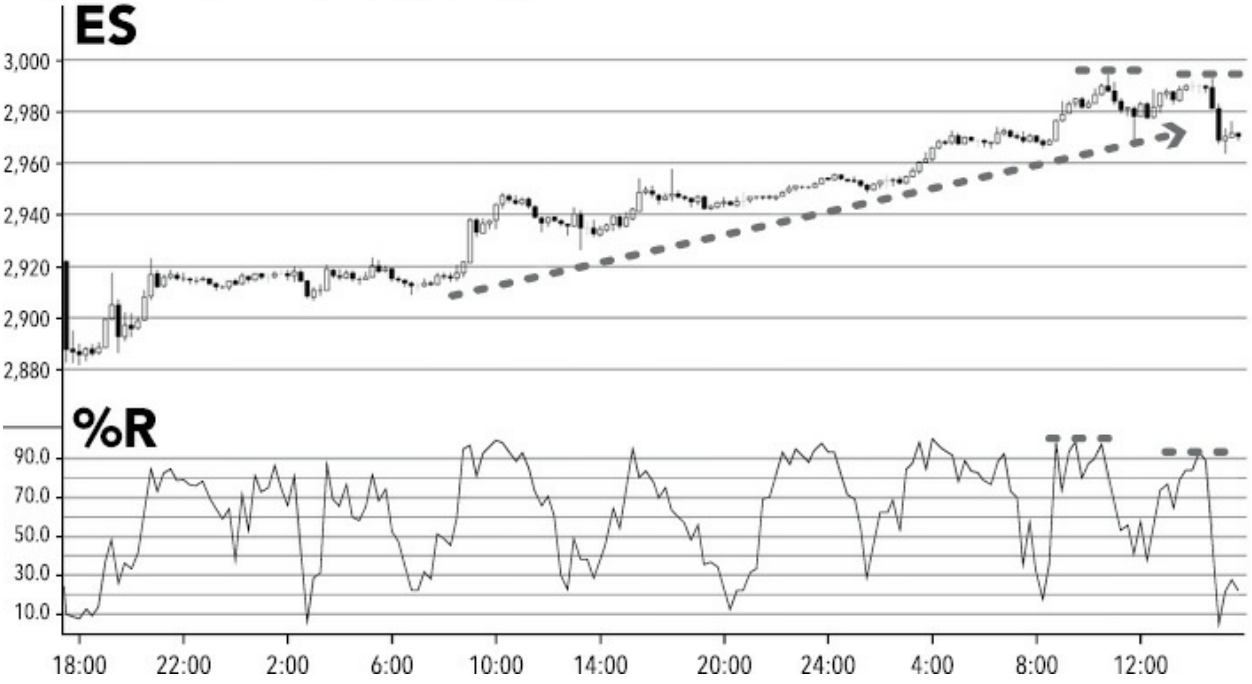
The value of %R changes along with movements in price. Mathematically, it is computed by comparing the most recent price to the lowest low and highest high during a given period, the most common time frame being seven days.

For instance, if prices are closing near recent highs, %R will approach 100

(although some charting software uses a scale from zero to -100, with zero being the highest level possible). On the other hand, low readings from %R suggest bears are in control because prices are near the lower end of the range. Generally, readings below 20 suggest that the market is oversold and readings above 80 indicate an overbought market.

The 15-minute chart of the S&P E-mini (ES) in figure 50 shows a longer-term downtrend, but plenty of ups and downs along the way. Meanwhile, %R (plotted at the bottom of the chart), reaches extremes of 80 when prices reach the upper end of the longer-term trading channel and less than 20 when prices dip to the lower end. Notice the formation of a double top at the end of the bullish uptrend, as %R reaches overbought levels just before a sharp drop below trendline support.

GRAPHIC fig. 50



birwp xr

Created by George Lane in the 1950s (and similar to Williams %R), the computer-generated indicator called stochastics is available in most charting packages today. It is plotted at the bottom of a chart and compares the closing price to a range of prices over a certain period. Stochastics moves in a range between zero and 100, with overbought signals occurring when it reaches high levels (more than 80) and oversold conditions when it falls to low levels (less than 20).

Traders use stochastics and %R in similar ways:

- When the oscillator drops below 20, the market is possibly oversold and due to bounce.
- When the indicator tops 80, the situation is overbought and ripe for a downside reversal.
- Be careful using oscillators to identify overbought or oversold readings in trending markets, because the overbought and oversold readings might be premature.
- Look at readings over different time frames to determine the extent that the market is overbought or oversold.

Probably the best use of these indicators is when prices are range-bound moving sideways, and you're interested in selling the high end of the range or buying the low end of the range. Oscillators like stochastics can be effective in helping you time this type of trade. Be sure to use fairly tight stops on the other side of the support/resistance levels, because markets will break out of ranges. As long as they continue to trade within the range, this tactic can be profitable.

L r‘t

Markets often move in cycles. For example, seasonality is important in many of the commodities markets, like natural gas, heating oil, and grains, because there are times of the year when demand is stronger compared to other times of the year. The traditional business cycle within the economy can also be regularly observed with its pattern of booms followed by busts or recessions. The stock market is heavily influenced by business cycles. Always forward-looking, the market can rise and fall in anticipation of oncoming periods of economic strength and weakness.

According to Wyckoff Market Cycle rules (covered in chapter 6), a cycle includes four distinct phases: accumulation, markup, distribution, and markdown. This dynamic can be observed in the standard business cycle as well, but over a longer time horizon.

Finding profit opportunities by identifying cycles is no easy task for the day trader. Things like weather patterns, supply/demand, and business cycles are obviously very difficult to predict. In addition, it is impossible to determine exactly when a market cycle begins and when it will reach an end point. Nevertheless, knowing that there are longer-term boom and bust cycles in various markets can help you make sense of short-term trends within the larger picture. The short-term trends are the ripples and waves, and the cycles represent the tide.

This chapter covered several technical indicators such as MACD, stochastics, and Bollinger Bands. There are hundreds (maybe thousands)

more indicators available in advanced charting packages like those from TradeStation. Fortunately, once you understand the basics of those outlined in this book, learning new ones will not take long—many newer indicators are simply variations of ones that have existed for quite some time. Nevertheless, each is different, and some might make a lot more sense to you than others. Experiment and look at different indicators over different time frames, but focus on intraday charts of futures and forex for day trading.

Over time and with some experience, you will develop a finer appreciation of the nuances and applicability of various indicators. Soon thereafter you will gain a sense of how various indicators fit in (or do not fit in) to your winning tradeplan.

Lwp t atrp

- Day traders use indicators to identify periods of market strength and weakness, trends, and potential reversals, and to help them better time their entries to trades.
- The moving average is a common and useful type of chart indicator.
- Momentum indicators move with the price but can also identify overbought or oversold market conditions.
- Oscillators are often used to help spot potential turning points when prices are moving in a range.

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c t ıuc pst

Lwp t X t xt

- » Managing risk
- » Consistent trading opportunities
- » Setups and strategy
- » Stop-losses and profit targets

The last three chapters provided a lot of tools for your day trading. You learned about technical analysis—drawing trendlines, using indicators like MACD and RSI—and you now know how to identify support and resistance areas on a chart. All these methods or indicators can be backtested and used as part of a trading strategy. The goal is to find an approach that works over periods of time and a system of buying and selling that generates consistent profits.

Now we are going to talk about specific trading strategies day traders can use when encountering various setups—such as reversals, pullbacks, and breakouts—that were discussed in Chapters 6 to 8. It is one thing to spot a reversal, but then what? Do I buy or sell? What if I spot a pullback or divergence? What is the best strategy? How should I approach the markets when my indicators scream action?

We will finish this chapter and part II of the book by talking about

different order types that we can use when buying or selling. After all, it is impossible to implement a trading strategy without knowing the mechanics of trading and how to place orders.

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Maybe you feel ready to test some of the indicators and jump-start your trading in a live account. I suggest you wait and finish reading the entire book first. It is extremely important to test ideas and strategies before risking real money. Part IV will give tools you need to conduct a successful backtest. For now, we are going to talk a little bit about strategy; that is, what kind of strategies are suitable for different setups.

My strategies are custom, I create them, and most are based on price patterns I have identified that lead to high-probability outcomes. In other words, I feel a strategy has higher odds of success when it has been tested and proven in advance. In that respect, the rules that follow are only examples and not suggestions. Only you can determine what strategy and plan is best for your personal situation, and that decision should be based on personal analysis and thorough backtesting.

K t pzı

Setup: One of the best trading situations is when prices are breaking out of a range, above a previous resistance level or below a support level. The move can often attract a flurry of buying and selling interest, as players try to play the new trend that might develop as a result of the breakout. Breakout moves typically come after the market takes a pause (price consolidation) and can be identified using some of the patterns discussed in chapter 7.

» **Continuation patterns**: The flags and triangles are often followed by a breakout in the same direction as the main trend.

» **Sideways or consolidation patterns**: Sometimes the market will trade sideways or coil before an explosive move higher or lower.
» **Support and resistance**: An obvious breakout below a key support/resistance level or moving average can trigger a flurry of trading activity as the move gets underway.
» **Trading Strategy**: The typical strategy when playing a breakout setup is to trade in the direction of the breakout. If prices have been moving sideways, or coiling into a triangle, the breakout move could be to the upside or downside. Trade breakout moves above resistance to the upside with long positions, and trade moves to the downside below support with short positions. Place a stop-loss somewhere below support for long trades or above resistance for short trades.

In figure 51, for instance, prices are in a range between support and resistance. There is a breakout, and a long position is entered as the price moves beyond resistance. Then, a protective stop-loss can be opened just below the previous reaction low, because a drop below that level might suggest the breakout has failed to materialize.

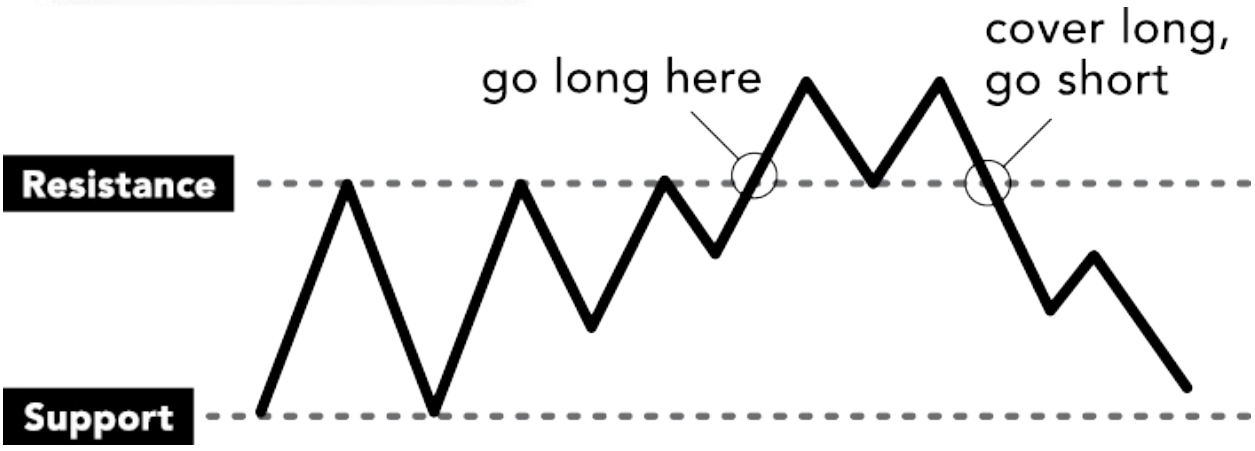
GRAPHIC fig. 51

CAUTION

In some cases, the stop in figure 51 may be best placed below the support, giving the trade more room to develop and avoiding the risk of stopping out prematurely. More risk would be assumed in such a trade, but it could be necessary.

There is a lot of nuance to trading breakouts because breakouts often fail when many traders have the same idea for trading the move. One of my favorite trades is to wait for a failed breakout. When the breakout does not follow through with continued price action in the same direction, I trade in the opposite direction. Often, a failed breakout in one direction will lead to a large move in the opposite direction. These are the trades that I relish, and with a little practice you can learn to spot them for yourself.

GRAPHIC fig. 52



In figure 52, the breakout above resistance fails. This occurs on the right shoulder of the "M" pattern, because the price is unable to move higher. It

fails to make a new high. Then, it moves down to test the resistance line. As is so often the case, resistance becomes support. There is an attempt to hold support (at the point of previous resistance). A double top reversal pattern unfolds before prices eventually fail to hold support, offering the opportunity to take a short position after the price fails to move higher (as indicated in figure 52).

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Setup: Markets trend up and down but do not move in a straight line. Instead, the trend will experience several counter-trends that we call pullbacks or retracements. A pullback in an uptrend represents a momentary period of weakness and a buying opportunity. A pullback in a downtrend is short-term strength that can be sold into.

Trading Strategy: In a bullish uptrend, identify pullbacks toward key price points or support levels to initiate long positions. These represent some of the best day trading opportunities, especially early in the move. Place a stop-loss below the prior support. On the other hand, look to take short positions when the trend is obviously to the downside and prices see an uptick toward resistance areas or key price levels. Set a stop above the previous level of resistance.

The action, reaction, and subsequent action move is a good example of trading a pullback. Recall from chapter 6 that trends have two components: action and reaction. Since the subsequent action move (the next action after the reaction) tends to mirror the first action move to some extent, many types of trade setups can be used to take advantage of this phenomenon. I look to trade the action, as trading the reaction has much lower odds and generally loses.

I use a momentum indicator or a specific moving average to help mark where

a reaction move might end. As a general guideline, the reaction move should be approximately one-third to two-thirds of the first action move. Fib retracement levels can also be used to identify pullback zones and the possible end to a reaction. Then, a subsequent action move might begin, which often tends to mirror the first action move. Of course, nothing is perfect, but this subsequent action move is often predictable and tradeable.

Also, if in a trend, and the action move is waning and losing energy in comparison to the earlier action moves, it is probably a warning sign that the trend is running out of steam. Then, what might seem like a reaction move or a pullback could be a new action move in the opposite direction! It is a good idea to see what is happening on the charts with longer time frames to help align more stars in your favor and avoid getting caught in a higher time frame reversal when trying to play the primary trend on a faster chart.

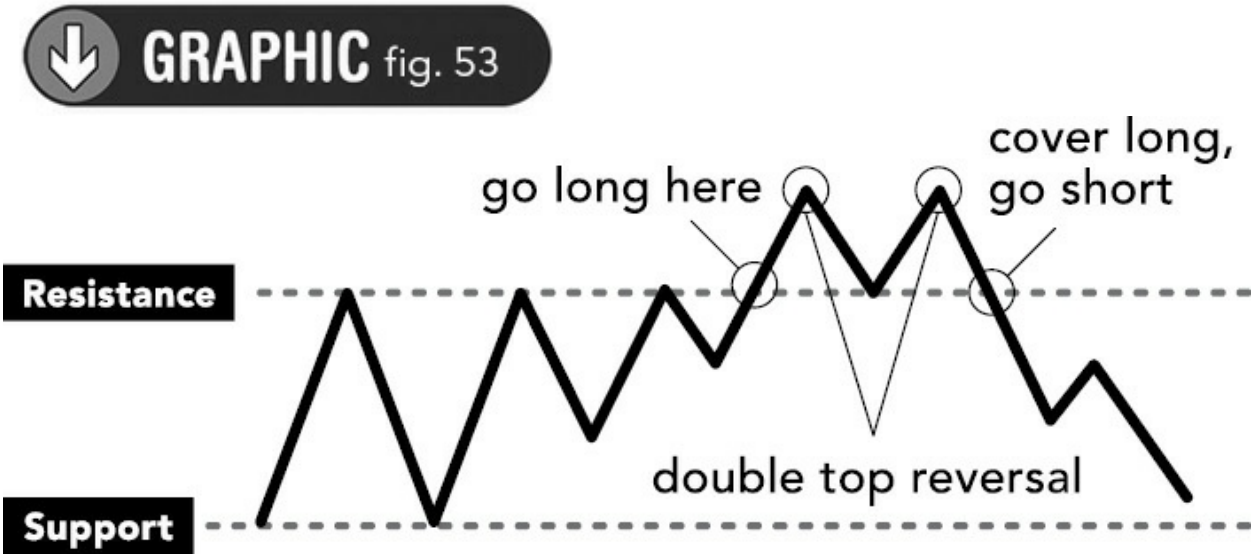
at t p“

Setup: Reversals occur when major trends change direction; they offer excellent trading opportunities when correctly identified. Some of the classic chart patterns, like double tops and bottoms or head and shoulders, may warn of impending reversals. Divergences between momentum indicators and price action often happen before important turning points as well.

Trading Strategy: Tread carefully when trading reversals. Day traders want to ride the trend—not bet against it—and it is difficult to determine when a trend is reaching its end. Timing a reversal is difficult in the action, reaction, action move, but there are a few early warning signs that the action move is waning and set to become a new action move in the opposite direction. For one thing, the action move begins to wane and lose steam.

The stair-step action might give way to a few stumbles, such as a failure to make higher lows in an uptrend as in the head and shoulders or double top.

Then, failure to hold support (or resistance) would be the next telling sign that a reversal was underway. That was the case in the failed move discussed earlier, illustrated in figure 52 (also see figure 53). A double top reversal formed on the chart and prices fell through support.



If you are in an open position and are convinced that the action move has changed direction—a reversal is unfolding—it makes sense to change direction on the trade. If you were long, it might make sense to stop and reverse to short, or, if you were short, the optimal play might be to close the short and go long. At the very least, it probably makes sense to close your current position. Do not become married to a position or point of view. Always be on the lookout for potential trend reversals and the opportunities they present.

Mx t vt”rt

Setup: Some traders believe that divergences between technical indicators and price action can signal that a reversal is imminent. We saw, for example, that if prices reach new highs and indicators like RSI or the MACD histogram

make lower highs, it might signal that the uptrend is running out of steam and the market is about to turn south. The opposite is true when prices reach new lows and the indicators do not confirm the new lows with new lows of their own. They make higher lows, which is what causes the divergence between the indicator and the price action.

Trading Strategy: Divergences are my least favorite setup. I find these types of signals to be flaky in real time. For example, it might seem as if the MACD is making a higher low while prices are making a lower low, but how do we know at that time that the MACD is finished going lower? Remember, it is a lagging indicator. It is much easier to see this phenomenon after the fact, which to me makes it impractical for use in trade decisions. It is better to use divergences as confirmation information that a reversal is possibly at hand.

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People might tell you that day trading is risky. It is. But it might not be as risky as you think. For one thing, each trader decides on the size of their trades. If, for example, you buy 100 shares of a $5 stock, how much are you risking? Answer: 5 x $100, or $500. The risk of a trade varies based on the size of the position (and the amount of leverage, which we will discuss shortly).

Risk can further be reduced with stop-loss orders (or “stop orders”). In the previous example, if a stop-loss is placed .25 below the share price, the risk on a move lower is only $25 if shares are sold at $4.75, or $475 on 100 shares. I never enter a trade without a stop-loss, and neither should you.

Second, most day traders will end the day without any open positions. That is, they are “flat” and holding only cash at the end of the day. There is not much risk in holding cash unless your account is funded with Venezuelan

bolívars.

The risk that day traders face is when positions are open, or live. For example, if you are long on crude oil futures, the risk is that crude oil will fall while the position is open and not yet covered through an offsetting sale. The time frame for open positions will vary based on the setup, the targets, stops, and movement in price. The time can be from just minutes to a few hours (I prefer minutes). Remember, there is no risk when your account is flat, and the risk on opened positions is from the entry price to the stop-loss—the risk should be defined precisely before the position is opened and should also include trade costs like commission and slippage.

I am not saying that day trading is without risk. Mr. Beast can get into a foul mood at any moment, quickly turning in one direction or the other, and whack a day trader with unexpected losses. In addition, the use of margin and ***leverage*** can greatly affect the potential for large profits and, when used irresponsibly, big losses.

Many students ask me about margin and how much they should trade. My typical answer is that if they are worried about margin, then they are probably overtrading their account–trading larger than they should. A better approach is to stick to a small risk: capital ratio. Specifically, risking 2% of their account on any one trade is a good guideline, and they should only risk that 2% on trades that fit within the context of a proven winning tradeplan. If they do that, they will never need to worry about margin.

c pst N tr x”

Trade execution is the process of placing trades. Day traders use a handful of order types to enter and exit positions. As noted earlier, the stop-loss order is among the most important, because it allows traders to limit risk. Other order types, like stop-limits and stop market orders, are used for entering trades if our entry is above the current market price for longs, or below the current market price for shorts. The market has to continue moving in the direction of our trade to get to our entry price and fill our order.

If we want to avoid paying too much in slippage, which, if you recall from chapter 2, is the frustrating phenomenon that occurs when the market moves too fast and we don't get the transaction price we think we are getting, we can place a stop-limit order. If we cannot get filled at the price we specify, then we don't enter the trade. On the other hand, if we want to be certain that we get filled on a trade, we might place a stop market order. If the price moves to our stop price, we will get filled but will most likely pay some slippage. Slippage can really add up over the course of a year's worth of trading.

For the type of trading I do, I typically use stop-limit orders and specify zero slippage, but a case can be made in some markets to accept a small amount of slippage. If you find that you are missing a significant number of trades due to not wanting to pay any slippage (the market often moves through your designated entry price too quickly, leaving you standing at the station), then you will greatly increase the chances of getting filled if you allow a small amount of slippage. Heating oil futures is a good example. The tick is only $4.20 as compared to crude oil futures, which are $10 per tick. Heating oil is an explosive market, and you can catch a big runner (a trade that continues to move favorably way beyond your initial target). But heating oil futures is a thinly traded market with much less volume being traded than in the crude oil futures market.

Trading thin markets makes it more difficult to get filled at exactly your stop-limit price and is also prone to larger-than-usual slippage. In this case, it makes sense to mitigate both risks by setting a small, acceptable amount of slippage. You might allow 4 ticks ($16.80) of slippage, for example, in heating oil futures. That is still less than 2 ticks ($20.00) of slippage, in crude oil futures. Yet, if you can pick up a 100-tick trade, which is not uncommon in that market, it is worth paying a little extra slippage to increase your chances of getting into the trade.

Kp xr X st c t

Quotes for futures, options, or stocks include a bid price and an ask price. The bid price is the best price available to sellers and the ask is the current price for buyers. With limit orders, we can place orders to buy and sell at any price, including mid-market between the bid and ask.

If I place what's known as a ***market order*** to buy, I will probably pay something near the asking price and sometimes extra slippage. In fast markets, I might pay a lot more or a lot less, but my trade will go through at the best price and there is no chance that it will not get executed (filled).

On the other hand, I can place a ***limit order*** for the same buy or sell and specify my price. While a limit order guarantees I will not pay more than my price (or receive less on a sale), there is no assurance that the trade will get executed. So there is a huge difference between market and limit orders:

» **Market Order**: An order to buy or sell at the best available price.

» **Limit Order**: An order to buy or sell at a specific price. With a limit order, for longs, the order price must be below the market, and if the market pulls back and touches your limit, then you may be filled at that price. The opposite is true with short selling. A limit order price needs to be above the market.

» **Stop-Limit**: An order to buy or sell, when a price is reached, at a specific price. It can be used to enter or exit a position. When entering a position, if going long, the order price is placed above the market. When the price moves up and touches the limit price, it will trigger the stop-limit order and you will be filled, if there is someone else willing to sell at that price. For example, you could place a stop-limit order and be tenth in line, that is, nine orders were already placed before you placed yours. If there are only nine sellers, then the first nine orders will get filled and yours will not. The price could keep moving higher and never retrace back to your order. You remain on the sidelines unfilled, as the market moves up to what would have been your profit objective. The opposite is true with short selling.

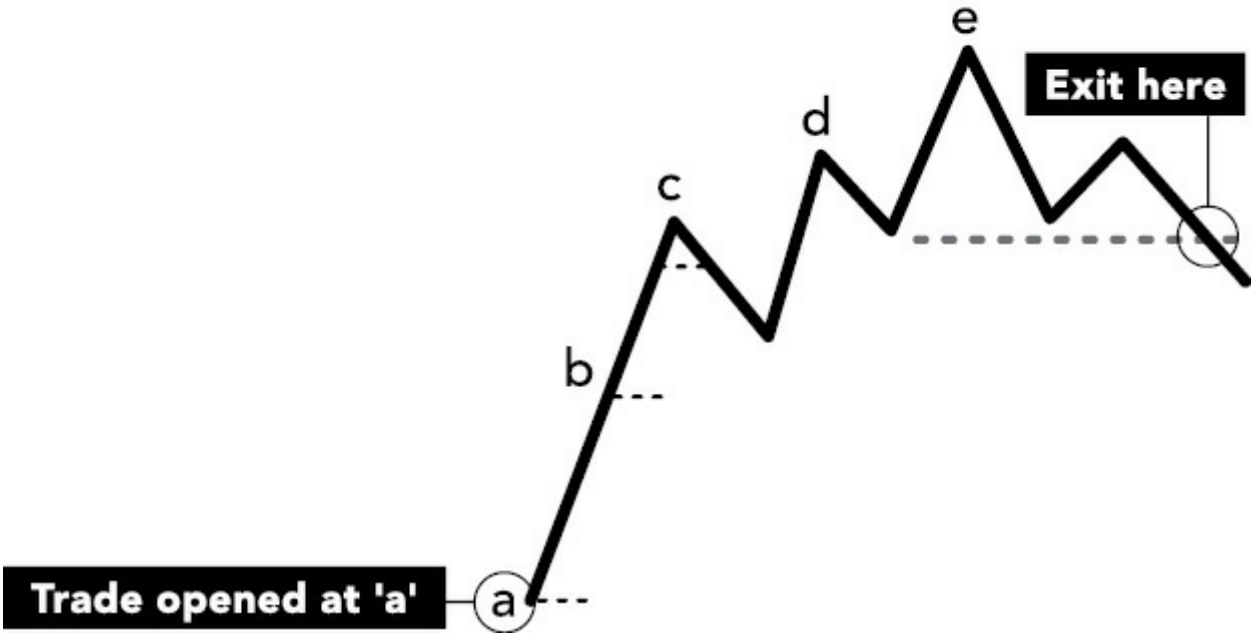
Typically, I try to get into my trades using stop-limit orders. Such an approach greatly reduces slippage costs. On rare occasions, I might not be filled on the limit and will miss the move I was anticipating. This usually happens in a fast-moving market. Had I entered the trade with a stop market order instead, it would have filled, but I probably would have paid higher-than-usual slippage.

When sending limit (profit target) and stop-limit (stop-loss) orders along with an entry order, the targets and stops make up a "bracket." For example, a long position can be bracketed with a sell limit above the price and a sell stop below the price. Some of the better online trading platforms allow traders to easily create brackets around orders when going long or short. That is the only way I trade.

- **Stop Market**: An order to buy or sell a position when a specific price is touched, at the best available price. Stop market orders are like stop-limit orders except that when the price is hit, your order becomes a market order. Say you want to get into a long trade if the price moves up to a certain price, and the price is hit. Your order becomes a market order and you are quickly filled, usually paying some sort of slippage.
- **Trailing Stop**: A type of stop order that is adjusted either automatically or manually (by the trader) in increments, as the price of the stock, futures, or forex continues to move in the direction of their trade. It is adjusted up for longs and down for shorts. Not all trailing stops move in regular increments, as there are many different trailing stop techniques—some adjust by a dollar amount, some by percentage moves, some by technical levels, and some even by proprietary (custom) algorithms. The idea is that the stop moves below the market (on long positions) as the price continues to move in a profitable direction. By trailing the stop, you lock in profit while giving the trade room to make more and more, as the price continues to trend in your direction.

GRAPHIC fig. 54

A TRAILING STOP EXAMPLE



EXAMPLE

Figure 54 demonstrates one way of using a trailing stop. A new position is opened with an entry order placed at point A, where it gets filled. (The original stop has been placed somewhere below point A.) When the price reaches B, the stop-loss is moved to point A, eliminating the risk on the trade. When the price reaches level C, the stop-loss is moved to point B, locking in some guaranteed profit in case the price does an about-face and heads lower. The price does react down, but doesn't fall far enough to hit our stop at B, so we remain in the trade. Once the market resumes upward, we can move our trailing stop to one or two ticks below the end of the reaction move, which reveals the next support level that we will hide our next stop behind. When the price reaches D, it retraces again with another reaction move, making a higher low and revealing a new support area when it moves up to E. We can now move our stop higher

and hide it just below the new reaction level. The stop-loss orders *trail* the higher lows, each representing a level of support revealed on the chart by the price action itself. After the price reaches E and then falls back to below the prior reaction level, the stop is finally triggered. When the price hits the stop, the position is closed, and the profit is the difference between point A (the entry) and our exit, which is our stop price.

- A good-till-canceled, or GTC, is an order type that specifies that the order is to be left open until canceled by the trader. That contrasts with the more commonly used day order, which expires at the end of the trading day. By default, orders to buy and sell are day orders and expire at the end of the day's trading session.
- A fill-or-kill order is one that is either executed immediately at a limit order price or, if not, canceled. Fill-or-kill is probably the least used order type.
- The market-on-close is a common order type for day traders who want to exit a trade at the close of the day to prevent holding an open position overnight. It specifies that the trade be executed at the last closing price of the day. It might be used in conjunction with a ***bracket order***. The bracket designates the target and the stop. Whichever "handle" is hit first cancels the other. But if the market closes prior to hitting one of the handles, the entire trade is closed at the market close. The idea is to give the trade every chance to fulfill itself but to be assured it will flatten out at the close of the market.

Js p"rts X st c t

Brokerage firms often offer more advanced order types. The menu can vary depending on the trading platform, but the ones already mentioned are standard throughout the industry. Order sends order (OSO) and order cancels order (OCO) are two advanced order entry techniques that I consider

essential to my day trading.

I use OSO and OCO simultaneously when I place trades. The OSO includes a primary order and one or more secondary orders. The secondary orders become active orders once the primary order is executed, or filled. I refer to OCO orders as "handles" because they represent the target(s) and stop-loss of the trade. I use a template where the handles are always a predesignated distance from my entry. Then I slide the handles to an exact price level based on what the trade needs per my strategy and tradeplan rules.

- **Order sends order**: An order type that has a primary order (an entry) and one or more secondary orders (stop-loss and targets). The secondary orders become active orders after the first order has been executed. In other words, your entry price is hit and you are filled, triggered into the trade. At that point, the handles become live orders. Prior to the entry being filled, the handles were just pending orders and completely inactive.
- **Order cancels order**: A secondary order to cancel an opposite open order, both being "attached" to each other. Once one is hit, the OCO cancels the opposite open order and the trade is finished (flat). This type of order is also referred to as a bracket order. If the target is hit, then the corresponding stop-loss is automatically canceled, and if the stop-loss is hit, the targets are canceled. This way, there are no "orphan" open orders hanging out in the market that the trader may have forgotten about. If you don't use bracket orders (OCOs), you run the risk of forgetting to cancel all open orders that are still in place after your trade has finished. That could lead to a disaster and unlimited losses.

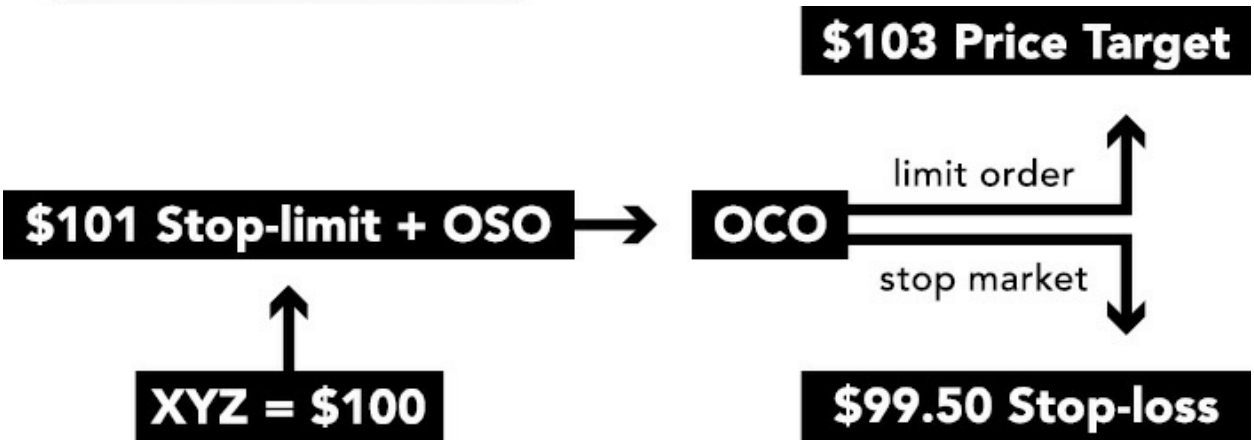
Let's begin with the OSO part of the trade. When I place a trade, I know

what my entry will be, whether long or short. For instance, let's assume an asset is trading at $100 and I want to enter the trade at $101, going long on a breakout move above the current market price. I set a stop-limit order to buy at $101, and that is my primary order.

I also know, before entering the trade, what my stop is going to be. In this example it is $99.50. Instead of just placing a stop-limit order, I use an OSO order that includes the stop-limit buy at $101 and a stop-limit sell at $99.50. When the entry of $101 is hit, my stop-loss order is automatically sent, placed, and is now an active order. This is how an OSO works: order sends order.

Going one step further, though, rather than having a stop-loss as my secondary order, I can use an OCO that includes both my price target (a limit order to sell at, say, $103) and my stop-loss (stop-limit at $99.50). Once my primary OSO order is filled, it automatically sends the target and stop orders as OCO orders, as shown in figure 55. Then, if the target gets hit, it automatically cancels its corresponding stop-loss. If the stop gets hit, the target(s) is automatically canceled.

GRAPHIC fig. 55



An OSO can be used to send an OCO, creating a bracket around the position. After the primary order of an OSO is filled, the OSO fires off an OCO that consists of two active orders to either 1) take profits or 2) stop out.

Using OSO and OCO orders is the best way for me to day trade because the entire trade is planned, managed, and easy to visualize from the beginning. If you do not use OSO and OCO orders, then you must remember to manually cancel any stray orders that remain active once the trade has run its course. Believe me, you do not want to hit a target (or a stop) and discover that you had an open order that later gets triggered without your knowledge, because you accidentally forgot to cancel all open orders. Such mistakes can be costly and incredibly frustrating. The habitual use of OSO and OCO orders provides an insurance policy against this unneeded anguish.

These types of brackets can even be set up with offset limit orders to use for multiple targets. If I have a two-position trade (for example, consisting of two contracts), I might have a bracket where the stop on both positions is 20 ticks away from my entry. My targets might be 20 ticks and 22 ticks. I can then slide the handles to their correct locations. Since the stop and targets are bracketing the entry, they are handles that can be dragged right on the chart to their exact stop-loss and target levels as each planned trade setup dictates.

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When I initiate a trade, I usually use a stop-limit order to avoid slippage. Then I wait for the price to move in the direction of my trade, to my entry price, which triggers my buy (if I am going long) or my sell (if I am going short). I have an exact entry price based on my proven tradeplan. Most of the time I get filled on my limit orders, and since they are limit orders I avoid paying slippage, which is a very real cost and can quickly add up.

If the market is very fast, or thinly traded, then it is possible that I will not get filled on a stop-limit order, even if the stop-limit price is reached. If there

is no one to take the other side of my trade at my stop-limit price, then the actual market price could blow right by my entry price and leave me on the sidelines. It is like a speeding train that fails to stop at the station. On the other hand, had I placed a market order during a fast market, I would probably have paid too much in slippage in that same scenario. Therefore, I tend to take my chances with limit orders rather than market orders. As I mentioned, slippage costs add up and take too big a bite out of my profits, so I'm a big believer in stop-limit orders for my entries rather than stop market orders.

Slippage can add up to thousands of dollars over the course of a year. Imagine a contract of crude oil, where every .01 represents $10. The commission and exchange fees are only $5 or less per contract. But one tick of slippage would be $10 per contract. Three ticks of slippage, which is not uncommon, would be $30 per contract. Beginning traders don't usually pay attention to slippage because they don't see its costly effects right away. But it becomes hard to ignore when your $150 target objective only nets $115 in your account. That's what three ticks of slippage, your commission, and your fees would cost you, per contract. That's a 23% haircut!

Always use stop market orders for your stop-losses. Using a stop-limit order as a stop-loss is quite foolish and can lead to disastrous losses if the limit doesn't get filled. A stop market ensures that you will get out even if you have to pay slippage. At that point, I just look at it as the cost of doing business. Getting out of the trade at the stop-loss, even when you get dinged with slippage, is far more important than avoiding slippage with a stop-limit order and not getting filled at all as the price continues to move further and further against you.

While I typically like to use a stop-limit order to enter my trades to avoid slippage, there are cases when you really need to use stop market orders. A "stop and reversal" offers an example. Let's say we are in a long trade and the market is moving against us. In accordance with our trade strategy, a new short trade might present itself, which will put us in a situation where we need to exit our long trade and enter our short trade. The short entry price is closer than the full stop-loss on the original long trade. In other words, we can cut the loss on the first trade, while flipping over to the short side with a new short trade at the same price at which we exit the long trade. In such a case, we must use a stop market order for the new short entry, or there is a chance we could exit the long but not get filled on the short.

The downside to this approach is that there is no guarantee of the price of the new short entry, because it is a stop market rather than a stop-limit order. Slippage costs are inevitable in this case. Nevertheless, once you have experienced this scenario, not getting filled on the reversing order, only to watch the short trade run to its full target objective, you learn right away the importance of knowing when and how to place the proper order for the specific situation.

For targets (where we exit the trade), we will use simple limit orders. To be guaranteed a fill, the price has to trade through your target by 1 tick. Depending on the market, hitting your target exactly to the number will usually fill you and exit your position, but not always. Some markets fill easier at the exact target than others. The ES (S&P E-mini) is notorious for not filling you unless you trade through the price.

Many of my strategies often prove to have very precise results; the price hits the target exactly and then turns in the other direction. When this happens, I

check to be sure that my position was actually filled. If it was not, then I quickly "market out" by hitting the "market out" button on my trading platform. Entering this command exits the position at the next best price. I immediately make sure that all open orders are also canceled. That should become a habit so you never forget.

What if I miss a nice target objective by just 1 tick or, similarly, the price goes 95% of the way to my target objective but can't quite get there? I know I am not going to get filled because my specified limit was not hit. This is a tricky situation, because I have not hit my full target, but at this point the price could turn the other way and go all the way back to my entry. Not good! I don't like to fight over 1 tick while the rest of my profits are at risk of evaporating. I either just market out at this point or push my stop forward a bit to lock in a majority of my profit while still allowing the trade a chance to reach its designated target.

I have a final practical tip on trade execution that you might not have considered: be prepared for potential hiccups when trading online. For example, your screen freezes, the internet goes down (which it probably will), your power goes out, or your computer crashes. You cannot manage your trades, and that can lead to big problems if the market takes a turn in the wrong direction.

Create and maintain a backup plan that allows you to execute trades under any circumstance. Whether it involves trading on your smartphone or your tablet or—if you want to be archaic—calling your broker's telephone number, have a plan. When your mind is made up about a trade, it is important that nothing stands in the way of your ability to execute your trade correctly from start to finish. A huge benefit of always using bracket orders as I described is that your broker has the order and if you do lose control of your trade, you've

already predefined your risk by having your stop-loss in place.

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- Different setups sometimes call for different types of trading strategies.
- Breakout moves above resistance or below support often offer opportunities to enter long or short positions.
- Be wary of failed breakouts and reversals; do not be afraid to change a trade from long to short (or short to long). These decisions should be based on your tradeplan rules.
- The amount of risk on one trade can be known ahead of time, and limited, with stop-loss orders.
- Day traders can use several different order types, including stop-limits, order cancels order, and order sends order, to better manage each trade.

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- » Real trade examples
- » Entry and exit
- » Trading reversal patterns
- » More on flags and triangles
- » Know your stop
- » Trading classic chart patterns, pullbacks, and open spaces

At this point, your head might be ready to explode with all the information you have taken in. It is a lot to remember, but since I wanted to write a book for all trading levels, I thought it best to provide a lot of background information to help aspiring day traders get started quickly.

This chapter turns the things we've talked about so far into real-world examples. Keep in mind, these are not necessarily trade setups that I use in my own day trading. For example, I am going to show you a profile for trading a head and shoulders reversal, which we detailed in chapter 7. I normally do not use this formation in my personal trading because I follow the precise rules of my tradeplan, which looks for patterns in an entirely different way. Nevertheless, the head and shoulders pattern that I highlight in this chapter is the pattern that launched my trading in the early '90s. The

head and shoulders pattern works the same way now, decades later.

At the end of this chapter you should understand the basic elements of a real trade. In other words, you should have a solid understanding of the terms we outlined in chapters 6–9 and how they apply to real trading situations:

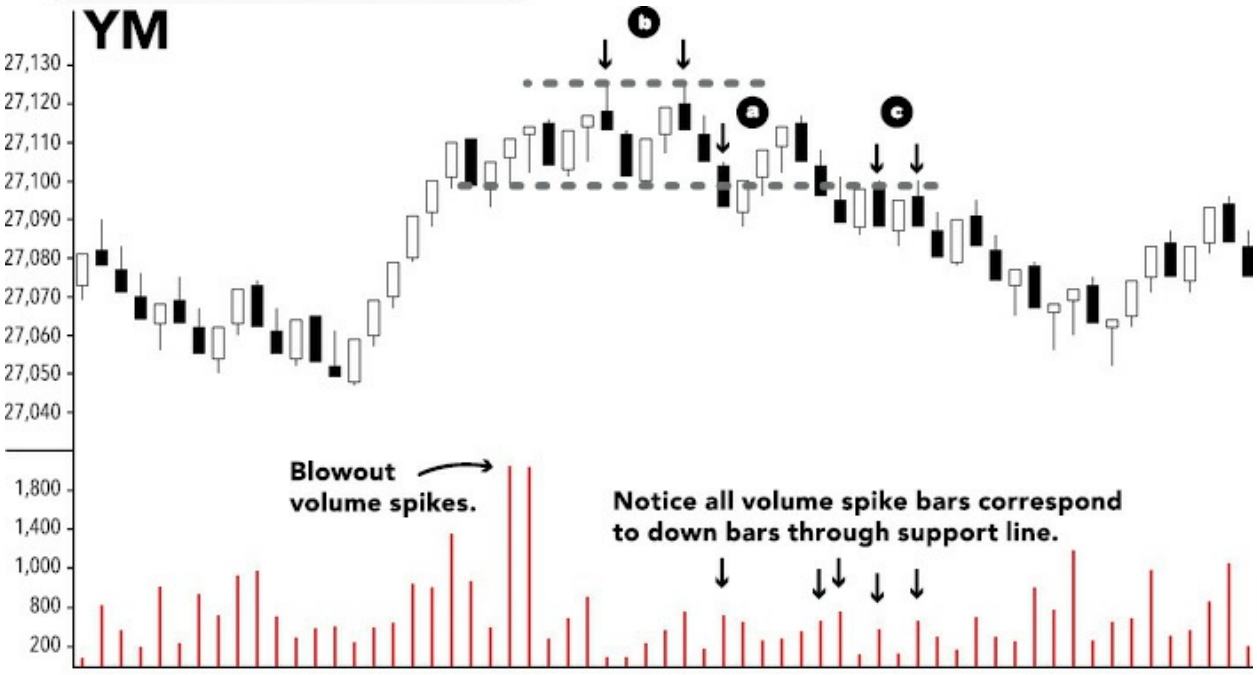
- **Entry**: The price where I want the initial trade executed. For example, if my plan says to sell crude oil at $55.34, my entry price would be at the 55.34 price quote.
- **Setup bar**: A (candlestick) bar on the chart that will present a trade with a given set of parameters. It can help determine where a position is opened, where the stop is placed, and where other important elements of a trade are defined. It is the bar that sets up the trade based on the rules defined by the specific trade setup.
- **Profit target**: The target is our profit objective and is where we exit some or all of the position to take profits.
- **Stop or stop-loss**: A stop is the price where we exit the trade if the market makes a turn in the wrong direction. It is originally placed at a price level that defines the maximum risk we are willing to accept on the trade. As the trade progresses, the stop can be moved to reduce or eliminate risk or even to lock in profit.
- **Key level**: The key level is a technical level that represents a significant price point on the chart where we can expect to find support or resistance. It can be a price point, usually at big round numbers—10, 25, 50, and 100—but can be multiples of five as well, for certain markets. It can also be at a chart level where we can identify pivot points and swing levels.
- **Key level adjustment**: An adjustment to the entry, the stop, targets, or any combination of these to account for a key level is called a key level adjustment.

The walk-through trades in this chapter are highly detailed, and you can look forward to learning a lot about the step-by-step realities of trading. Nevertheless, if you are serious about becoming a successful trader, then you will also want to check out my training videos and the other digital assets available in your digital asset vault at **www.clydebankmedia.com/trading-assets.**

M q‘t c ı bt

The first example (figure 56) is a basic reversal trade after the chart shows a double-top reversal. This pattern marks the end of the run higher and paves the way for a move to the downside. Looking at this 12-tick momentum bar chart, you may recognize the pattern as an example of a double-top pattern discussed in chapter 7.

GRAPHIC fig. 56



a An aggressive entry on the first downward break through the support line is the riskiest.

b Place the stop-loss a few ticks above resistance.

c Better odds can be had when entering on a retest of the support line. Support becomes resistance.

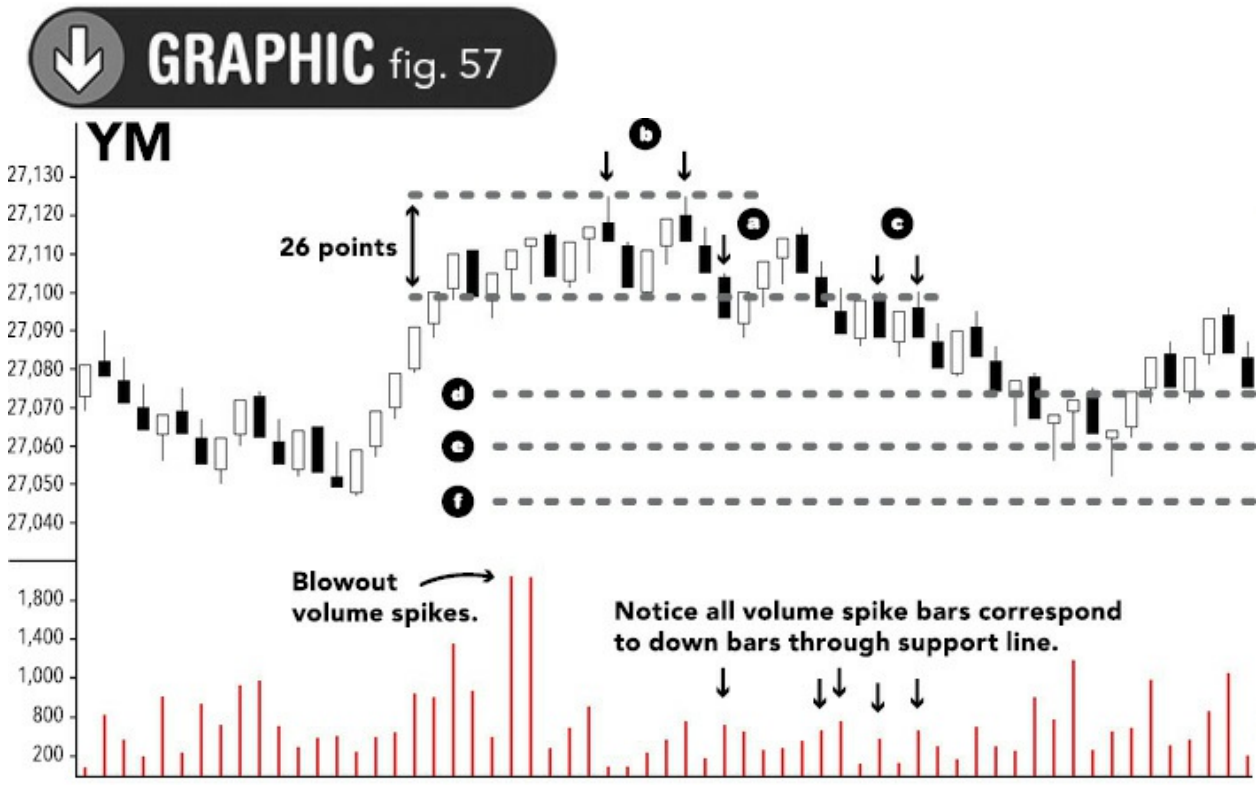
How might one trade a pattern like this? You can see in the example two locations where a short position could be initiated (see points A and C). You can craft an appropriate profit target by measuring the distance between the resistance line at the double top and the support line below it. Then, project that same distance downward, below the support line, to initiate a very high-probability trade. This is Target 1.

REMEMBER

Dow E-mini futures trade in points, and each point is worth $5. Therefore, the value of a position that includes two contracts will increase or decrease by $10 for every one-point move in the futures contract.

Target 1, which is 1x the distance between the resistance and the support line, extends downward from the support line (see item D in figure 57). It has the highest odds of being hit. Target 2 can be established similarly but extends downward 1.5x the distance between the resistance and support lines. Target 2's odds of being hit are also excellent but not quite as good as those of Target 1. Target 2 is the "primary target" when trading one contract; when trading more, you might begin to aim for the third target. Target 3, which is at 2x the distance, has decent odds of success too, but not as good, obviously, as the odds of Targets 1 and 2, which require less price movement.

When the price passes the 1.5x level, you can move your stop to the 1x level, locking in the fruits of your Target 1 success and guaranteeing a nice profit, while also giving the trade a chance to hit the 2x (Target 3) level. For many traders, this simple, common-sense approach to trade management is enough for success.



d 1 x 26 = 26 points = $130 profit per contract when hit

e 1.5 x 26 = 39 points = $195 per contract when hit

f 2 x 26 = 52 points = $260 per contract when hit (the price was unable to reach this 2x target level in this case)

Qt ps p”s bw “st bt

Sometimes it takes a keen eye to spot a head and shoulders pattern with intraday charts, but with a little practice, you will get the hang of it. In figure 58 we have a five-minute Dow E-mini chart (each bar represents five minutes’ worth of trades). A head and shoulders pattern forms during the morning session.

In this example, we see an ascending neckline, which is drawn across points 2 and 4. As prices break the neckline at point 6, a short trade can be initiated.

The price will often come up and retest the neckline from below (support becomes resistance), which is a better place to get short with high odds of success. In this case, the price failed to rebound. Sometimes buyer capitulation is so strong that they cannot find enough strength to push the price back up to retest the neckline from below. If you did not get short at point 6, but waited instead for the retest, then you lost the opportunity and missed this move. Nothing is ever perfect with trading.

1. Is the first shoulder (or the "left" shoulder).
2. Marks where the sellers initially find support. The buyers then step in and push the price to new highs (point 3).
3. Marks the head, and the highest point of this pattern.
4. Shows where sellers find support again as they attempt to push the price lower.
5. Shows the feeble attempt of the buyers to push the price higher. They quickly run out of energy, as exhibited by the very weak right shoulder (2nd shoulder). This is a very bearish pattern.
6. Shows where shorts can be taken (a few ticks below the ascending neckline).

How might one take advantage of this opportunity with a completely planned trade? Similar to the double top example, if you measure from the lowest part of the pattern, point 2, to the highest point of the pattern, point 3, then you get what we call our ***x factor (multiplier)***. You can then project that distance down from point 2 to generate a family of viable targets. The x

factor in our current trade is equal to 72 (see figure 59).

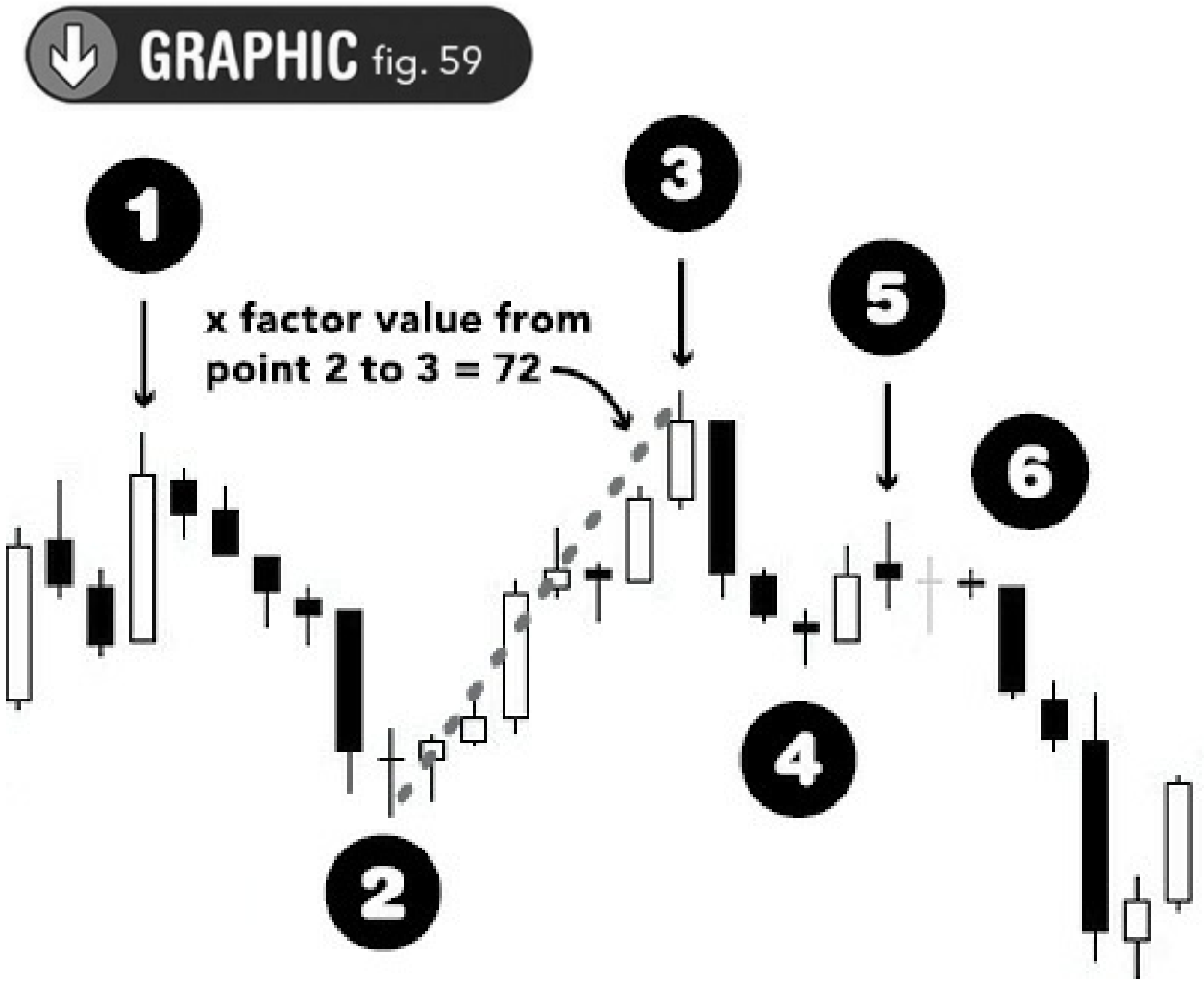


Figure 60 shows the labeled targets, so you can see how accurate they turned out to be:

» Target 1, aka our Money Management Level, was hit perfectly (right on the nose) before the price bounced from that level. We refer to it as the money management level because after it is hit, we like to reduce or eliminate the risk on the trade by moving the stop. In other words, the trade has gone far enough toward our objective so that now we want to manage our risk. We will review our trade

management practice in more detail in a few moments.

» Target 2, aka our Primary Target Objective, was also hit perfectly before the price bounced. The primary target objective is the target level where we typically expect to claim our profits and exit the trade.

» Target 3, aka our Enhanced Goal, was just barely missed before the market headed higher. The enhanced goal target level may or may not be attempted, depending on the trade management approach taken and how many contracts/positions we are trading.

TRADE PROFILE Shorting the Dow E-Mini (YM)			
ENTRY	27227	The entry is a couple of ticks (one tick = $5) below the ascending neckline at point 6.	
STOP	27266	The stop is a few ticks above point 3. (I like to hide the stop around the key level of 5, so I put the stop 4 ticks above point 3.)	
TARGET 1	27120	1x below point 2	
TARGET 2	27084	1.5x below point 2	
TARGET 3	27048	2x below point 2	
RISK	39	The risk is stop-loss – entry x $ per tick (27266 – 27227 = 39 x $5 = $195 risk per contract)	
PROFIT AT TARGET 2		+143 = $715 per contract	
PROFIT AT TARGET 3		+179 = $895 per contract	**x = 72**

TRADE PROFILE NOTE: Using key level adjustment (KLA), we intentionally avoid setting our stop at 27265. That last digit, 5, at the end is potentially a key level, so we would prefer bumping it up by one point.

TRADE PROFILE NOTE: Since we know that each point is worth $5 (when trading one contract), we can easily convert our risk into dollars: 39 x $5 = $195 risk per contract.

It should be noted that trade costs like slippage and commission are not accounted for in our trade profile. I look at those costs as normal business expenses like taxes or utilities, and I account for them elsewhere.

The risk-to-reward ratio in this trade is quite favorable. Our risk—as calculated in figure 60—is 39 ticks ($195), and our reward is 143 ticks ($715), as defined by the difference between our entry and our primary target objective (Target 2, or 27084).

Now that we have the key metrics for the trade, how do we go about managing this trade from start to finish?

» **Step 1**: Decide how many contracts to trade. I like using the 2% rule. Only risk about 2% of your account value on any given trade. Since there is roughly $200 of risk on this trade ($195), you would need a $10,000 trading account to keep the risk within 2%. That would allow you to trade one contract.

You may be a bit taken aback by the 2% rule. Abiding by it in this YM trade would limit you to a single contract. It is important to remember that every trader is different, and the 2% rule is just a general guideline for risk management. Remember, some trades lose even when all the odds are in our favor. Losing two or three in a row is quite common, even with a pattern that wins most of the time. If you risk too much, you can be hurt when you encounter multiple consecutive losing trades. Two percent is a risk level that should keep you from suffering a massive drawdown, so long as you are trading with superior odds on your side. You have to keep in mind, though, that even a strategy that wins 90% of its trades may in fact suffer a 10-trade losing streak, or worse, at some point.

» **Step 2**: When Target 1 is hit, move your stop to one tick beyond your entry price to eliminate your risk entirely on the trade. That extra tick helps you cover the trade costs (slippage/commission) if the price should move against your position. At this point you are in an entirely risk-free trade, which is a great position to be in. I often refer to this position—with Target 1 hit and the stop adjusted—as the "money management position" or "MM" level of the trade. From here we know that we are at least going to break even.

» **Step 3**: When Target 2 is hit, exit your position with your full Target 2 objective. I recommend using Target 2 as your "primary target objective" in a single-contract trade. Go ahead and cash out here.

» **Step 4**: In the event you pursue Target 3, when the price gets 95% of the way to Target 3, protect the position by moving your stop to Target 2. Doing so will lock in Target 2 profits even if the trade turns against you.

Let's take a look at another situation in another market where the head and shoulders pattern comes into play again.

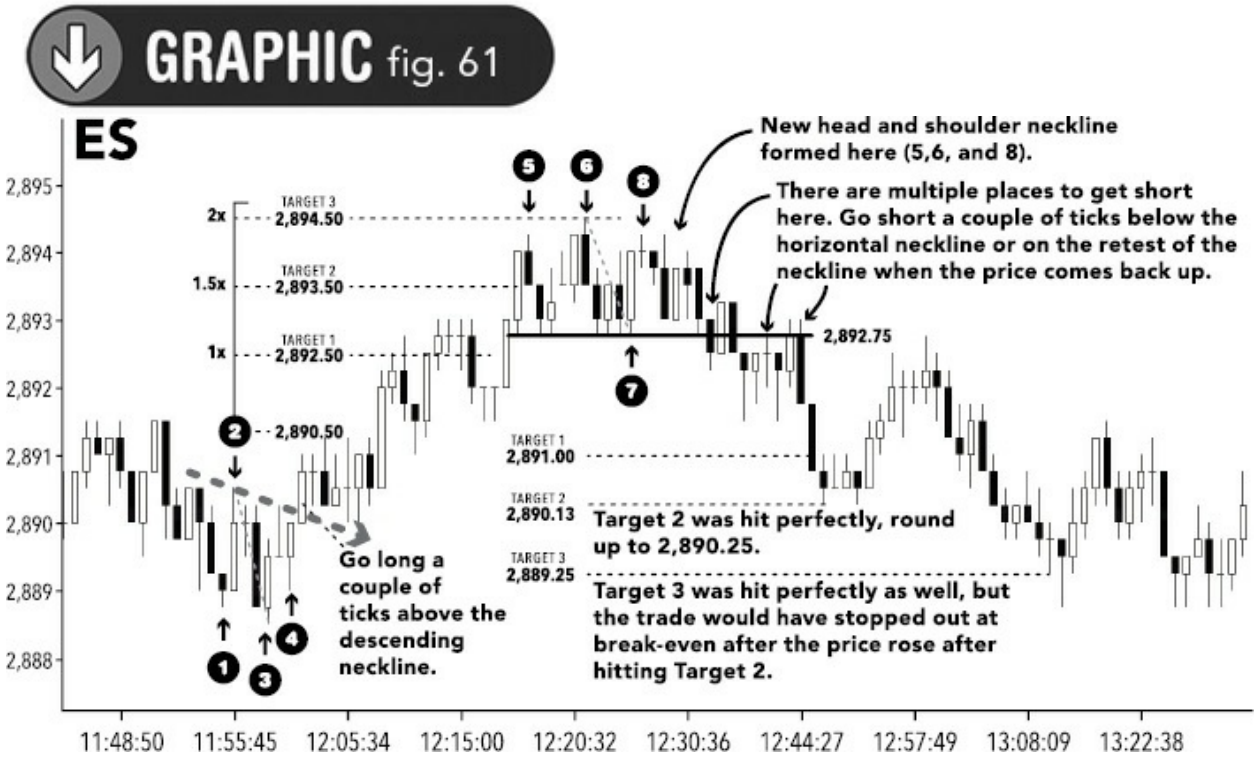
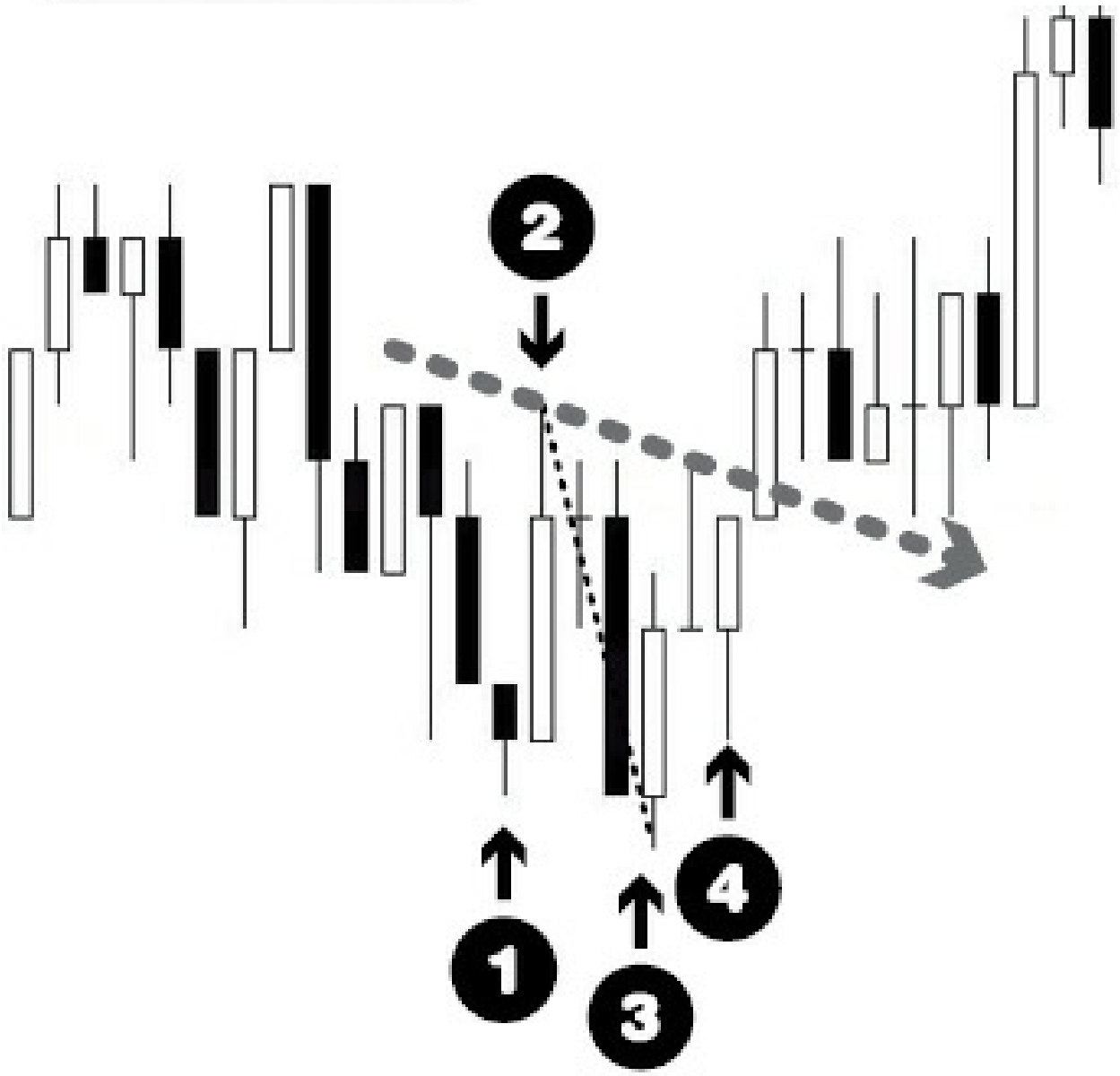


Figure 61 shows the power of the head and shoulders setup. This is a chart of the S&P E-mini (ES). There are two tradeable patterns of note.

Figure 62 zooms in on the upside down head and shoulders pattern from

figure 61 that sets up the long trade. Following the same process we used in the previous example, the first thing to do is measure the distance from the lowest point of the formation at point 3 to the highest point of the descending neckline at point 2.

GRAPHIC fig. 62



This range from point 3 to point 2, as shown in figure 62, is our multiplier (or x factor). In this trade x is equal to 2. As with our previous example, our x factor is multiplied 1x, 1.5x and 2x and extended by this amount from the top of the pattern (point 2, 2890.5), to establish a family of three targets, as we saw in figure 61 and can now see mapped out in figure 63.

TRADE PROFILE Going long on the S&P E-Mini (ES)			
ENTRY	2890.75	Enter off of the right shoulder, a couple of ticks above the descending neckline (each tick = $12.50).	
STOP	2888.00	The stop is placed two ticks below point 3.	
TARGET 1	2892.50	1x above point 2. Remember, when Target 1 is hit, move the stop one tick beyond the entry for a risk-free trade.	
TARGET 2	2893.50	Primary Target Objective. 1.5x above point 2, $137.50 in profit when hit (2.75 points of movement at $50 per point)	
TARGET 3	2894.50	Enhanced Goal. 2x above point 2, $187.50 in profit when hit (3.75 points of movement at $50 per point). The second target when trading additional contracts (notice how perfect it was).	
RISK	2.75	The risk is the difference between the entry and the stop (2890.75 – 2888 = 2.75 points = $137.50).	
PROFIT AT TARGET 2		+2.75 = $137.50	
PROFIT AT TARGET 3		+3.75 = $187.50 per contract	**x = 2**

TRADE PROFILE NOTE: The ES trades at $50 per point, per contract. The minimum price movement (1 tick) is one-fourth of a point. Ergo, each tick is worth $12.50.

TRADE PROFILE NOTE: Since we know that each point is worth $50 (when trading one contract), we can put our risk into dollars: 2.75 x $50 = $137.50 risk per contract.

As often happens in trading, new tradeable patterns can begin to emerge before we have even exited our trade. In our figure 61 chart, the exact Target 3 of the long trade also represented the head in a new head and shoulders short setup (point 6). Notice the left shoulder (point 5), the head (point 6), and the right shoulder (point 8).

In the head and shoulders, our neckline was horizontal, not angled as it was in the other examples. The short trade here proved to be a winner, with Target 2 getting hit perfectly. Even the Target 3 projection was accurate, but in this case, following our tradeplan rules, the trade would have stopped out when it came back up after hitting Target 2 (figure 64).

TRADE PROFILE Shorting the S&P E-Mini (ES)		
ENTRY	2892.25	Enter short 2 ticks below the neckline.
STOP	2895.00	Place the stop 2 ticks above the head (point 6).
TARGET 1	2891.00	1x down from the neckline.
TARGET 2	2890.25	1.5x down from the neckline. Target 2 is an even 2 points away from the entry; hitting target 2 will earn $100 in profit per each contract traded (notice how perfect the target projection proved to be).

TARGET 3	2889.25	2x down from the neckline.	
RISK	2.75	The risk is the difference between the stop-loss and entry x $ per tick (2895 – 2892.25 = 2.75 x $50 = $137.50 risk per contract).	
PROFIT AT TARGET 2		+2 = $100 per contract	
PROFIT AT TARGET 3		+3 = $150 per contract	**x = 1.75**

TRADE PROFILE NOTE: Our x factor is 2894.50 – 2892.75 = 1.75 = $87.50 per contract.

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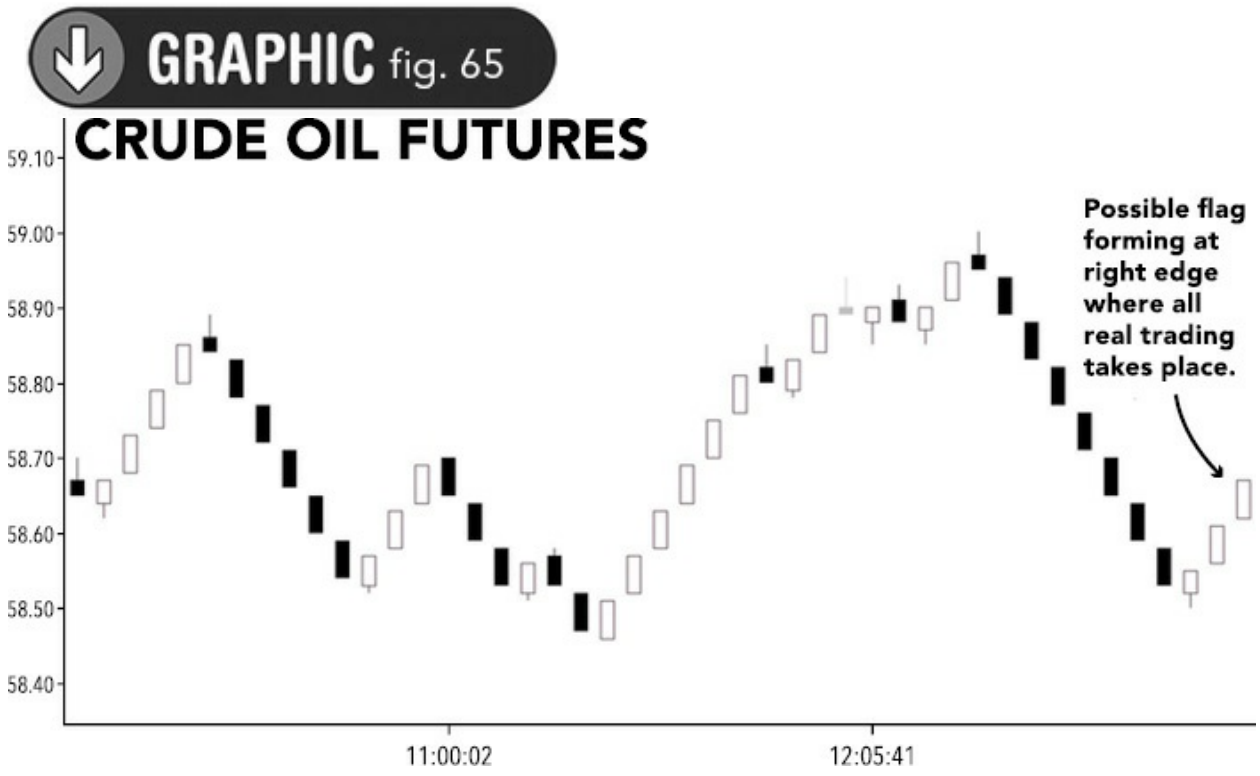
The flag continuation pattern is an excellent one to look for when day trading. There are many favorable ways to trade such a pattern. Furthermore, these are not hard to locate; they can be found on all day trading charts. I am going to outline here a simple approach I use when trading these highly profitable patterns.

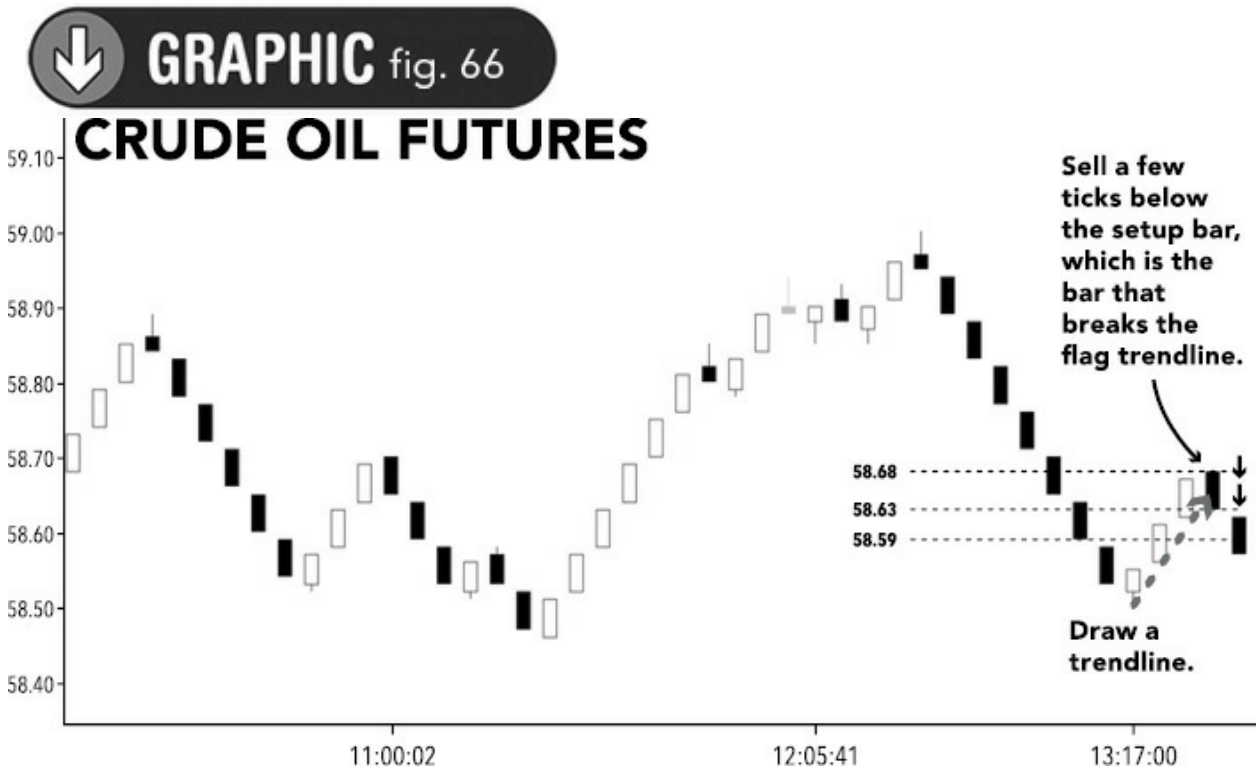
I find the trading opportunity most alluring when the flag continuation pattern is identified after the first leg (action move), usually following a breakout, a reversal, or the beginning stages of what could become a strong trend.

Trending price action on a security is often comprised of action, reaction, and subsequent action moves. The subsequent action is the move that is most predictable and tradeable.

The flag continuation pattern is one of the best reaction moves on which to trade, because it is so clear and easy to see. Look at the next three chart examples. Figure 65, an excellent day trade chart, is a crude oil futures chart featuring 5-tick momentum range bars. Notice what appears to be a flag pattern forming at the right edge of the chart. A nice extended action move down has just occurred. As you watch price action more and more, you will begin to anticipate the eventual pullback (reaction move). In this case, the reaction move is showing up in the form of a flag pattern. Great!



If I were trading this pattern in real time, I would first draw a trendline up, along the bottom of the reaction move (the makings of the classic flag continuation pattern) as is shown in figure 66. Next, I would wait for a down bar that breaks the upward trendline. You can see that this down bar—which is an excellent entry for a short setup, which would be 2 ticks below the low of the setup bar (58.63)—is where I placed two arrows.



As you can see in figure 66, I placed my entry 4 ticks (as opposed to 2 ticks) below the setup bar at 58.59 (rather than 58.61). I am making a key level adjustment. I consider price levels that are at multiples of 10 to be key levels; for instance, 58.40, 58.50, 58.60, etc. For many markets, including crude oil futures, I don't like to enter a trade on or one tick in front of a key level. I want the price action to first prove that it is going to push through and not bounce off the key level. Let's reiterate some of the important factors and considerations we are dealing with in this trade:

- The low of the setup bar is at 58.63; we are typically looking to enter the short trade at about 2 ticks below the setup bar.
- Our unadjusted entry, 58.61, is 2 ticks below the setup bar, but it is one tick in front of the key level of 58.60 (a multiple of 10); that's too close for comfort.

I want to hold out for a little bit of extra price action confirmation before I

get into this short trade. In other words, I want to see if the price has enough selling strength to push it 1 tick beyond the key level of 58.60. We will therefore put our entry at 58.59, 1 tick beyond the key level and 4 ticks below the setup bar, instead of just two.

You can see that the additional downward price action ensues, and the move lower triggers the entry order into the short trade at 58.59. Sure, in hindsight it would have been better for us to get short at our unadjusted entry point (58.61), but we are playing it safe and insulating ourselves from a scenario where the price action is unable to push through the key level and might even reverse. Often, the price won't be able to push through the key level and our adjustment will save us from entering a losing trade. Think of the key level adjustment as an insurance premium. You give up a little bit of profit and add a couple of ticks to the risk profile (the distance between entry and stop), but in return for this sacrifice you get extra price action confirmation, which can decrease the odds that you end up with a loser on your hands. Even after all that, the trade might still lose, as nothing is ever guaranteed until you hit your target and exit the trade with a profitable outcome. For that reason, we make very small price adjustments around key levels.

Our stop in this trade, just as it was in our long head and shoulders setups, is placed a couple of ticks away from the top of our flag pattern. As shown in figure 66, the highest point of our flag continuation pattern is the top of our setup bar at 58.68, so our stop (unadjusted) goes 2 ticks above that point at 58.70. It looks like we have again hit a key level. Should we adjust our stop a little higher or a little lower? Find the answer in the trade profile (figure 67).

TRADE PROFILE Shorting Crude Oil Futures		
ENTRY	58.59	Each tick in crude oil = $10
STOP	58.71	**We set our stop 1 tick above the 58.70 key level. We don't want to exit the trade until it's broken against us with enough force to overcome the key level. We need to adjust the stop one point higher than the key level.**
TARGET 1	58.45	1x lower than 58.63 (1x from the bottom of the setup bar)
TARGET 2	58.36	1.5x lower than 58.63 (1.5x from the bottom of the setup bar)
TARGET 3	58.27	2x lower than 58.63 (2x from the bottom of the setup bar)
RISK	0.12	The risk is the difference between stop and entry (58.71 – 58.59 = .12 = 12 ticks = $120 per contract).
		x = .18

Often, hiding a stop one tick beyond a key level is enough to keep you in a trade that otherwise would have stopped out. In my own trading, I can't tell you how many times this happens to me—real nail-biters. Missing a stop by one tick and then running all the way to full target is far more common than you might think.

As you may have gathered, in the crude oil futures market one tick is a hundredth of a point, one cent in other words, and, when trading one contract, each tick in this market is worth $10.

The minimum price movement, known as a tick (or a "pip" in forex trading), is determined by the specific market being traded. The dollar value attached to each tick (or pip) per contract traded is also determined by the specific market.

Converting our risk and profit levels into dollars is incredibly easy. Since we have calculated the risk on our crude oil short trade to be 0.12 (12 ticks), then we know we are risking $120 (12 x $10) for each contract we trade. Target 2 (which is usually our primary target objective) is 23 ticks away from our entry. If hit, we will profit $230. Once you understand these basic factors (there's no hard math here), then you will find it quite easy to assess risk/reward dynamics in concrete terms. In our current trade example, we risk $120 for a chance to make $230.

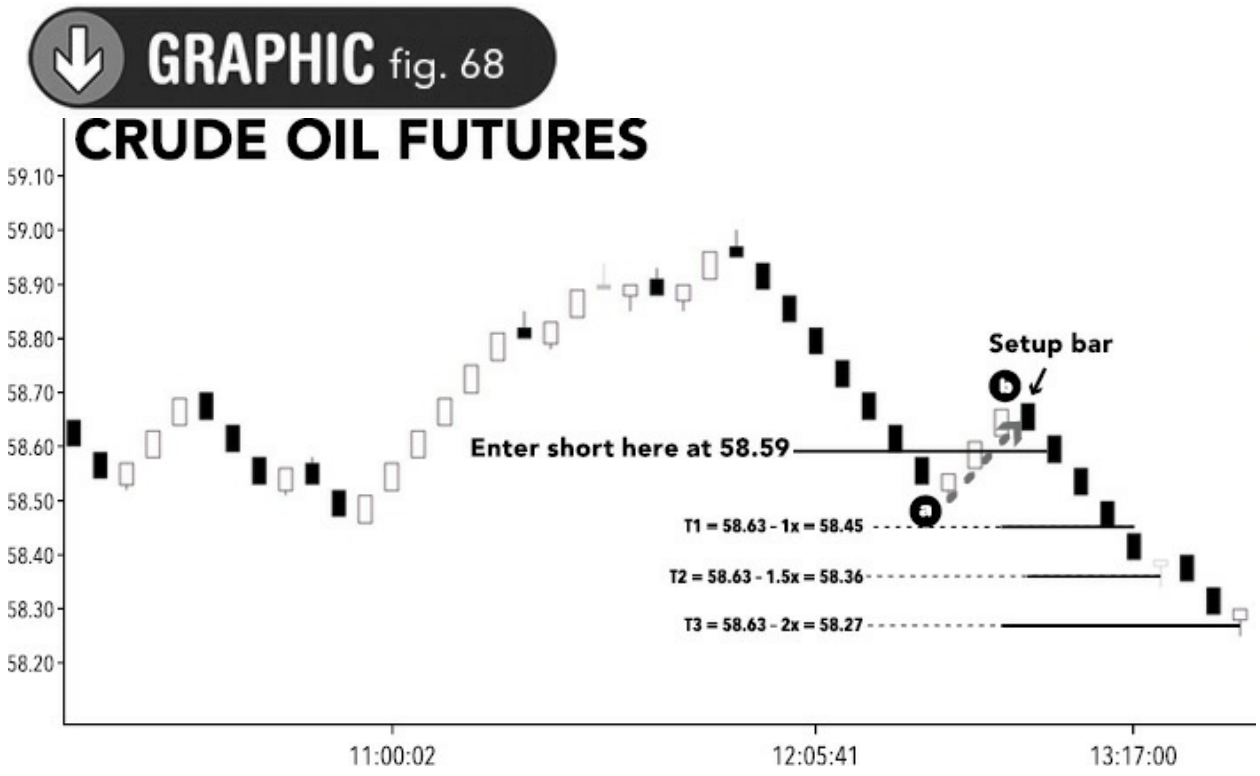


Figure 68 shows our trade entry point and targets 1 to 3. In this trade our targets ended up being perfect. The trade was based on the formation of the flag pattern (A through B) and proved to be a substantial winner, with targets 2 and 3 both being hit.

Let's go over some important trade management considerations:

» Secure your MM level: Once Target 1 (58.45) is hit, you have earned the right to move your stop one tick in front of your entry, guaranteeing a risk-free trade. You will also recoup some of your trade costs should the price turn against you and stop out.

MY TAKE

I like to hit T1 (target 1) with at least 10 ticks of movement in my desired

direction (in our current trade, T1 is 14 ticks away from the entry). In situations where T1 is less than 10 ticks away from the entry, I recommend waiting until the trade has moved a full 10 ticks before making that first stop adjustment. If you move the stop before enough momentum is established, then you might stop out prematurely and miss the move to your full profit objective.

» Navigate no-man's-land: Prior to reaching your MM level (T1 and 10 ticks, whichever is lower), you are in a no-man's-land and must shoulder the full risk of the trade. Though this is difficult for many traders, it is essential to success. There is nothing you can do at this point, and you must let the planned trade play itself out as planned. This is where many traders fail. When in no-man's-land, we have no control over what happens next and are still in a position where we could experience a total loss on the trade. This makes people feel extremely uncomfortable, but that is simply the reality of trading. Remember, people make terrible traders until they have learned how to transform themselves into actual traders. With practice, no-man's-land becomes less and less of a concern, especially when you take trades that are part of a proven winning tradeplan and with appropriate position size. Some trades will lose, but so long as our tradeplan wins, we achieve our reason for trading, and that's all that really matters. Losing trades exist inside of winning tradeplans.

» Move toward progressively better risk/reward dynamics: Your trade begins with your risk at .12 ($120 per contract), and your reward, as defined by your primary target objective (T2), is .23 ($230 per contract). Once your MM level is established, your risk is reduced to zero and you are still seeking a $230 reward. Your risk/reward ratio goes from no-man's-land, $120:$230, to a risk-free trade, $0:$230.

When trading only one contract, I think the primary target objective (T2) is the best place to take your profit and close out the trade.

» Consider setting up additional targets (T3, T4, etc.): T3 can be calculated as 2.0x and can be used when trading with multiple contracts. If you have already hit your T2 target, you may wish to scale out at T2, taking some profits and eliminating all risk from your trade in the event you pursue T3 or beyond. You could also decide to let your trailing stop be your ultimate exit. A lot depends on your tradeplan rules.

It may have occurred to you, as you continue to grasp the basic mechanics of setting up and managing trades, that a large part of what we are doing is removing our emotions from our trading routines. We focus instead on pattern identification, some basic math, a tweak here or there, executing without mistake or error, and sticking to our plan to give us the best chances for success. Not knowing exactly when to enter or exit or how to manage a trade is the Achilles' heel for many traders. Because they lack a sufficient plan for their trade, they become afraid of exiting too soon and leaving profits on the table, or they fear exiting too late and seeing their profits evaporate if the market turns against them.

The successful trader knows how to establish the key metrics of his trade. He does not give in to fear or greed. He knows that not every target is going to be hit and that not every trade is going to win, but he's spent time working on, testing, and refining his tradeplan to the point where he knows it is

highly attuned to the market and should win over time. The successful trader doesn't worry about whether a trade will win or lose. Instead, he focuses on executing his proven tradeplan that will grow the equity in his account. He lets the superior odds of his tradeplan do the heavy lifting.

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When trading multiple contracts and targets, you can lock in profits as the trade progresses if you trail your stop downward (or upward when going long). This technique is often referred to as trailing stop orders or ***trailing stops***.

Sometimes we settle for a partial profit. When you have accurate price targets, sometimes the price will come to within one tick of the target without hitting it. When this happens, I move my stop to the prior target or merely market out. So, for example, if I'm in a short trade and the T2 objective is 51.43, and the price stalls at 51.44, then I will move my stop to T1 to guarantee a worthy profit for the trade.

The risk/reward ratio changes after the price moves to within one tick of your target. If T2 has a potential of .20, $200 in profit, and the price has gone to .19, then you are now risking the $190 in profit to make .10 more, $10. It doesn't make sense to risk $190 to make $10 more, right? Probably not, in my opinion. But it depends on your trading style and your trading plan.

There are many different approaches to trailing a stop. Here are a few that come to mind:

- When the price hits T2, you can move your stop to T1 to lock in T1 profits, as described above.
- You can trail your stop a tick above the last closing bar for shorts, or a tick below for longs. This is called a "one-bar trailing stop," and you will need to pay close attention to the type of chart you are using so that you understand exactly what each bar represents.
- You can trail a tick above the highest point of the last three closed bars (for shorts). This is called a "three-bar trailing stop."
- You can trail behind a moving average or other type of indicator. This is more art than science and will vary based on the indicator that is being used. I usually trail behind my own proprietary indicator.

When trailing, much depends on the size of the trade, the market, the chart type, and your use of a thoroughly developed tradeplan that's been verified through testing. The bottom line is that an effective trailing stop should give the trade room to develop, while also protecting your position by locking in profit along the way as the price continues to move toward the overall profit objective (target) or beyond.

The thoughtful application of trailing stops is a key aspect of effective trade management. As you become more experienced and proficient with trading, you will learn to find the fruitful middle ground between being too aggressive and being too passive when using trailing stops. As always, going into your trading with a well-thought-out and tested plan will be essential to success in choosing the right time and place to deploy your trailing stops.

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Trading flag continuation patterns on long positions involves the same approach used for short positions. Figure 69 is an example of an excellent day

trade forex chart. It is an 8-pip momentum range bar of the GBP/AUD (British pound vs. Australian dollar). You can see a nice flag pattern setting up on the right edge of the chart, and a downward trendline has been added. We are looking for a long bar and then a break above the descending trendline. The long bar is our setup bar and will form the basis for the trade.

GRAPHIC fig. 69

It is important to note that the first long bar that forms at the right end of the "flag" of short bars is only a possible setup bar. It does not actually become our setup bar until it passes a critical test. It must break out above our descending trendline and the price of a subsequent bar must then move up to hit our entry. The small horizontal line slightly above the setup bar will show our planned entry point. It is three pips above the high of the setup bar.

GRAPHIC fig. 70

TRADE PROFILE Going long on FOREX: GBP/AUD		
ENTRY	1.8241	3 pips above the high of the setup bar. Ordinarily we would enter 2 pips above the setup bar, but we are going to make a KLA to ensure we push past the key level of 1.8240.
STOP	1.8228	2 pips below the low of the setup bar.
TARGET 1	1.8262	Money Management Level. 1x pips above the high of the setup bar (+21 pips profit).
TARGET 2	1.8274	Primary Target Objective. 1.5x pips above the high of the setup bar (+33 pips profit).
TARGET 3	1.8286	Enhanced Goal. 2x pips above the high of the setup bar (+45 pips profit).
RISK	13 pips	The risk is the difference between entry and stop.
		x = 24 pips

The high of the setup bar is 1.82379. I always round to the fourth digit (after the decimal) in forex pairs. The fifth digit represents one-tenth of a pip. I'm only interested in full pips. So, consider the high of the bar to be 1.8238. Again, the 2-pip entry lands on the key level of 1.8240, and after adjusting to 1.8241, it becomes a 3-pip entry.

With points A and B defining the top and bottom of our flag formation, we can calculate the x factor. We have everything we need to set up our trade (and all the details in figure 70).

Prepare for execution. If the price pushes past our entry point, then the trade will trigger and we will be in it to win it (figure 71). That being said,

even though we did everything right, this is day trading, and we could still end up losing. That doesn't make it a bad trade.

As shown in several of the preceding figures, I like to use horizontal lines to mark important levels on my charts, such as entries, targets, stops, etc. You can easily add this type of markup to your charts according to your own preference and approach.

As shown in figure 71, our price does indeed break above the trendline and push through our entry, triggering the trade (no turning back now!). The stop-loss is placed 2 pips below the bottom of the setup bar, the lowest point of the flag formation. Remember to consider any necessary key level adjustments. We do not come up against a key level when placing our stop in this trade, but if we did, then we would adjust our

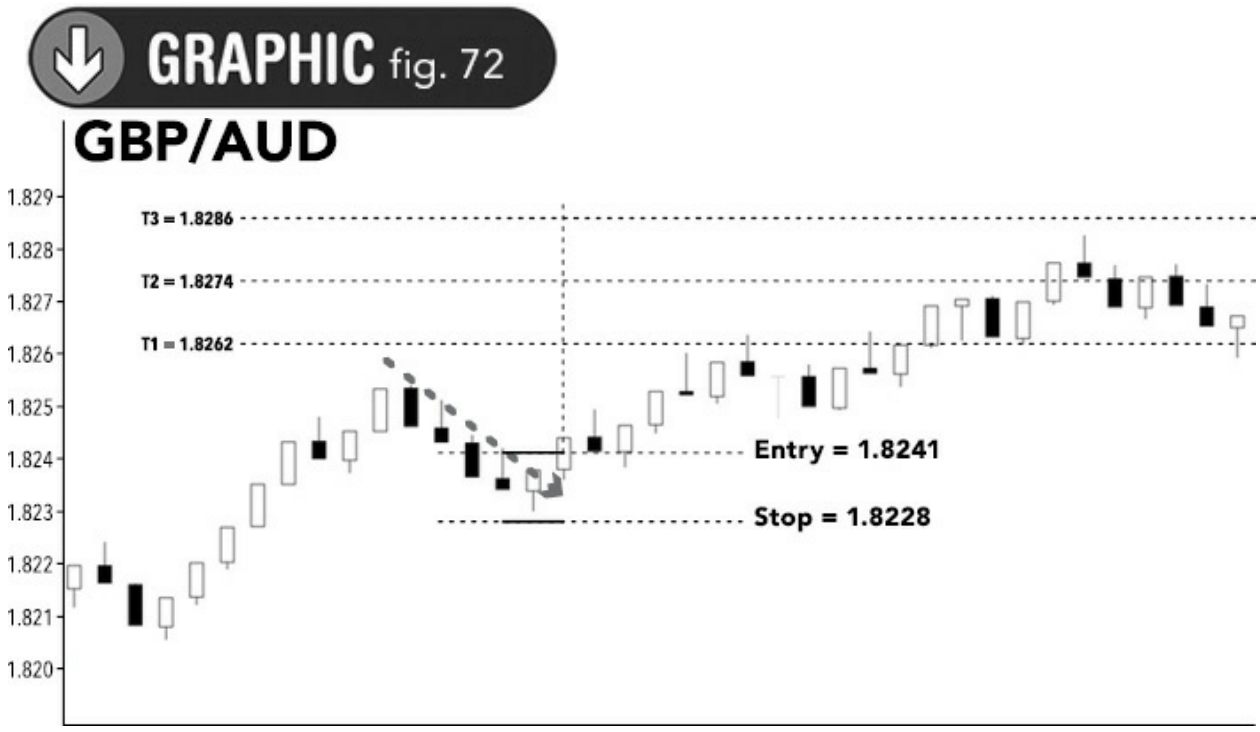
stop to 1 pip below the key level. If the price were to hit the key level and bounce off of it, we would not stop out but would remain in the trade.

It is worth noting that our T1 at 1.8262 is a full 21 pips away from our entry. That is a lot of price movement in the right direction, and if hit it would represent a tidy 21-pip profit on a trade that only risks 13 pips. In this case, it could be worth it to take some profits after hitting T1, even though T2 is technically our primary target objective.

One of the nice things about the forex market is that it allows great flexibility in position sizing with the use of micros, minis, and full-size lots (see chapter 5). Traders may find the position size flexibility in spot forex preferable to the contract-based trading in the currency futures markets.

Figure 72 shows us how the trade played out. You can see how adding the horizontal lines provides an obvious convenience in the form of easier visualization of the trade's targets. I was even able to add labels to the targets denoting their price levels.

Notice how the buyers had no problem pushing the price up through T1 and T2. We barely missed T3, but if we had managed our trade properly with trailing stops, then we would have exited the trade with a partial profit before letting it come all the way back down again.



A few additional notes about flag formations:

- When drawing a trendline to identify the flag pattern, draw the line across the highs of the bars in a bullish, descending flag and across the lows of the bars in a bearish, ascending flag.
- You don't really know the setup bar is the setup bar until you have placed your order and the price then breaks the trendline and moves to hit your entry, triggering in your trade.
- The setup bar needs to be a bar in the direction of your trade. In a bullish, descending flag, the setup bar needs to be an up bar that closes higher. The opposite is true for shorts. It must be a down bar that closes lower.
- A flag formation is a reaction to an action move. It should retrace about one-third to two-thirds of the prior action move. If it goes any farther than that, then you need to consider that what appeared to be a reaction move could actually be a new action move in the

opposite direction (a reversal) and, therefore, not a good flag pattern to trade.

» If you do not allow the reaction to play out in full, then you might find yourself trying to enter a trade before the flag is finished forming, which lowers your odds of success in the trade.

» Nothing is perfect in trading. All patterns have the potential to lose. But they win more than they lose, and the odds are certainly in your favor with this type of setup.

c xp”v‘t bt

In figure 73, we have a 610-tick chart, again of the ES. The 610-tick chart is ideal for day trading the ES. A bar prints every time 610 trades have taken place. Recall that tick charts are dynamic and based on actual order flow, not time. A triangle is forming on the right edge of the chart. In fact, earlier in

the session, another triangle had formed as well. Let's focus in on the triangle forming on the right edge, where all trading takes place.

Let's zoom in and take a closer look at the triangle (figure 74) and discuss how we can go about placing a trade with high probability of an outcome in our favor.

I treat triangle formations very similarly to how I treat flag formations. Here are the broad strokes:

- Measure the distance from the highest point of the triangle to the lowest point. Sometimes this range can be found within the length of a single price bar, like the long up bar in the pattern in figure 74. Just like that, we've got our x factor.
- The small down bar on the right end of the triangle should become our setup bar. There is a good chance that we are reaching the end of the triangle and that a bearish trend is about to reassert itself. If

the price breaks lower and moves below the ascending trendline, then we can begin to assume that a new action move might be underway.

Adjusting around key levels is optional with triangles, and some traders don't do it. Compared to key levels within flags, a key level within a triangle is much weaker, because the actual trendlines that mark the triangle are showing where the near-term support and resistance levels are forming, as the price consolidates from the prior action move. When the price breaks out, it often does so aggressively, and key levels become much less significant. I tend to always account for key levels as a matter of habit, but they just aren't as relevant to triangle formations.

» Use the x factor to project targets down from the bottom of the setup bar.
» To better visualize the entire trade, insert horizontal lines on your chart to mark the trade's components: stop, entry, and targets (as in figure 75).

GRAPHIC fig. 75

GRAPHIC fig. 76

TRADE PROFILE Going short on the ES		
ENTRY	2920.00	2 ticks below the setup bar.
STOP	2921.50	2 ticks above the highest point on the triangle.
TARGET 1	2918.75	1x below the low of the setup bar.
TARGET 2	2918.00	1.5x below the low of the setup bar.
TARGET 3	2917.00	2x below the low of the setup bar.
RISK	1.50	The risk is the difference between entry and stop = .50.
The x is the distance between the highest point on the triangle and the lowest point.		**x = 1.75 points**

I marked the components of the trade using horizontal lines in figure 75, and you can also see the breakdown in that figure. Notice on the right edge, the price did break out bearishly. It's important that you set up your entry point and the rest of your trade prior to the formation of the big down bar; otherwise, you would most likely miss this high-odds trade opportunity, as it can move quite quickly.

Other essential mechanics and metrics in play for our trade in figures 73–76 include the following:

- The ES trades in ¼-point ticks. Each point is worth $50 (per contract traded); therefore, each tick is $12.50.

In our current example, we use the word "tick" in two different contexts. First, in the 610-tick chart, tick is like a stand-in term for trade—a new bar is formed after 610 trades have transacted. But this type of chart is referred to as a "tick" chart, not a "trade" chart. When it comes to determining the size of the chart, one tick equals one trade. Thus, a 610-tick chart requires 610 trades to take place before the current bar closes and a new bar opens. A 377-tick chart would require 377 trades to occur, etc. Second, we use the same term to describe minimum price movement. In the ES, for example, one tick represents ¼ of a point and is worth $12.50 (the tick sizes for several futures can be found in appendix I). Yet another use of the word tick refers to the NYSE Tick Index (or $TICK in many charting programs). The NYSE Tick Index measures the number of stock issues trading on an uptick compared to the number on a downtick.

- When the price hits T1, we move our stop to 1 tick lower than the entry (2919.75) in order to eliminate all risk on the trade. We have achieved our money management (MM) level!

» Our risk of 1.50 points, when converted into dollar value, is $75 per contract.

NOTE

In our current trade profile, our target calculations (1–3) have all led us to easy-to-handle numbers that fit neatly within the ES's ¼-point increments. It does not always work out so nicely. When we calculate our targets, the resulting value may not end on a multiple of .25. We often must round our calculated target to the nearest .25 price level. I usually round my targets closer to the entry to give them a better chance of success. More aggressive traders could choose to round in the opposite direction, further away from the entry. It is a matter of personal style.

GRAPHIC fig. 77

In figure 77, we see how the trade unfolded, hitting our targets and even

trading through them, which is important with the ES because getting your orders filled can sometimes prove to be tricky business. My experience is that merely touching my price level will not always get the job done. To guarantee my exit order gets filled, the price must trade through my target level by one tick.

Here are some additional insights into the ES that I would like you to be aware of before you begin trading in this market:

- The ES is an advanced market, offering unique challenges that we don't find with other markets.
- It is a highly traded market with huge volume. We may have to "wait in line" to be filled on a trade. Unless the price trades through our price level, there is no guarantee that our orders will be filled.
- This lack of predictability makes this market difficult to test and therefore difficult to trade.

A trader hits his target on the nose on the ES and is waiting to get filled. He's feeling quite nervous because the order may get filled or it may not. If the ES trades through his price, he will get filled, but if the market backs off and moves against him before he is filled, then he will have to decide whether to stay in the trade or cut and run. If he exits the trade, then he is exposed to additional and expensive slippage costs. If he stays in the trade, then he's taking on a whole new world of risk. What if the price doesn't move back toward his target? Tough call.

- Remember, each tick is $12.50, which makes the ES more expensive than other markets. Because of the one-quarter-point tick pricing of

this instrument, each tick represents a larger percentage of the overall trade profile. Slippage costs really add up fast.

It is important to reiterate the idea that the rules of our tradeplan dictate how we trade. Trading triangle patterns is a winning proposition more times than not, assuming you are executing and managing the trade properly. When you hit your first target, you always have the option of moving your stop to one tick beyond your entry to eliminate risk. In one sense you can rest easy after doing so, knowing that you have reached your money management level and will not incur losses, but keep in mind that this conservative play could result in your getting stopped out, breaking even, only to watch the market resume its course to your primary target.

It's a fine line we walk, trying to give the trade the room it needs to develop while tending to our own need to reduce or eliminate the risk on the trade. Nothing is perfect. Success in trading comes down to the use of large sample sets that can be adequately tested and used to develop a winning tradeplan. Once you settle in on your tradeplan rules, you will remove the stress that comes from having to make spur-of-the-moment calculations and decisions.

Patience pays off, and as you can see in figure 76, in our current trade the price worked its way lower and traded through our targets. The trader was willing to let the trade do its thing, trusting in his initial pattern recognition and then following through with a coherent and comprehensive plan and execution.

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Two tools come to mind that are quite useful for helping us act in a timely and organized manner when a viable trading opportunity makes itself known:

» **Tick counter.** Used with a tick chart, a tick counter counts down the ticks that remain until the next bar is formed. For example, say we are working with a 610-tick chart, and the tick counter informs us that we are 590 ticks into the bar; thus, in 20 ticks, we can anticipate the current bar closing and a new bar being plotted (added) to the chart, which starts the tick counter all over again. If we know when a new bar is due to print, perhaps a possible setup bar, then we can be more alert and ready to place a new trade. Without the counter, we would not know when the current bar would close. It might close fast, with the new bar zooming through our would-be entry before we could place our order. Another benefit is that you can time your bathroom breaks. I can't tell you how many times I was one trade away from a positive overall finish for the day but then missed my last trade due to having to use the facilities. With a tick counter, you can make better decisions about when to temporarily take your attention off your charts.

The tick counter is a custom indicator that integrates with your charting platform. We will provide you with access to this tool through your digital asset vault at **www.clydebankmedia.com/trading-assets**.

» **Bracket orders**. As noted in chapter 9, many trading platforms allow traders to use preset templates to set some specific parameters for a

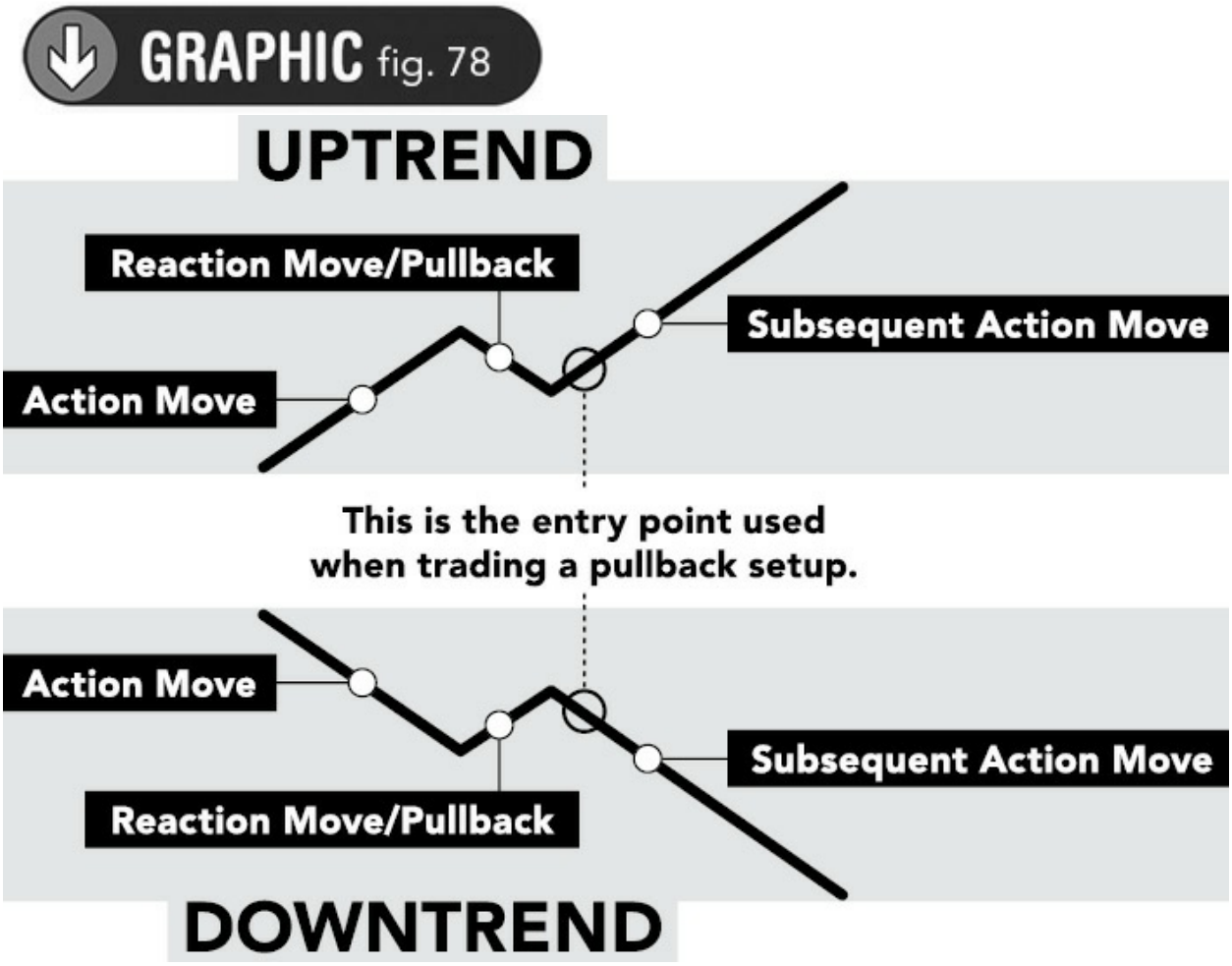
trade. For example, with a bracket order, the trader needs to enter only one or two components of the trade and the other metrics populate automatically. When the price hits their entry and the trade triggers in, all components of the bracket order template become active. The trader's "handles," the targets and stops, become active orders. After the initial template is applied, some components may need to be tweaked a bit; mainly, targets and stops (handles) need to be moved to their proper price levels. If you have a template with a 20-tick stop and a 20-tick target, but the trade calls for a stop to be 16 ticks from entry and a target 19 ticks from entry, you need to move them to the correct price level. It's as simple as clicking and dragging with your mouse.

Mistakes made when executing trades can be costly. The skillful deployment of bracket orders is best practiced within the safety of a simulation account until you gain a comfortable level of proficiency. Simulation (sim) accounts are discussed in part IV of this book. With a sim, you can practice the maneuvers of your trade executions over and over again until you get so good at it that it becomes a reflex. Like riding a bike. Something you never think about. You just hop on and start riding. I want your trade executions to be like that. Repetition is the key, and it is one of the two valid uses of your sim account, to perfect your trade executions.

L‘p xr Y “qprz bt

The classic pullback setup is one of my favorite trade setups, because it is so easy to understand and quite simple to execute. Moreover, this setup has a

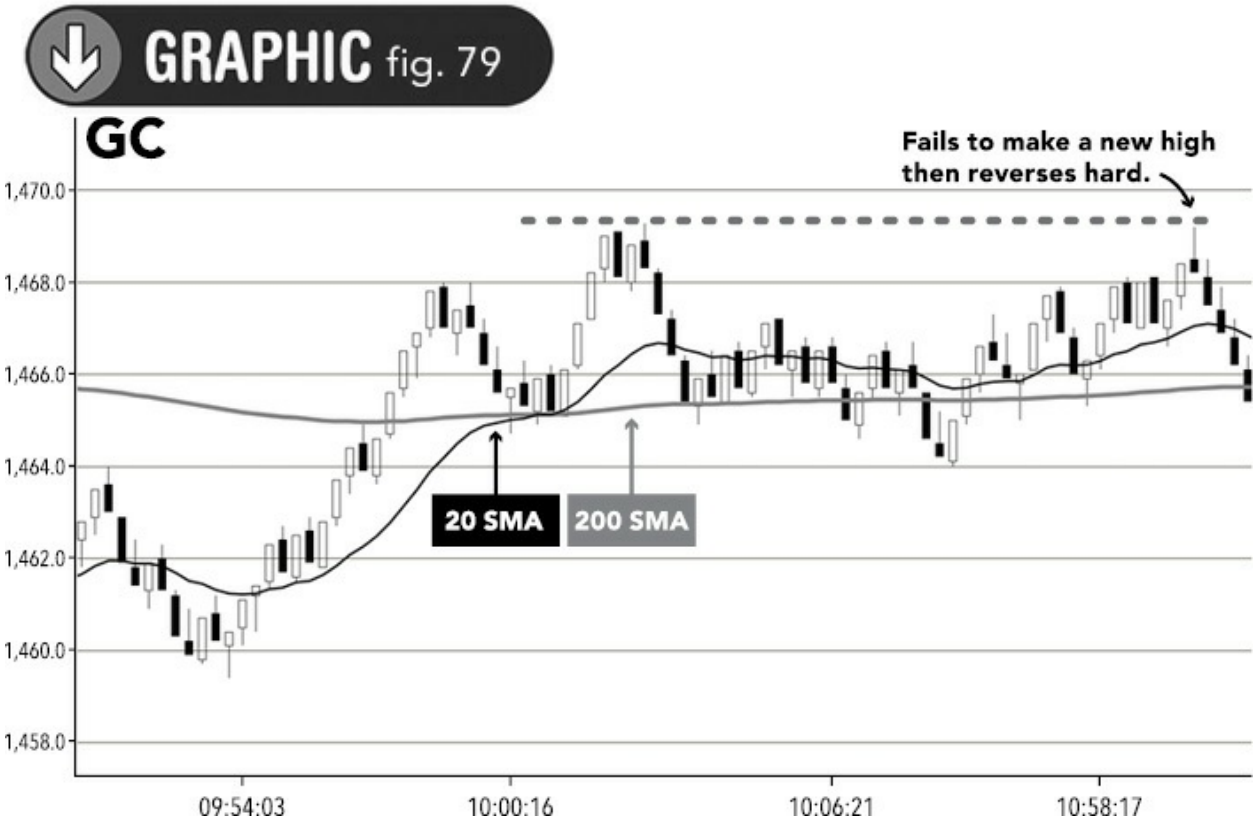
very low risk profile in relationship to its profit potential. It works on nearly every chart, symbol, and time frame. It is dynamic and versatile. And it just plain wins a lot.



When a strong move occurs, usually a breakout from an extended consolidation or perhaps the first strong move in an opposite direction once a bottom or top has formed, it often marks the beginning of a new trend: the first action move. What will usually happen next is a "pullback," or a reaction to that prior action move. The best traders have learned how to identify the end of the pullback in real time. It's easy to see the end of the action move, because the price begins to retrace. Will this retracement be the beginning of

an action move in the opposite direction or will it merely be a reaction, with the high probability of setting up a new, subsequent action move (that could mirror the first action move)? The subsequent action move is tradeable and highly effective when the end of the reaction move can be identified with a high degree of accuracy. This is the basis for the classic pullback trade setup.

There are many approaches one can use to take advantage of this tried-and-true setup; we'll be looking at a few of them here in this chapter. Let's begin by taking a look at this one-point momentum bar chart of gold futures (figure 79).



I have found over the years that a 20 simple moving average in particular can help identify where a reaction pullback might finish.

In a 1-point momentum bar chart, each price bar is 1 point from high to low. Each bar may form over varying lengths of time depending on how long it takes for the price action to span a point's worth of range plus 1 tick. Check out the seemingly haphazard time markers in the *x* axis in figure 79.

The first thing we are going to do is broaden our view of this chart, so that we can scroll through and study several weeks' worth of data. If you leave the 20 and 200 SMAs plotted on the graph, then you should notice how the faster 20 SMA cycles around the slower 200 SMA. When the two SMAs are close to one another it indicates a slow, balanced market where pressure is building. But when buyers or sellers start to take over, the 20 SMA begins to follow the price action.

The 20 SMA is thus a great trend direction indicator. When it begins to point down, you will look to take short trades. When it points up, you will look for long trades.

There are many ways to apply this basic idea. In our current gold futures scenario (figure 79) we observe that a long action move breaks away from both MAs. Next, we note that the reaction move brought our price back to the 20 SMA. What's key here is the idea that the reaction move often terminates on the 20 SMA. Our tactic is to trade the subsequent action move.

Accurately identifying the end point of a reaction move is a challenge that has long perplexed traders. Nevertheless, using the 20 SMA is one of the simplest and most reliable solutions to this dilemma.

It's not about being right every time. It's about being right most of the time.

Let's say that we were unable to take the long trade (the subsequent action move beginning near the chart's 10-hour mark). Perhaps we had just arrived in the trading room and that ship had already sailed. Now we're studying the chart in search of the next great trading opportunity. One classic pattern that we should be able to spot is the double top. After gold approached but failed to make a new high, the price action begins to trend downward. I walked you through setups for trading double tops earlier in this chapter, but this time let's further refine our approach by using the SMA technical indicators. For this setup, I want you to notice how the fast 20 SMA near the end of figure 79 begins to point downward and closes in on the slower 200 SMA. Near the beginning of the chart, you can see how the 20 SMA was well beneath the 200, then it ascended and hovered close to the 200 as the price action tightened up. Near the right edge of the chart, with the price failing to make a new top (double top setup) and the 20 SMA pointing downward, there is reason to believe that a new action move may be taking shape.

If we are correct and it turns out to be an action move, then our standard double top trade setup (measuring the pattern, establishing the x factor, and setting a target) should work great. But let's be a little more patient. There

are other high-percentage ways to take advantage of what is likely to happen next.

My favorite trading patterns are those that can be explained by the idea that "the immediate past predicts the immediate future." Let's say that we didn't take the short trade after the double top but we let the price action play out a little further.

The "immediate past" in figure 80 would be the action move downward following the double top, as well as the reaction move that happens on the right edge of the chart. The "immediate future" would be the subsequent action move that often happens. We are going to use the 20 SMA to show us where the reaction is most likely to end and the subsequent action move likely to begin.

Following the clear action move downward, the price turned back up via a reaction move, meeting the 20 SMA. And, as we discussed earlier in this chapter, the 20 SMA will often mark the end point of a reaction move. We know there is a great chance that a subsequent action move could follow. The immediate past predicts the immediate future. In figure 81, notice that the last white bar on the very far right is the first to touch the 20 SMA. The very next bar (which moves downward in the direction of our trade) can be thought of as our "setup bar."

We are going to look to get short, 1 or 2 ticks below the low of the setup bar. Notice how this looks like a bearish flag continuation pattern, as we discussed earlier. Though we could use that same technique to trade this pattern, I want to show you another approach:

1. Enter 1 or 2 ticks below the setup bar.
2. Put your stop right above the end/highest point of the reaction move into the 20 SMA. In some situations this high point could be the bar that moves up into the 20 SMA, the "pullback bar," or it could be the actual setup bar itself (as it is in this scenario; the setup bar is one tick higher than the pullback up bar). The stop is placed 1 or 2 ticks above the higher bar. The double down arrows mark the bar that actually pushes through the entry and triggers the trade.
3. You can project targets down, using the first action move as your guide. The first action move spanned from 1469 to 1462, approximately 7 points (70 ticks). Keeping in mind that the immediate past predicts the immediate future, let's predict that our subsequent action move will be similar in length to our first action move. After entry, when our trade moves about 3.5 points in our favor (a distance that is approximately 50% the length of the first action move) then we can consider moving the stop to break-even. A more aggressive and probably better approach is to wait

until the subsequent action move continues downward to a distance that is 75% the length of the prior action move.

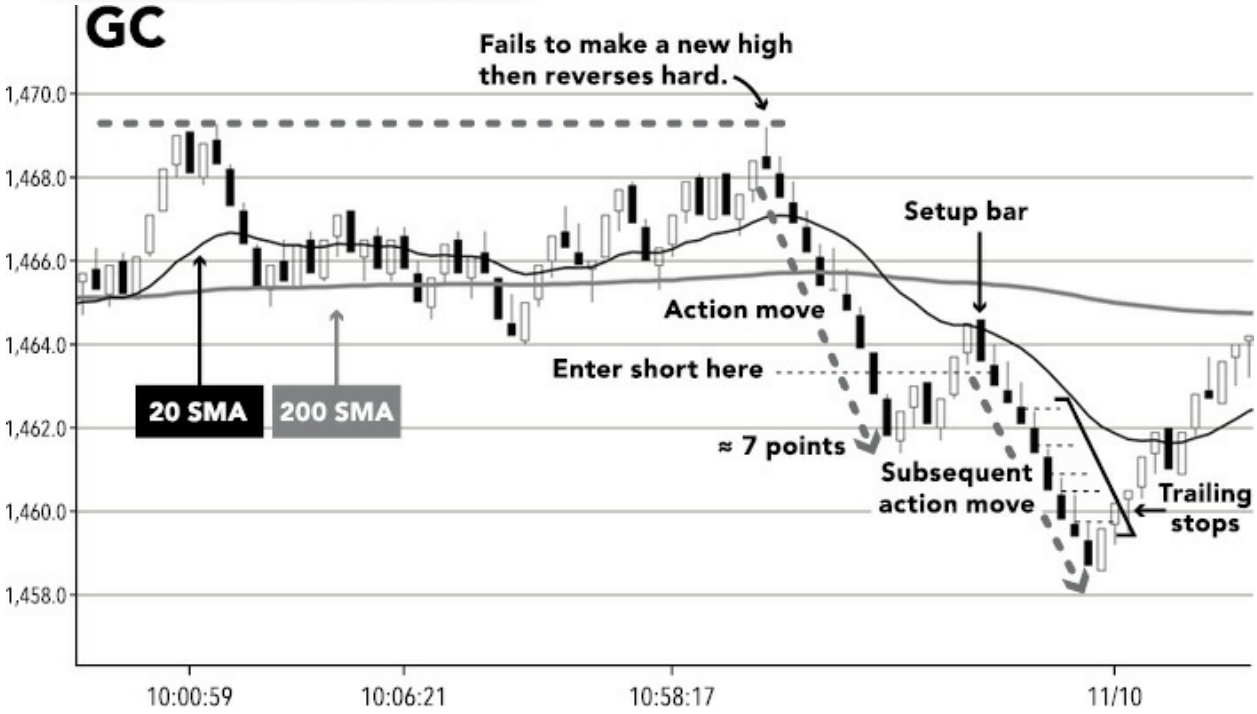
4. You can also trail the stop. Once you have moved your stop to break-even, then with each lower high of subsequent bars, you can move the stop 1 tick above the prior closed bar.

In gold futures, one tick is equal to one-tenth of a point. Enter short two ticks below the low of the setup bar.

Figure 82 shows how the trade unfolded. You can see the subsequent action move down and how it ended up resembling the first action move. Our theory of the immediate past predicting the immediate future, and the simple but clever use of a few basic tools, including our SMAs, allowed us to accurately anticipate the price movement. The result was a trade that had great odds of success with very low risk. Notice the dashed trailing stop lines

placed one tick above the high of the prior bars. Our use of trailing stops here allowed us to stay in the trade until the appropriate time to exit was revealed by the price action itself (as soon as the price broke higher we automatically exited). We only risked about 4 ticks more than the length of the 1-point bar. We risked 1.4, in other words. The risk was very small in relationship to the very large reward potential.

GRAPHIC fig. 82



MY TAKE

In my opinion, if you do nothing else but master the classic pullback setup, you will be in a very strong position to achieve your financial goals from day trading.

Let's look at another example of the classic pullback setup. I find that the Dow E-mini (YM) is a symbol that trades in smooth moves sometimes and seems to present nice action, reaction, subsequent action price patterns. The 20 SMA does a great job for us in identifying possible pullback zones that mark the end of the reaction so we can trade the next action move. Sometimes the price will stick on the line before it finally breaks away, as in this next example (figure 83). I have marked the action move and the possible end to the reaction move so you can begin to train your eye to spot these patterns when they happen. The area from the 1 to the 2 shows you a strong action move up. From the 2 to the 3 shows a possible reaction move down, into the 20 SMA. Sometimes the price will come down to meet the line, and other times it might stick on the line and then decide if it will continue lower or find support before launching into a subsequent action move.

I also drew a vertical line to show you when the markets open, 8:30 a.m. central time (the YM, along with the other E-minis, is traded out of Chicago). We are not generally interested in trading prior to the opening (unless, through testing we can prove that such trading is viable). Let's focus on the most active times. I put an arrow marking the bar at the far-right edge, where trading takes place. This bar is closing up above the 20 SMA and is a setup bar for a possible move higher. Notice how, unlike in our previous trade, we have to be a little more patient and wait through some sideways price action. The price closes below the 20 SMA for several bars until finally (see the up arrow / setup bar in figure 83) an up bar closes above the 20 SMA, giving us the price action confirmation we need to go long with favorable odds—we will use this as our ***setup bar***.

The next chart (figure 84) takes a closer look at this trade setup. Like figure 83, this is a 12-point YM momentum range bar, meaning every bar represents 12 points.

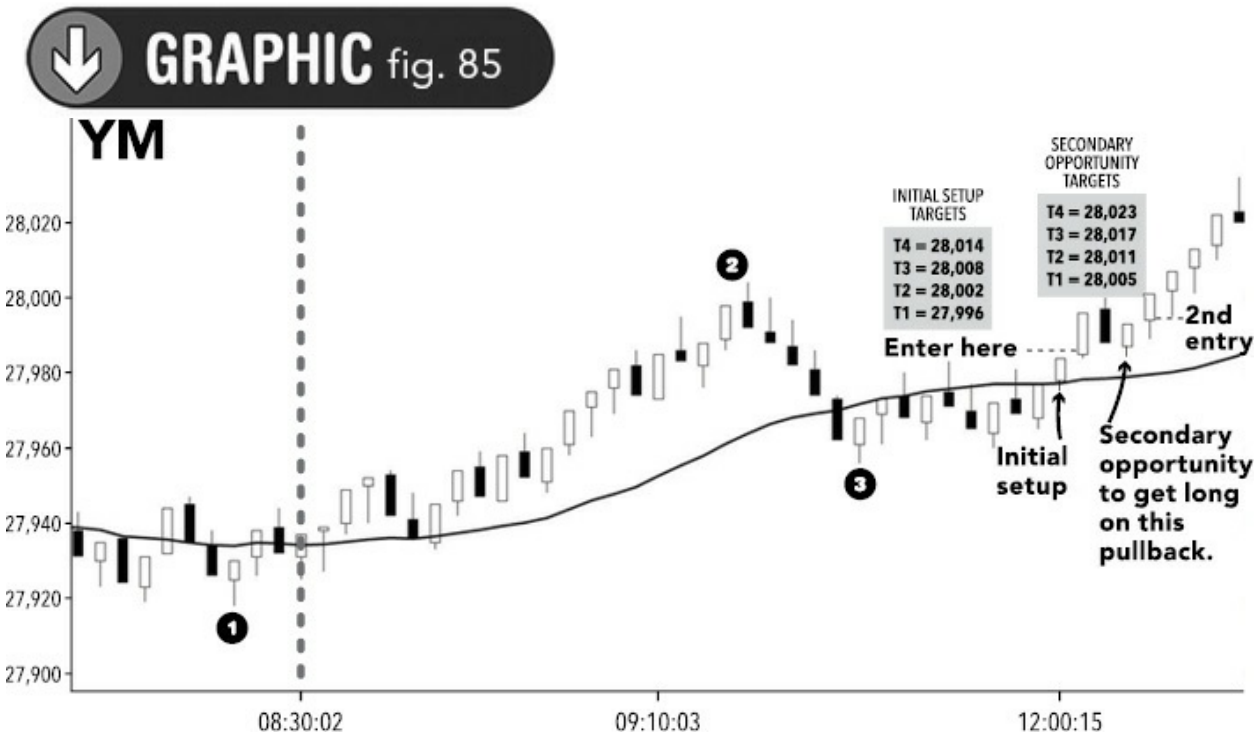
NOTE

In the YM, each whole point is one tick. It trades in full-point increments.

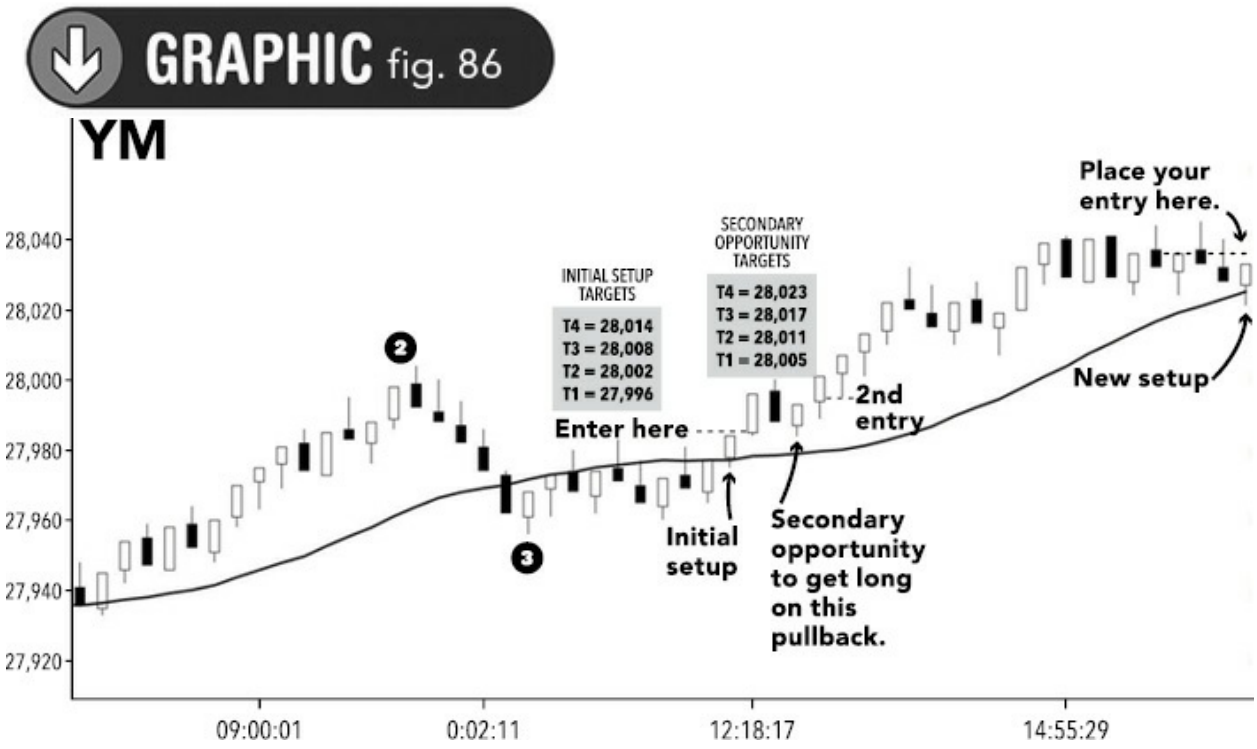
In the YM, each point is worth $5. We can place an order to go long on the YM if the price moves up 2 ticks above the high of the setup bar, as indicated by the horizontal dashed line that says “Enter here.”

In figure 85, we can see that the trade did trigger in and proceeded to move higher, as anticipated. The move higher resembles the prior action move, and this is the type of trade we want to be involved with. I placed possible target numbers (1–4) above the setup bar marking 1x, 1.5x, 2x, and 2.5x. I used the standard bar length for this chart (12 ticks) as the x factor. Profits can be taken at 1.5x, 2x, and/or 2.5x, and you can trail this move once the price has moved far enough to move your stop to break-even, usually at Target 1 and also after moving a minimum of 10 ticks from the entry.

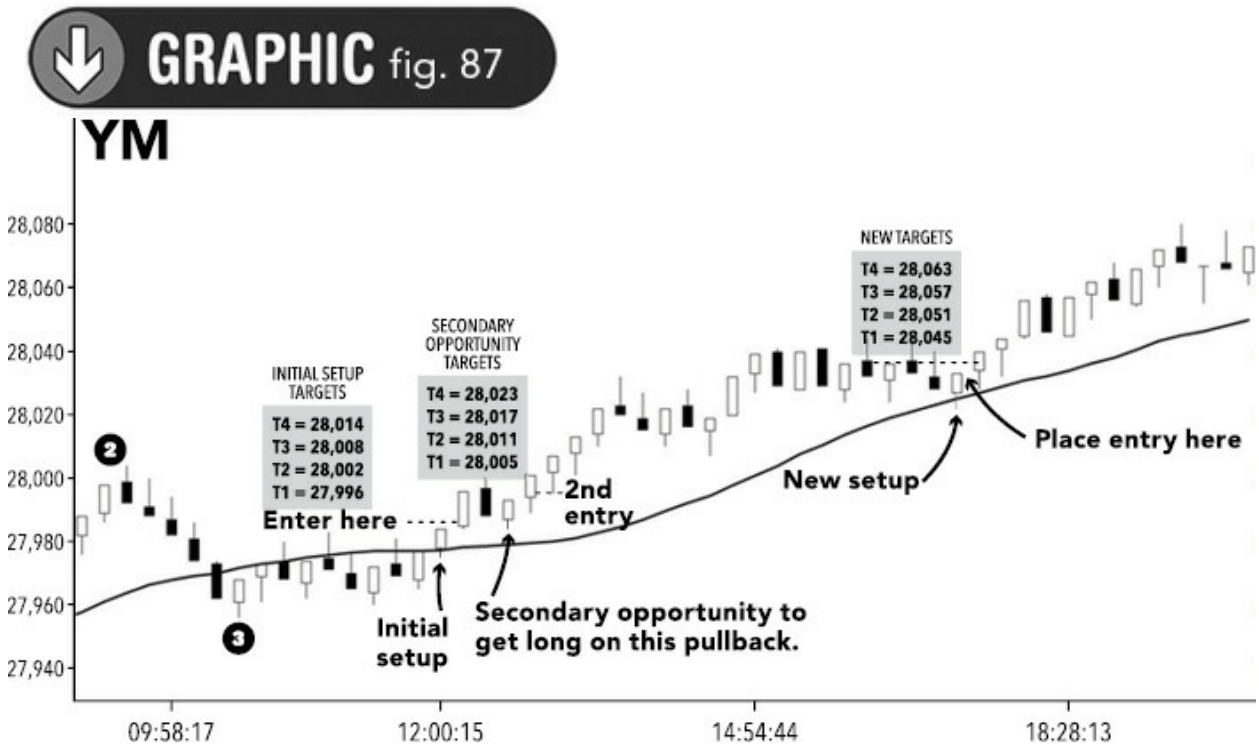
There is a second chance to get long. As we have learned, resistance often becomes support, and the price will sometimes come back to our 20 SMA line, offering a secondary trade opportunity.



The trend continued for a couple more hours, and a new opportunity presented itself. The action, reaction is not so clearly defined as we have seen with other examples, but the pullback into the 20 SMA is quite clear. By now you should know what to do. Place your entry 2 ticks above the setup bar and place your stop 1 or 2 ticks below it (figure 86).



As you can see in figure 87, the trade triggered in and progressed nicely, pushing through all our projected targets. This setup is quite simple to learn once you get used to spotting these patterns. It takes a little work to get a feel for the execution, but as with any method of trading, you can practice placing these trades in a sim account until you have perfected the techniques involved.



PKY3JdMY “qprz

Let’s look at another example. Here is the exact same trade setup, but this time we find it on one of my favorite forex day trading charts, an 8-pip momentum bar in the GBP/AUD (figure 88). As you see from our examples, it doesn’t matter what the symbol is; this setup works across multiple markets.

What I love about this setup is that you usually can see it very clearly. It’s either there or it isn’t. It is easy to see a seemingly obvious action move up and a reaction pullback move into our 20 SMA. You can see in figures 83–87 from our previous example that the reaction move (from point 2 to point 3) is approximately one-third to two-thirds of the action move, pulling back right into our line.

Many traders will use a Fibonacci retracement tool to mark the possible end of the reaction move (see chapter 7). If it pulls back to one of the main

Fibonacci levels, 38.2%, 50%, or 61.8%, then they will place a trade to go long in anticipation of another move higher. For me, I find that a simple eyeball test and a pullback into our handy 20 SMA is just as effective as the Fibonacci method and easier to see and react to.

You should know what to do with this setup by now. Place a long order 2 pips above the high of the setup bar, marked by the arrow (see figure 88). Place a stop 1 or 2 pips below the bar. I usually just go with a 1-pip stop unless there is a key level to adjust around (chapter 6).

For targets, again we will use the size of the bar itself as the x factor—in this case, 8 pips, since it's an 8-pip momentum range bar. All the bars are 8 pips. This uniformity in our range bars not only makes for effective profit objectives but also makes it quick and easy for us to be clear and decisive about our targets.

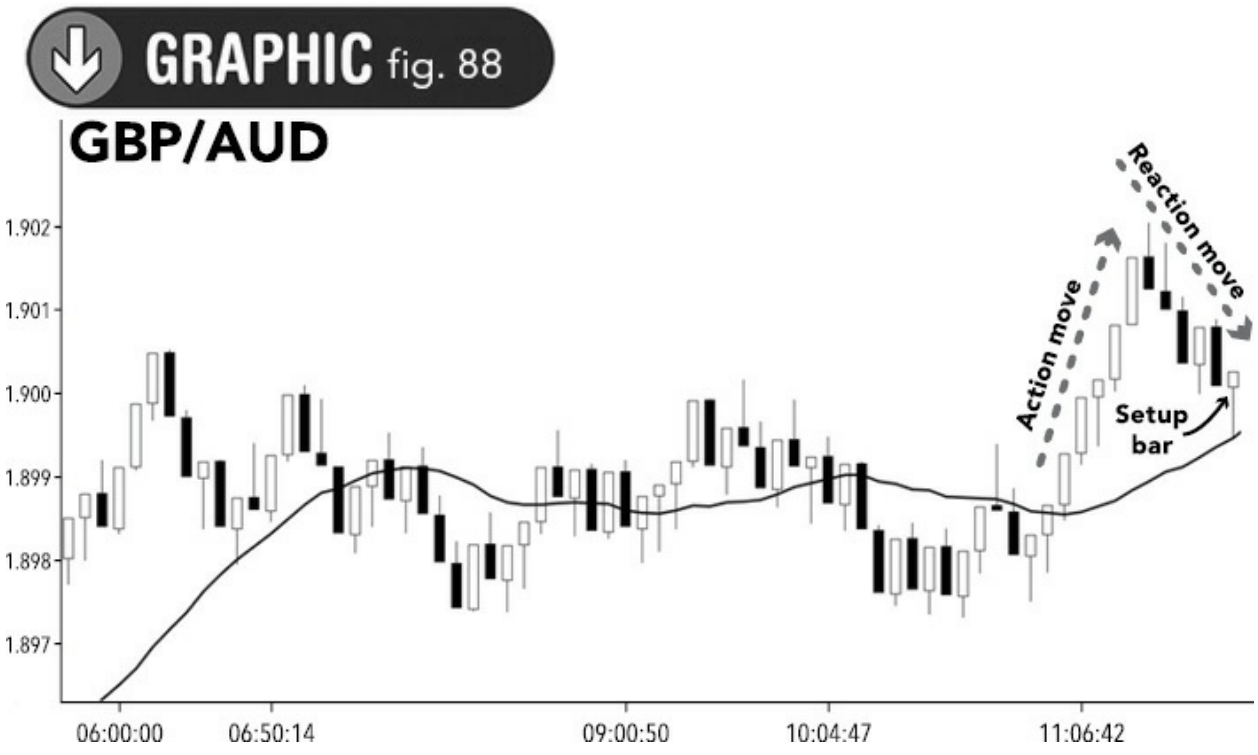
Turning to our go-to x factor multipliers, 1.5, 2, 2.5, and 3, we need to take into account some special considerations:

- 1x is too small after accounting for spread costs. We will begin with 1.5x for our first target.
- 1.5x is 12 pips, but we have to subtract the 2-pip "entry breakout" (the 2 pips above the setup bar that must be passed before we enter) which leaves us with a target that is exactly 10 pips above the high of the setup bar. With this chart and market, a 10-pip target is not quite adequate for me, because there will also be another 2 to 3 pips in spread costs to account for—so it's not really worth my time. I'm interested in a 2x, 2.5x, and possibly a 3x target if the backtests point to decent odds of success.

"Spread costs" are a part of trading. Spread cost is the difference between the bid price and the asking price. The key to minimizing these costs is trading instruments that have high levels of liquidity, because they typically have smaller spreads between the bids and asks.

- 2x is 16 pips – 2 pips entry breakout – 3 pips spread = +11 pips. There's a profit target I can live with.
- 2.5x would be +15 pips (net).
- 3x would be +19 pips (net).

Remember, the actual net profit is relative to the size of the trade, which in forex refers to our lot size: micros, minis, full-size, etc. (chapter 5 and appendix II). One can learn to trade forex with a small account using micro and mini lots; as the account grows, the position size should be increased.



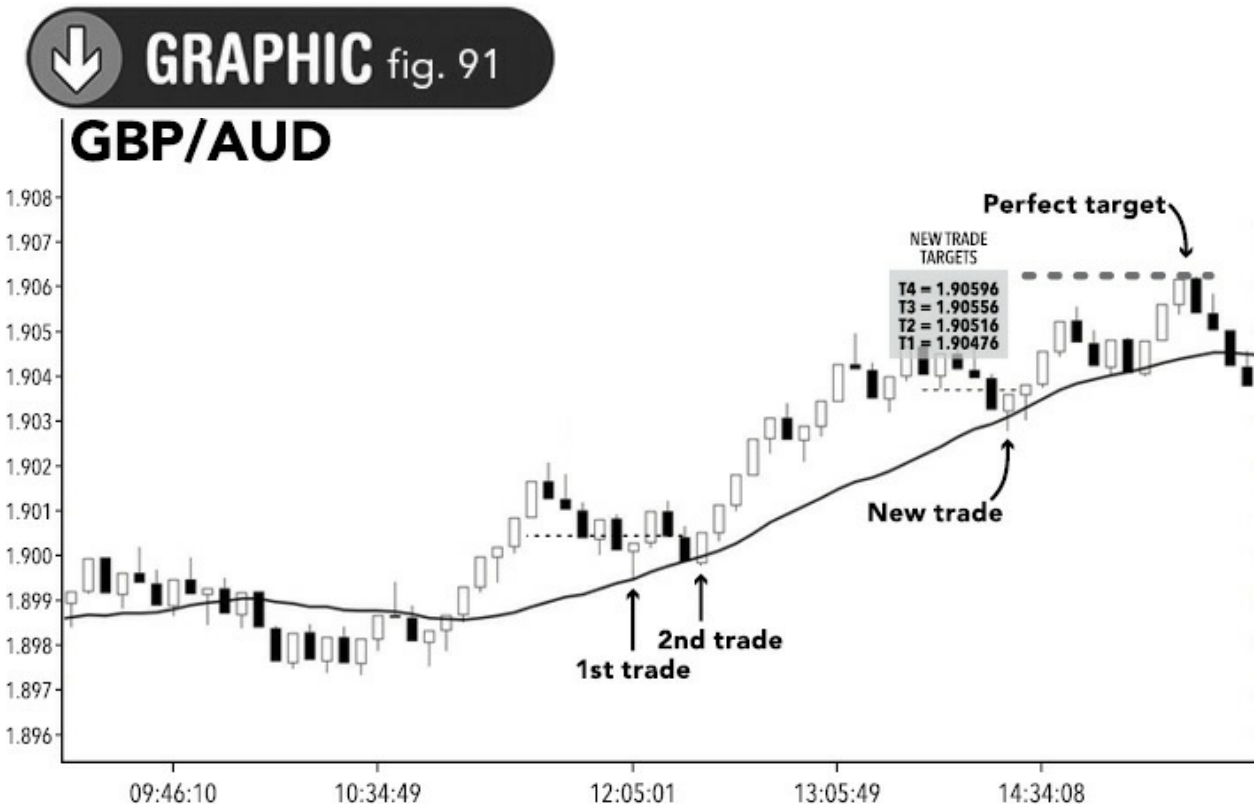
As with prior examples, there was a second place to get long (see figure 89). I projected targets from 1.5x through 3x. Notice how the subsequent action move practically mirrors the prior action move.

This is a great example of one of my simple trading ideas: that the immediate past (first action move and reaction in our 20 SMA) predicts the immediate future (the subsequent action move). This idea has made me a lot of money over the years!

As you can see in figure 90, as the price progressed over the next 40 minutes or so, yet another trade opportunity presented itself. This next setup might as well be a carbon copy of the first. And just like before, I projected the targets above the setup bar, as was done in prior examples.

MY TAKE

I recommend that you peruse a bunch of different charts and train your eye to find these setups, so when they happen in real time you will be ready for them.



Not much is ever perfect with trading. We live in a world of probabilities, risk mitigation, and smart money management. But the projection using our special "one-bar x factor setup," has an uncanny way of predicting accurate targets much of the time. Notice how the price traded just two pips past our 3x target (see figure 91) before "coming off" (reversing direction).

This is a beginner's guide to learning how to day trade, so I've been teaching you very simple trade setups. But just because these setups are simple does not mean they are not highly profitable, effective ways to day trade.

COURSE

HANDS-ON LEARNING: To get detailed video walk-throughs of some of my custom trade setups and techniques, **check out my course at www.clydebankmedia.com/trading-assets**. Some of the ideas you will learn about include the following:

» **Catapult Scalper**: An active day trading strategy that can be used on many different charts and markets.

» **Counter Punch Trader**: This technique makes use of "exhaustion levels" and a "balance line" to score big knockout victories.

» **Spotlight Power Trader**: Evolved out of its predecessor, *Counter Punch*, this strategy introduces new trading ideas that focus on higher-percentage setups.

» **Fun with Moving Averages**: Unique applications of innovative moving average setups that use Spotlight technology and concepts.

On my own journey over the years, I have picked up many different trading strategies. Somewhere along the way, I learned this next, very simple technique.

X t" b prt

I've spent many years in the day trading community, and certain trading tactics and setups have left lasting impressions on me. Many years ago, while reading posts in a popular trading forum, I happened upon a very interesting discussion where the writer was explaining how he hated the act of trading but loved the benefits it brought him. His plan involved taking only one trade per day, with a setup that, as he was able to verify, would win 93% of the time. Needless to say, his statement attracted a lot of attention. I read with interest to learn what I could about his method.

By this point you have seen and studied enough charts to know that price action moves back and forth, covering the same territory over and over again. Support becomes resistance and resistance becomes support. Prices tend to hover around support and resistance lines until buyers or sellers win the "tug-

of-war," causing the price to continue its previous trajectory or reverse direction.

When support and resistance are tight (close together) price action tends to chop. But when there are wide-open spaces between support and resistance levels, the price tends to move through those open spaces with relative ease. This is the idea that was the basis for the forum thread that grabbed my attention.

This particular trader focused on the Russell E-mini, which was the "ER2" in those days. Each point was worth $100 and, like today's Russell E-mini (RTY), traded in one-tenth-of-a-point ticks, worth $10 each. Today, the RTY trades at half that size: $50 per point and $5 per tick.

The big idea behind this technique—as articulated by the author of the thread, the trader who "hated to trade"—was to only take Russell E-mini trades into open spaces. I condensed the broad strokes of the plan into three basic steps:

- **Step 1**: Determine what constitutes an "open space" on any given day. This trader had a unique but reliable way of accomplishing this.
- **Step 2**: Buy or sell into these open spaces when the price had penetrated into them by three ticks.
- **Step 3**: Exit with five ticks of profit—in other words, after the price had traded eight ticks into the open space.

In those days, as I said, such a trade would create only $50 of profit. That didn't really get me excited, but as I kept reading his story, I began to see the larger play. He said that with each $1,000 of growth in his account he added a contract. It took a while to reach his first $1,000 milestone, but as he kept increasing his size with each additional $1,000 of profit, the rate of his growth increased faster and faster. He capped his trade at 20 contracts. By now you should be getting as excited as I was.

He claimed his trade took, on average, 10 seconds to 10 minutes of time to execute. Twenty contracts x $50 = $1,000 per day. That's approximately $20,000 per month x 12 months—over $200,000 per year, when considering holidays and assuming that 7% of his sessions are losing. I was never able to directly substantiate this claim, but it got me thinking about what trading could actually mean to me in my own life. It taught me that you didn't have to work harder to make more money. The same trade that would make $50 in 10 minutes or less would also make $1,000.

I dug deeper and set up my charts, following, to the best of my ability, his described techniques. The results were quite amazing. As you should do with any trading method that you adopt, I made open spaces my own. Let's take a closer look at some key elements of this technique that I was able to discern and develop over time.

- The strategy works well with the four major E-minis (RTY, YM, ES, and NQ) and uses five-minute charts.
- The strategy requires a special "custom session" chart. Most of the professional charting platforms allow you to create these, but explaining them step by step is beyond the scope of this book. The examples I'll introduce to you shortly will allow you to solidly grasp the idea.
- For the purposes of this strategy, we are only interested in price data from the open of the US stock market to the close. We want to eliminate from the chart all premarket data (data that occurs prior to the markets opening at 9:30 a.m. ET as well as all data after the markets close at 4:15 p.m. ET). TradeStation has a special chart that does this for us called the ".D" chart.

Let's say we are using the RTY (Russell E-mini). And let's specifically use the RTYZ19 chart as an example. "RTYZ19" refers to the December 2019 Russell E-mini futures contract, which is what was used to trade the E-minis through much of the fourth quarter from the second Friday in September through the second Thursday in December. This "normal" chart would show all price data for all hours that the RTY trades, including premarket and after-hours data. If we only wanted to see the actual US stock market price data—that is, between 9:30 and 4:15 ET—then the symbol would be "RTYZ19.D." That's it. Simple.

The next step in this process is to set up a workspace with four charts: @RTY.D, @YM.D, @ES.D, and @NQ.D (Russell, Dow, S&P, Nasdaq).

The @ symbol in front makes the chart a "continuous chart," and it will automatically default to the front-traded/currently traded contract. These are the contracts most heavily traded, so they are more likely to feature dynamic price movement.

While you cannot trade directly from these charts, they are great for displaying your workspace. If you want to trade right from your chart, then you will need to use the actual contract's symbol, RTYH20.D, YMH20.D, ESH20.D, and NQH20.D, for example, which are the March 2020 contracts for each of the four markets. These four contracts expire each quarter, so by the second Friday of March you will need to change the H in the symbol to

M (the June contracts). Then U for September, Z for December, back to H again, etc.

Don't feel overwhelmed. Some of these notations and concepts may seem intimidating for pure beginners. You'll get the hang of it in good time. It's not as complicated as it seems at first.

We are using five-minute charts here (figure 92), though I believe this approach would also work well with tick and momentum charts. Personally, I have not spent much time using tick and momentum charts with the open spaces technique, but once you learn the broad strokes here you will be able to explore the method on your own (and make it your own) just like I did. You may even come up with ways to introduce other ideas, indicators, etc.! Here is what the workspace of all four charts would look like:

GRAPHIC fig. 92

These markets all trade out of Chicago, hence the 8:30 a.m. CT / 9:30 ET opening time.

NOTE

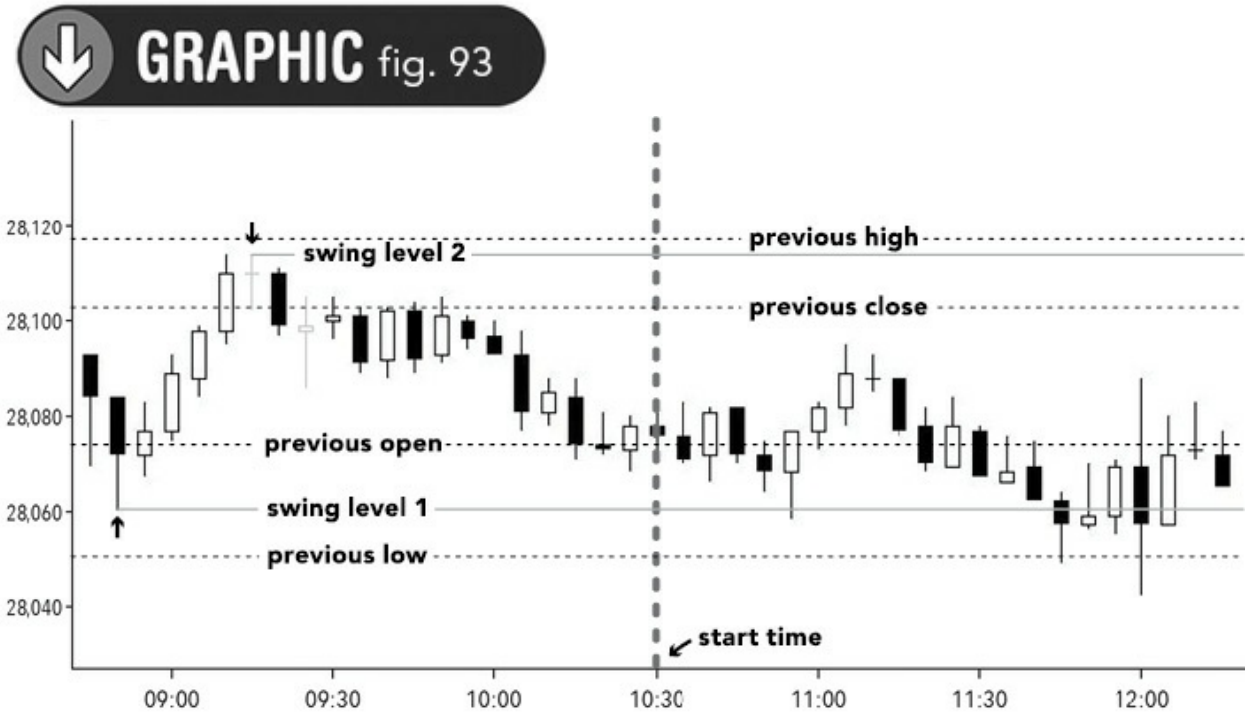
If you were to set up .D "session-only" charts like this using a platform other than TradeStation, then you would likely need to seek help from that platform's tech support team.

Upon first glance, these charts look like any other price chart, and in fact they are. But once we start figuring out where the open spaces are, the context will completely change. Let's explore how to go about discovering the open spaces to trade into (figure 93). It's quite simple, actually. It merely requires drawing some horizontal lines at the right locations:

» **First**: Draw a horizontal line over yesterday's open, high, low, and close.

» **Second**: Draw a horizontal line at the significant "swing levels" of today's price action during the first two hours of trading (8:30–10:30 a.m. CT). Swing levels, or pivot levels, are the peaks and valleys of price action—either a high point that is higher than both the two bars to the left and the two bars to the right, or a low point that is lower than both the two bars to the left and the two bars to the right.

» **Third**: At 10:30 a.m., two hours into the session, begin looking for trades. Draw a vertical line to mark the start time.



Examples of swing levels identified prior to a 10:30 a.m. start time.

MY TAKE

One of the things I love about this method is that this simple preliminary work (drawing the lines) can help you see, way in advance, where your trades will likely take place. I like to use some custom indicators as well to help pinpoint the location of my likely trades. I will show you these as we walk through the examples that follow.

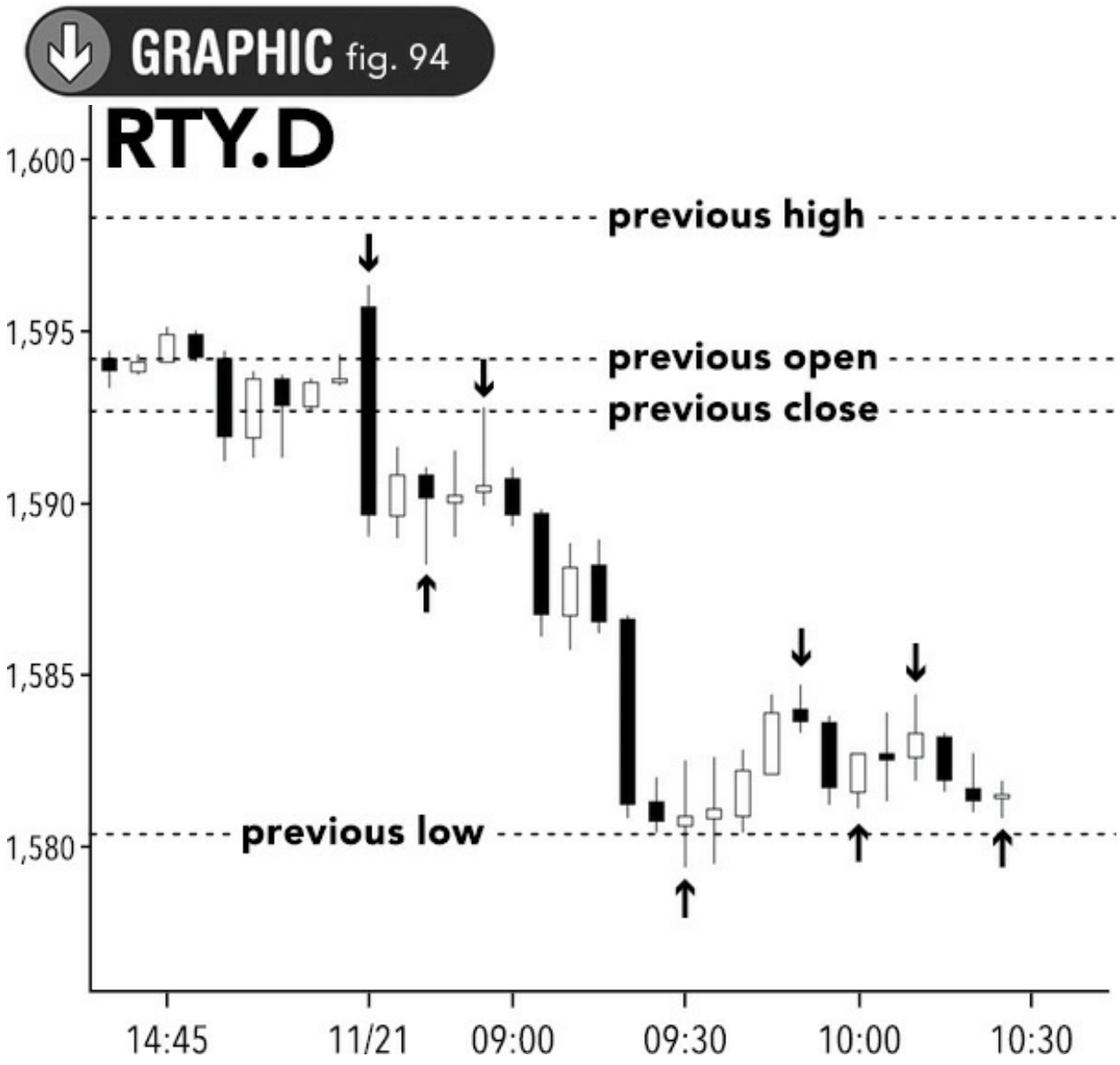
In our first example of the open spaces technique, we're going to look at the RTY.D on a random session. The first thing we are going to do is draw our horizontal lines over the previous trading day's open, high, low, and close. Simply look at the previous trading day's chart and draw your lines right at those levels.

Next, we are going to identify our swing levels from the first two hours of today's trading session.

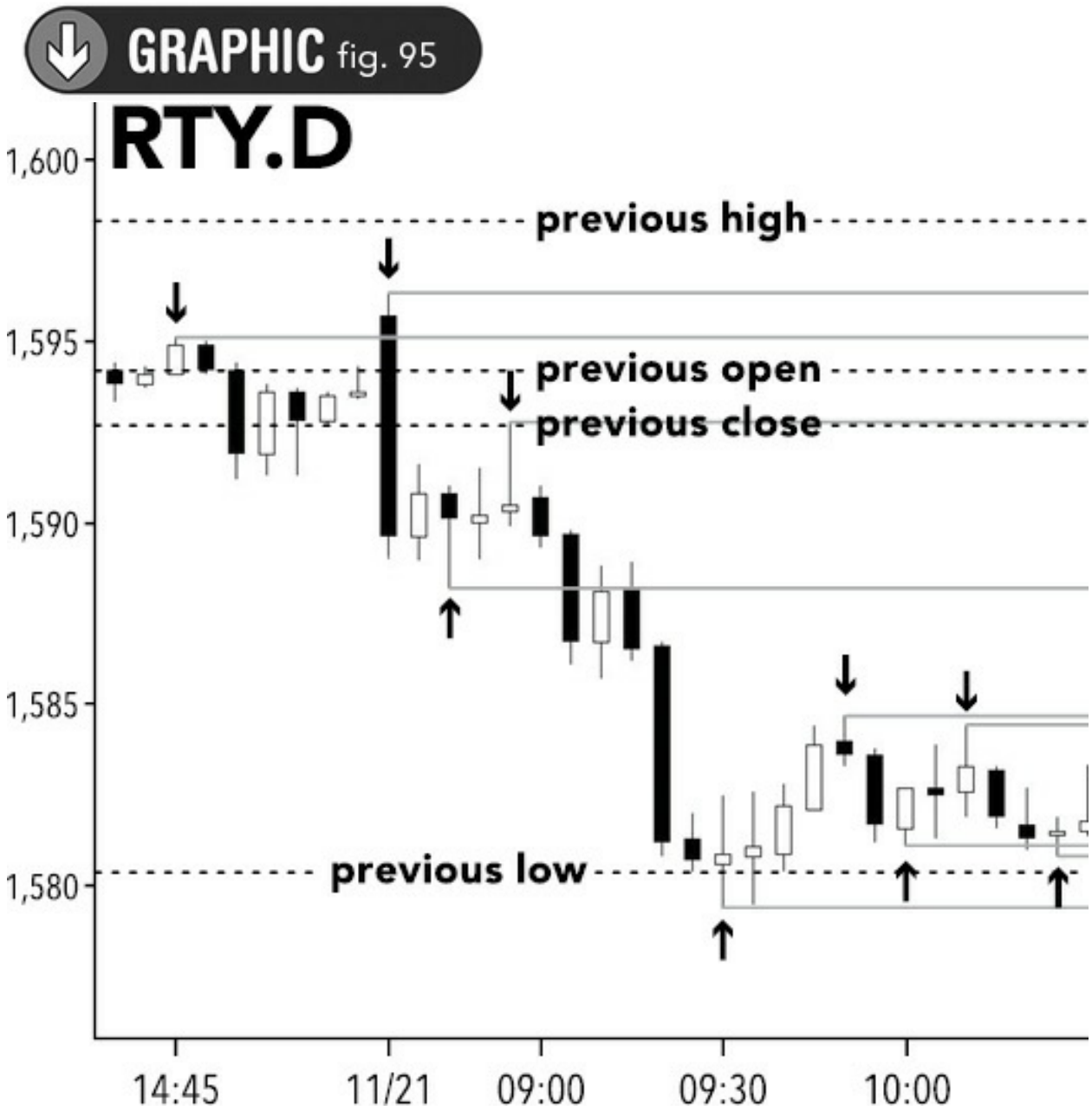
REMEMBER

A swing level is either a) the high of a price bar that is higher than the two bars immediately to its left and the two immediately to its right or b) the low of a price bar that is lower than the two bars immediately to its left and the two immediately to its right.

In figure 94, I have placed arrows to mark the significant swing levels that occur before 10:30 a.m. during our session. I have also transferred the four horizontal lines from yesterday's chart into today's chart.



The next step is to add in more horizontal lines at the swing levels that occur within the first two hours of the session. In a real live trading session, we would draw these lines about five minutes before 10:30 a.m. It only takes a few seconds.



Many trading platforms feature custom indicators that will automatically add lines like these to your charts based on yesterday's trading data, swing levels, etc.

I want you to see what these horizontal lines can potentially reveal to us. In figure 96 we can see how price action proceeded past 10:30 a.m. You can see where the price got hung up on the lines that were bunched together and how the price easily moved through the open spaces.

GRAPHIC fig. 96

After studying and backtesting several of these types of charts and sessions, you'll be amazed at the predictive power of this open spaces trading tactic.

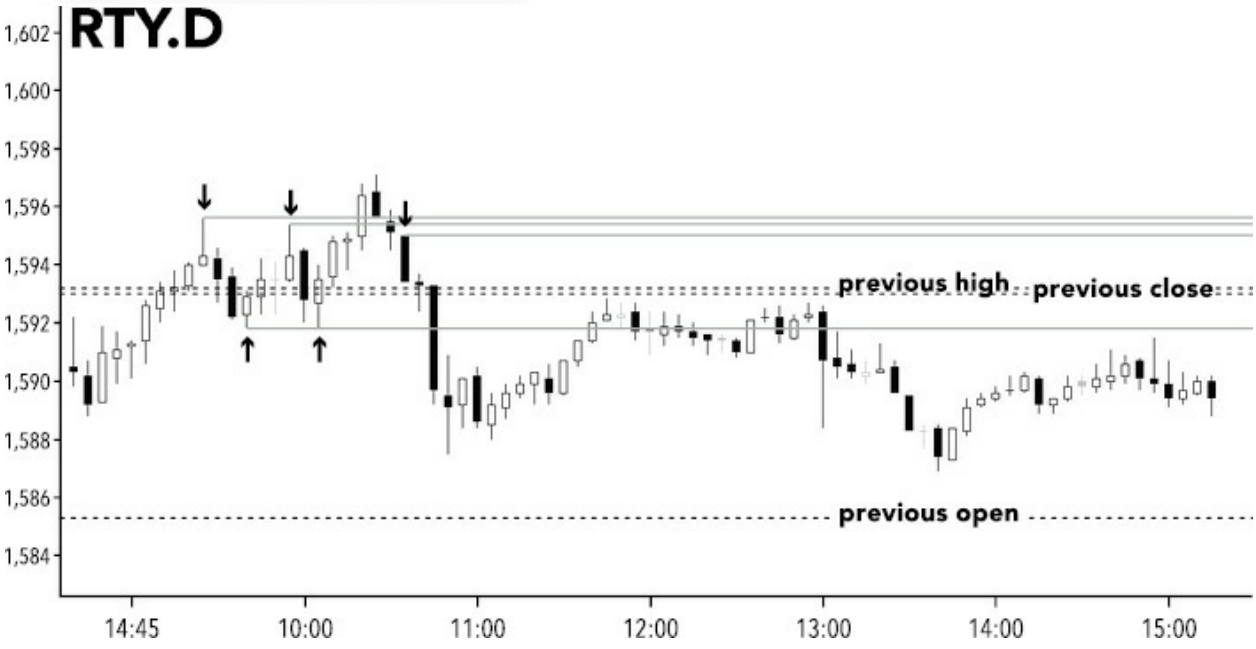
MY TAKE

Sometimes the easiest trading ideas prove to be the most effective. Ease of learning paves the way for consistent, reliable execution and measurable, testable results. Hence, ease of learning paves the way for success. I use my custom indicators to automatically draw the horizontal lines for each session. This saves me time. Like using the right tools to build a house or to fix a car, using the right tools for trading can make a world of difference.

Let's take a look at another full trading session, figure 97. Notice how different this session looks from the previous one. Notice also how trading

into the wide-open spaces would have easily achieved the modest goals of this particular tradeplan—enter 3 ticks into the open space and exit with 5 ticks of profit; that is, the price must penetrate a total of 8 ticks into the open space to complete the trade.

GRAPHIC fig. 97



REMEMBER

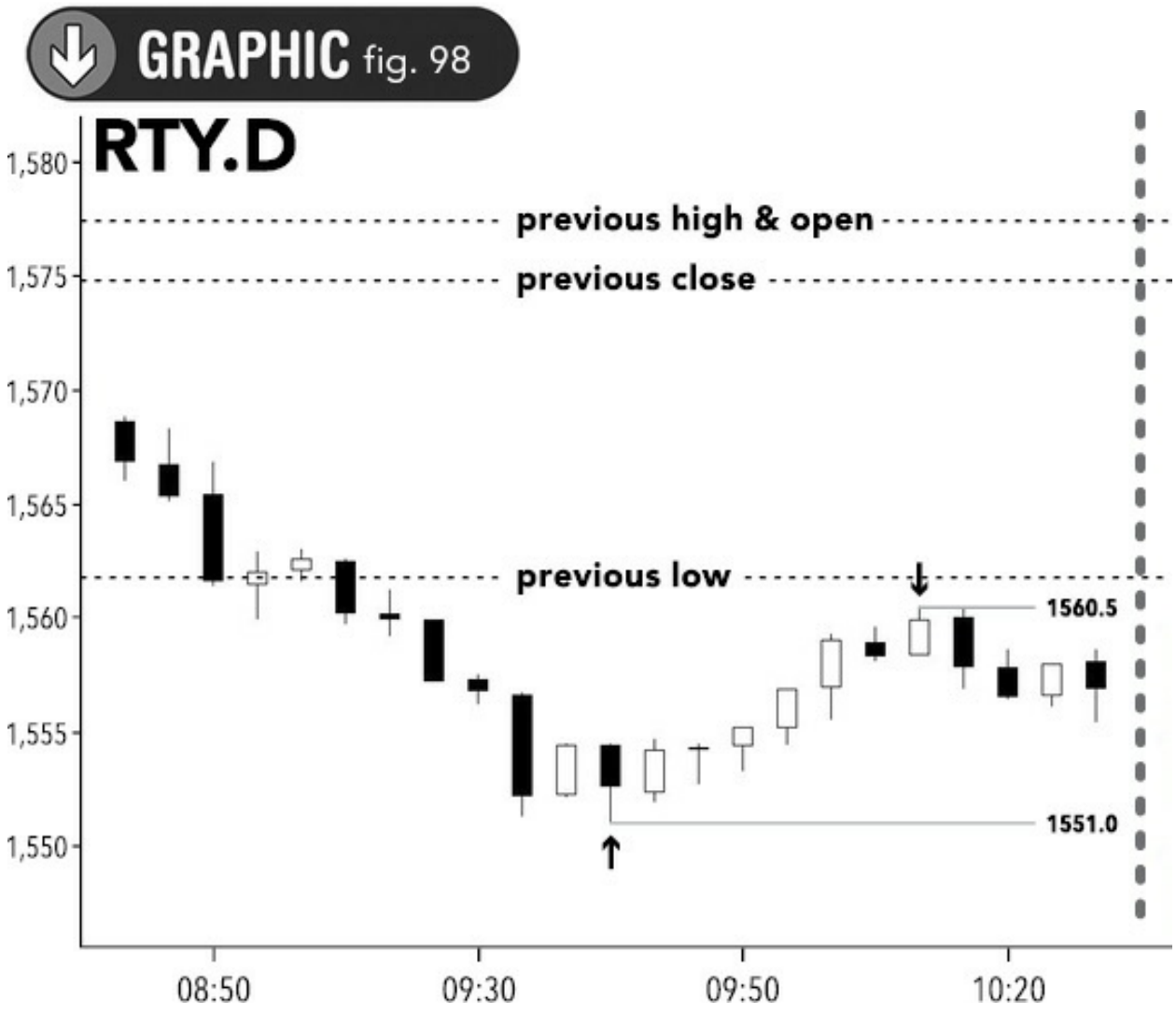
In the RTY each tick is one-tenth of a point.

NOTE

There is no "previous low" line in this chart. This is because yesterday's low was low enough to be unviewable in this chart. This happens regularly and is to be expected. It's best to focus on the open spaces you can readily visualize.

Now that you understand the basic idea of open spaces, let's drill down a bit into some of the finer details.

In our next example (figures 98–102) we begin with a look at our early morning price action (8:30 a.m. to 10:30 a.m.). The four horizontal lines derived from yesterday's prices are already on the chart. Note that yesterday's previous high and previous open are represented by the same line. We have a couple of excellent wide-open spaces with which to work.



Today at 10:30, the time we are ready to trade, the price is already in the middle of a big open space (figure 99). You have to look carefully to see the bar that forms right after 10:30, because it is a "doji," a candle with no body (same open and closing price), and it is somewhat obscured by our 10:30 vertical line marker. But it's there. We have to be patient and wait for the price action to exit this open space before looking to take a trade.

We can see that, should the price move higher, there is another wide-open space we could trade into. We don't need to wait around to watch and see what happens. If the price ends up climbing into the open space by three

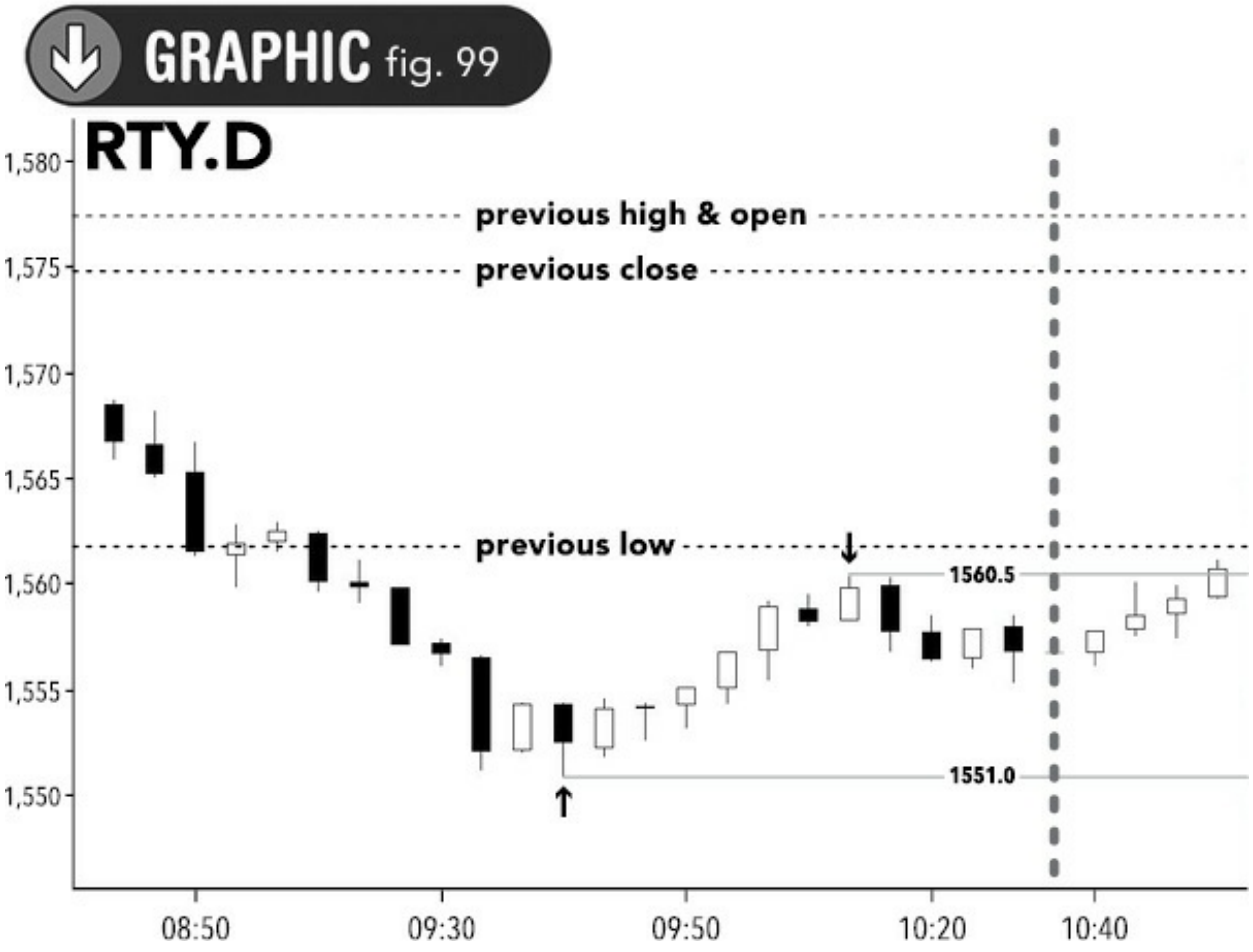
ticks, then we want to take the trade. Therefore, we can go ahead and place an open order to go long right now. The order will only trigger if the price moves into the open space at some point later in the trading day. There is no reason to wait. We will place our open order to go long 3 ticks into the open space at 1562.1, and our target will be set for 5 ticks further (1562.6)—simple. We do need to think about where to place our stop, but we will get into stop placement later on in this section.

Bracket orders–discussed in chapter 9–can be used to configure all parameters of a trade. You can submit your entry, target/exit, and stop all at once.

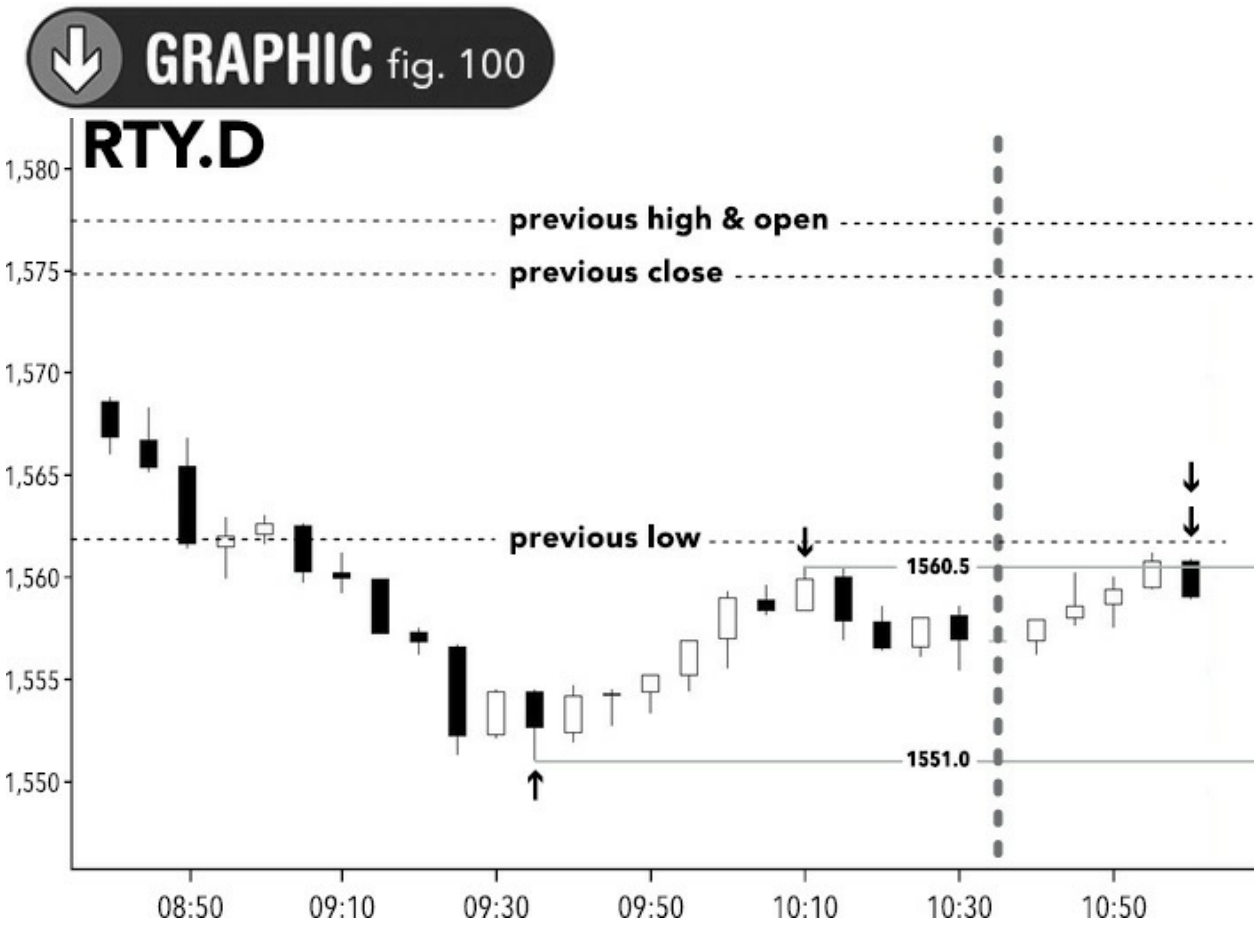
Take a look at figure 99; after a few bars, we can see that the price has traded and closed into the narrow space right above the wide-open space it was just in (between the previous low line, 1561.8, and the swing level line, 1560.5). We have already submitted our bracket order for the long trade to be placed 3 ticks above the previous low line into the next wide-open space, but now we need to be prepared to trade down as well, back into the wide-open space that the price has just moved out of.

We will now set up a bracket order for a second trade, this one to go short. We will place our entry at 1560.2, 3 ticks below the horizontal line that marks the top of the big open space the price just exited. If either of our orders triggers in, then we'll cancel the other one. As traders, we can't control price action. We just need to be prepared and to execute accurately. The rules of getting into these trades are quite simple: we enter the trade if the price

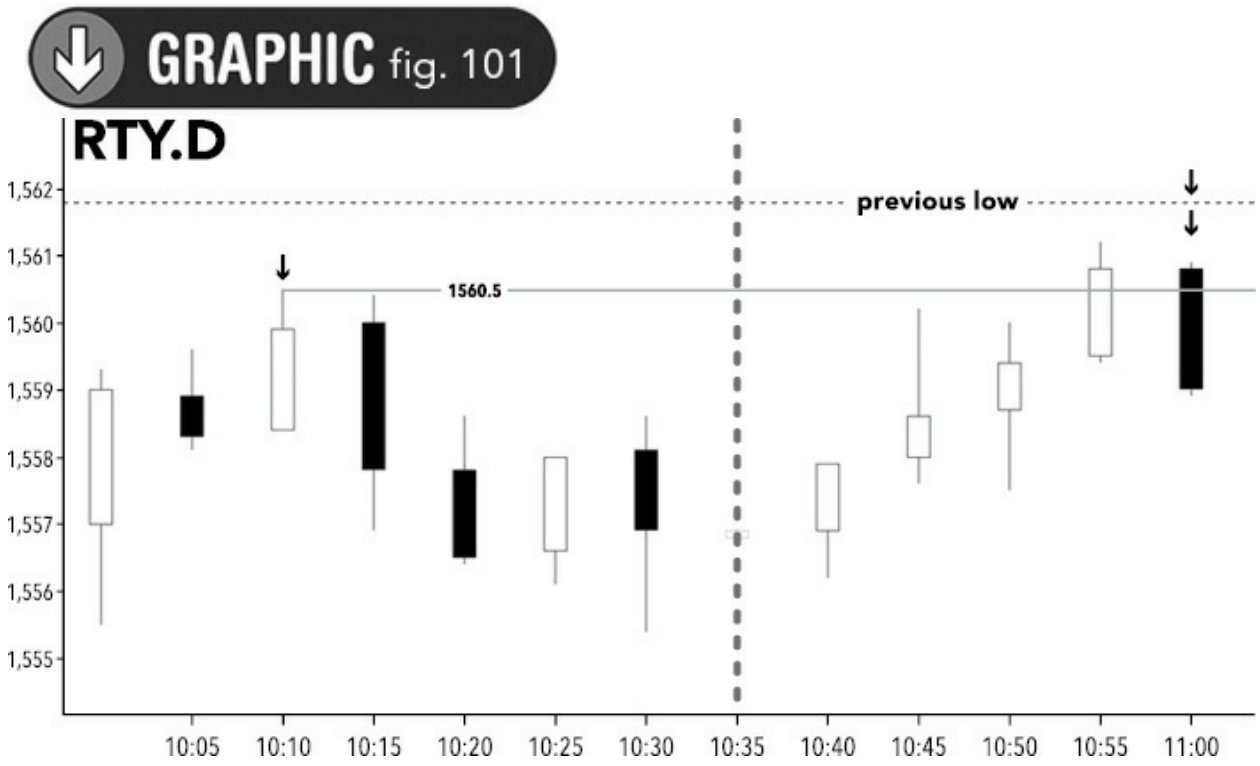
trades 3 ticks into a wide-open space. If we can see the wide-open spaces, then we have what we need to place our trades.



As price action progresses (figure 100), the very next bar does indeed trade lower, into our wide-open space, triggering in a short trade. Be sure to immediately cancel the long setup that was placed earlier.



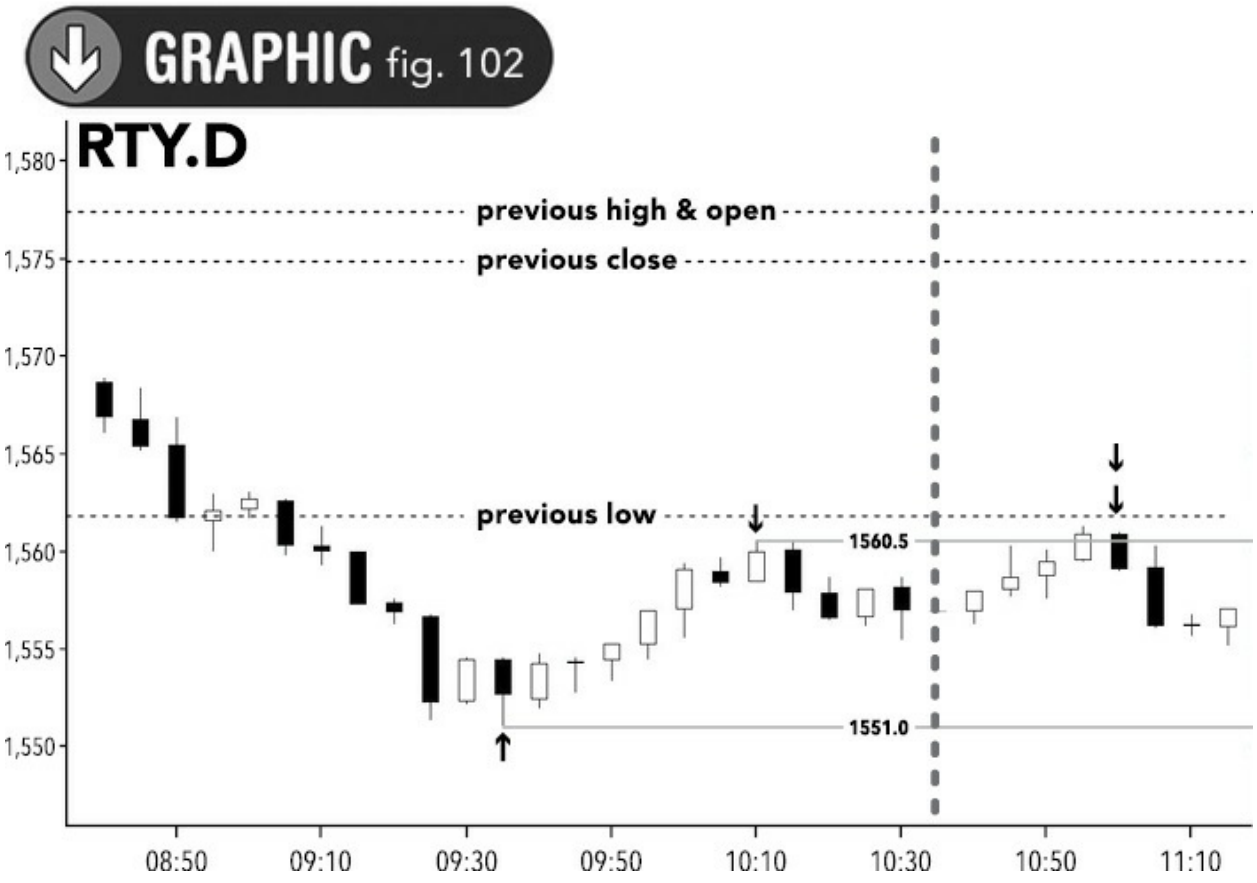
Let's take a closer look and zoom in to the bar that triggered the new short trade (figure 101). That particular bar ended up being two full points in length (20 ticks) with a high of 1560.8 and a low of 1558.8. In other words, within the course of a single five-minute bar, the trade was triggered (3 ticks into the open space at 1560.2), and the 5-tick target was then hit at 1559.7, and the position was closed. This lightning-fast action should prove to you why we always enter trades using bracket orders. A trade like this could have taken anywhere from a few seconds to a few minutes.



As we reflect on this seemingly simple yet powerful trading strategy, there are a few important factors to consider. First, open spaces is an example of an incredibly simple and elegant tradeplan. And, as you should know by now, having a tradeplan that you can learn, test, and execute is everything in the world of day trading. The trader who shared this idea on the forum was initially pursuing $50 on every trade per contract; trade 3 ticks into the wide-open spaces and exit with a 5-tick profit—$50 per contract. As I mentioned, the Russell E-mini at the time traded at $10 per tick for a single contract. Today it trades at $5 per tick, so to procure the $50 per trade in accordance with that tradeplan we would need to use two contracts, doubling our position size. The second thing we should reflect on is the fact that I never had the chance to meet this guy. If I had, then I would have asked him how he handled his stops. I would also have asked him what he did in the event that his first trade lost. Did he quit for the day or keep going? It wasn't until I

began to explore and implement new variations to the plan, making it my own, that I was able to flesh out some of these missing elements.

As was mentioned, price will easily move through the wide-open spaces. Let's go back to the trade example we were just looking at. Check out what happened over the course of the next several bars. The price proceeded to drop to 1555.1, more than 5 full points lower than when we first would have entered the trade. That's not 5 ticks, that's 5 points! And the price has plenty of open space left below and could test the prior swing level indicated by the lower boundary of the space (figure 102).



As you apply the open spaces technique to more and more chart examples, you will probably notice the same thing I did: there is a lot more profit

potential to be had during many trade sessions inside of wide-open spaces! Still, before we continue to customize the tradeplan and tilt it in a more aggressive direction, the question remains of where to place our stop-loss. Let's look into that now.

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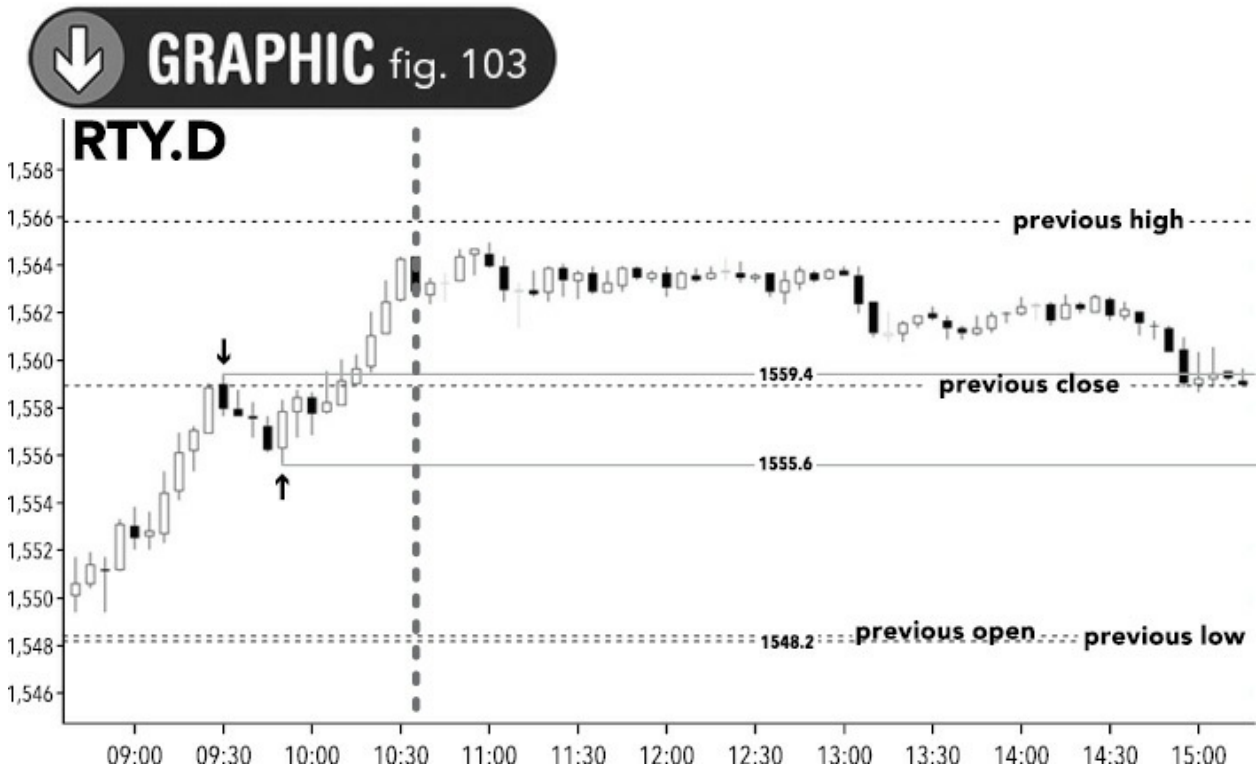
When deciding on where to place a stop-loss, a few important factors need to be considered. The big question at hand is this: how do we place the stop-loss in such a way that it is unlikely to get hit unless the trade is completely wrong? Let's consider several factors:

- What is our risk/reward ratio? What are we risking in relation to what we stand to gain? How long of a leash should we give our trade? It should at least be allowed to flirt with disaster before we pull the plug, but to what extent? Let's say we'd like to risk 10 ticks for a chance to win 5 ticks, 10:5. Is this a good ratio? Unfortunately, there is no obvious yes or no answer to be had here, at least not yet. The answer depends one hundred percent—and quite obviously—on how frequently your trade setup wins, and you must determine and prove that through backtesting (chapter 16).
- How frequently do I need to win? If you lose 10 ticks on a trade, then you would have to win 3 trades of 5 ticks each to make a profit, 5 + 5 + 5 = 15 ticks – 10 ticks = 5 ticks of profit. However, when you subtract your trade costs, you will be lucky if you make a single tick of profit! So, clearly a 75% win rate is not going to be good enough for this risk/reward profile. What about a 93% win rate? That would probably work. Would a 10-tick stop-loss produce a 93% win rate? What does your testing suggest?
- How do we know the 10-tick level is in that sweet spot that is unlikely to get hit unless the trade ends up being completely wrong?

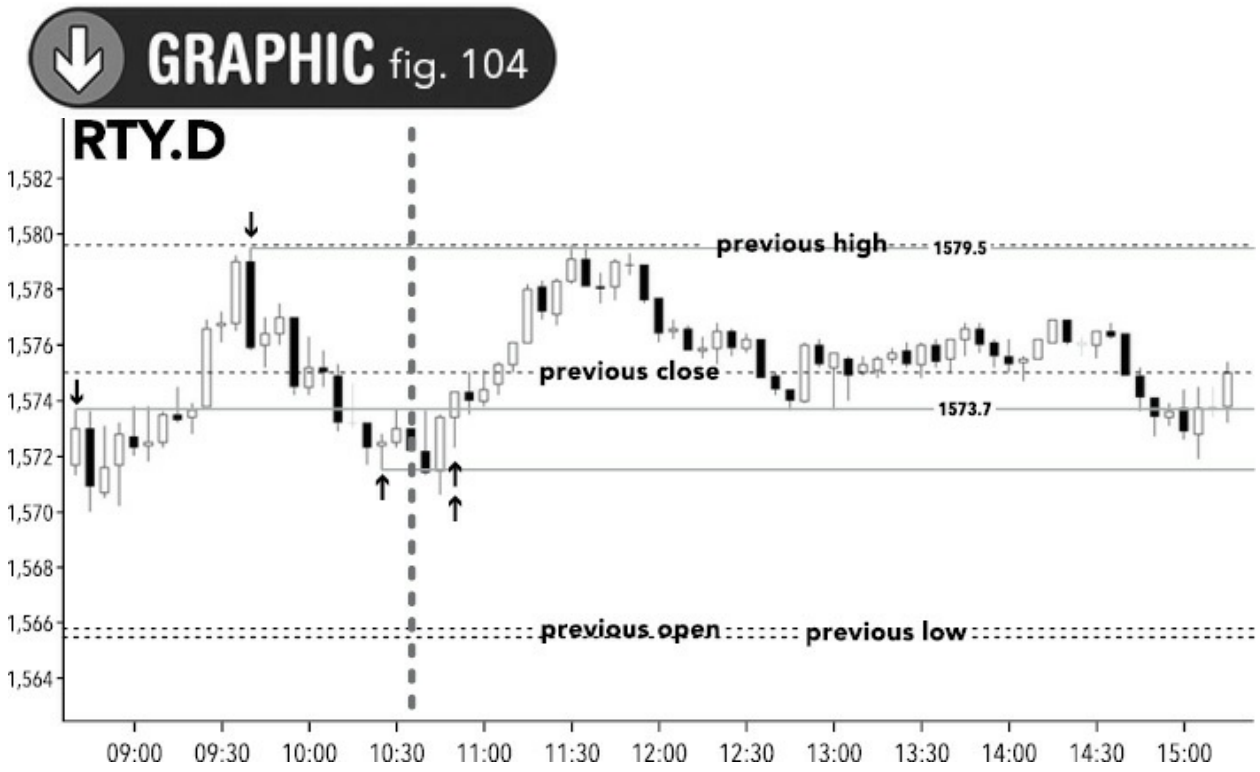
> If it is indeed in the sweet spot, then it will most likely produce the 93% win rate that we need, but how do we know for sure? By testing!

The preceding considerations specifically pertain to our evaluation of a fixed 10-tick stop. But what if we believe that our best results will come if we are willing to be a little more flexible? For that matter, why should our 5-tick target be set in stone? Perhaps a more dynamic setup method would be more effective. Is it possible to maintain a testable tradeplan where we periodically alter our stop levels and even our target levels without it devolving into a whimsical disorganized technique? Not only is it possible, it is an essential skill of successful traders, as it allows them to adapt to dynamic market conditions. We will learn more about adaptability in part III of this book when we discuss the Power of Dynamic Setups.

Let's take a look at a few more examples using the open spaces technique. For sure, every session will be completely unique, but the simple trading approach will remain the same: trade into the wide-open spaces. In this next example (figure 103), the price traded up into the highs of the day and never really turned back down until late in the session, when it still wasn't able to break into the wide-open space below. This session produced no trades at all.



The next day, though, was a completely different story. This session was as clean and simple as they come. At our start time, the wide-open space was right above the price and ideal for a long trade. The price had no problem trading through the open space that represented over 6 points' (60 ticks) worth of price action (figure 104).



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In my experience with the open spaces technique, the question of where to place your stop is a persistent one. Here are a few considerations in the context of our current example:

- One idea is to place the stop below the low of the bar that stabs up into the space. Then, once that bar closes, if you are still in the trade, move it to 3 ticks below the horizontal line. The risk is that while the bar is forming, the price can travel lower and make a new low of the same bar, and then proceed to move higher again. In other words, you could get stopped out intra-bar, during the same bar that triggered you into the trade. Each bar represents five minutes and a lot can happen in five minutes.
- Another, safer idea would be to temporarily place the stop below the low of the prior bar. That is, unless the trade turns around and heads

in the other direction before hitting your 5-tick target.

Take a look at the same example that we just examined, only this time, let's add a 5 SMA (figure 105).

Unlike in our previous discussions of SMAs, we are using increments of bars, not days. In the context of a 5-minute chart, the plotting of a "5 SMA" tracks the average of the close of the last five bars.

During ascending price action, the 5 SMA often tracks the lows of each bar. During descending price action it often tracks the highs of each bar. And during sideways price action it often hovers in the middle.

Another key thing to take note of in figure 105 is that, as with previous examples, the price action easily moves through the entirety of the open space; from one horizontal line to the next, the price action moves a whopping 58 ticks! This brings up a question: why does the technique's author insist on exiting the trade after only 5 ticks of profit?

I'd like to suggest a powerful technique that not only solves our stop problem but also gives us a pathway to making more money from these open spaces trades, well beyond 5 ticks of profit. We are going to employ our 5 SMA as a benchmark that will help us set up a series of trailing stops that will limit our risk as we pursue greater profits. Here are the key aspects of this technique:

» We will aim to stay in the trade longer; rather than exit after 5 ticks, we will look to exit after the price action has moved 80% of the way to the next horizontal line.

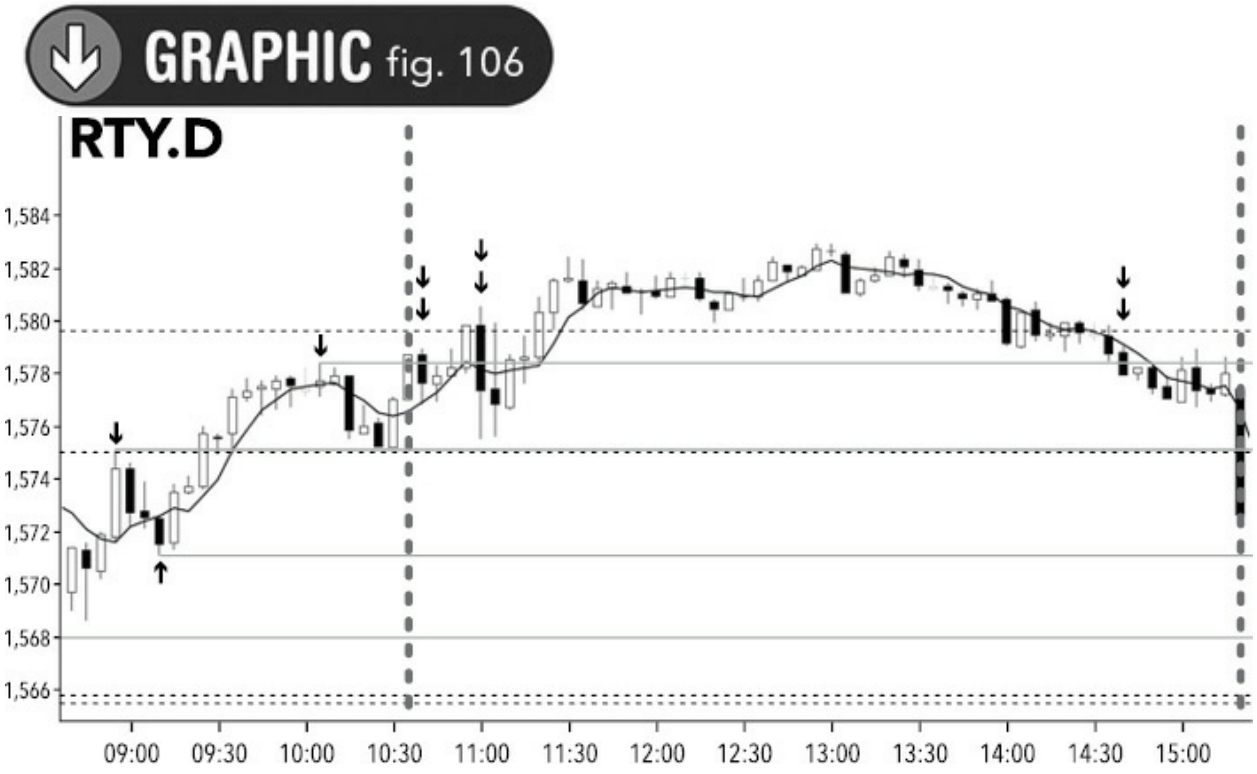
» To temper our ambition, we're going to set up a series of trailing stops and use the 5 SMA as our guiding indicator. In figure 105, after we enter the trade (see the arrows), we will place our stops 2 ticks below the 5 SMA line beneath the previous closed bar. And we will move it up with each new closing bar.

Note how, in using this technique for our trade in figure 105, we would have hit our 5-tick target right away *and* given ourselves a chance to profit from a larger move.

The next day (figure 106), there were a few good wide-open spaces established prior to our 10:30 start time. The start time bar actually closed above a wide-open space. A short order should have been placed at that point. The very next bar (first pair of double arrows) moved down into the open space, triggered into the trade, and continued on to hit the 5-tick target,

all within the same bar. The speed of this trade shows why it's always important to trade with bracket orders.

Our stop-loss dilemma continues here, in that we were trading short, yet our 5 SMA was still below the market and unusable as a stop. While the humble 5-tick approach would have worked fine, the ambitious technique that we just outlined would not have been effective here; had we traded for a larger move, the trade would have failed.



But there was a second chance to get short! This time—as you can see in figure 106 (the second pair of downward arrows)—the price moves down more than 80% of the way to the next horizontal line, all in a single bar. In this trade, our ambition would have been rewarded!

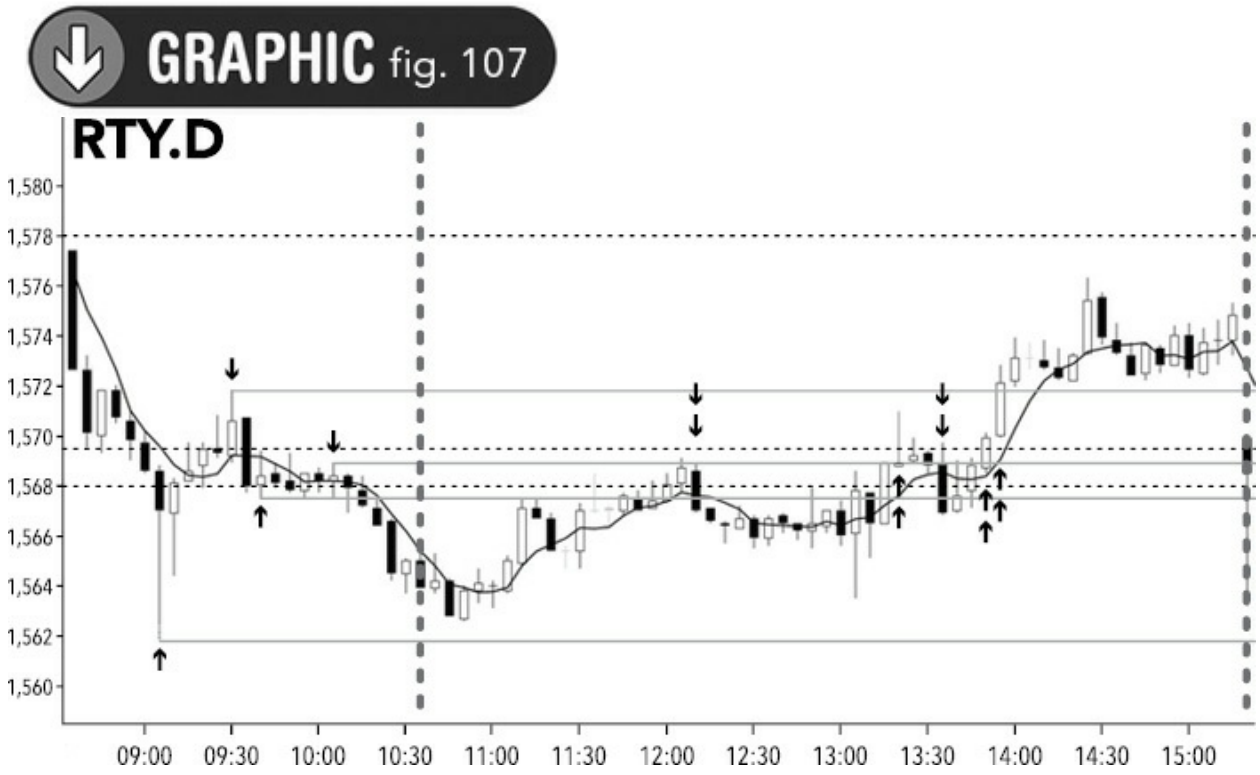
When trading into open spaces, we trade into the spaces with clear top and bottom boundaries. We don't trade into the limitless void above or below the highest or lowest visible horizontal line. This is the reason we continued to go short in our second trade in figure 106, trading *down* into the wide open space, as opposed to going long and trading toward the limitless area above the topmost horizontal line.

In our second trade in figure 106, a stop could have been placed a few ticks above the high of the trade bar, the one that triggered into the big short trade, or above the bar to the left, whichever was higher. It could also have been placed a few ticks above the horizontal line, since it marks the end of the open space.

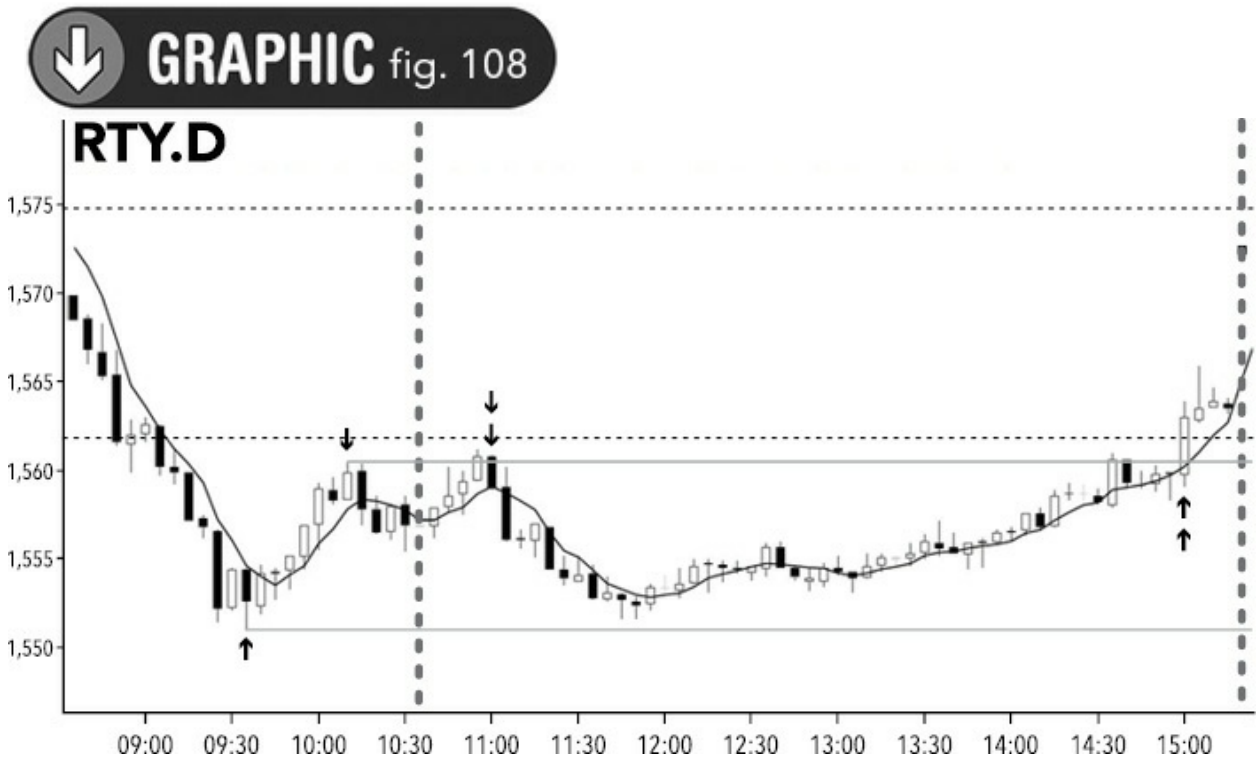
There is a reason I am not giving you a hard stop-loss rule with this trading idea. I want you to think things through and use the concepts you are learning in this guide, so you can become self-sufficient as a trader. The reality is that throughout your trading career you will discover many new and interesting trading ideas and opportunities. If you stick to the 12 Powers (part III) and the Step-by-Step Guide (part IV), then you'll learn how best to navigate this vast ocean of trading ideas, systems, methods, techniques, etc. You will be able to test and implement the most promising ideas in an orderly fashion. You will be measuring your results and zeroing in on what works.

Notice that still later in the session (figure 106), another short trade

occurred, this time lining up nicely with our 5 SMA, the way we want it to line up when we're using the 5 SMA to place our trailing stops. Would waiting for trades that properly align with our 5 SMA produce more consistent winners? It's a question that would be easily answered with a simple fast-test (see chapter 16). Meanwhile, let's look at the next day's example (figure 107).



In this example, there were five excellent trade opportunities (see the double arrows) but only the last two could have made use of the 5 SMA trailing stop technique. Also, only the fourth trade made it to the other side of its open space, and it was an open space that wasn't one of the widest.



All the trades were 5-tick winners, at the very least. Stops could have been placed 1 tick beyond the prior bar, which would have been sufficient to produce winning results for each setup. The next day's session (figure 108) was interesting as well. (Personally, I find every session interesting, as they are all completely different.)

By now you should be able to look at the chart and identify the potential trades of the day. You should also be able to note where the 5 SMA can be used to set trailing stops. There was an early-session short trade where the 5 SMA could certainly have lent its services as a perfect trailing stop. The initial stop could have been placed above the prior bar or right above the higher-level horizontal line. Both would have worked perfectly, in that they both would have kept us in the trade until we transitioned our stop to the 5 SMA, two bars later.

There was a late-session trade as well, which would have required closing

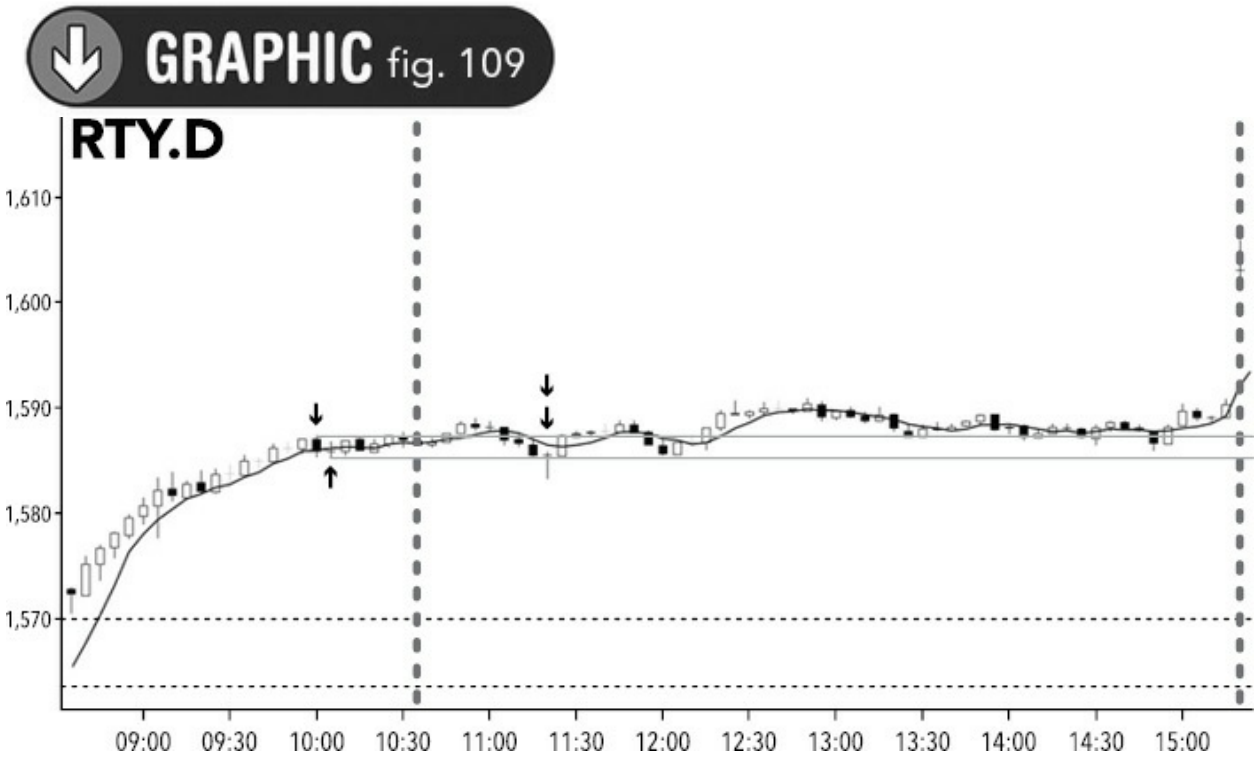
of the trade upon the close of the market, so as not to hold the trade overnight, into the next session. We're interested in day trading with this approach, not swing trading.

It doesn't get more straightforward than this when it comes to day trading. Trade 3 ticks into the wide-open spaces! That's the main strategy in a nutshell. The only decision you have to make is whether you want to attempt to go the extra mile. How much profit do you aim to take out of these trades, and what method will you use to place your stop-loss(es)? If you pursue the 5 SMA technique, then you can, in theory, have your cake and eat it too, a concept I personally love applying to day trading. Alternatively, you can seek to "scalp" out of your trade with your 5-tick minimum objective and keep adding contracts as you grow your account. You may want to pursue a strategy that incorporates both approaches, the conservative and the aggressive. Once your position grows to multiple contracts, you can scale out with 5 ticks and continue to trail the remainder of your position for larger gains.

In this next example (figure 109), notice how tight the price action was throughout the session. There was only one trade setup, which did poke below into its wide-open space but then quickly moved back up into its tight trading range. Still, though, that one trade went far enough to hit its 5-tick minimum target. I find it amazing, still to this day, that a tiny little line on a chart can represent profit flowing into my trading account. Is that a beautiful thing, or what? What seems like a late-session long trade actually was not. Remember, we don't trade into highs or lows of the day, only established open spaces.

We have looked at a number of different sessions, one after another. Each one exhibited a completely different look and feel, and yet with the simple idea of trading into the wide-open spaces, excellent winning trade

opportunities presented themselves. This open spaces technique is a very elegant approach to trading that solves a lot of problems that haunt most traders—mainly, overtrading and trading without clear and concise objectives.



As I said when I began to explain the open spaces method, you could trade the YM, ES, and NQ in much the same way. Use the techniques taught in this guide to decide on a minimum target level, a stop-loss method, and how and when to pursue larger profit objectives. I think if you apply the same ideas we've discussed here, you'll be in good shape. Just decide on a high-percentage winning minimum target, like the 5 ticks we used for the RTY. The YM, for instance, is $5 per point, so perhaps a minimum target of five points with two contracts would work well. You could also try 10 points with one contract. The ES and the NQ are a little trickier, because they trade in ¼-point ticks. The NQ is $5 per tick, though, so you could try two contracts for a 5-tick move. The ES is more costly and the trickiest of the bunch. It is

$12.50 per tick, a full point being $50. The problem with the ES is that you often need to trade through your price objective in order to get filled. So you would likely need 5 ticks of price movement to successfully capture a 4-tick (1-point) move.

The good news is that you have learned (or will learn in the ensuing chapters of this book) fast-testing and backtesting techniques that will help you develop effective tradeplans that can incorporate the open spaces technique.

We've covered a lot of ground in part II. We looked at basic technical analysis tools like trendlines and support/resistance. You know about moving averages, momentum indicators, and other charting tools. We explained how to implement strategy once you have identified an interesting setup. You now know how to use simple and advanced order types as well. Congratulations!

Now, our focus turns to the 12 Powers—the 12 essential keys that I have discovered over many years of trading experience—that are necessary for consistent success in trading. In part III we explore each of the 12 Powers in detail.

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» A trade profile is the anatomy of a trade setup, which includes all the information about a trade: entry price, exit price, stops, targets, and risk/reward ratios.

» Regardless of the setup, plan the trade and trade the plan.

» Price targets can be established ahead of time and, when trading multiple contracts, there is room for multiple price targets and/or trailing stop tactics, depending on the tradeplan rules.

» Execution mistakes can be costly. Practicing the maneuvers before trading real money can save a lot of money and prevent potential headaches.

» The classic pullback setup and open spaces are examples of trading techniques that are as powerful as they are simple.

PART III

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- » Winning and losing
- » The Power of Why
- » Foundations
- » Plan the trades

What does it mean to be a winning day trader? Many traders never consider that crucial question. But, ultimately, your goal—if you are reading this book—is to become a successful and profitable day trader. What does that mean and how do we do it? Parts I and II provided some information that can help, but things like charts, indicators, and order types are only tools. Giving somebody a toolbox does not make them a mechanic or a master carpenter.

Becoming a successful trader requires a lot more than a set of tools. It requires a mindset and an understanding of some of the obstacles that nearly all traders face. Now, in part III, we cover the 12 Powers of successful day trading. These lessons, which I have learned over many years, are provided to give a broader perspective about the business of day trading and provide a road map to help you on your journey. Once you understand the 12 Powers, you will be in a much better position to overcome common hurdles and achieve success as a day trader.

These 12 Powers are completely within your control and need to be part of your day trading plan if you want to achieve high levels of success. By incorporating each one (along with the steps in part IV) into your trading business, you will put yourself in the most advantageous position, and you will be far better off than 90 percent of the traders out there. I state that opinion after working with hundreds, perhaps thousands, of traders over the last 15 years, and I believe my opinion carries some weight and comes from a very informed point of view.

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Let's start with a very basic question: What is success in day trading? In the early stages of working with a trader, as a coach and mentor, I ask them what winning or losing means to them. I ask them to imagine a current or recent trade and to imagine that the trade loses. What does that mean? Does that make them a losing trader? Then I ask them to imagine that the trade wins. Are they now a winning trader?

It is such a simple exercise to imagine both of those situations, and yet, when the typical day trader makes trades, they never stop to think about the basic question of what it means to win or to lose.

When you think of a trade and ask those questions, it quickly makes you realize that there is much more to winning or losing as a trader. It is never about one or two trades. We are traders. We trade. That is what we do. There is always another day, another setup, another trade. One trade does not define anything. Yet the effects of a single trade can really cause havoc for the unaware trader and make them react by doing things that are very destructive to the long-term health of their trading account.

What, then, defines a successful trader? When do you know you have "arrived"? After 100 trades? 1,000 trades? 20 years of trading? Think about it.

This simple thought process will help put things in perspective so you can begin doing the work necessary to achieve your financial goals from trading.

More important, ask why. This is where it all begins. Why trade? If you do not know why you are day trading, you are not setting yourself up for success. Most people don't really think about it or know why they are day trading. Most traders either haven't given this critical question any thought or they are confused by it. They think they know why they are trading, but their actions suggest that they really do not.

The only reason to day trade is to make money.

Commit to your reasons for trading and then do the things that will help you achieve your goal: to make money. Do nothing else. Learn to operate from a higher point of view and make sure your actions are consistent with your objective. This is your singular and only reason for trading in the markets.

The Power of Why is knowing and understanding that the reason we trade is to take money from the markets. This is not easy to do. The benefit of knowing why you trade is that you will focus on those actions that lead to making money in your trading account. On the other hand, failing to give this key ingredient the attention and respect it requires will lead to consistent losses. The market has an uncanny way of giving you what you want. The problem most traders have is that they don't know what they want, it is reflected in their muddled actions that don't have anything to do with making

money, and the market reciprocates appropriately. I would go so far as to say that this is the root of all the evils that haunt most traders. I can talk to a trader and within a few moments know why they are failing, and it typically boils down to their neglecting the critically important Power of Why.

Once you commit to trading to make money, the next logical question is *How?* How do you achieve consistent profits and success in day trading?

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The proven tradeplan is how we make money and grow equity. It begins with backtesting, which is a critical step to prove that an approach can make money due to the statistical advantage, or edge, that it provides. Remember (from chapter 3) that backtesting is the study of past data, charts, and a specific set of rules to determine if a trading style or approach can deliver steady profits. When done right, the backtest yields a record of trades that give us measurable results from which we build our tradeplan.

Once we establish that the backtest results are adequate to assist in our only reason for trading (making money), we then practice the plan, logging our trades in a spreadsheet. This process (in contrast to a backtest) is called a forward test. It's great when we can prove that a plan would have worked in the past. That's a very important first step. The forward test helps confirm that the tradeplan is working in a live trading environment.

- Fast-testing is an exploratory phase in the tradeplan process to see if a strategy is worthwhile enough to do a full backtest.
- Backtesting is the study of past data and charts to determine if a trading style or approach can deliver acceptable, measurable results.
- Forward testing is the ongoing testing of your tradeplan on the right edge of the chart, going forward as the markets unfold.

The tradeplan itself establishes a specific way for us to trade, with exact

rules to follow from start to finish that we can duplicate repeatedly. It should be practiced until it can be executed perfectly each and every time, without error. The plan should be written in a journal or notebook and include all the details regarding the methodology, types of trades, and rules that were thoroughly tested and proven.

Every aspect of the plan needs to be clearly defined. For example, will it be focused on futures or forex? What instrument? Here is a list of questions that must be asked, answered, and proven in a backtest before the plan can become a full-fledged tradeplan:

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- What shall I trade?
- Am I adequately funded?
- What time of day will I start trading?
- Am I available to run my tradeplan consistently each day, like a business?
- What are my stopping rules for the day?
- What are my daily goals?
- When a trade is placed, what are the trade management rules from start to finish?
- When do I add another contract to increase my position size or, likewise, reduce my position size?
- Can I execute the trades without error? Have I proved that I can?
- What consequences, if any, will I impose on myself if I break my rules or make execution errors for any reason?
- Do I believe in the plan enough so that I have confidence to take each trade per the tradeplan rules?
- When will I take a break from trading and reevaluate my approach?
- When will I consider adding another market?

» How will I grow my business over time?
» What kind of financial projections can I estimate looking forward one year, two years, five years, etc.

Once you have been trading your tradeplan for a while, whether it be in simulation or in a real account, there are very important follow-up questions to ask:

» How do I respond to a losing trade?
» How do I respond to a losing session?
» Did I lose due to not executing my proven tradeplan correctly, or was it just part of the normal distribution of random wins and losses?

Asking and answering these questions will indicate exactly where you are as a trader and what you need to work on next. There is a good chance that your answers will point to our first power, the Power of Why, and if that happens, stop trading and resolve your Why. Success will elude you until you solve this problem; the best time to catch it is early on. Be warned!

The details of creating a tradeplan, and examples, are offered in part IV, chapter 16.

The confidence inspired by a carefully crafted tradeplan will help you execute your trades with proficiency and precision. You will be fully focused on execution and not distracted by strategy, which is already built into your tradeplan, or be emotionally attached to the outcome of any trade or series of trades.

Your winning trades cannot be disassociated from your losing trades. Outcomes, when viewed from the ground level, appear random. I call this the random distribution of winning and losing trades. You must not let this discourage you. Sometimes a trade will seem squarely within the wheelhouse of your tradeplan. You will feel great about it at the time. And it will fail. This is okay. It does not necessarily mean your tradeplan is broken.

Each trade is like a tree in the forest. The forest itself makes up an equity curve and measures the value of our trading account: it's either growing or shrinking. The tradeplan teaches us to live above the forest and not down on the forest floor, among the individual trees. There will always be losing trades —in other words, some trees will fall. You do not want to be a little grunt, running around the forest floor trying to dodge a bunch of random falling trees. No matter how hard you try, you will get crushed.

The little grunt has no perception of the forest. He only sees the trees that he is trying to dodge. The successful trader learns how to grow a pair of wings, rise above the trees (high enough to see the entire forest), and obtain the perspective of a successful trader.

From above the forest, like an eagle, you can see one-third of your trees falling, for example, and not fret. You can also witness that the forest itself grows two-thirds larger, even as one-third of the trees fall—two steps forward, one step back. And in fact, the two-thirds growth cannot even occur unless we are willing to sacrifice the one-third that falls. This key essential fact is lost on most losing traders. Losing trades inevitably exist inside winning tradeplans. Yet, a majority of would-be successful traders continually try to "fix" their losing trades and in doing so destroy their winning tradeplan. The root cause of this error is the trader's failure to solve the Power of Why. Their reason for trading is to prevent losing trades, it is *not* to make money as a trader. There is a night-and-day difference between these two mentalities,

which directly affects one's trading success or failure.

Some of my best tradeplans are like a forest that loses one-fourth of its trees and grows three-quarters more as a result: three steps forward, one step back. This is an ideal formula for a winning tradeplan. This is what trading to make money, based on the edge that our tradeplan gives us, actually means. It is better to discover this before you risk your hard-earned cash. The good news is that you can.

Every trade is like a tree in your forest. The forest itself is the value of your trade account, and the goal is to fly like an eagle, watching the forest as a whole grow bigger and not panicking at the sight of individual felled trees.

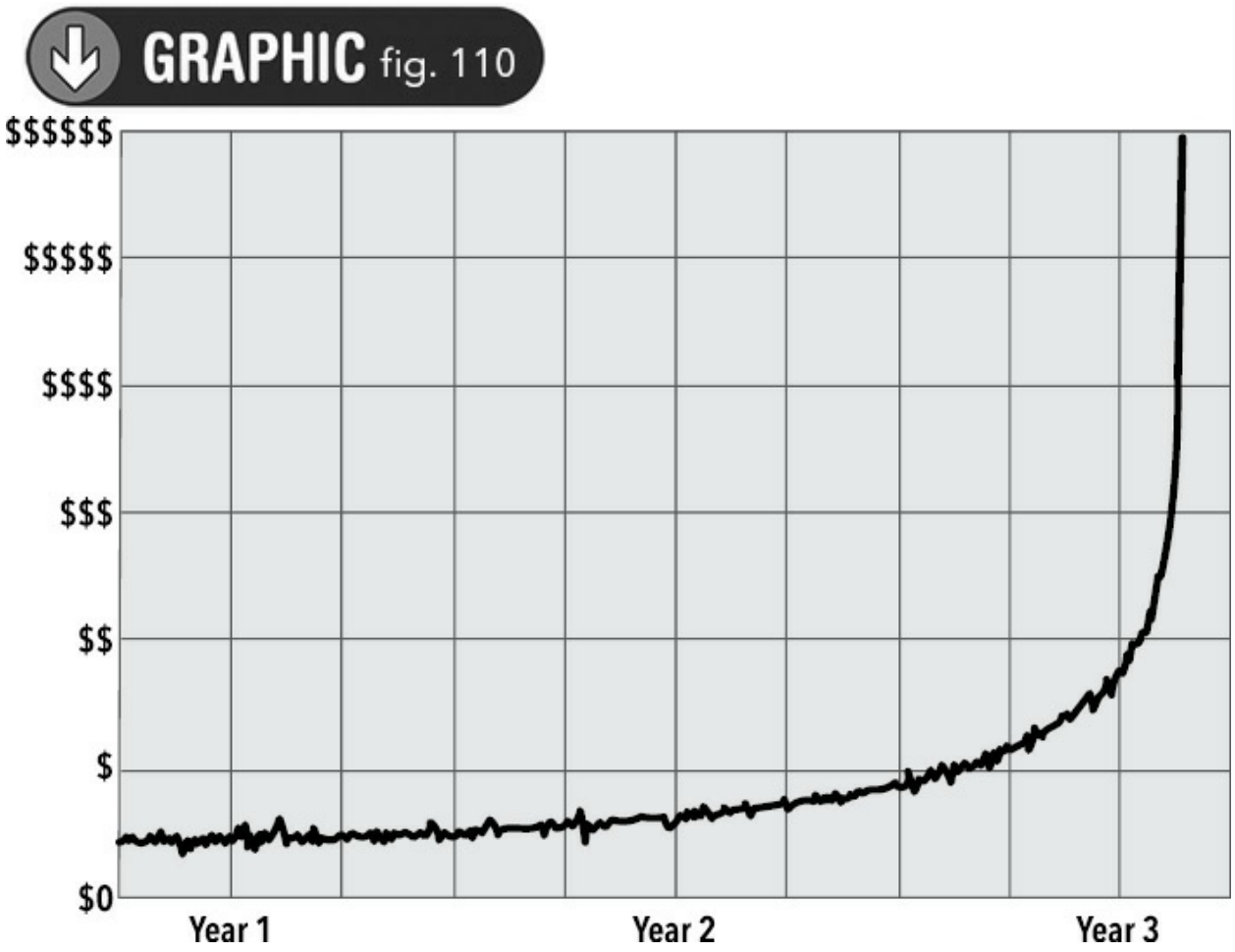
Sometimes, the most uncomfortable and awkward-feeling trade setup will be the one big winner that allows us to quit with our daily goals in hand (in our account). As traders, we are on the right edge of the chart and, in fact, we do not know what the outcome will be on any trade. One of the 12 Powers, the Power of Surrender (chapter 14), speaks on this subject in greater detail. For now, suffice it to say that we do know our tradeplan has provided us with a distinct, winning advantage that we have been able to prove before we ever risked any money. Still, we will have losing trades within that winning tradeplan.

Part of the recipe for failure is overreaction to trades that go bad. The question begs to be asked, though: why are you overreacting? You have proved that your tradeplan makes money; you've lived through the random

distribution of wins and losses, witnessing firsthand the good, the bad, the ugly, and the great. You've continued to see your equity grow, despite some ugly trades. Why are you overreacting? The answer is typically found in your reason for trading. If you are overreacting, you are trading for the wrong reasons. You are not trading to make money, but for some other reason that you do not yet understand, and until you address that, trading success will remain elusive, if not impossible.

Simply stated, if you are trading to make money, then give your plan time to work. Remember, you did not thoughtlessly assemble this plan. You did the work to build a plan that provides a statistical advantage. Your plan grows equity in your account despite the losing trades that randomly occur. Therefore, why are you overreacting? Instead, turn your attention to disciplined and accurate executions. Your job is to execute the tradeplan, not to be emotionally attached to the outcome of any given trade.

If you do find your belief is still shaky, it is probably an indication that your foundation work is not finished, and you should not move on to subsequent steps until you solve that problem. The best thing you can do is to honestly face your hesitation and continue to work on your plan, along with more studying of your win/loss column and the random distribution of wins and losses that continues to grow the equity curve (figure 110). At this point, repetition is essential.



I once suffered a 16-trade losing streak on the Russell E-mini. It happened in the live traderoom in the early days of my career as a coach.

I will never forget when we lost 16 trades in a row. As the losses kept coming, over a period of a week or so, I felt the air being sucked out of the room more and more with each subsequent loss. This was happening in front of a live audience who had paid money to attend our virtual trade room online. We resumed trading on Monday after a break for the weekend, and the very first trade, per the proven tradeplan, was another loser! At that moment, I saw half the people immediately exit the trade room, probably never to be heard from again.

As things typically go in trading, once people have taken on more pain

than they can handle, winning trades start replacing losing trades. It is a classic example of one step backward before two steps forward. Although trading is never perfect, and an average one step back and two steps forward is how it smooths out over time, sometimes you get three or four steps back and then six or 10 forward.

That first trade on the Monday morning, after a week of losing trades, was the 16th losing trade. Now, you can probably guess what happened on the next trade. (Hint: I did not say it was a 17-trade losing streak.) My next trade was a winner and served to break the losing streak. Then the next trade won. And the next. In fact, the trade that broke the losing streak marked the beginning of a 24-trade winning streak, which set all-new equity highs for the lifetime of the tradeplan. Record profits! Too bad so many had already turned tail and run away.

So, how do you know when to stick with a tradeplan when you experience a string of losses and when to stop trading to avoid further losses? The answer depends on the parameters of the tradeplan that were tested and established before you began your execution of the plan. The maximum loss threshold is discovered through the process of backtesting, which is explained in greater detail in chapter 16 when we take a deeper dive into creating a tradeplan.

People tend to do the natural thing, to begin trading right when the market seems safe, after nice winners—right at the end of the two steps forward. Then, when the pain of losing trades has become too great, they quit! Right at the end of the one step back. They run off to find the next strategy or trading approach, only to repeat that destructive process over and over again. This is commonly known as "chasing performance" and is evidence that this person hasn't solved their why yet.

Even a plan that wins two-thirds of its trades has a chance of losing 10 or more in a row. If there is a chance that something can happen in trading,

then trust me—at some point, it will happen. Believe me, a nasty losing streak will rear its ugly head sometime and make you want to quit trading. However, winning streaks put the bad trades in the rearview mirror. Focusing on the tradeplan and the bigger picture can keep you in the game when other losers have already quit. Be the eagle, minding the growth of your forest by executing your proven tradeplan.

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Have you ever noticed that great athletes, regardless of their chosen sport, share defining characteristics? Confidence is one of them. Confidence is essential when trading as well, and it is not something that just happens. It rests on a foundation that is built through preproduction work. In other words, the point of preproduction work is to build a foundation of belief.

Mathematically, we want to create a win/loss column of trades, following a specific set of tradeplan rules, so that it is possible to see the random distribution of wins and losses. With a solid tradeplan, we can experience the losses but still witness the equity curve rise.

This is when serious transformation finally begins to take place. These are often light-bulb moments, epiphanies that come from actually understanding what it means to make money as a trader. The Power of Foundation refers to achieving absolute belief in your trading approach.

Forward testing is one of the critical ingredients that builds a foundation. It is the process of seeing results from actual trades that were executed based on tradeplan rules. If the tradeplan truly has an edge, the random distribution of wins and losses will continue to grow the equity in the account, thus reinforcing the belief that the tradeplan will accomplish one's reason for trading. In other words, there can be no belief in the tradeplan without backtesting and forward testing.

Testing is how belief is built. Despite the insecurities that one feels from losing trades, the successful tradeplan sees money coming in, growing the account, and achieving the reason for trading. If one's real reason for trading is to make money, the way to achieve that is from the edge that one's tradeplan gives. Backtesting is how the edge is established and witnessed before real money is risked. The process begins to "recalibrate a person's internals," transforming them from "a person trying to trade" into a trader. Forward testing will reinforce the belief and bolster confidence in the tradeplan.

Digging ditches is not glamorous activity, but it is essential when creating the foundation for a construction project. In day trading, our ditch digging is our preproduction work, namely our backtesting and forward testing of trades and trading systems. Of course, just as the building of a skyscraper is more glamorous than the digging of the ditches, most of us would prefer to be watching live price action and trading real money, not backtesting, or building schedules to govern our optimal trading times, or thinking about the best times to boost or shrink our position size.

The work of building the tradeplan might seem dull, and the actual execution of the plan dramatic and stimulating. However, in all my years of going through that very process, I have found real joy and pleasure in digging the ditches necessary to build successful tradeplans. I have spoken with many of my students who feel the same way. It is our time, our alone time. It is almost a cathartic, meditative experience, when you get the real "aha" moments. The light bulb goes on in your head and you finally begin to understand what it takes to actually make money as a trader. This is when all the epiphanies happen and when you begin to transform into a real trader.

This is a process that happens naturally, and it must happen in order to give you a proper foundation for success. It provides you with the belief you

need in your tradeplan, so that you have the confidence to trade the plan as it was designed. Your trading foundation is, in fact, the achieving of one-hundred-percent belief in the outcome of your tradeplan. You have to believe in it in order to have the confidence to carry it out. Without belief, you'll remain on the forest floor. Belief gives you the eagle's perspective.

If you go into the market without building a foundation, you will not believe in what you are doing. You will second-guess your approach and yourself after a series of losses. Without belief, you will fail at day trading. It is as simple as that.

Ditch digging, backtesting, and preproduction work force you to realize that you will suffer losing trades. However, when your ditch digging begins to produce positive measurable results, you will have confidence that your tradeplan has a statistical advantage—it will win more than it loses. When you see your equity grow despite your losing trades, you will begin to firmly establish that all-important belief.

Many hazards lurk along the path of any successful day trader. It is important to understand that you are going to suffer your worst trading session ever, your worst week ever, and your worst month ever. It is the Power of Foundation that will keep you trading throughout these tough periods, because a) your mental foundation allowed you to anticipate and prepare for trading's more difficult experiences, and b) you believe in your plan, because you have worked hard at proving it.

You are learning what it means to live with the win/loss column that you have developed, that represents all the correct tradeplan trades. You have learned to live with the good, the bad, the ugly, and the great over and over again; yet despite the ugly, the equity curve continues to grow and grow. This is how you finally learn to believe in your tradeplan and gain the confidence you need to "take the next trade" per your tradeplan rules. Without this belief

in place, you will most certainly fail to take the next trade, which will put you on the slippery slope to inevitable losses and destruction.

A new home is a beautiful thing. It is the result of months of building and begins as nothing more than a hole in the ground. The hole is filled with cement to build a solid foundation. Would you buy a home—risking your hard-earned money—without a solid foundation? Of course not.

In day trading, the foundation of belief is built through backtesting and other preproduction work. You have already started, because the act of reading this book is part of building your foundation. You must believe in what you are doing, and you cannot talk yourself into it. You have to experience it over and over, enough so that you actually transform into a real trader.

Lwp t atrp

» The only reason to day trade is to make money.

» The tradeplan answers the question of how to make money.

» A tradeplan includes many individual trades, and each individual trade must follow the rules of a tradeplan that can be proven through preproduction work, which includes backtesting and forward testing.

» Building a solid foundation of belief will give the trader the confidence needed to execute his tradeplan consistently, day in and day out, which is what accomplishes the one true goal of trading in the first place: to make money.

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- » Winners never quit
- » The Power of Numbers
- » Compounding and equity curves

We have spent a lot of time talking about the random distribution of winning and losing trades and how to build your belief so that you have the necessary confidence to lean on your system. In this chapter we introduce the Power of Quitting, which is knowing when to take your profits, and perhaps more important, how to keep them; the Power of Numbers, which is using the advantage of probabilities and getting a statistical edge; and the Power of Compounding, which is the key element that can transform a small trading account into a massive one.

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Greedy traders usually run into trouble. After a big win, they want to leverage the profits into an even bigger win. They don’t know when to quit. Overtrading, even after a few nice wins, can result in even more pain than an initial loss right out of the gate. There is nothing more frustrating than making a nice profit and then giving it all back because you didn’t know when to stop.

Setting goals can help day traders make better decisions while avoiding common pitfalls. The Power of Quitting is a dynamic goal-setting strategy that can help you grow your equity, minimize drawdowns, and inject a degree of discipline into your trading that will help you perfect your edge.

Recall from part II that when we day trade it makes sense to have a specific family of targets established for each trade—targets 1, 2, 3, etc. The most straightforward and common application of the Power of Quitting dictates that once we reach our full target objective (typically Target 2) and we have a net positive result for the trading session, then we quit for the day.

It is, of course, possible that we reach our full target objective on our first trade of the day. Great, we're done. Let's go to the beach. But what if our first trade loses? Then we move on and take the next trade. And what if that trade loses? Then we take the next one. The point is that we want to avoid quitting out of discouragement and missing out on the winning trade that could be just around the corner. We want to quit on our *own* terms, in accordance with our own plan.

What if the second trade wins, but the profits are not enough to offset the first loss and create a positive outcome for the day? Then we take another trade. On the other hand, if the second trade hits the full target and brings us into positive territory for the day, then our objective has been met and we quit.

At this point, it doesn't matter how much we made. We are not trying to pay our utility bill with the outcome of today's trading session. That would be putting our personal needs in front of the needs of our trading. We must take what the market wants to give us as a result of following our proven tradeplan. We must not attempt to extract from the market what our personal needs dictate. That will never work. The great irony here is that if we execute with discipline and take what the market wants to give us, then at some point

down the road, at the right time, our trading should in fact be able to take care of our personal needs.

Don't put your immediate personal needs in front of your trading needs. If you do, you will suffer the consequences; both your trading and personal needs will remain unfulfilled.

But what do we do if it is just not our day? We are following our proven tradeplan, but the market—wild beast that it is—just seems dead set on kicking our butts over and over again. There will be sessions when our trading plan is just not in sync with the market. What is critical is that we follow our plan and not our feelings. We need to set specific limits in advance. We might say that we will quit after *X* number of trades for the session or after *X* number of losses or after hitting our goals.

If you're experiencing excessive losses, it could be that your tradeplan needs some work. It could be that you need to work on better executions. It could simply be a period of time where your plan is out of sync with the market. This is a good time to pause and reassess. If it is an execution problem, then it is easy to fix. Practice more. If it is a tradeplan problem, then you may need to step back, stop trading it for a while, but continue to monitor how it performs going forward. If you have done your preproduction properly, then your tradeplan is probably foundationally solid and you are simply experiencing the natural "one step back" that is bound to occur (and will continue to occur). The best trades follow the worst. The best sessions follow the worst as well. There is no getting around it, and the more you experience

it, the more you'll learn to accept it (and expect it).

As I noted, the Power of Quitting represents a dynamic goal-setting strategy. There are many ways to set goals and objectives to define when we quit, but it's important to temper our discipline with a degree of flexibility. If I'm looking for one trade in the day to reach its primary target objective, and I come close—let's say 95 percent of the way there—I seriously consider moving my stop up and locking in enough profit to satisfy my goal for the day, and then I quit.

Whether or not I choose to move my stop at 95 percent to protect some profits depends on the size of the profit objective. A trade that's too small is simply not worth tampering with, and I'll just let it run its course.

Some tradeplans have built-in limits based on time rather than results. For example, you may have a tradeplan that is only viable in a certain market and within a certain time period. Once the clock runs out, it's time to quit. Or the tradeplan itself may dictate time constraints derived from your preproduction testing or your personal schedule or availability.

Some traders, if they have the capital and the time, pursue several tradeplans concurrently, each subject to its own "power of quitting" parameters. Sometimes these tradeplans are cookie-cutter duplicates–the trader applies the same plan to different sessions throughout the day or in different markets. This concurrent use of multiple tradeplans (which we discuss more in chapter 16) is a fine approach for traders who simply want to do more trading, but for each plan the Power of Quitting should always be applied.

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- » I will quit if I get to 95% of my primary target objective and have a positive result on the session.
- » I will quit after I have a positive outcome within the first hour.
- » I will quit after I have a positive outcome after my first three trades.
- » I will quit after I have reached my goal and after a certain number of trades.
- » I will quit after I have reached a positive outcome after a specific amount of time.

cwt Yı t ıuW – qt

A casino makes money because it has a statistical edge. Sure, it might pay out large amounts to lucky winners from time to time, but the individual gambler does not have favorable odds. The house always wins in the end.

Successful day trading is a pure numbers game and is all about the odds. We cannot control which trade will win or which one will lose. We can only develop a tradeplan that has an evident statistical advantage and, like the casino, stack all the odds in our favor.

Remember, wins and losses come in random distributions and cannot be one hundred percent predicted trade by trade. What we *can* do is predict that we will win more often than we will lose. That is our edge. That's where our

money is made as traders.

A random distribution is a set of numbers that are statistically random. For instance, a coin toss is random. We cannot control whether it will land on heads or tails, but, over time, it should land on heads 50% of the time and tails 50% of the time. However, we do not know where it will land *next*, even if it has landed on heads 30 consecutive times.

In day trading, we want to let the statistical edge of our tradeplan do the heavy lifting. That's what I mean by the Power of Numbers—a system that has been backtested and has demonstrated positive measurable results has the best chance of being profitable when moved from a simulated situation to a real trading environment. However, the plan must be allowed enough time (number of trades) to let the probabilities play out. Just as a casino does not close its doors if a few people win jackpots, the day trader does not quit a winning tradeplan when it suffers a losing streak. That's what humans do. That's what people "trying" to trade do. It is *not* what successful traders do. That is why it is so critical to know why you are trading and to put a solid trader foundation of belief in place while arming yourself with a proven, effective tradeplan. See how all the powers begin to make sense as you fit them together?

Consider Trisha the truck driver. She makes a living by making deliveries and depends on her navigation equipment to get to her destination on time. Some things are not predictable, like traffic accidents and engine problems. Yet she knows that her navigation equipment will be accurate quite often. Trisha rarely misses a deadline and, in fact, usually gets to her destinations a bit early. She has a method that works and is extremely dependable when it comes to delivering her freight on time. The navigation equipment and the Power of Numbers make it all possible.

By now, as we are midway through the 12 powers, you should be seeing a

clear path that will lead you to successful day trading:

- Figure out why you are day trading.
- Develop a tradeplan.
- Build a foundation for the tradeplan with backtesting.
- Add the Power of Quitting to your tradeplan to better "dance" with the market, taking what it wants to give you while steadily growing your account.
- Build the foundation further by placing small-risk trades commensurate with your trading account size.
- Let the Power of Numbers do the heavy lifting, and take advantage of your edge, the superior odds you have proven to yourself from your foundational work.
- Use the Power of Compounding to grow the account after the plan has produced positive results (which is what we talk about next).

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Small things can grow exponentially and become gigantic. Consider a snowball rolling slowly down a mountain slope; it gathers momentum and gets bigger and bigger.

Small things can snowball and deliver big results over time. A day trader who is coachable and determined to succeed can begin with a relatively modest amount of capital. Through the implementation of successful trading plans, this same trader will build equity over time.

cwt Awf ı"st ıu wt f ı "s

Albert Einstein is said to have claimed that the power of compound interest is the "most powerful force in the universe" and the "8th wonder of the world." He was referring specifically to the interest paid on cash plus the interest generated on the interest itself. Over a certain amount of time, the

accumulative cycle of compound interest has the power to dramatically boost one's wealth.

Here's a simple example: say a savings account with $10,000 earns 10% per year in interest (in a fictional world, of course). At the end of the first year, it has generated $1,000 in interest and there is now $11,000 in the account. The second year begins with $11,000 and, 12 months later, it has earned interest on the initial $10,000 in savings and the $1,000 in interest from the first year. So the total interest in year two is $1,100 and the account is worth $12,100. By the end of year three, the balance has grown to $13,310. The 10% interest payout grows each year: $1,000 in year one, $1,100 in year two, and $1,210 in year three. That is the power of compound interest. After 10 cycles, the $10,000 will have earned an additional $15,938, thanks to compounding.

Day traders are not paid interest (although some brokers do pay interest on cash held in accounts), and day traders essentially control the speed of their own cycles. Rather than relying on the passage of time, as investors and loan holders do, day traders rely on their ability to cultivate winning tradeplans. As a trading plan achieves positive measurable results, position sizes can be increased, thanks to the profits that are generated over time. And those same measurable results can be obtained again via the next round of successful trading. As the trader matures, as his equity curve grows, as he becomes ever more proficient at crafting winning, provable tradeplans, he will wield with increasing comfort ever larger sums of capital, thereby providing opportunities for larger and larger gains.

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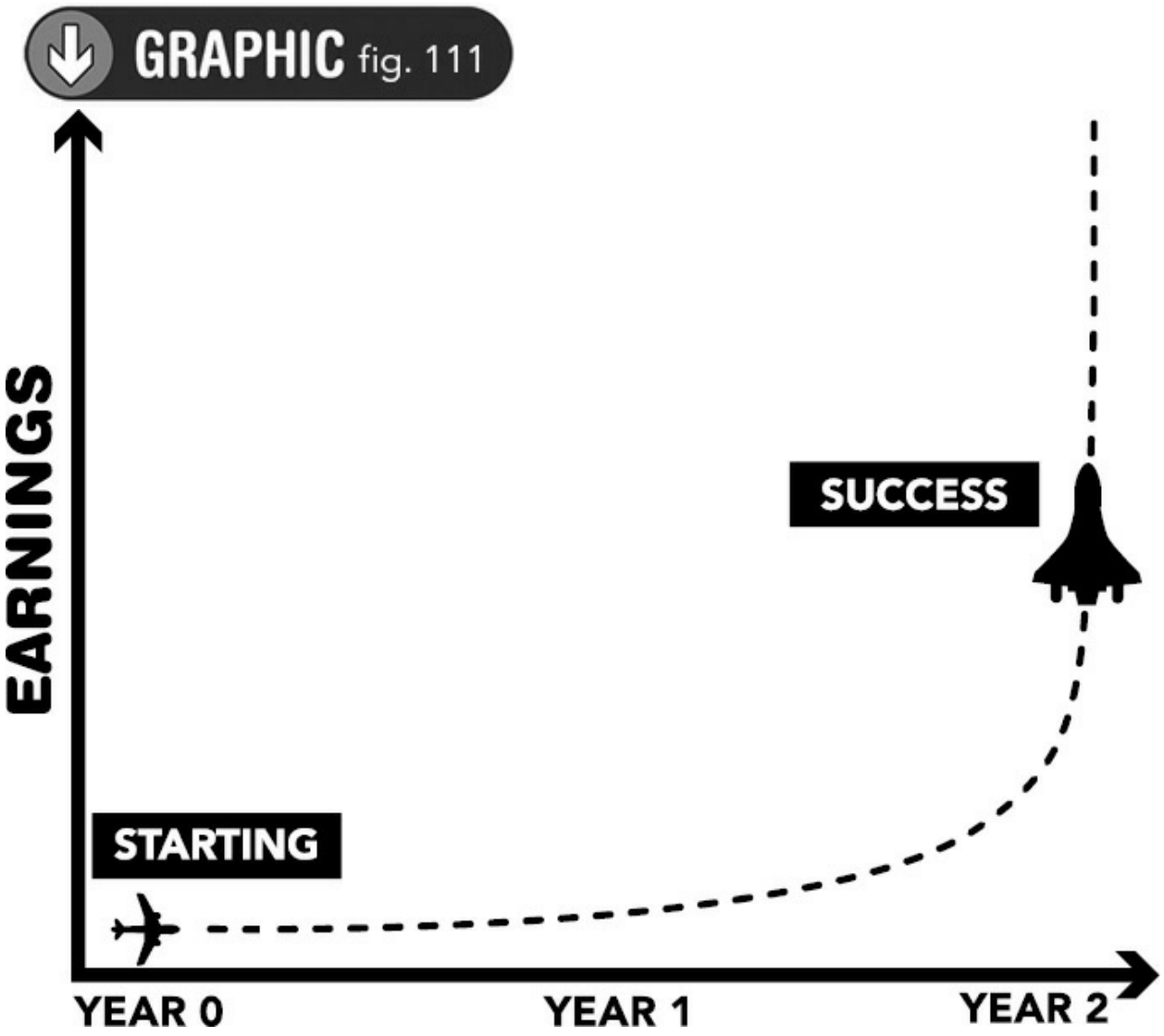
Recall from chapter 3 that the early stages of a trading career are like a jumbo jet trying to take flight. It begins slowly and experiences a few bumps as it

gathers momentum. It might bounce a bit, higher and lower, before getting airborne. Then, the jet is in the air, gradually gaining altitude. “Gradually” gives way to “rapidly” as the rate of growth increases, faster and faster, as the account grows larger and larger.

A trader’s equity curve can look like the gradual lift of a jumbo jet, but at a certain point—thanks to the Power of Compounding—it can take off like a rocket. This is made possible by increasing position sizes of trades and turning a modest trading account into a massive one that grows exponentially. That is the power of compounding.



You do not need a lot of capital to benefit from the Power of Compounding. Remember, some forex brokers offer 50:1 leverage. There was a time when domestic forex brokers offered even steeper leverage (many foreign brokerages still do). But keep in mind that just because a broker offers high-octane leverage does not mean you would be wise to use it! You should not!

Remember the random distribution of wins and losses? There are losing trades within winning tradeplans. What a shame to get wiped out on a few

losing trades and completely miss the winners that follow next, just because you are over-leveraged. Trade within your comfort zone and within a safe and small ratio per your overall available capital. Then you will be able to safely endure the losing trades that ultimately get you to your winners. It is okay to get kicked in the shins, so long as you do not lose your legs. Eventually you develop very tough shins.

To succeed long-term, you should not over-leverage. If you do, you are putting yourself at greater risk of blowing out your trading account with only one or two losses. Not good. There is no one-hundred-percent winning trade or tradeplan, so we must protect ourselves by risking small and letting the Power of Compounding do the work for us over time.

If we do our proof-of-concept preproduction work, then we will have created a tradeplan that allows us to take on the proper risk, or approximately 2% of our account. If we stick to that, margin calls will never happen (you won't have to worry about your broker knocking down your door demanding payment). In short, we do not need to focus on leverage and margin when we are using the power of compounding coupled with the proper position size.

Lwp t atrp

» There is nothing more frustrating than giving back profits from winning trades.

» The Power of Quitting is a dynamic goal-setting strategy that adjusts to market conditions. It allows you take what the market wants to give you and to quit trading with a positive result the majority of the time.

» Day traders can use the Power of Compounding to their advantage. Let's not argue with Einstein!

» The Power of Compounding can do a lot for us; we do not need to use a lot of leverage or make large trades to achieve success. The size of our trades will grow in proportion to the growth of our trading account.

» A large position will still be small in relation to your available trading capital.

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- » Mechanical versus dynamic
- » Types of setups
- » Structures build foundations

Many day traders start trading without any type of plan. Maybe they watch a few videos online, learn how to enter orders through their broker's platform, and start trading based on price movements they see on the charts. They learn a little bit and jump right in—risking real hard-earned capital in a live trading environment.

I suggest a different approach. Placing trades using real money is one of the last steps in a much larger process. Obviously, day traders need to understand charts, order entry, and various market indicators. Those things, however, do not translate into success.

Success requires building a foundation and developing a tradeplan that you have belief in. Confidence is a must. Only when there is enough confidence in the tradeplan does it make sense to risk capital, because when there are periods of losing trades, which there will be, it is important to know that winners and new equity highs will soon be forthcoming. In addition, each trade within the tradeplan must be thought out, planned, and managed as

well.

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I know a trader who, believe it or not, does not fully understand the strategy he is using. But nevertheless, he consistently makes profits. Is he making a mistake? I would say, no way! I would be very hesitant to try to teach him how to use the strategy the correct way, because I wouldn't want to break his money-making style and method.

It is not the strategy's way of doing things, but it is his way. He has a method, a setup, that is succeeding with a high level of consistency. In fact, he is a regular in my live trade room, and I am constantly telling him to cover his ears when I introduce a new concept. I do not want to persuade him to change anything he is doing. His methods are working.

The point is that you do not always need to know why something is working. That's what's great about ***mechanical rules***, which have specific entry and exit points that are known in advance. There is no guesswork. You deploy mechanical rules on a trial basis and subject them to backtests and forward tests to confirm that the system has an edge. Once confirmed, the set of rules is established and will govern your trading decisions going forward.

We want to remove ourselves from the tradeplan as much as possible, because humans make terrible traders. Mechanical rules help separate us from the tradeplan by making the decisions for us.

The idea behind mechanical rules is to remain disciplined and execute the tradeplan from a position where we are focusing on things we can control and not on things we cannot control. It helps us stay objective, taking advantage of the statistical edge in the market that we have identified through our preproduction work, thus realizing our reason for trading in the first place.

The Power of Mechanical Rules forces us to lean on the strategy and rules of the tradeplan. The idea is to follow the rules, stay objective, and remove the human element from the decision-making process. It also allows us to focus on the execution of the strategies to master the trading platform, eliminate costly mistakes, and perfect the ability to flawlessly place trades.

Rules that can and should be tested:

- Start time
- End time
- Strategies (based on rules)
- Dynamic session goals (outlined in the Power of Quitting)
- Maximum number of trades
- Targets, stops, and entries based on our strategy

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An effective trading strategy must also be able to adjust to market conditions. Setups that can tune themselves, no matter the chart or time frame, are dynamic and have a better chance of surviving over time.

Remember Trisha the truck driver? She makes her living driving a big rig. She was not interested in going to college. But she learned somewhere along her journey how to just go with the flow. It would be silly and unproductive for her to sit there and honk her horn all day when she's in a traffic jam. She knows that she is stuck, and it is beyond her control to do anything about it, other than resign herself to the reality of the situation. Her job has instilled in her certain characteristics that could make her a successful trader:

- She goes with the flow and changes her route based on traffic or weather.
- She is not married to one point of view or perspective.

» She can change course on a moment's notice but still arrives at her destination on time.

Dynamic strategies go with the flow and are typically based on pure price action and, as a result, can better stack the odds in your favor. I often find that when my results veer outside of what I expect, it is not the strategy that needs to be changed. It is usually just a period of time when the strategy is a bit out of sync with the market—like when a smartphone camera's autofocus gets a little bit unfocused. After a brief time, it can refocus itself. This will happen sometimes even with the best dynamic strategies. Be very slow to make changes. If you have proven your plan works with enough testing, then the odds are extraordinarily good that it will get back into sync and the winners will again come pouring in.

It doesn't hurt to explore additional charts with different time frames to see if you might find something more effective. But that fits more in the "research and development" department of your trading business. An effective trading strategy that uses dynamic setups that can tune themselves in real time, bar after bar, will typically be evergreen and should be able to stand the test of time. But you may need to tweak other variables, like the market or the time frame on the chart. For example, I might look at a 5-tick bar chart instead of a two-minute chart. Or I might apply the strategy to EUR/USD instead of EUR/JPY. In other words, I apply the same strategy to a different chart.

Also, strategies and tradeplans with which you try to make a fixed amount of profit tend to have the hardest time remaining viable. For example, insisting that you profit 10 ticks on every trade is way too rigid. You may have winning streaks, but it is highly unlikely that all your winning trades will win 10 ticks. What if the price moves 8 or 9 ticks in the right direction, but then changes direction and erases most or all of your profit? It's better to have

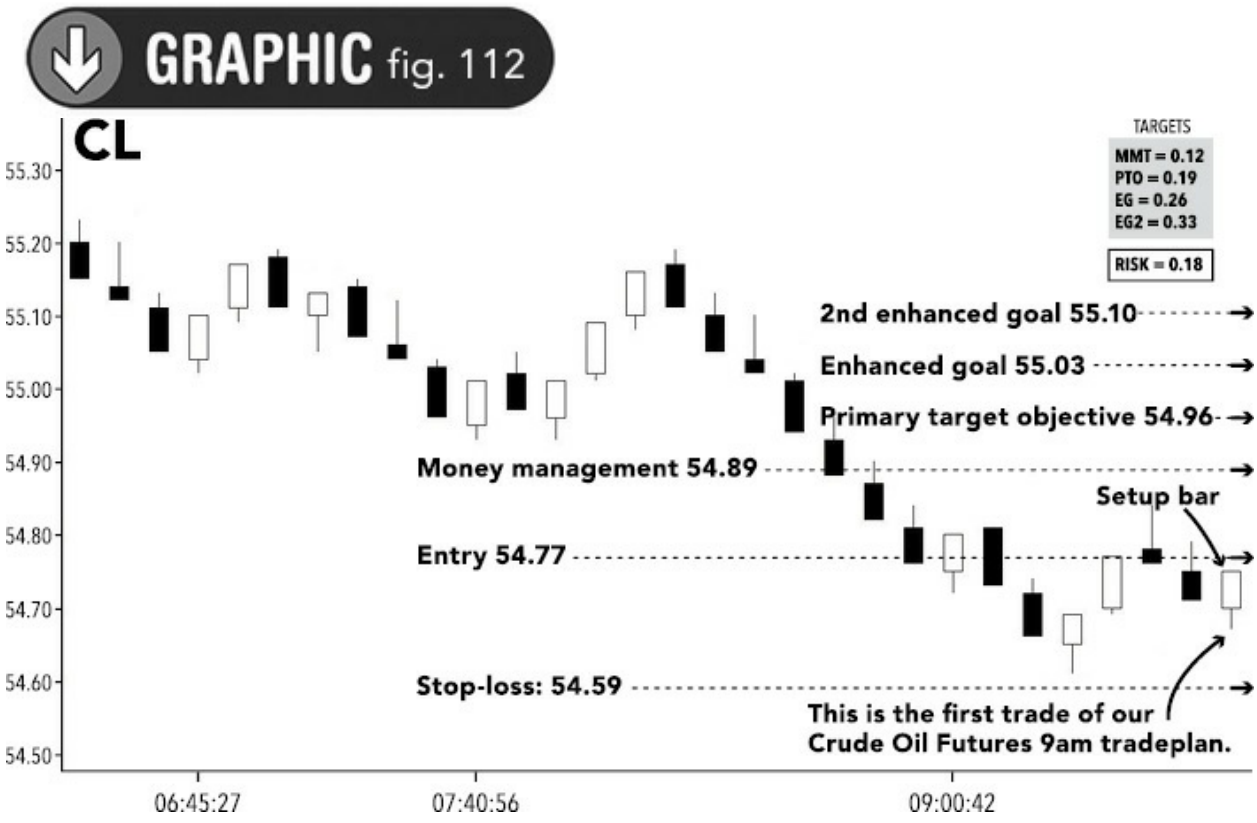
a trade setup that uses an accurate formula for calculating a target that is most appropriate for that pattern and moment in time.

A "tick" refers to the minimum potential price movement of an investment like a futures contract, whereas the term "pip" is used to describe the price movement of a forex pair.

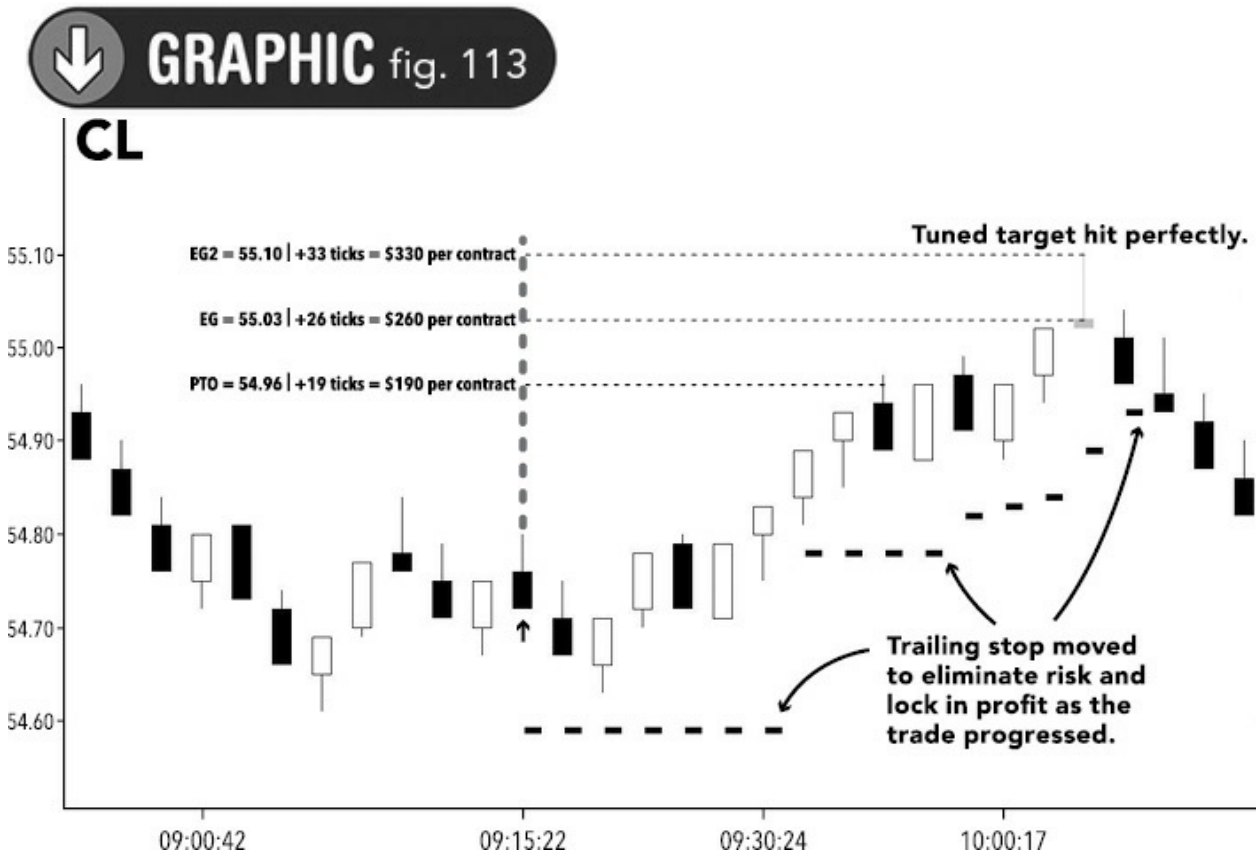
A strategy that dynamically adjusts itself will be far more effective than a rigid one. The types of trades it produces are in tune with the ever-changing market conditions. All my strategies are custom and are based on price patterns that I have identified that lead to high probabilities of achieving desired outcomes. I want them to be perpetual, not just a whim, like trying to make 10 ticks on every trade.

Let's consider an example. Figure 112 is based on a plan that says to begin trading crude oil futures at 9:00 a.m. This trade, which was a long (bullish) play with crude oil at $54.75 per barrel, was tuned to market conditions with targets of $54.89, $54.96, $55.03, and $55.10. Notice that we have a fourth target that adds a new level of calculated, dynamic ambition to our trade.

This is dynamic because the size and reach of the trades is adjusted—larger or smaller—based on changing market conditions that influence the magnitude of the x factor and other attributes. For example, one day the target might be 10 ticks, but another day it might be 15. The adjustments will help keep the tradeplan viable during changing market conditions, when many rigid systems eventually break and fail.



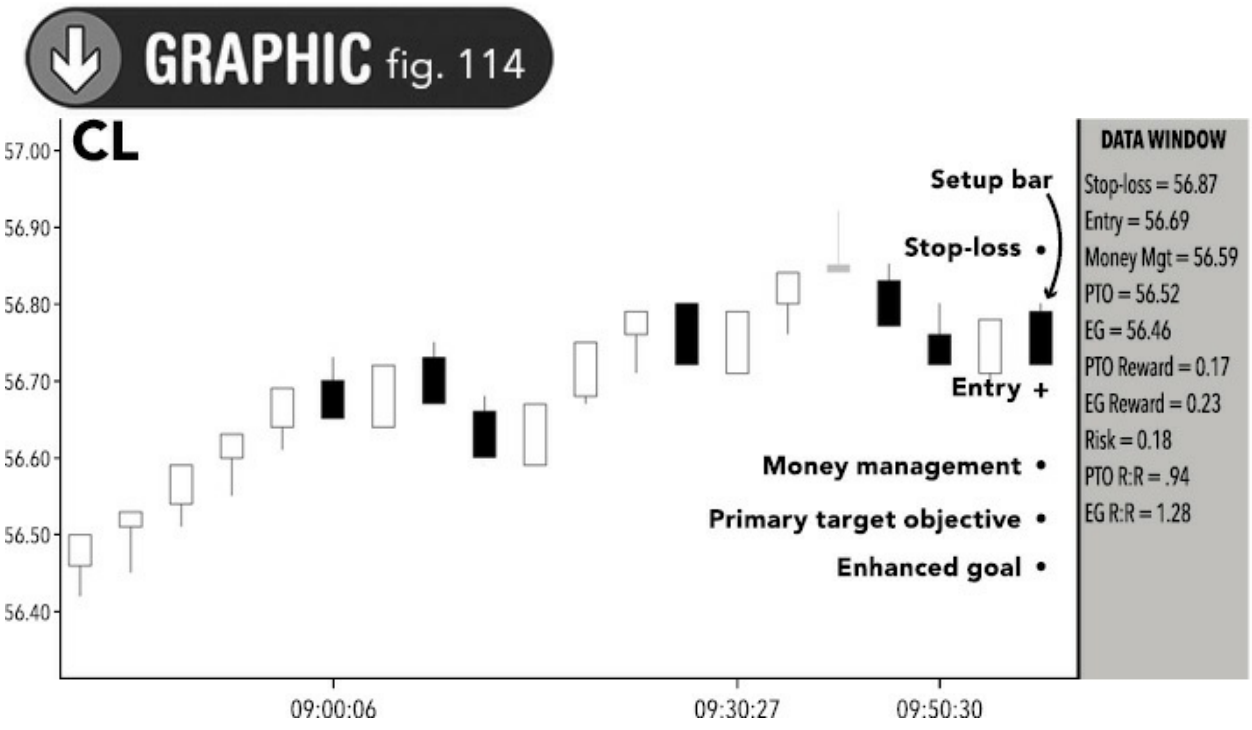
You can see how the trade worked out in figure 113. Notice how accurate the final target was. It was hit exactly. This trade was predicted in advance based on the dynamics of the strategy and the type of trade setup it used, being able to adjust to the market conditions when the setup occurred. While it is not possible to have accurate winning trades one hundred percent of the time, the most effective strategies will be able to produce trades with this precision a large enough percentage of the time to stack the odds in the favor of the trader.



Crude oil hit its tradeplan goals with the first trade of the 9:00 a.m. session today with this perfectly tuned long trade.

cwt Yı t ıub r t

Here in figure 114 we have an example of a trade that is fully planned and governed by a set of rules.



Notice that we have a multitude of data points that define the trade and leave little to the imagination; that's the Power of Structure.

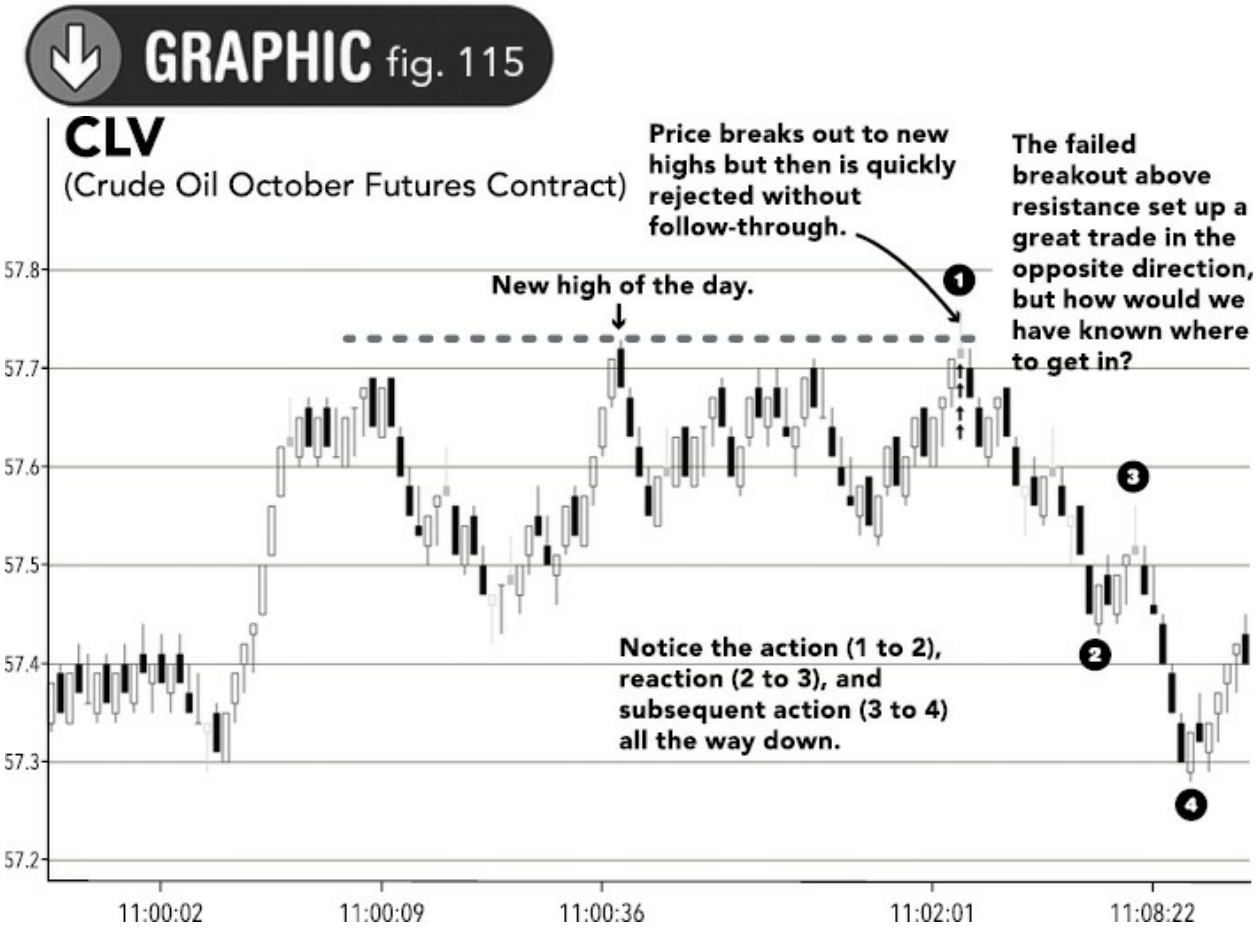
You know where to enter the trade, where to place your stop-loss, and what your targets are. Notice that all the data and aspects of the trade are visible on the chart.

The Power of Structure deals with the nuts and bolts of the tradeplan being structured in such a way that the whole trade—the entire structure of the trade—prints right on the chart, leaving no guesswork. It takes the strategy, the tradeplan, the mechanical rules, and the dynamic setups and displays all of that on the right edge of the chart, just when a trade sets up and it is time for you to execute it.

You can see the entire structure of the trade in the "Trade Profile" graphics in chapter 10: entry, stop, targets, and even the trailing stop, once the trade progresses. And if you use one of the charting platforms that we recommend, you will also get a data window that you can put in a convenient place that

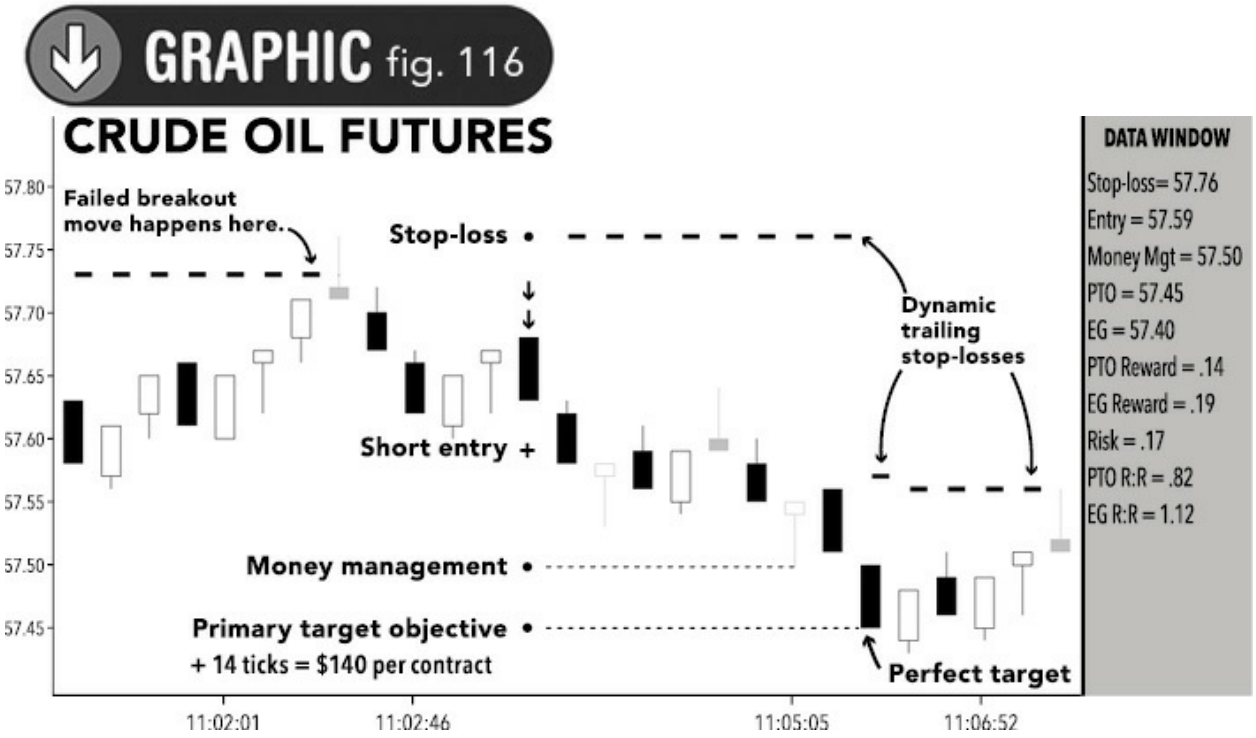
shows you all the specific numbers of each trade. I like to position my data window to the right of my charts, but there are several ways to utilize this helpful tool.

Let's revisit an example from chapter 7 where we talked about trading a failed move. Recall that I had a rule to wait two minutes after the crude oil inventory report was released before beginning to look for trades based on my strategy. In this trade, prices moved a bit lower but then rallied to the high of the day, making new highs shortly after the report was released (figure 115).



When trading a breakout move to new highs, many traders try to trade in the direction of the breakout move but get trapped when it fails. That, in turn, sets up the potential for a strong move in the opposite direction, as

players scramble to reverse positions. That was the case in this example, as we can see when we zoom in on our figure 115 chart (shown in figure 116)—there was a failed breakout to the upside, followed by a big move to the downside.



A timely short trade in the crude oil futures example took advantage of the tendency for a strong move in the opposite direction after a fake breakout. Recall that the failed breakout occurred shortly after the report was released (see figure 116, where it says, "Failed breakout move happens here").

Two minutes had passed since the report's release, which was the desired time allotment and one of the parameters of the tradeplan. You can see my trade (selling crude oil short) printed on the chart, with a clear short entry at the plus sign. The stop-loss stayed at a strategic location to give the trade all the room it needed to succeed, and then, once the price went low enough (to the money management level) the stop moved and began to "trail" the price

lower.

Notice that the targets below the entry are plotted at a price point where the strategy indicated the price would likely end up; it was an indication that would soon prove quite accurate. I exited the trade with a nice profit after my target was hit. I stopped out on the trailer, ending the trade. The EG was never hit (note that the EG is not even shown on the chart). I was able to rely on the structure of the trade and act upon it in real time, thanks to the use of indicators and data points that maximized my ability to trade the strategy properly.

We can see several of the powers at play in this example:

- **Power of Structure**: The trade has specific exits, entries, and adjustments. It is a structured trade within a structured tradeplan. Moreover, the structure is visible and prints right on the chart, almost giving an unfair advantage to the trader. Once you trade with this unique advantage and tool set, you will never want to trade any other way.
- **Power of Dynamic Setups**: The trade in crude oil is dynamic in the sense that it was a finely tuned trade that self-adjusted to the current condition of the market using a unique formula for calculating highly accurate targets. The next time, the trade setup would most likely be a completely different size, based on the current conditions of the market.
- **Power of Mechanical Rules**: The mechanical rules of the trade are based on a set of strategy and tradeplan guidelines. However, this is not something we need to think about too much, thanks to the Power of Structure—now the rules have been worked out and, most important, now the plan uses those rules to create the trade setup (which prints directly on the chart and shows every aspect of the

trade) in advance.

Lwp t atrp

» Each trade within the tradeplan is important and needs to be executed accurately.

» Mechanical setups take the guesswork out of entry and exit decisions and everything else that relates to managing each trade from start to finish.

» We want to take the human element out of the tradeplan as much as possible, because humans are terrible traders by nature.

» Dynamic setups are far more effective and enduring than fixed, static setups.

» The Power of Structure is the nuts and bolts of the tradeplan: entries, exits, and trade management rules print directly on the chart, making trading far easier than it is for those who don't have such structure.

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Lwp t X t xt

- » Coping with loss
- » Lifestyle
- » Be in charge
- » Master of your destiny

The 12 Powers are intertwined into all my trading plans. They are my light in the darkness. I know that there are many things I cannot control when trading—like unexpected market moves and inevitable trading losses—but some things are within my control. I focus like a laser on these things, and the 12 Powers are among them. There are three more powers that I want to tell you about before we conclude part III.

cwt Yı t ıub t”st

Drawdowns are inevitable in day trading. A drawdown occurs when the account dips in value due to a series of losing trades. It represents a dent in the equity curve. Of course, nobody wants to experience a drawdown, but since equity curves do not move in a straight line, periods of losing trades and drawdowns are bound to happen. We can’t win one hundred percent of the time. In fact, it’s common for strong winning tradeplans to be in drawdown more often than not, sometimes as much as 80% of the time. Think about

that for a moment. It may seem discouraging to be in drawdown 80% of the time, but in my mind it's actually very exciting, because if you are in drawdown 80% of the time, on average, then you are necessarily hitting new equity highs (when your total account balance grows to a new high) 20% of the time (or two out of every 10 trades). If you knew that you essentially had a money-making machine, how would that affect your trading decisions? If you knew that with two out of every 10 trades you were going to grow your trading account to all new equity highs, would that affect your ability to believe in and execute the tradeplan correctly and per the objective proven rules?

If you think about it, anytime a trade is not pushing your account value to all-new high levels, the account is in drawdown. Continuing with that thought, if it were even possible to win one hundred percent of your trades, then trading would quickly be made illegal by the governing authorities. No government is going to give someone a license to print free money. That is a fantasy, and yet so many would-be traders freak out with each losing trade. Why? The fact that there is risk in trading, something we all know about, implies that some trades will lose. Remember, there are losing trades inside of winning tradeplans.

It is not the drawdown (which you cannot control) that is important, but how you deal with it (one of the many things you *can* control).

Remember Harvey the engineer with a master's degree from an Ivy League university? He feels an ongoing urge to validate how smart he is. Winning at trading is yet another way for Harvey to prove his high intellect and superiority. This mindset makes trading far more difficult than it needs to be. Instead of focusing on a trading method that will grow equity, he remains obsessed with finding perfection and cannot admit when he is wrong. There will be times when Harvey is on the wrong side of the market and cannot

accept the failure because he does not view the loss as part of a larger tradeplan. He views it as an affront to his own intelligence and reason for existing. One's reason for existing is not the same as one's reason for trading! He is trying to control things that cannot be controlled.

A tradeplan will include a random distribution of wins and losses. Why? Because we cannot control the market. What we can control is the execution of the tradeplan once it rests on a solid foundation that was built through backtests and proven measurable results. We can control that our tradeplan gives us an inherent advantage over other traders by the edge that it gives us over time, an edge that we can prove to ourselves before we ever risk our hard-earned money.

The Power of Surrender is acknowledging that we cannot control the market. We are, to a significant extent, along for the ride, and Mr. Beast is the driver. Mr. Beast will swing us around, right, left, long, short, and we will lose money if we do not surrender. Be humble. Realize that you cannot control price action. Don't be like Harvey.

Once the tradeplan has been proven, do not tweak past results to fix one or two trades, because it will likely break the entire plan. It might be tempting to look at a trade that did not work and adjust a small variable or two and say, well, now it worked. But what about the other trades in the plan? Some of those that were winners are now possibly losers because of that one small tweak. If you had understood the Power of Surrender, then you would have surrendered to the random distribution of wins and losses, which exists no matter what you do.

Continue to execute trades set by the parameters of the tradeplan unless the losses are growing beyond the threshold established by the tradeplan. You want a tradeplan that makes money and wins more than it loses on a high-percentage basis. That is what determines your edge and delivers your *why*.

The Power of Surrender is about acknowledging those things about our trading that we cannot control and turning our focus on everything that we *are* empowered to control.

What we can't control:

- Price action: once we are in a trade, we cannot control what the market will do next
- The risk that exists in the market
- The random distribution of wins and losses

What we can control:

- Proving in advance that our tradeplan will grow our accounts
- How well we can execute our trades with extensive practice and repetition
- How much risk we put on each trade
- Stacking all the odds in our favor to mitigate risk
- Quitting our session with a positive result a majority of the time, while controlling drawdown with minimal and efficient trading
- The perspective we operate from, safely above the forest and not down among the trees

These are but a few of the things we can control. The Power of Surrender teaches us to acknowledge what we cannot control but then to turn our attention and full energy on what we can control. That is what will put you on the winning track to successful trading. It requires acknowledging things that are very difficult for humans to accept but that are necessary for winning

traders to focus on one hundred percent of the time.

cwt Yı t ıuUxt ‘t

I backpacked around Western Europe for several months in the 1990s during the dot-com boom. It was a time when internet cafés were cropping up all over major European cities. When I arrived in a new city, I would usually log in to my trading account at one of these cafés before checking into my hotel.

I had been trading for several years with a lot of ups and downs, but I was enjoying it. I was really loving this new freedom I had while traveling: coming and going as I pleased, turning left when five minutes earlier I had turned right, and choosing the times of day that suited me for trading (these were primarily swing trades at the time). Nothing was more satisfying than sitting down in a café in a place I had never been before with a cup of freshly brewed European coffee. Best of all, I was able to watch my account grow as I journeyed.

Traveling across Europe and trading in cafés taught me to focus my trading on the hours of the day that worked best for me. The fact is, I want to trade as little as possible. That doesn’t mean I don’t want to work, because developing a tradeplan does involve work. But after I have my plan up and running, I want to be in the markets as little as possible. Ideally, I want to trade only a few minutes per day.

It is up to you to find a personal style of trading that works for you and to factor realistic and personally suitable trading times into your tradeplan. For example, if you do not want to watch the market all day, it is probably better not to create a plan that focuses on slower-moving charts like 15- or 30-minute bars.

I prefer tradeplans that require minimal time in the markets.

The Power of Lifestyle also means you need to balance your personal needs with your trading needs. For example, do not count on using profits from your day trading as a source of income to pay things like electric bills or a monthly mortgage, when you are first starting out. If you depend on your trading profits to pay bills, you will probably stray from the tradeplan, pull equity from the account at the wrong times, and put yourself under too much stress.

Do not put your personal needs over your trading needs. Most inexperienced traders do this, and it will never work. Always put the needs of your trading first. That is, follow your proven tradeplan regardless of whether you need to pay your electric bill or not. I realize this is easier said than done and is something that each person needs to figure out. If you put the needs of your trading first, you have a good chance of crossing over the line to consistent profits, and then, when you've mastered the 12 Powers, your trading will reach a point when it can take care of your personal needs. That is the big irony here. Put your trading first and your personal needs second. Like any business, it takes time to ramp up and become profitable.

The Power of Lifestyle reinforces our reason for trading in the first place. We trade to make money. We achieve it from the edge that we enjoy from our proven tradeplan. That same edge enables us to take advantage of the other powers, particularly the Power of Compounding, which in turn gets us to a point where our trading results can take care of our personal needs in a

way that gives us the kind of lifestyle we have always imagined. It is important to understand how all the pieces of this amazing puzzle fit together. Just know that you should not have to adjust your lifestyle too much to accommodate your trading. It is far better to adjust your trading to accommodate the kind of lifestyle you want to live.

cwt Yı t ıuLNX

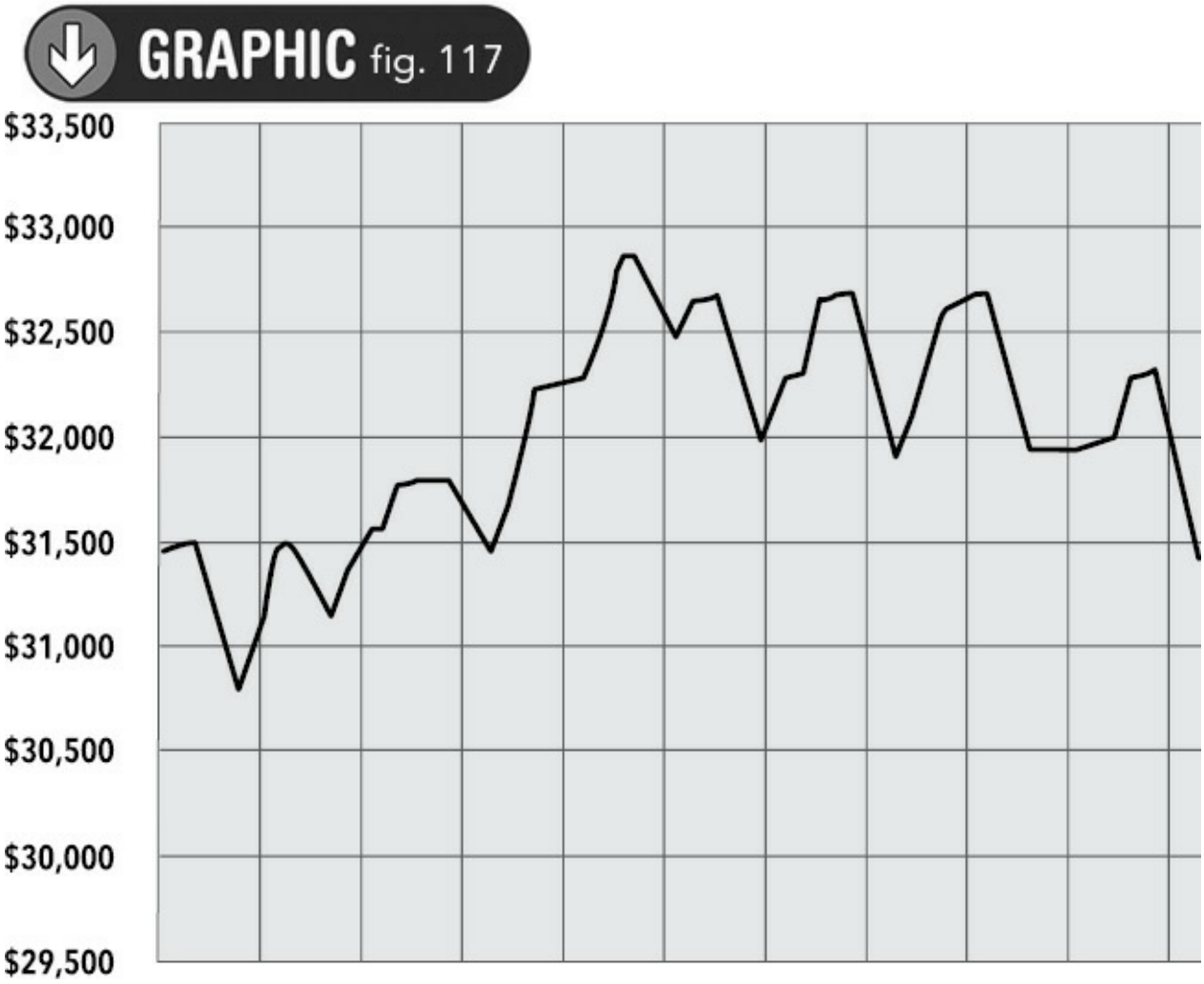
You are the master of your own destiny. You have heard that before, but have you really thought about it in the context of a day trading business? Once you have achieved successful backtests, you move on to the next steps, with the goal of eventually trading real money. Once you have success in a small account, you can reproduce the results in larger amounts. Thanks to the Power of Compounding, there is no limit to how much equity you can build. There is no limit to the size of your forest. As you fly above it like an eagle, you are the CEO of your day trading business.

Yet, most people who try day trading eventually quit. Why? The fact is, we are wired to fail at day trading because of our survival instincts. Taking losses is painful, and if it happens repeatedly, it is human nature to turn tail and run.

One thing that has helped me—and countless other traders I have worked with—is to pay close attention to the overall forest. The best way to demonstrate this idea is to look at two equity curves. Ask yourself what you would do if you were experiencing an equity curve like the one shown in figure 117. Notice how the curve increases and decreases a bit but shows no real overall progress.

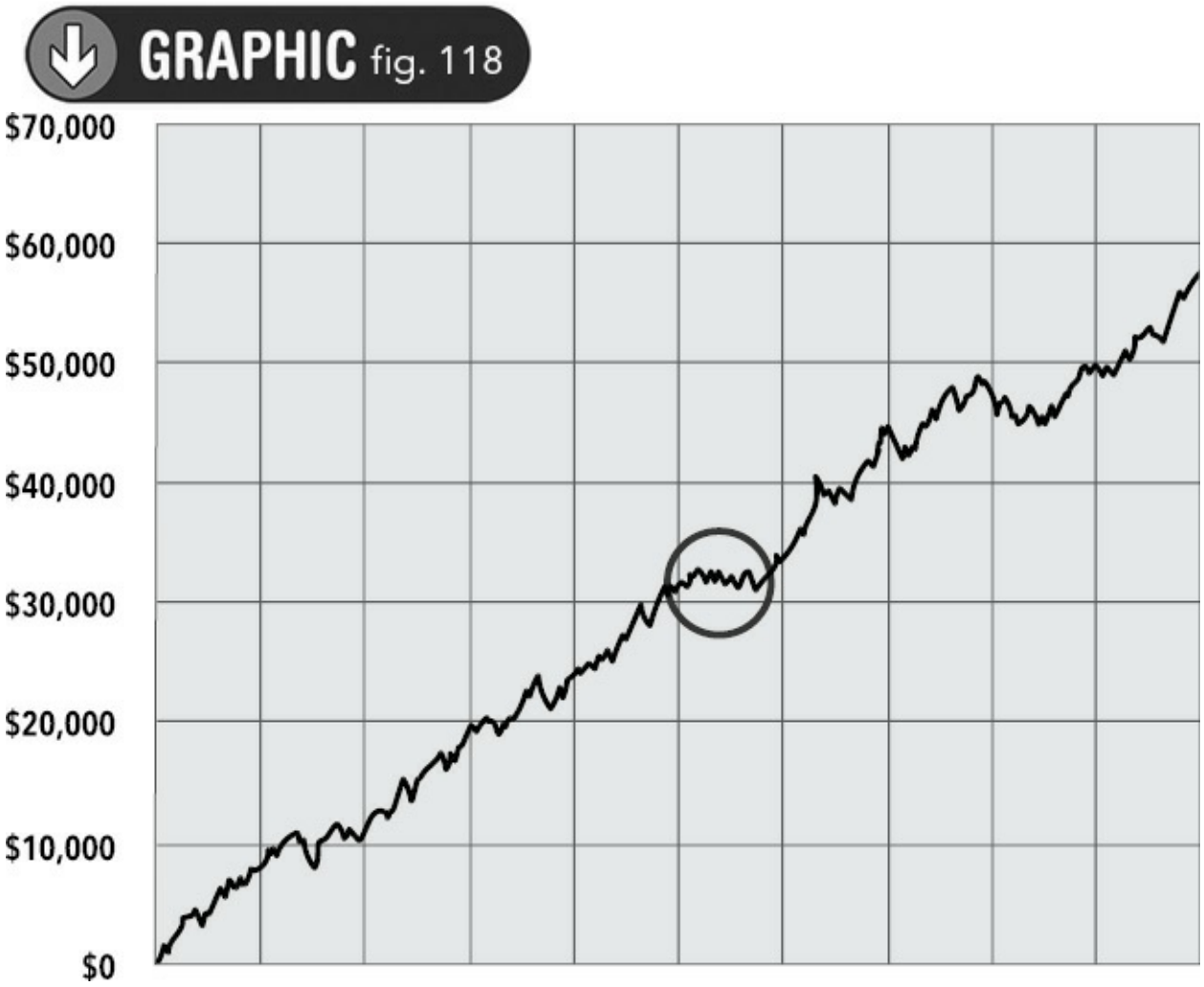
Imagine how you would think and feel after working hard as a day trader for an extended period of time, only to end up flat, or negative. I can tell you from my own experience that the sight of an equity curve like this would

cause most traders to quit. In a panic they would throw out the baby with the bathwater. The tragedy is that their trading system might have been a very workable and profitable one. Often, this person is only *trying* to trade and is not necessarily a real trader.



When you pull back and elevate to a higher point of view, and when you develop a broader and deeper understanding of the results of your tradeplan, you might experience an equity curve like the one shown in figure 118. It looks a whole lot more attractive, does it not? Since it captures a much longer time frame, this equity curve represents the overall forest. Look closely and

you will see that there are a lot of losing trades.



In fact, the figure 117 equity curve that looked and felt rather dreadful is the small part of the figure 118 curve marked by the circle. It is amazing what a proper point of view can teach you about successful trading! Ask yourself this: Would you be able to endure the first equity curve if it meant you could ultimately enjoy the second equity curve?

The power of CEO teaches us how to be disciplined and run our trading business like any other business owner would. As with any business, there will be slower days and days marked by losses and other immense challenges.

There will be days when you want to quit or even feel you *should* quit, but deep down, you know that moving forward is the right choice.

By using these 12 Powers in conjunction with the step-by-step plan that follows in part IV, you will put yourself in the absolute strongest, most advantageous position you can be in. You will be far better off than most traders and on track to creating long-term success for yourself.

The random distribution of wins and losses associated with trading is hard for the human mind to handle. That is why we need to transform into a different animal with a different mindset. How is this possible? The only way to really overcome the human instinct to flee from pain is through practice and hard work: developing a tradeplan, backtesting, getting odds in your favor, and using the power of dynamic setups, numbers, and compounding.

The person who is simply "trying to trade" will fail. If you want to dip your toe in the water without diligent preproduction work and preparation, you will not have the necessary belief in yourself or your trading, and you will lack the confidence you need to stay the course when hit with a series of losses.

Detach yourself from losing trades (they are not personal; they are inevitable parts of the plan). See the big picture of the tradeplan and focus on the things you *can* control, the things that can make you money. That is the power of being CEO of a trading business. Here is how you do it:

Run your trading as a business

- Establish rules, policies, and procedures.
- Establish long-term and short-term goals.
- Commit to effectively managing yourself, your strategy, and your trading capital.

Diligently execute a proven trading system

- Strive to trade objectively, consistently, and with minimum emotion.

- » Invest your energy into improving your trading system *after* the market closes—not while trading—but avoid tweaking your system just because you had a handful of losing trades.
- » Evolve from being a fretful trader worried about where the market is headed to being a confident trader who knows their system will win and make money over the long haul.
- » Understand that confidence and belief are not states you can just talk yourself into. You must go through the proper steps to transform so that you truly believe.
- » Learn how to live with your win/loss column created from your backtesting and preproduction work. That means experiencing the good, the bad, the ugly, and the great, over and over again, until you finally begin to truly believe in your tradeplan.
- » Practice your tradeplan in a sim account, repeatedly, as if you are running it for real, until you have the repetition you need to execute it perfectly every time.

Think of yourself as a CEO

- » Insist on operational excellence in all phases of trading.
- » Focus like a laser on the *why* of day trading—to make money.
- » Don't be the guy or gal *trying* to trade. That will only land you on the forest floor among the trees.
- » Be the CEO of your trading business and operate from above the forest—it is a completely different point of view that will give you a distinct and critical advantage.

You are in charge. Hold yourself accountable. Judge yourself by what you do and not by what you think or say. Walk the walk, don't just talk the talk. Know that there are some things you cannot control and some things that you can and must control. The 12 Powers are within your control and need to

be part of your day trading plan. Now let's talk about the step-by-step process of building that winning plan. That's next in part IV.

Lwp t atrp

- Focus on the things in trading that you can control and not on things that are beyond your control.
- There are times to adjust a trading plan, times not to adjust it, and times to reevaluate it entirely.
- Set your goals and trading practices to achieve the lifestyle you really want.
- Day trading is a business, and you should run your activities with the mentality of a CEO.
- Align your actions to be congruent with your reason for trading.

PART IV

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Lwp t X t xt

- Humans are terrible traders
- 10 steps to success
- Optimal approaches to trading markets
- Charting a course
- Brokers

What often separates successful traders from unsuccessful ones is the mindset. Nobody likes to lose money, but if you are taking the leap into day trading, you will need to accept losing trades and even, at times, a series of losing trades. It’s a lot more fun to talk about winning trades, isn’t it? When we get it right, there will be a whole lot of winners. But we cannot divorce winners from losers. Losing trades are a part of what we do as traders. So why is it so hard for most people to deal with losing trades?

We are not trading to lose money, and yet accepting losing trades is a part of winning. Our winners are often found hiding behind the losers. It is a bit of a paradox and tough to wrap your head around, but until you do it, it will be impossible to succeed as a trader.

As humans, we seek to avoid pain and loss. We have a survival instinct. In that respect, not wanting to lose and being pained by losing is a normal

human trait. It is part of our nature as human beings. But, as you know, traders are not normal humans. If you follow the steps described in this chapter, you will transform into a real trader—the CEO of your trading business.

Certain aspects of this transformation are highly counterintuitive. You may recall our hot stove story from part I. Your mentor tells you to touch the stove. You obey. You burn your hand. You experience enormous pain. And then you are told to touch it again. Our natural tendency, as human beings, is to avoid loss and risk. We have a survival instinct that tells us when to quit and to run away from danger. We feel pain, and we are motivated powerfully to do whatever is necessary to make the pain stop. On a deeper primal level, pain represents extinction, and nothing alive in this great big world wants to become extinct. Losing money on a trade is painful. As we witness our account balance dropping closer to zero it can cause us to do some pretty drastic things. We perceive that the risk of becoming extinct has moved a step closer to becoming a reality. It hurts, and we will do anything to stop the pain. That is an intuitive and normal response for most people, but for traders it is quite often the absolute wrong response.

While humans will do whatever it takes to avoid pain, traders do not have the luxury of feeling pain. Traders must take the next trade and must not allow fear to contaminate their focus or their belief. So how do we make this transformation from our default human condition into this completely unnatural creature known as a trader? How do we unlearn a primal instinct? I realize that this transformation might sound next to impossible to accomplish, and, for many, it will prove to be so. What I want to do for you is to lay out an easy-to-follow, step-by-step plan to help you bridge the divide between human and real trader.

This plan will help you recalibrate your internal compass and set a course

for success in day trading. Once accomplished, this critical recalibration will set you apart from most other would-be traders who, due to their unawareness of their own weaknesses as human beings, are destined to simply wash up and quit.

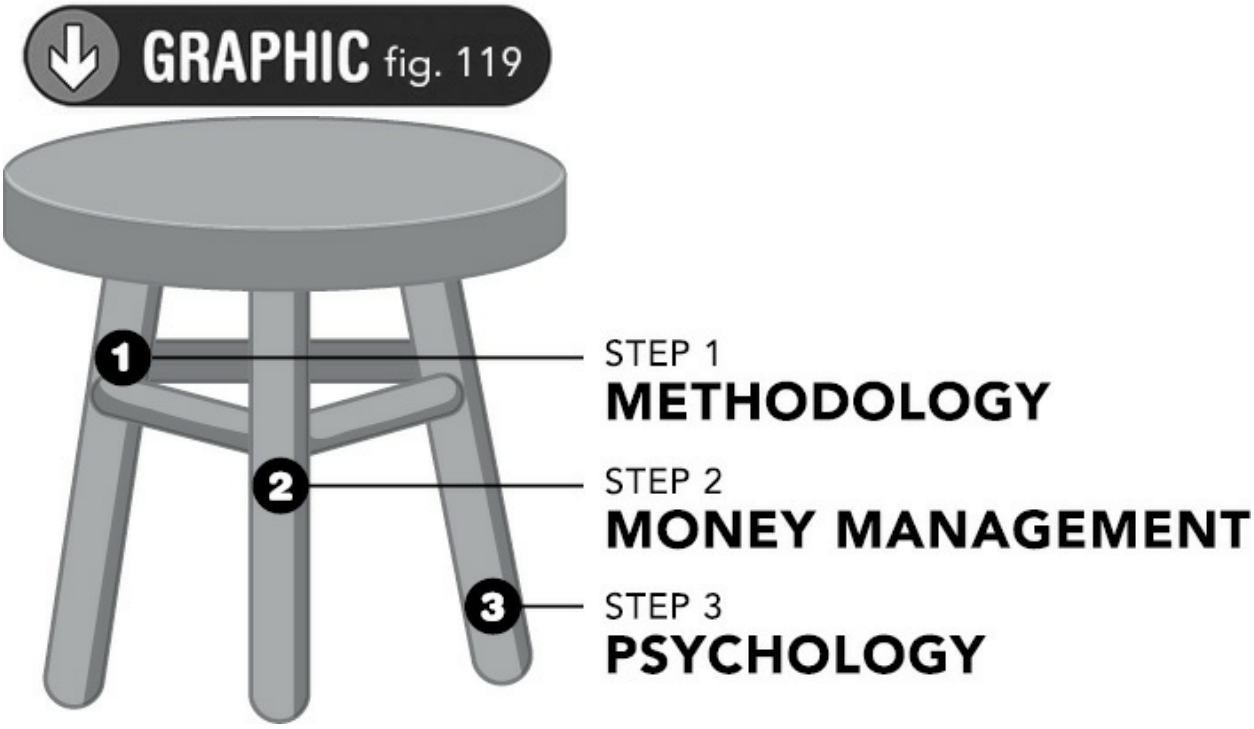
It is important to realize that you cannot simply talk yourself out of being human. You may currently understand this idea of transformation on an intellectual level (we are all smart enough to understand the inclination to avoid pain and extinction) but in order to succeed you must come to this new understanding of yourself as a trader on a very visceral and practical level. And in order to do this you will need to go through a series of tangible steps–things that you *must* do!

When confronted by the necessity for transformation, most people nod their heads yes in agreement and then move on to become losing traders. It is not enough to just nod your head yes and move on. If you want to put yourself in the best position for ongoing success in trading, then commit to following the steps I am about to outline. Doing so will ensure that you secure your advantages before you risk one penny of your precious capital.

In this chapter, we will discuss the first three (of ten) steps to becoming a successful trader.

- **Step 1 - Methodology**: Find your distinct and personal way of trading.
- **Step 2 - Money management**: Learn how to use risk the proper way.
- **Step 3 - Psychology**: Scrub the human emotions out of your trading business.

These first three success steps combine into what I call the "three-legged stool." Methodology, money management, and psychology are the three legs. All legs are necessary (without one the stool topples), and together they support a foundation for successful day trading and pave the way for steps 4–10.



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Most new traders approach trading without any real method or strategy. They win some trades and quickly think they are genius traders; they've "cracked the code" to succeeding in the markets. Then, as markets change, they begin to experience losses, maybe even a series of losses. And because they have not taken the time to understand their methodology and prove it to themselves in the context of a proven tradeplan (steps 5 and 6), they will not handle the losses well. Now the would-be trader is faced with feelings of despair and inferiority that are quite unpleasant, and the perceived risk of

extinction looms heavily.

Most traders want to self-validate and prove how smart they are. They take their failures as a direct assault on their ego. It is a humiliating experience because they must come face to face with how little they actually know. In truth, success in trading has nothing to do with one's ego or one's intelligence. To the contrary, success begins with acknowledgment of what one *doesn't* know.

Trading is war, and it's a dangerous world that we operate in. The trading battlefield is a place where coldhearted Darwinism is on full display. The strongest survive and the lambs are led to slaughter. The survivors quickly learn that "just winging it" is not going to cut it. They are going to need a battlefield strategy, a trading methodology that is going to work and keep them in the fight, gaining experience, battle scars, and ultimately competence, control, and sweet victory. Without a methodology, traders have no hope of withstanding the shock of the battlefield. Their sense of being out of control in a high-risk environment will lead to their demise as a trader.

V Yt ı"p"Sı "t ı p c pst V t wı sı"ı v

Like many traders, I too experienced the exhilaration and shock of making a lot of money fast only to lose it all in a flash. After going through that several times, I came to the realization I needed a strategy. I needed a trading methodology that would help me weather the chaos of trading and its emotional fallout, while steadily and consistently growing my capital—a winning plan. So I sought help.

I began sitting in on webinars and learning about the methods used by other

traders. I found a trading "expert" who claimed his method could provide the type of ongoing success I wanted. I became a customer and set out to master this method.

The result was disaster. What I did not realize at the time was that my early battlefield experience (winning big and losing it all), chaotic as it was, had already taught me a great deal about myself and what would eventually become my tried and trusted personal methodology. I did not know it at the time, but there were elements of my original approach to trading that were actually quite effective. The problem was that I was not focused on defining (and refining, step 5) my method. I was missing step 1. Copying someone else's trading strategy wholesale was, for me, doomed to be ineffective. My understanding of this other person's method was superficial; it was not born of *me* and my experience. I did not understand the how or the why—I did not understand the *edge* that I have since come to know as indispensable to success in day trading. At the time, I did not even know what was meant by the term "having a trading edge." I had not been introduced to that concept. If you have made it this far in this book, then you are already way ahead of where I was.

The developer of the strategy understood his methodology through and through, without a doubt. It had become intuitive to him, an organically derived, Darwinesque adaptation that had accompanied his transformation from human to day trader. He understood that the cumulative results of winners and losers would grow his account over time. As for me, though, a customer, and someone who just wanted to win at trading, I had no vision or perspective deep enough to understand the edge that this strategy provided. I experienced what most would-be traders experience when trying to learn someone else's trading method: failure.

Later, I would come to realize that in order to understand a trading method not one's own, one must commit to a certain amount of preliminary work. Anyone can paint by number, but very few can study the techniques of the masters and then put in the work needed to become actual artists. Most customers of someone else's work can never fully understand how or why it is supposed to work without investing a lot of time and effort into figuring it out. This idea of "figuring it out" as a precursor to successful implementation is critical. I like the term that I have used throughout this book when referring to this and similar processes: "preproduction." We will dissect preproduction in chapter 16, but for now, suffice it to say that I learned an important lesson in my first attempt at being coached: I needed a personal methodology, a personal "way of trading."

I continued to sit in on webinars and ultimately found a trading method that I connected with and felt I could understand at a deep level. I paid for materials and instruction on this method (putting actual skin in the game is important; you will be more serious and dedicated to your pursuit when financially invested) and I set out to fully learn how and why this trading method worked. I learned what it meant to have an edge in the market and that "leaning on that edge" is where the money would be made. At this point in my trading career, everything started to change. I was recruited by the same company I was receiving instruction from. I became a trading coach and shortly thereafter began moderating a live trade room using their trading method. I did the necessary preproduction work to ultimately make the method my own. I took ownership of it and of my trading.

The first leg of the stool and the first step of our action plan is methodology. In this step you are going to reflect on what you have learned throughout your reading of this book—from the various markets, to trading times, to chart types—and you are going to envision what your day-to-day

agenda might look like as a trader.

How do we precisely define the scope of "methodology"? What does it entail? What does it not entail? Let's look at three crucial features:

» A personal methodology is one in which the trader has full understanding of the *how*, the *where*, the *when*, and the *why*. How is this methodology applied? In what markets and at what times? What is its edge in the market? Do I understand it? Have I witnessed it enough times to truly understand it?

» A personal methodology must be conducive to one's own personal trading style.

Many traders do not know what kind of trader they are. Discovering one's style is not always easy. I'll tell you what helps a lot, though. When you witness a particular trading method winning over and over again (despite the losing trades in between the winners), then what you have observed–the success you have witnessed with your own eyes–helps you move closer to discovering your personal approach. Every insight moves you closer to your discovery of who you are going to be as a trader.

» A personal methodology must harness the 12 Powers. There are so many trading gurus, systems, and ideas out there. You will be a more distinguishing connoisseur of methodology if you study the 12 Powers as detailed in part III of this book.

There is no one-size-fits-all method for day trading. There are effective methods out there that might not work for you. Learning and adhering to the 12 Powers will put you in a great position to discover a method that *will* work for you.

Finding the right trading method or system and learning how to wield it and why it works goes a long way toward determining whether a trader succeeds or fails. Most people will not become successful traders without standing on the shoulders of the giants who have gone before them, learning their methodology, studying it, proving it to themselves, and ultimately making it their own. This is the first step to kick-starting your career as a trader.

There will always be the odd outlier, the talented savant trader who jumps into the game with a natural instinct that all but assures his or her success. These oddball savant traders should be left alone—it would do them great harm if they tried to trade someone else's method. But for most average people out there who want to trade, the most likely path to success begins with someone else's method. The question then becomes: how do you develop your own trading method using what you learn through someone else's success?

Using someone else's method will solve a lot of obvious issues, but it will create some not-so-obvious challenges that you will need to work to overcome. Just as I had to do, you will need to work hard at establishing your belief in and understanding of the method. You will need to do the preproduction work so that you can make the method your own. You did not

create it, yet if you hope to succeed with it, then you will need to understand it as if you had. But how?

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At the time, I did not realize what an advantageous position I was in, moderating a trade room, nor did I have a clear sense of the awesome responsibility that came with this new post. I had to show up every day and live in the markets. As the days passed and I spent more and more time intimately involved with every price bar that printed on the chart, the dots began to connect in more and more ways—the accumulation of my experience compounded upon and reinforced itself.

Time and experience are things that cannot be taught. Those of you with children of driving age know exactly what I mean. If I could instantly bestow upon my kids all my own time and experience as a driver, then I would feel a lot more comfortable with them being behind the wheel. But in reality, all I can do is tell them and show them what I know, and then hope and pray that they survive. While supportive, my efforts cannot hold a candle to the value they will gain from a decade of real driving experience.

A system can be extremely simple, such as buy at 10:00 a.m. and a sell at 10:05 a.m., or extremely complex with many indicators, rules, and other variables. In day trading, the simpler the system the better, so long as it's effective. A simple system is easier to learn and duplicate. Moreover, the results achieved by simpler systems are easier to analyze; you can readily identify when the system has broken down.

What's most important is that you prove to yourself that a system will work. As you observe the system over and over again, you should begin to develop a deeper understanding of it, the good, the bad, the ugly, and the great. Deploying the system in a simulated environment (step 7) will help you refine your understanding, risk free.

I want to share a couple of personal notes on system selection. First, it's mandatory, in my view, that my trading strategies can easily be backtested and proven in advance, before I put anything at risk. For example, my latest strategy involves identifying exhaustion points and trading the momentum revealed by the price action itself. I have custom indicators that allow me to easily identify key exhaustion points on the chart, which I can then backtest. Second, when implementing a given strategy, you will need to decide whether you are going to make your trade setup calculations manually or with automated tools. Chapters 8 and 10 illustrated the kinds of setups that come into play, and in step 5 (chapter 16) we will explore calculation tools in further detail.

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Recall our discussion of mechanical rules from chapter 13. Systems can be mechanical, with strict rules, or discretionary, with the trader making some key judgment calls on the fly. A discretionary approach, for example, could involve going long every time crude oil breaks a resistance level, but the resistance level is not defined by any specific set of rules and is based on the trader's interpretation of what constitutes a resistance area, whether it is a trendline, retracement level, or moving average.

A mechanical system is more exact. It will specify resistance precisely, with no room for guesswork. In fact, a true mechanical method of trading will tell you

what to trade, when to trade it, how to trade it, and where to get in and out, and it will provide rules on how to manage the trade from start to finish. It also gives you a clear and concise method that you can test and prove to yourself, which, you should know by now, is absolutely critical to your success. As the trader, your job is simply to follow the mechanical rules of your method—which you have scrupulously studied and tested—and execute trades.

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When I am moderating my trade room, I follow a specific trading method that is guided by a specific set of rules. Over the years, though, I have learned that a small degree of discretion can pay big dividends and can be mixed into a mechanical setup. In fact, certain discretionary decisions can also be reduced to mechanical rules.

Your mechanical setup instructs you to enter a trade at a specific price. But you notice that your system-generated entry is a tick or two below a major resistance. You adjust by moving your entry a tick or two beyond said resistance. This discretionary adjustment to a mechanical setup can at times keep you out of a losing trade. Use a similar discretionary adjustment for your stop price and it could at times keep you in a winning trade. With experience, you can reduce this discretionary maneuver into a mechanical rule so that you treat these situations the same way, each and every time.

A major economic news release is due to be published in five minutes. Your mechanical setup is telling you to enter a trade, but you hold off because you understand your mechanical setup well enough to know that it does not account for the volatility that may be created by the news release. You begin trading again two minutes after the news release. Your discretionary decision to avoid trading in close proximity to a major economic news release may become one of your mechanical rules.

However, discretionary decision-making must be a small part of the process. In fact, maybe 5% of trading can be a work of art. The other 95% must be completely objective and consistent per your tradeplan rules.

It is important never to exceed the 5% "artistic" threshold. It can be tempting to do so, especially after experiencing the pain of one or more losing trades, which can cause you to doubt yourself and the system you have developed. Remember, nothing is ever going to work one hundred percent of the time. Your focus should be on adopting rules that can be tested and proven and applying those rules consistently. By accumulating and applying a working body of rules, you can increase your success rate and develop an edge. Sometimes applying a new rule will be beneficial and sometimes it won't, but if you don't make it mechanical, and if you don't do it the same way every time, then you'll have no way to measure the longer-term effect that the rule change had on your results. You need to know how it stood the test of time. Did it improve your edge or not? Even if your edge was only marginally improved, increasing your odds of success by just a small amount will significantly compound your advantage over time.

Over the years I have strived to reduce my 5% share of trading artistry down to about 1%. I vet, study, test, and adopt as many mechanical rules as I can. My application of these rules is not always shown in the indicators on my charts; nevertheless, they are rules I follow in the exact same way each and every time a specific situation appears. The results I accumulate over time are measurable, allowing me to prove their positive impact.

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A common problem among traders is that they break the 5% rule. Fueled by fear, ego, or something else, their “artistic” flair begins to account for 10%, 20%, or even 30% of their trading decisions. If their artistry ends up procuring some big wins for them, then the condition may end up being even further aggravated. Soon they can no longer point to what is working and what is not working and why. They completely lose their method. They begin to second-guess the provable aspects of their method. The bad results inevitably arrive and they are unprepared to adapt. This is the slippery slope to death and destruction as a trader.

Most successful traders have come to understand the cons of discretionary trading. If you cannot articulate in quantifiable terms how or why a trade should be taken and managed from start to finish, then how can you ever hope to test your plan? How can you ever secure the belief you need to stick with a plan—especially during the hard times—and maintain the confidence that you will ultimately come out on top? You can’t, and this is a huge problem.

The Power of Foundation and the Power of the Tradeplan–both of which

hinge on testing and building belief and provable results—are essential for developing a successful trading method. Discretionary trading (in excess of the 5% rule) makes these critical powers nearly impossible to establish.

One important caveat here—remember the talented savant trader I spoke of earlier? That guy is real. But he is also extremely rare. There are, in fact, some traders who do better with highly discretionary approaches. I am not one of them, and the odds are you aren't either. The trading savant should be left alone to pursue his own methodologies, as highly discretionary as they might be. The reason we trade is to make money, and if it ain't broke, don't fix it.

So, savants aside, what, if anything, does the average trader have to gain from discretionary trading? We have discussed the cons, but what about the pros? In my view, the benefits of discretionary trading can be learned only through time and experience. As you gain a deeper understanding of the nuances of your chosen market, chart, and method, you will notice tendencies and patterns that allow you to make intelligent discretionary decisions that will help you put a finer point on your trading edge. Moreover, you should be able to incorporate your discretionary insight into refinement of your mechanical rules.

Let's say that a trader is using a trend-following method. If the trader has well-honed discretionary skills, then he may be suspicious of continuation trade setups that occur late in the trend. He will know how to identify a trend that may be tiring and could be prone to changing direction. Not to say that such a change in direction is a given, only that the risk is greater, and therefore the trade setup may have lower odds of succeeding. Perhaps he will use discretion and avoid the trade. And, if he is really on

top of things, he will quantify his discretionary decision into a measurable mechanical rule so that he treats this situation the same way each and every time he encounters it.

Most traders find success by staying focused on the mechanical rules of their methods, not the discretionary ones. Preoccupation with discretionary trading puts you at high risk of becoming that grunt that runs around on the forest floor trying to dodge falling trees. He thinks he's a ninja (he's not). If you are interested in soaring above the forest floor and watching your forest grow despite the falling trees, then focus on developing the mechanical aspects of your trading. This can be accomplished without any rare talent or savant-like knowledge. Nevertheless, it is important that you design and refine your mechanical trading systems as intelligently as you can, which means that you need to understand the pros and cons of this approach.

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Mechanical trading systems are valuable because the decisions are not subject to interpretation. Once an anomaly, a specific price pattern, or another "way of trading" that produces consistent results has been identified, then a mechanical system can be created or updated to determine specific buy and sell points.

The pros of this approach are many. We know that humans typically make terrible traders, so it makes a lot of sense to remove the human element from the equation. In other words, mechanical rules help you get out of your own way. Mechanical trading systems go a long way in serving that purpose.

Mechanical trading systems give us a set of rules to follow and to test in our demo/sim accounts. Through testing we prove that our mechanical setups will produce steady trading profits, before we risk our real money in the

markets.

Again, I cannot emphasize this enough—the ability to prove that a method will succeed is the secret to success. If we can't prove to ourselves that a method will succeed, then we are going to fail. Mechanical setups provide this proof by allowing us to quantify and automate our trading parameters. Not only can we get measurable results prior to risking our money, but we can also practice our method and prove that we can execute it consistently and without mistakes. By the time we expose ourselves to the risks of real trading we will have already stacked up huge advantages.

The biggest con of mechanical setups is that they can make traders too complacent. For example, consider the many signal and alert services out there that allow traders to pay a fee to receive trade recommendations. These recommendations may even include precise details; enter long or short at this price, place your stop at this price, etc. It can be tempting for some traders to rely too heavily (and blindly) on the systems of others. The danger is that a trader who does not take the time to understand and study the inner workings of his methodology will have a difficult time seeing the big picture. When the system produces a series of losing trades, it is only normal for the subscriber to second-guess the service and quit. They don't understand the reason why the service works, the statistical edge the system has in the market, so they will most likely quit, throwing the baby out with the bathwater. Ironically, that usually happens right when the system is about to post a string of winners and rise to new equity highs. Without a solid understanding of your trading method, you will quit right in front of the next wave of winners, as the statistical edge swings back in the method's favor.

To sum it up, mechanical systems are powerful, but a deep level of understanding must be pursued if you wish to leverage this power to the

utmost. From there, a trust in the methodology may be established that will ensure that your confidence and belief in the system are not shaken in the aftermath of losing trades. Moreover, a thorough understanding of what makes your mechanical system tick will improve your testing efforts, your execution, and any discretionary trade decisions you may apply in accordance with the "5% art."

At this point you may be wondering how to go about finding the right day trading methodology. I am a big fan of applying the process of elimination in this context. One way to do that is by looking for systems congruent with the 12 Powers. You should also narrow the list of choices by focusing on the most appropriate markets and charts for you to trade in light of your unique circumstances.

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Many people ask me what markets they should trade. I cannot answer that question, but I can tell them about several markets *not* to trade (because of liquidity or other factors). In fact, finding the best market to day trade is often a process of eliminating the unfavorable ones and coming up with a short list of appropriate candidates.

Here is a series of questions that can help in eliminating the less suitable markets for day trading:

- When am I available to trade?
- When am I not available?
- When is my ideal time to trade?
- How much capital can I put at risk?
- What can I afford to lose (financially and emotionally)?
- What is my skill level?
- How long is my attention span?

» How will I avoid distractions that could hurt my trading results?
» Do I have the necessary tools? (charting platform, trading computer, high-speed internet)
» Are there any other personal factors that I need to consider?

Write down your answers. Once you have evaluated your personal situation, it will be easy to identify markets and charts you probably should stay away from, and, in turn, you will be in a much better place to decide what markets and charts you should focus on. From there, it will be easier to determine which systems (mechanical and/or discretionary) to apply.

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How much time do you have to day trade? If you are retired and have no other work responsibilities during the day, there is no limit to what markets and times of the day you can trade. But do you want to be up in the middle of the night trading forex, or do you prefer the morning hours? If you live on the West Coast and you only want to trade during the first half of stock market action, then be prepared to trade from 6:30 a.m. to 10:00 a.m.

If you can only trade around a work schedule, you might need to focus on daily charts and hold positions for longer periods of time (swing trading).

Swing trading, while being beyond the scope of this book, can be a great option for many people. What I like about it is that with the right charts and tradeplans, you can literally spend an average of five to 15 minutes at the end of the day perusing your charts, setting up trades, etc. This is a great choice for people who are busy in the daytime and can't dedicate consistent, concentrated time to day trading.

There are a couple of other possibilities that should be mentioned here. You can still day trade in the late afternoon/evening (depending on where you live) during the Asian forex session, when the next day's forex trading reopens on the other side of the world. This session begins around 6:00 p.m. ET, so it can work really well for those just getting home from work. This session requires great patience and discipline, however, because it is not consistently active. Nevertheless, the Asian forex session has a good selection of AUD and JPY forex pairs available to trade.

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If you have a smaller trading account—$2,000, for example—then you will want to focus exclusively on forex until you build more capital. Using the Power of Compounding, patience, and an effective tradeplan, you can grow your account to a substantial size. With forex, you have great flexibility in tuning your position size to appropriate risk levels. Through a mix of micro, mini, and full-size lots, you can place trades with risk levels that will keep you relatively safe when experiencing drawdowns.

Another option for those just starting out with smaller accounts: try your hand at trading micro futures contracts. If a full contract of the S&P 500 Index futures trades in tick sizes of $12.50, then the E-mini Micro S&P 500 Index tick size is $1.25, or one-tenth that of the larger contract.

Little by little, since their launch in March of 2019, these contracts have been gaining in popularity. My biggest concern was lack of interest and low volume in many of these markets. Low volume often means not getting good fills on your orders. But what I have heard from many of my own students who are trading some of these instruments is that they are not really experiencing problems with their fills. Sometimes they pay a little more in slippage costs, but for the most part they have been happy with these

markets. Between small forex lots and micro E-mini contracts, even traders with smaller accounts can find something that works for their day trading.

Here is an example to illustrate how you can aggressively compound a small amount of capital with a good tradeplan. Using a preprogrammed spread sheet, the Ultimate Trade Analyzer (UTA), available for download at www.clydebankmedia.com/trading-assets, I logged a full year of trades for a specific day tradeplan.

The strategy is called the Trend Jumper Trading System. Assuming a $2,000 account as my starting point, I logged every single trade for a 12-month period per the rules of the tradeplan in the UTA spreadsheet. Each trade consisted of three micro lots (three total "positions") all entering at the same point; the first position was to be taken off at Target 2, the second at Target 3, and the third had no target at all—we would use the trailing stop to exit that position to capture larger moves when they occurred. By the end of the year, the account had grown to $2,502, which is a 25% growth in capital. From an annualized percentage basis, that's pretty good. If a Wall Street wealth manager could promise 25% annually, they would never lack for clients.

Deciding what to trade and how to trade it is one of the most important early decisions you will make as a day trader. When it comes to trading hours or what markets to trade, do not take other people's advice, because they do not know your personal situation. Take responsibility and, ultimately, take ownership of your own decisions, whether they relate to trading plans, markets, times of day, trade setups, or available capital. It's worth spending the time and answering the important questions that will lead you to optimal situations.

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Money management is the second leg in our trading stool, as well as step 2 of our Guide to Trading Success. Money management is all about choosing the right risk level. You can have an amazing methodology (step 1), but if you are not shrewd when selecting appropriate risk levels, then you will stunt your growth as a trader. Worse, you could get discouraged and quit. As with every leg of the three-legged stool, weak money management risks total collapse.

In the previous section, I told you about running a test using the UTA spreadsheet that netted a 25% annual return. I want to tell you about another test that used the same exact trades and incorporated a very specific and very simple money management strategy. I set the UTA to apply a modest 1.5% risk level to the average risk of all the trades in the log. The risk level determines the position size of each trade, from the first to the last. As the account grew or drew down, the position size would scale accordingly, always adjusting to maintain its 1.5% risk level.

The tradeplan, as you know, won more often than not—about two-thirds of the trades were winners. As you may recall, the account had grown to $2,502—a 25% return based purely on proper methodology—with position sizes remaining constant. After applying our 1.5% risk level in the second simulation, the account grew to a whopping $6,625! That is a 231% return, a mind-boggling number but by no means an unattainable feat. Credit the Power of Compounding and a simple money management strategy.

Now I want you to imagine what could be possible for a trader who effectively uses money management strategies, who knows when his methodology and overall tradeplan will win 66% of the time. Imagine if this trader was able to be slightly more aggressive, risking, say, 3% on every trade.

What do you think the $2,000 account would have grown to? Write down your best guess now. We'll revisit this scenario in a few moments.

The good news is that the path toward expert money management begins very simply—do not risk too much in one account or on one trade. Remember, you want to weather the inevitable periods of losses (one step back) without too much stress or anxiety, so that you can experience the series of wins (two steps forward) that are part of the tradeplan. My standing rule for beginners is not to risk more than 2% on one trade. This 2% risk level is not set in stone but can be scaled to the positive measurable results that you can demonstrate in your proven tradeplan.

After rigorous testing, Trisha is able to establish belief in a tradeplan that wins 75% of the time (a whopping three steps forward for every step back). Compelled by her belief and comfortable with the added risk, she adjusts her risk level upward from 2% to a more aggressive 3.5%.

We may presume that Trisha has already had some success in her trading career. She knows how to test and prove a tradeplan that inspires belief, and she has made enough money to be comfortable with higher levels of risk. A confident trader may be willing to make a case for risking 3%, 4%, or even up to 5% per trade, depending on the effectiveness of their methodology. An adjustment of just 1% to your risk level will have enormous ramifications.

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The baseline money management approach that we have introduced (risk no more than 2% on any one trade) is known as a "fixed fractional" money

management strategy. One commits a fixed percentage of their capital to every trade they take.

But since your account balance is always changing, how do you know what amount to use to compute the 2%? I use the end-of-day account balance from the previous trading day. Since I am a day trader, I am flat (no positions opened) at the end of each day. Say it is Wednesday and my account balance is $20,000 at the end of the day. On Thursday, I use that account balance ($20,000) to calculate my 2% risk level; 2% of $20,000 is $400, and so $400 is my maximum risk amount, per trade.

It sounds simple, but it is actually more dynamic than you might think. The amount of capital available to you in your trading account is always changing based on your winning and losing trades. Moreover, in order to apply the fixed fractional strategy accurately, you will need to place risk sizes that a) represent 2% of your total capital and b) fit as neatly as possible within the confines of your tradeplan. I recommend finding the average level of risk in your tradeplan and using that amount as a guideline for your default risk level.

Risk equals the difference between your entry price and your stop-loss price.

I have a $20,000 trading account. Following the 2% rule, I do not by default risk more than $400 per trade. My tradeplan consists of various setups and methodologies. Like most brokerages, mine allows me to view all data from my previous trades, both real-money and simulated. I am thus able to determine that the average risk for a trade in this plan is .20 points in crude oil, or $200 per contract. Therefore, to follow my 2% fixed fractional money management strategy I should aim to trade two contracts on every trade. I like to use my account balance from the end of the previous trading day to compute the 2%.

If you want to play it a little more conservatively, then in lieu of looking for the average risk, look for your largest loss (in terms of points or pips) in a particular log of backtested trades. Then determine how many contracts you can afford that would cover that loss without going over $400. If your largest loss was 40 cents, or $400 per contract, then you would aim to limit your risk to one contract per trade.

Remember our first example scenario that we tracked with the UTA spreadsheet? We began with a $2,000 account that grew by 25% when we applied methodology (step 1) and then it grew by 231% when we applied basic fixed fractional money management at 1.5% per trade (step 2). I asked you to write down your best guess on what the result would be if a trader was a bit more aggressive, risking 3% of the current capital per trade. The results are mind-boggling. The account would have grown to $23,123! That is a 1,056% growth of capital over a year's time (if the win rate held up, imagine what the second year would look like!). This result came from the exact same trades as were traded in the previous scenario. The only difference was position size.

The exponential growth potential of a proven tradeplan is the pathway to success for a day trader. Remember the example of the jumbo jet rising in altitude faster and faster until its nose was pointing straight up and it

transformed into a rocket ship? That is what happens with proper money management techniques.

Even a mediocre tradeplan–let's say it's one that wins 55% of the time–can produce large, mouthwatering results like those just illustrated, through the Power of Compounding and proper money management.

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Recall our discussion on the Power of Surrender on the topic of risk. I said that no government would ever allow you to print free money. Risk is a powerful tool, certainly a thing to be respected and handled with care.

The overuse and abuse of risk will prevent you from making money and will do tremendous harm to your financial well-being. So, don't bet the farm—stick to your 2% rule. Failure to respect the dangers of risk has ruined many people over the years, even traders who were otherwise sound strategically. Yet, without risk, we cannot make money by trading. I want you to remember this the next time you suffer through a losing trade. If you have followed the steps in this guide, then you should be able to compartmentalize that pain. You will understand that it is but a necessary by-product of risk, the powerful tool you are using to make money, and nothing more.

The Power of Numbers comes into play here in a major way, because it reminds us that over significant periods of time, the edge of the winning tradeplan will eventually materialize. No tradeplan will win every time. Moreover, even the winningest tradeplans will subject you to strings of tough

losses. Successful traders parry the blows by embracing the necessity of risk and hunkering down through the ugliest, nastiest trading sessions, persevering so that they can experience the larger victory that has been etched into the DNA of the tradeplan.

For beginners in day trading, I recommend applying risk using the straightforward fixed fractional strategy we have discussed. Aiming to risk 2% of your entire account value on each trade is a good guideline and helps you determine the proper position size for each trade. As your capital grows, so will your position size. Perhaps most important, use a tradeplan with positive, measurable results (steps 5 and 6) and a methodology that suits you (step 1), and make sure your money management is a part of the tradeplan itself.

Trading is war! We can arm ourselves with all the right tools and venture onto the battlefield of trading with enormous advantages. We would not want to expose ourselves to such dangers with anything less.

Together with a carefully selected and well-honed methodology, money management further empowers traders in the pursuit of lasting success. If you lose sight of proper money management, then you lose sight of your true reason for trading in the first place—remember the Power of Why. We day trade for only one reason: to make money. This fundamental raison d'être of the day trader should assert itself with every trading decision you make, especially when it comes to risk and money management.

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Psychology is the third and final leg of the stool. You can have airtight methodology and a solid command of all things money management, but if you are unable to control your emotions, then it is highly unlikely that you will be able to follow through with your methodology, and your whole enterprise will be doomed to come crashing down. Trade psychology is a skill you acquire with practice, but in the end you must detach your emotions from the outcome of any given trade. The trick is to believe in and lean on your system.

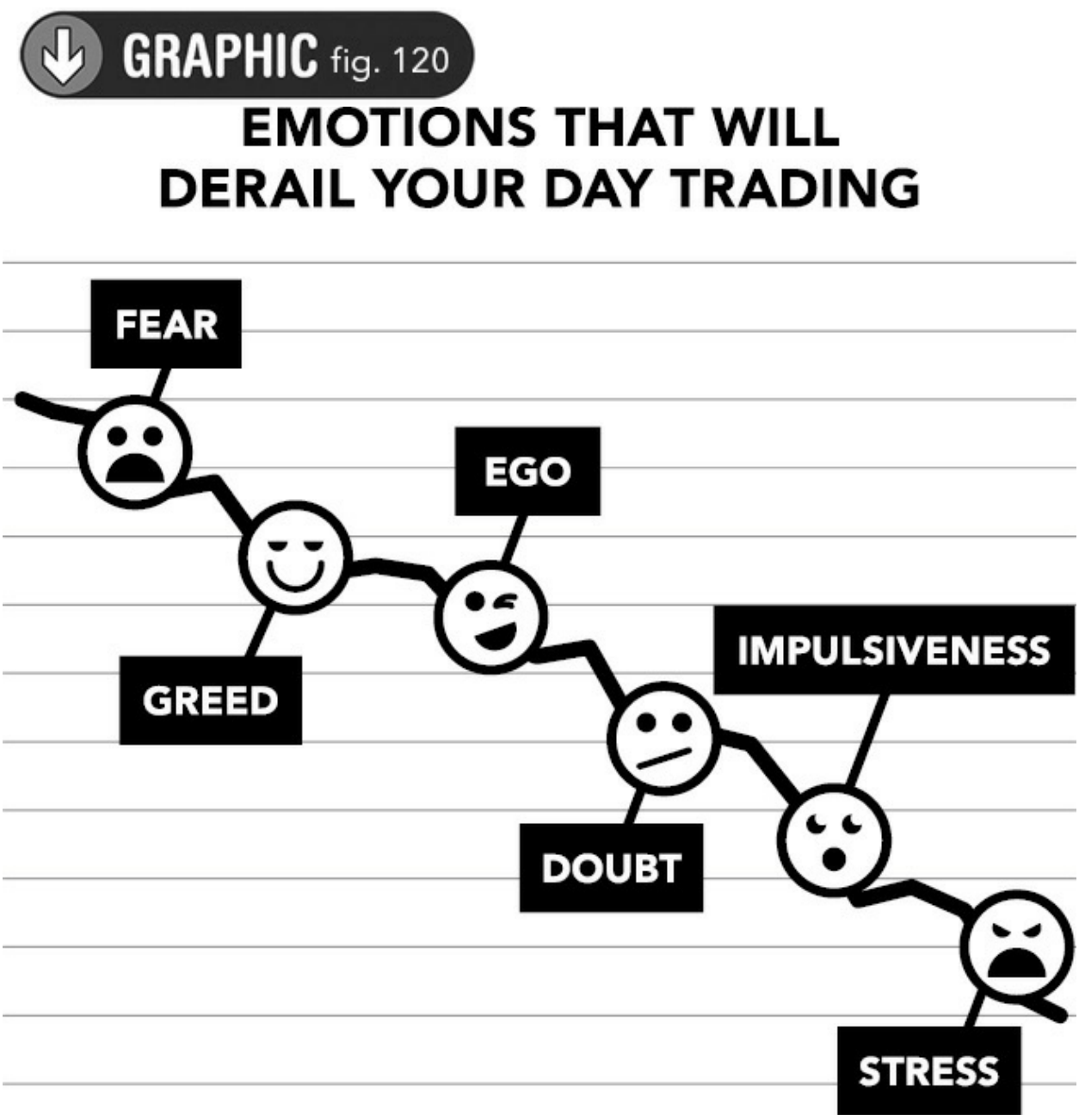
Trading, with its ebb and flow of profits and losses, can elicit powerful emotions. When things are going well, traders can get overconfident and begin placing larger trades, only to give back their earlier hard-earned gains. On the other hand, when things turn sour and a trader suffers a string of losses, depression can set in and they might feel like quitting altogether. They may stop trading right before the winners come pouring in. They will flirt with breaking from their tradeplan. Then, they'll see great trade opportunities that they missed, that their plan would have capitalized on, so they'll jump right back in. At that point they're out of sync and vulnerable to finding themselves right back at the end of the two steps forward, just in time to catch the one step back yet again. They will be emotionally and psychologically devastated, and recovery will be very difficult or impossible. This is the common trap that dooms most would-be traders to death and destruction.

A day trader is a being completely distinct from a human.

Unchecked emotion can cause promising day traders to regress. Those bad habits that you thought you had broken will come flaring back up. You may find yourself all too human after all, unable to operate from the higher point of view "above the forest."

I'm going to list some of the common strong emotions that plague many traders and that are prone to flare up in day trading. In part I of this book, we discussed the prevalence of some of these emotions. But now we are armed with the 12 Powers, and it is essential that we lean on these powers as we seek to keep our emotions in check or, better, eliminate them altogether, as they have *no* place in the world of successful day trading.

GRAPHIC fig. 120



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When you find yourself wrangling with one or more of the emotions or symptomatic behaviors shown in figure 120 (or with other emotions not listed) your first line of defense is the Power of Why. Why are you trading? To make money, right? How is the outcome of this particular trade, which is causing you such distress, going to accomplish your *why*? Win, lose, or draw,

the trade that has caused you to feel this way is nothing more nor less than the current trade in your proven tradeplan. Soon your tradeplan will be directing you to the next trade.

Try not to attach yourself emotionally to any one trade, winner or loser. Keep your emotions at bay by simplifying the mission at hand: you are here to execute on a proven tradeplan. You are here to make money. That's it. Learning to just lean on your system is one of the most important skills you can develop as a day trader. If nothing else, it gives you something other than yourself to blame when you experience setbacks.

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Pay attention to your emotions, because they will reveal to you exactly where you are along the pathway to becoming a trader. They will show you what you need to work on next.

- » If you are fearful, what are you afraid of? Losing? Or are you really afraid of winning and success? It is natural to be afraid of dramatic change, and discovering that you have the power to live the life of your dreams can indeed be unsettling, ironically enough. The solution is to ground your emotions deep in the task at hand and to lean on the Power of Why. You are not here to worry about the future. You are here to make money.
- » If you find yourself getting too greedy, take a moment to remind yourself what it is you are trying to accomplish through trading. Are you doing this to make money, or are you doing it to feel exhilarated by big wins? Again, the Power of Why comes to the rescue. If you are trading for the purpose of making money, then stop chasing jackpots and stick to your tradeplan. The great irony is that by doing so, with the Power of Compounding, you will begin hitting huge

jackpots with regularity.

» If you are stressing out, take a deep breath and think about why. Are you at a point where each trade you take feels highly stressful? Are you going to end up screaming or punching a hole in the wall if you lose one more time? If this is your mental state, then you are probably overtrading and risking more than you should. Take a break and think hard about why you are trading and what it takes to accomplish your core objective. Are your expectations realistic, or are you trying to do too much, too fast? People who stress out or are fearful of the outcome of any trade are those who tend to put their personal needs in front of the needs of their trading. Their natural human tendencies are getting in the way of their success as a day trader. On the other hand, if your reason for trading is to make money, then you must find a way to put the needs of your trading in front of your personal needs. If you commit to the needs of your trading, then at some point you will find that your trading results allow you to easily take care of your personal needs. It never works the other way around.

» If you have doubts, then you have not put enough time and effort into your preproduction work. You will need to return to this 10-step action plan and figure out where you missed a beat.

» If you are too impulsive, then you do not know or believe in your reason for trading. Many impulsive traders are more eager to prove their intelligence than to make money. Is this you?

Emotions are very powerful, and they will usually control the things you do. You may already know what you should be doing. The question is, are you doing it? Pay attention to your actions, because they typically reflect your emotions. Of all the many indicators we've learned about in this book—and the countless other indicators also available to you—it is the trader's actions that are the most illuminating. Pay attention to your actions and you will know what you need to work on in order to become successful.

It can be difficult to control emotions when trading real money. After all, most of us work hard to make a living and it takes time to build savings. It is a nice feeling to have a series of winning trades. Losing streaks can depress us, as we lose sleep and fail to meet our financial goals. We often feel that losing trades are a result of our own inadequacies. We allow losing trades to directly impact our self-esteem. As with many of the emotional interferences we have discussed, the solution can be found in the Power of Why. We do not trade to gratify our ego or to improve our self-esteem.

To simplify this critical third step in our guide and third leg of the trading stool, let's break down our defense against destructive emotions into three broad planks:

» **Plank 1: Separate your tradeplan from individual trades**. You need to see these two entities as completely distinct from one another, and you should work to obliterate all emotions associated especially with the latter, individual trades. Each trade should be thought of as a specific business transaction and your overall tradeplan as your business.

» **Plank 2: Trade money you can afford to lose**. If you need money for paying bills or sending your kids to college, then keep that money out of your trading account. If you feel a high level of anxiety when trading, one likely explanation is that you are trading beyond your

means. As a best practice, use risk levels that are small compared to your available trade capital.

» **Plank 3: Pay attention to your emotions**. How do you feel when you are in a trade? Ideally, you don't want to feel anything at all. Know the common destructive emotions and symptomatic behaviors that we have discussed and what you must do to avoid them.

Understand yourself and how your emotions or biases can interfere with successful trading. Commit to a process to trade objectively. It's not easy, but if you remember that your day trading is a business, then you will begin to see results in dollars and cents, rather than as a reflection of your personality or your emotional responses. There is no place for emotion in business, especially in the business of day trading, except to show us what we need to work on in order to get rid of said emotions. How's that for irony?

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The why of trading must be established, committed to, owned, and reflected upon. Every action a person takes regarding day trading should lead back directly and swiftly to the goal of making money. You must judge yourself honestly by your own actions and decide if those actions are consistent with the goal. If you are losing at trading, most likely your actions are not congruent with what you think your "why" is, and that in turn points to what you need to work on to rectify the problem.

I am not exaggerating when I say this is the most important step in this book. Failure to establish the why is the root of all evils. Everything else in this book is useless until you commit to the real reason for trading.

It is not what you say, think, or feel that matters. It is your actions that matter. So, from this point forward, pay attention to your actions and watch to see if they really reflect whether you have accepted and taken full

ownership of the true reason for trading. Do not trade with real money until you are fully committed to this vital concept. Moreover, I would strongly encourage you to hold off on trading with real money until you have completed all of the steps here in part IV and have earned your "rites of passage" as described in the following two chapters.

Lwp t atrp

- Long-term success as a day trader is all about the things you do, not what you think, say, or feel, because actions speak louder than words.
- The three pillars that form the three-legged stool and represent the first three steps in the 10-step action plan are methodology, money management, and psychology.
- Negative emotions can affect trading, and the first step in overcoming these tendencies is to be aware that they exist and figure out what is causing them.

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Lwp t X t xt

- » Preproduction work
- » Proof of concept
- » The tradeplan
- » Practice trading
- » Rites of passage

If an aspiring day trader does not, or cannot, do the necessary work to prove that the trade method will achieve its goals, then that person is doomed. When the inevitable losing streaks of the random distribution of wins and losses begin to surface, they will run for the hills, perhaps discarding a perfectly effective trading approach. They ventured into the trading world, hoping to win, doing everything possible to avoid the pain of losses, only to end up becoming extinct as a trader. It doesn't have to be that way.

Try to accept the fact that the edge (the statistical advantage) provided by the tradeplan is how the money is made over time. You must learn to believe in the tradeplan and the methodology that has demonstrated proven positive results. Without steadfast conviction, you will end up just taking leaps of faith, thinking that a method will work, but not truly believing in it one hundred percent. That is the common recipe for disaster that most would-be

traders suffer from. But you don't have to.

That's why the serious trader is better off learning a good strategy and committing to the necessary preproduction work to gain that all-important proof of concept and belief in the strategy; this is the Power of Foundation in action. A teacher or coach can show you a strategy, but they cannot build your foundation for you. You must prove it to yourself. When traders work out their own proof of concept on their own terms, they are less likely to cut and run when things get tough. In other words, they will not throw out the baby (the proven trading plan) with the bathwater when the system goes through the natural ebbs and flows of equity growth.

This chapter is about the critical steps of preproduction work. We will begin with step 5, where we acquire the all-important "proof of concept." We do this by utilizing smart step-by-step backtesting and forward testing techniques and proving that we can execute our plan over and over again without making mistakes. In step 6, we will lay out our full tradeplan that has been proven with positive measurable results. We will draw up specific rules that can actually be inserted into other tradeplans that we can use to diversify our trading. In step 7 we will subject our tradeplan to the rigors of the market in a simulated environment. We will log our results and, as we enter the real-money trading arena, we will perfect not only the belief we will need, but also our actual executions of live trades.

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Nobody can spoon-feed you a tradeplan, not even me. That is, I could, but it wouldn't end up helping you, because you would not truly believe in it. You would have no Power of Foundation. I would be doing you a great disservice by robbing you of the opportunity to make your own discoveries and thus create your own foundation of belief. And you should not take my word for

it, nor anyone else's, that a tradeplan or method is successful. It is something you need to prove to yourself. I am going to introduce you to some powerful tools that I use for establishing proof of concept.

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While backtesting is critical, it is very time-consuming. Even if you have all day to spend on your trading, you could easily fill up every available hour with testing. You don't want to do that. What you want to do is intelligently screen your ideas and test only those that have a good chance of being successful.

I use a specific technique that allows me to zero in quickly on viable tradeplans. Before I developed this easy preliminary test, I would spend countless hours backtesting something only to learn that it was not something I wanted to trade.

I've given this technique many names over the years, but in the end I settled on the 3-Step Sniff Test, because that is exactly what it is, metaphorically speaking. The idea is that if it looks like a duck, walks like a duck, quacks like a duck, and smells like a duck, then it probably isn't a skunk. It's a duck! The 3-Step Sniff Test is a process by which we can economize our time and only commit to backtesting after we have identified a plan with high success potential. From there we can invest our valuable time more productively when we drill down deeper using our Ultimate Trade Analyzer spreadsheet.

You can see the 3-Step Sniff Test in action by accessing my course materials and other downloadable digital assets, such as the UTA spreadsheet, at **www.clydebankmedia.com/trading-assets**.

Sniff Test 1: Does your proposed tradeplan signal enough trades in your session? This is easy to answer by looking at a chart and seeing if there are enough trades to make the tradeplan worth it, or even feasible. I usually begin by looking at the current day's session. Then I look at the previous day's. I'll then glance at the last 10 to 15 sessions to quickly see how many trades would have been available if I had followed the rules of my prospective tradeplan. Admittedly, this analysis is a bit subjective. "Enough trades" could mean just one reliable trade, or it could mean several.

I like to see three to five trades on average, as a general number, but it's not set in stone. My crude oil mini session tradeplans typically produce one to three tradeable opportunities per one hour of time, which is the length of my mini session. The plan wins so often that, for me, one to three is a sufficient number of trades. Occasionally, there are no trades at all, but that's rare. Were I trying to establish a supplemental tradeplan that I planned on trading in conjunction with my main plan, then perhaps one good dependable trade per session could be considered sufficient. So, in that regard, the required number of tradeable opportunities observed can be subjective, but you can determine an objective answer if you clearly define your purpose for the tradeplan.

On the other end of the spectrum, what if your strategy is triggering too many trades? Is the chart too noisy? Trades that are too fast or too plentiful not only result in excessive commissions and slippage, but they often don't have sufficient profit objectives relative to the risk one has to place on the trade to begin with—which leads me to the second sniff test.

Sniff Test 2: Are the trades of an appropriate size? Determine the average risk per trade by computing the dollar amount of each trade in terms of risk

from entry to stop. If the number is too large, the plan will involve taking too much risk per trade as a ratio to your available capital. If the risk levels are too small, then you are probably looking at a chart with insufficient price range or profit potential to make it worth your time and effort.

Moreover, the prevalence of smaller risk levels likely coincides with a chart that is too "noisy," with too high a frequency of potential trade setups. What you want is a slower, smoother chart, with appropriately sized trade setups. Trading charts of this nature will serve you better in the end. Commission and slippage as a percentage of your overall profit objective must be kept in check. It's one thing when your average trade cost is 3% to 5% of your average profit. It's an entirely different case if your average trade cost is 20% to 30% of your profits. That's like trying to win a footrace with a ball and chain clamped to your ankle.

Sniff Test 3: The fast-test: Can you quit your trading session with a positive outcome most of the time? I'll take that question even further by asking: can you quit with a positive outcome a vast majority of the time, while controlling your drawdown with minimal and efficient trading? While the first two sniff tests take a matter of minutes to figure out, a good fast-test could take a few hours. But it is time well spent, and you will learn a tremendous amount of invaluable information you could never have learned except through a much longer, more time-consuming manual backtest.

This is the most important part of the 3-Step Sniff Test. Because our goal is to quit with a positive result most of the time, ***fast-testing*** will determine whether our tradeplan has the potential to win. If it smells like a duck, it most likely is one. I tell my students to apply this test to about a dozen possible tradeplans and let the cream rise to the top. Choose the one or two plans that produce the best session win rates. Let it prove itself before

dedicating your valuable time and effort to your more intensive manual backtest and Ultimate Trade Analyzer spreadsheet work. You can thank me later, but—you're welcome!

Q: What do we fast-test?

Answer: You can fast-test anything. The objective is to build something where the cream rises to the top and minimizes drawdown. A lot depends on asking the right questions, beginning with *What do we test? What do we trade? When do we trade? What charts are we using?*

Suppose you can only trade a few hours in the morning. Then you will fast-test the time frames that fit with your trading hours. Your trading hours will also help determine what markets to trade, what charts to watch, and stop times. In short, fast-testing is a very detailed process in which you consider a list of specific parameters in order to address key questions:

- What market should I trade (CL, RTY, YM, GBP/AUD, etc.)?
- What chart settings (12-tick momentum bar, 377-tick chart, five-minute chart, etc.) should I use?
- When do I start?
- When do I stop?
- What are my specific tradeplan goals?
- What is the maximum number of trades that I am allowing?

» What is the maximum number of losses?
» Any other nuances: key level adjustments, setups, indicators, "getting in sync"

Figure 121 is an example of what a fast-test looks like if we fill in the blanks with the previous checklist:

Fast-Testing	Example	Notes
Contract symbol	CL	December-Z20
Chart type	8-tick momentum bar	
Start time	10:00 am	EIA report is Wednesday
Stop time	10:59 am	2 ticks above the setup bar
Entry rules	xyz' strategy	2 ticks below the setup bar
Exit rules	xyz' strategy	Begin trailing the 'special line' when the price gets 90% to target
Trade management rules	xyz' strategy	
Min # of trades (per session)	3	
Max # of losses (per session)	2	
Session goals	Target 2 winner	Or two break-even trades
Session win/BE rate	75% – 80% or better	

"Getting in sync" is the term I use to refer to whether you are going to participate in trades that have formed and triggered in prior to the tradeplan's start time. Some traders prefer to let these trades pass rather than taking them–I call this "not getting in sync." There really is no set-in-stone way of knowing whether you should get in sync or not, until you test one or both approaches. You may test one way and like the results enough to not feel the need to check the other way.

The contract is CL, which you already know is for crude oil futures. The chart type is an 8-tick momentum bar. Start and stop times are 10:00 a.m. and 10:59 a.m., respectively. Note that I have outlined the details of the strategy including entry/exit rules, maximum number of trades, and maximum losses. My session goals are to either reach one trade that hits Target 2 or achieve two break-even trades, or two losses, or three trades total, whichever happens first. Once the goal is reached, I stop trading. Finally, I should be winning 75% to 80% of my sessions, which falls into my rule of a 70% to 80% winning rate, 2% to 5% break-evens, and the rest losing sessions. Tracking of your fast-test results should be simple and exact. I prefer a second-grade style "chicken scratch" counting of session wins and losses: four vertical tally marks and a diagonal marking the fifth. Such a rudimentary approach allows me to notate and check my results fast—hence the term, "fast-testing."

I suggest going through 100 or more trading sessions, counting winning, losing, and break-even sessions per your tradeplan rules. Your goal is to see results in the mid-70% range (of winning sessions) or better. Some of my past fast-tests had positive results more than 80% of the time. That's what you're

shooting for. A solid trading business should have session win rates of 70% to 80% and break-evens of 2% to 5%, and the remainder will be losing sessions. Numbers like that showing up in your fast-test warrant a full-blown backtest to fully flesh out your tradeplan rules and results.

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A ***backtest*** is a way to look at past price action and see if a methodology works with past data. Once you find something that wins on a large enough sample set of past data (while also hitting all the key metrics that prove the plan will make money), then you can begin forward testing it to prove that it continues to work the same way, as the name implies, going forward. I like to group backtesting techniques into three types: manual, automated, and hybrid.

Manual backtesting: Success at day trading passes through this step. I think of manual backtesting as the "ditch digging" method of backtesting, because, though essential, it is quite time-consuming. We look bar by bar on an intraday chart and, using the same set of rules we used for our fast test, we test the viability of our tradeplan. Obviously, this method takes time and can seem tedious at first. However, many traders I mentor end up using this as their "alone" time, where for them it becomes a cathartic, meditative experience, especially when they learn the wealth of information that their efforts reveal to them. This is where the "light bulb" moments occur, as they learn to live with the good, the bad, the ugly, and the great, over and over again, yet still witness the equity curve growing and growing, despite the ugly, when they discover a workable tradeplan. This is where they learn what it means to make money as a trader.

This is my preferred method of backtesting, in most cases. I go back far enough to backtest at least 100 trades. Even better is to look at 100 sessions or more that have cleared my fast-test hurdles, because our goal is to establish

tradeplans that allow us to quit with a positive result a vast majority of the time, while controlling our drawdowns with minimal and efficient trading.

The Power of Quitting tells us to stop trading after a specific daily goal has been met.

The best charting platforms provide enough back data for you to go back several months with tick and range bar charts (these are the types I prefer). For time-based charts, like a five-minute chart for example, you can usually look back even further. If you find your charting platform does not provide the data you need, then it's time to gift yourself a better service, because *this* is the work that will determine whether or not you succeed. You must have the data. Get a good charting platform, and never let the wrong tools be the thing that holds you back from succeeding at trading! This is not the time to be penny-wise and pound-foolish! I can't tell you how many times traders have told me they want to stick with their charting because it is free, even though it doesn't provide them the data they need to conduct adequate backtests. They are so wrong! It is *not* free! It is preventing them from succeeding as a trader, and that is an immeasurable cost.

Six months of past data is perfect for crude oil futures (CL), for example. Considering there are 20 trading sessions in a typical month, six months of past CL data would give me 120 sessions, which in my judgment is enough to run a proper backtest. I have found that statistics in a backtest begin to stabilize and become more valid at around 100 to 120 samples. Then you can

add to it going forward and continue to build your tradelog.

It's June, and I want to backtest the last six months of CL. I will go back and begin my testing with the December contract, which, for our purposes, is traded from approximately October 18 through November 17. In TradeStation, that contract is CLZ19 (December 2019 contract). The letter Z that comes after the symbol represents the month the contract expires, and the last two digits represent the year. For a complete list of contract symbols, please refer to appendix I.

When backtesting, it may be tempting to use a "continuous chart." This is a chart that continues from one contract to the next. Don't do it! Continuous charts back-adjust prices as time marches forward, to smooth out the gaps that occur between the actual contracts. The prices in the past continue to adjust and change over time. I learned this lesson the hard way after spending countless hours meticulously backtesting a tradeplan using a continuous chart. Later, when I went back to review my work, none of the trades I had entered into my spreadsheet corresponded with how the charts looked. Where were my trades? The price levels had changed. At first I thought I had lost my mind; I was nearly ready to commit myself to the funny farm! One of my colleagues pointed out how my use of continuous charts had skewed my data. While I was happy to learn I was not crazy, I was rather peeved at myself for the amount of time and effort I had wasted to learn such a simple lesson. Always use the actual tradeable chart when backtesting.

If you want to reap the incredible benefits of backtesting, then you must

record honest, real tradeplan decisions. If your testing is lazy, haphazard, and unreliable, then so will be your eventual tradeplan. Proper backtesting requires that you use clearly defined, objective tradeplan rules that you can rely on for every trade you test.

Let me walk you through some of the finer points of my personal approach to backtesting. I begin on day one. If I'm testing the last 12 months' worth of data, then I go back to the session that took place approximately 12 months before. I set my charts up so that at the far right of the chart is the moment just before my intended start time of the plan. I try not to cheat and look forward to see what has happened. I want to click through bar after bar and try to assimilate what would happen in actual trading. In real trading, we don't know what will happen next, yet this is exactly where we need to make our real trading decisions. This is one of the many benefits of this approach to backtesting. It trains your brain to make decisions at the right edge of the chart, where real trading actually takes place, following the rules of your tradeplan. There is no substitute for the benefits obtained through this exercise. I consider it a "do or die" step to becoming a successful trader.

Unless you have the extraordinary and downright rabid memory of my wife (who never fails to remind me to take the trash out), you are going to want to track and log your testing data. When I am going through old charts, clicking bar by bar and looking for my trade setup, the first thing I do when I see my setup is to pause and type the relevant information into my preprogrammed spreadsheet (the Ultimate Trade Analyzer). Usually I'm tracking things like time of day, entry price, exit price, and perhaps some specific labels that help me later when I look back to analyze my work. The UTA lets you then slice and dice your data and discover mission-critical information about your tradeplan, such as total profit, average net profit, the all-important equity curve, and many more high-value pieces of information.

Spreadsheets are great for backtesting, tracking trades, and creating the all-important win/loss column. I have created a customizable spreadsheet template called the Ultimate Trade Analyzer (UTA), which helps in the ditch-digging process of manual backtesting, and you can download it for free along with several other digital assets when you visit **www.clydebankmedia.com/trading-assets**.

When you learn about the UTA and what it can do for your trading, it will be an eye-popping epiphany experience and the single most important thing you can do to become a successful trader.

One of the most insightful results of your backtesting is your win/loss column. When you have your trades (and their results) logged in a spreadsheet, then you will truly comprehend what it means when we talk about a random distribution of wins and losses. Even though the trades are taking place in retrospect, you will still experience them one by one as you test them and enter the results.

When you are entering a series of losing trades (experiencing some "ugly") you will be tempted to try to "fix" the losing trades. You will have the urge to go back and tweak your tradeplan to avoid losing. "Maybe if I do this, or perhaps if I do that," etc. Don't do it! Keep notes on your revisionist insights —you can review them later—but force yourself to forge forward. All

winning tradeplans will experience losing trades. When you try to fix losing trades you end up breaking something else, and new losers will appear that would have been winners.

Automated backtesting: Remember our hopeless grunt, stuck on the forest floor. A common reason for a trader finding himself in this precarious and distressing position is that he skipped manual backtesting in favor of an overreliance on automated backtesting. If you do not *live through* the good, the bad, the ugly, and the great—an experience that can only be accomplished through manual backtesting—then you will never have enough belief in your system, and as soon as a few trees fall, you will be crushed.

While manual backtesting is critically important, there are some virtues to automated backtesting. Automation lets you define a certain set of rules whereby the charting platform will produce a report that tells you what would have happened. It is never going to give you the mission-critical benefits of manual backtesting. But it will give you something else.

Automated backtesting will allow you to test a group of different parameters to help you zero in on the best settings for your indicators, or the best entry levels or target levels. You can test for the best start times and the best "Power of Quitting" rules. There is actually a whole lot that automated backtesting can do for you when you know what to use it for.

It would take an eternity to test certain aspects of your tradeplan were you to manually go through 100 sessions with 20 different possible inputs. For example, how do you know a 50-bar moving average is better than a 64-bar moving average?

A good automated package will let you run optimization tests and then give you results where you can see what each possible input would produce. When done right, this type of analysis can produce very powerful and useful

information. When done wrong, it can lead to losses, mainly related to curve fitting. When someone is optimizing inputs to their indicators with automation, the tendency is to create a tradeplan that "curve fits" the inputs to fit all the past winning trades. The problem is that the markets are not going to repeat what happened in the immediate past. Markets change and evolve as they move forward. Overreliance on automated backtesting will potentially lead to disaster, because the tradeplan looks at what already happened and fits itself to win every trade but is ill-equipped to self-adjust and dynamically tune itself to the ever-changing market conditions going forward.

Hybrid backtesting: The hybrid approach combines both automated and manual backtesting. Usually, when an advanced trader discovers an excellent group of indicators, settings (inputs), and tradeplan rules with an automated backtest, he or she is tempted to begin trading it right away. The problem is that by jumping the gun, the trader misses out on the critically important benefits of manual backtesting.

Whenever I manually review the trades in an automated backtest, I discover occasional oddities. The automation fails to recognize certain things that the human brain is better equipped to deal with. A trade didn't trigger in for one reason or another. Although automation is great for certain things, it can't think for itself. How does it know to adjust an entry a couple of ticks beyond a major resistance level, for example? Another common thing that can happen, especially with time-based charts, is that a bar can touch the entry and the stop before the bar closes. In other words, intra-bar, it touches both. The automation has no way of knowing which it touched first. This alone will yield inaccurate results.

The hybrid approach combines the best of both automated and manual

methods. You can get some big-picture, generalized optimal settings and inputs for a particular chart. Then use your brain and eyeballs to manually test to make sure it does what it is intended to do, while you obtain the mission-critical belief and proof of concept necessary for success as a trader. You get to live through the good, the bad, the ugly and the great, while watching the equity curve go up, despite the ugly, trade after trade. You can't get this with automated testing alone. But with a hybrid approach, you can still benefit from the good things automation gives you.

Forward Testing: When you have accomplished a great backtest and are satisfied with the results, it is time to forward test. This consists of continuing to track trade results going forward. Eventually, you will begin trading your tradeplan in a real-time simulated environment (without real money at stake) and when you do, you will continue tracking your results. This forward testing is an important step in proving that your tradeplan will produce the types of results that you have been working toward with your backtesting.

From this point forward, all my references to backtesting deal with the manual backtesting variety.

The manual backtest teaches lessons that are critical to success as a day trader. First, the process forces you to think through your strategy and your tradeplan rules, click by click. This provides your brain with repetition (muscle memory) which it needs in order to have belief and confidence in the plan. Second, you will notice things while backtesting that might warrant

making changes to the trading rules, perhaps a tweak here or there. Be careful—only make nuanced changes when you can prove they really will improve your results.

Remember to resist the temptation to try to fix losing trades. Losses are okay and expected. It is the big-picture result that will ultimately allow you to accomplish your reason for trading. In other words, don't kill the goose that is already laying golden eggs. Finally, and most important, do not neglect to build your win/loss column as you live through the good, bad, ugly, and great experiences; you should see your equity curve growing, despite the bad and the ugly.

I once heard a trading coach say during a webinar that she wouldn't even consider trading a market or strategy without first backtesting at least 600 trades. At the time, I thought that was a bit excessive, and I thought, no way! But it left a big impression on me, even though I resisted the idea at the time. In fact, I refused to backtest back then. I didn't see the point of it. What a huge mistake! It wasn't until I finally did embark upon backtesting that I began to experience the "aha" light-bulb moments, and everything turned around for me. It was a profound, life-changing time.

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Despite what some people claim, no one knows where the market is going—today, tomorrow, or the rest of the year. Therefore, every trade that is opened involves risk and uncertainty, because there is no way to predict the future with one hundred percent accuracy. We can, however, predict some highly probable outcomes. That's where the whole idea that the immediate past can

predict the immediate future comes from, which is a concept we heavily rely on for trading. Successful trading is about stacking the odds in your favor on every single trade, using proper money management, and training yourself internally to remove your emotional responses from the outcome of any trade. The first step in being able to do that is acknowledging that we cannot win one hundred percent of the time. Nor do we need to. The Power of Numbers teaches us that if the odds are on our side, and we put on appropriate risk levels and execute the trades properly, then the superior odds will do the work for us by lifting our account value higher and higher. We become "the house" with "house odds" on our side, as opposed to being the gambler, on whom the house preys. And the only way to determine that the trade has superior odds is through the careful creation of a tested tradeplan.

While it can't tell us what is going to happen with one hundred percent certainty (nothing can), a great tradeplan can behave somewhat like a crystal ball by telling us what is most likely to happen from the standpoint of probability. We can use backtesting to prove a plan's statistical advantage. And we know that the plan, like the casino, puts the numbers in our favor over the long term.

That's what step 6 of the step-by-step action plan is all about. It presents the ins and outs of building a tradeplan and how to develop a winning approach that you will believe in.

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Each trading strategy should be fast-tested, backtested, forward tested, put into writing, and thoroughly practiced, before being used in a live market environment. There are no laws that require this, but it is my suggestion to you, because I want you to avoid the mistakes made by many failed traders. Day trading involves overcoming losses and obstacles and staying the course with a winning strategy, even during difficult times.

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Trading strategies can range from simple to complex. If you talk to an options trader, they might tell you about butterflies, condors, and other options plays that have interesting names but are usually not ideal for day trading. A simple option strategy would be to merely make a directional trade; to buy a call if you expect prices to go up or buy a put if you think the price is going down. I prefer simple plays like those, or going long on crude oil futures or short on GBP/AUD, depending on the rules of my tradeplan.

There are no right or wrong strategies as long as they can be backtested for positive results and have rules that are easy to follow, so that you can execute the trades without mistakes. You must know when to enter and when to exit a position based on clear guidelines. What are the stop-loss and target levels? How many trades should you place and what position size is correct? What are your daily goals? I recommend creating a checklist for each of your strategies and including all the important items:

- Goals (session and/or daily goals); Power of Quitting
- Entry and exit rules
- Trade management rules—how to manage the trade from start to finish
- Maximum number of trades
- Expected profit goals based on backtest results
- Trading start time(s)
- Trading stop time(s)
- Other factors, such as adjustment rules when working around key levels or chart levels, pausing trading (or not) for economic news releases, etc.

Remember our checklist for fast-testing? A similar one, like in figure 122, can be created for backtesting. Both are available in a downloadable spreadsheet that you can access by visiting **www.clydebankmedia.com/trading-assets**.

Backtesting	Example	Notes
Did you run a fast-test?		
Contract symbol		
Chart type		
Start time		
Stop time		
Entry rules		
Exit rules		
Trade management rules		
Min # of trades (per session)		
Max # of losses (per session)		
Power of Quitting goals		
Average net profit per trade		
Average net profit per session		
Average net profit per week		

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Trading is not a game of perfect, and we sometimes need to adjust an existing strategy along the way. For example, the start and stop times might need to be tweaked if a different window of time can be proven to be more effective. Beginning 10 minutes earlier or 30 minutes later, for example, could have a dramatic effect on tradeplan performance. The good news is that now you know how to quickly fast-test alternatives that vary from the tradeplan's primary theme.

You should account for the inevitability that you will make mistakes and experience losses in your trading plan. What if you make three trading mistakes in a row? Are you tired? Not focused? At what point do you take a break and return to the market later? These are all things to consider when creating and writing your tradeplan. Remember, there is no substitute for time and experience other than time and experience. You must realize that you will be much better at trading your tradeplan six months from now, and even better than that a year from now. Most traders don't plan for that, but you would be better served if you did.

And what if you suffer a steep drawdown in your equity? Does your tradeplan have rules that determine when you continue following the approach and when you do another round of backtesting? Do you know why it worked in a backtest but not in live trading? Bouncing back from steep drawdowns is perhaps the most difficult part of day trading. It takes courage, perseverance, and an eye on the big picture. If you backtested correctly, though, you can look back on your Ultimate Trade Analyzer spreadsheet results and study the worst losing sessions or losing streaks. By doing this, you have a good chance of identifying something that the losses had in common, and then you'll be in a position to make smart decisive changes to improve your plan.

I believe that if you go through the process correctly, you will discover in your forward testing and simulation practice trading (step 7) any unforeseen problems that could derail your tradeplan. Also, one of the many great benefits of manually backtesting using the UTA spreadsheet is that you can study your win/loss column and other valuable data pertaining to your plan. I have found that when I focus on the markets with the best volume and participation levels and when I have tested my tradeplan properly and thoroughly, the plan tends to stand the test of time. I have created many tradeplans with a variety of different strategies that, to this day, continue to work just as they did when I first created them. The power of dynamic trade setups plays a big role in their success.

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When I take a trade, my goal is for the trade to make a profit, and the trade is completely planned from start to finish. When the trade presents itself on the chart based on my setup parameters, I know what my entry price, my stop-loss, and the amount at risk will be. I also know my target objectives, which are part of my exit strategy. And once I am in a trade, it does not end there. I have a series of follow-up actions that are essential for each trade:

» **Moving the stop-loss to break-even**: It is a nice feeling to open a new position and immediately see things turn in your favor. If it happens suddenly and a lot sooner than expected, you might simply take the profit, if your target has been hit per your tradeplan rules. Alternatively, you can adjust the stop-loss after the initial move. Some traders, including me, like to adjust the stop to the break-even point and turn the position into a risk-free trade. That is, if the market reverses direction and triggers the stop, the position is exited at break-even—for no gain or loss.

» **Moving the stop-loss to protect profits**: Trailing stops are great tools for managing positions when the market is heading in the right direction. Recall from chapter 9 (Trade Execution) that a trailing stop is an order type that follows price. For example, if you're holding a long position in crude oil futures, a trailing stop might be placed 10 cents below the most recent price—as the price moves a dime higher, the stop adjusts automatically. Many brokers offer automated trailing stops, and they are excellent for protecting profits as prices move in one direction or the other. I typically follow my own custom trailing stop strategies.

» **When and how to take profits**: Anyone can get into a trade. The more difficult part is knowing when and how to exit a trade. When do you take profits, when do you let a profit run, and when do you cut your losses? Learning how to keep your gains can be one of the toughest lessons. There is nothing worse than having a successful trading session, only to keep trading beyond your tradeplan rules, which then results in your giving all your profits back to the market. Many traders exacerbate the problem by continuing to trade, taking on more losses, going from bad to worse. The consequences of straying from a proven tradeplan can be dire.

Fortunately, there are ways for us to take profits using our existing plan, per the rules, while also trading more. Namely, if you want to trade more, add another proven tradeplan (see the Diversification of Tradeplans section later in this chapter). But diversification only works if you are committed to your reason for trading. In other words, do not start another tradeplan while your current plan is live unless you have proven another plan will make more money, and that you can execute it properly without mistakes. Trading more than one plan at the same time can get you into trouble when both are firing

off trades or critical trade maneuvers at the same time, during a fast market. Two great tradeplans won't do you any good if you can't trade them properly. But if you can, you gain the added benefit of diversification.

Remember the Power of Quitting? When developing a tradeplan, set a profit objective, specific and strict time limits, and/or a maximum number of trades per market, each day. As I have stated, I typically want to reach one of my targets, usually Target 2 (but not always), and I want to have a positive result. Once these conditions have been met, my Power of Quitting rules kick in, empowering me to stop trading that plan and to enjoy an increase in equity in my trading account.

Do not overtrade your plan. If you are eager to make more money, then you need to use the Power of Compounding—increase your position size as you grow your account. You will begin to earn more with the exact same trades. Be patient and give your trading business the chance to get to that point. Overtrading or trading with too much risk will destroy your trading account even with the winningest tradeplan. Set up your overall business goals and milestones. When you reach them, it will trigger the next progression in your business, whether it's paying yourself, increasing your position size, or even adding another proven tradeplan. You are the CEO and you should think about methodically building your trading business into what you want it to be.

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If your strategy is thoroughly tested and you are well versed in the 12 Powers, then the likelihood of your tradeplan failing is much reduced. But, as I have said before, nothing is perfect or ever guaranteed. Trading is risky. The best way to guard against a tradeplan falling apart is to diversify and trade a few different plans, each one with its own market cadence or rhythm in the way it

grows equity. Diversifying can smooth out your equity curve and help you survive if a particular plan begins to fail.

A good example of this occurred well over 12 years ago in my trade room. We used to trade 10-year T-bill futures with a particular strategy that brought us great success. That market had enormous participation and great patterns to trade. But as the United States became more deeply immersed in a historically low interest rate environment, that particular market lost its attractive trading range and ended up becoming untradeable, at least for our day trading purposes. Those who also traded an E-mini like the YM (Dow futures) in addition to our core market, the T-bill futures, were able to diversify, adapt, and survive the changing times. Diversification has its virtues, so long as you can effectively and consistently execute your proven tradeplans without mistake.

Diversification involves running multiple tradeplans in different markets. For example, if your tradeplan using the Russell E-mini has been producing successful results in a live trading environment, you might start backtesting a similar or even entirely different approach on crude oil futures, soybean futures, or a currency pair that does not typically move in tandem with stocks.

Diversification of tradeplans requires multiple, simultaneous, successful executions, which can be quite challenging; it is a balancing act. When we talk about practicing our tradeplan executions (step 7) keep in mind that when you diversify it is important that you are able to execute correctly on all the plans you have in play.

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Simulated trading is practice trading in a live market but with a demo account. It has an account balance consisting of pretend money. We call this a "sim" account for short. Any trading platform that is worthwhile will offer its users access to a demo, or sim, account.

In my opinion, sim accounts are dangerous. Not because you can lose money when you trade with them, but because you will lose money when you begin trading for real, if you're not careful.

Most traders are flippant when it comes to their sim trading. They figure that since it is not real money, they don't really care what happens. Remember what I said earlier. Practice the way you intend to play. It is far too easy to develop terrible trading habits that will be impossible to break if you are not careful. Think of it as a flight simulator. If you are constantly trying dangerous maneuvers in a flight simulator that end up crashing your plane, your instructor will be very hesitant to let you fly a real one!

The sim account serves two valuable purposes, and if you venture beyond those two purposes, you will most likely do yourself more harm than good. The first important purpose is to practice placing trades.

It doesn't matter whether the trade wins or loses. You want to learn how to correctly place trades, so you practice over and over again. Practice using bracket orders. Practice placing stop-limit orders and stop market orders. Practice placing stop and reversal orders when already in a position. Practice canceling stop and reversal orders without messing up your original trade and then placing another one. Do this until you don't need to think about it anymore. It should be like a reflex. The last thing you want is to struggle with placing and managing live trades. There's no reason for that if you have used your sim account for this critical purpose. A trader I mentored spent an entire

week practicing how to place his various trade maneuvers before moving forward. By the time he finished, he could place any type of trade without mistake just by reflex and without thinking. Other traders I have mentored didn't follow this advice. Who do you think has a better chance of succeeding?

If you are trading multiple tradeplans, for the sake of diversification, for example, then practice everything mentioned previously to be sure you can properly execute all your tradeplans without error. What if you have to enter a trade in the YM and at the same time place a stop and reversal order in crude oil? That's not easy when the markets are moving fast, and it is impossible to do without costly errors if you have not practiced and mastered your order entry techniques. Nothing is worse than losing a trade when the tradeplan produced a winner. It is extremely frustrating to take a loss due solely to an execution error. Once you have experienced that in real life, you will understand how valuable a sim account can be for practicing execution. Just learning the sequence of what you have to do first, then second, then third, etc., is more challenging than you could ever imagine until you actually experience it, especially when trading multiple tradeplans at the same time. This should be thoroughly practiced in a sim account before you ever attempt such a thing with real money on the line.

The second valid and important reason to use a sim account is to put your tradeplan through a dress rehearsal and feel what it's like to actually run your business. Remember, you are the CEO of your trading business now. You have learned how to execute trades. You have a tradeplan that you believe in. Can you run your tradeplan like a business, with the discipline and skill that is required, day in and day out, without mistakes? This is when your sim account is the most valuable.

Anything beyond those two reasons is probably not a good use of a sim

account. Treat your sim account with respect and use it to hone your skills in the right way; otherwise, you will be instilling hard-to-break bad habits that will wind up being very costly.

Trading in a sim account is different from backtesting, which uses historical data to test patterns. Sim trading is based on live price action. After a successful backtest and forward test, the next step is to prove you can execute the plan as intended by following the rules and placing trades in your simulated account. This is a continuation of your forward test, if you think about it.

Many brokerage firms offer sim trading. You can access the TradeStation practice platform after you open and fund an account. NinjaTrader, TD Ameritrade's thinkorswim, Interactive Brokers, and a variety of other brokers offer some versions of simulated trading as well.

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Learning to trade in a simulated environment is like learning to drive a car: how to start, how to stop, rules of the road, and all the other things that experienced drivers take for granted. Would you want to take a ride with a driver who had never been behind the wheel? Of course not—they could crash. By the same token, you do not want to crash your trading account.

In a simulated trading environment, you can practice repeatedly without risking a dime. This builds the muscle memory you need to remain nimble in a real trading environment, and it will teach you many other things as well, such as how to do the following:

- Trade directly from the chart
- Execute trades the proper way; placing, canceling, replacing, stop and reversals, etc.

- » Set up your trading platform to your specifications for maximum efficiency
- » Master the platform
- » Create bracket orders (chapters 9 and 10)
- » Adjust stop-losses and targets
- » Use hot keys or other keyboard shortcuts
- » Practice the sequence of maneuvers when trading multiple plans that fire off at the same time

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I recommend logging 25 successful trades in a simulated environment before moving on to real trading. That might seem like a lot. It is! But you want to build a reflex; you want order executions to be like riding a bike.

Commit to taking 25 *consecutive* mistake-free trades, live, in your sim account, and that will get you ready for the next stage of trading with live money (you will move up to the junior varsity team, as we will see in the next chapter). I like to say that accomplishing this important milestone is a rite of passage to trading real money. Regardless of how long it takes to hit 25 mistake-free tradeplan trades, it is essential that you live through the experience of running your business perfectly before you introduce real risk into the equation.

A "mistake" can be anything, including execution errors, second-guessing the tradeplan, moving stops and targets outside of your plan, missing an entry, not adjusting at a key level, not paying attention to the trading screen for any reason, spilling coffee on your keyboard, or getting into a trade too soon because you were not patient enough.

If you make a mistake, you must start over (yes, even if it is on the 24th trade). This is a dress rehearsal for the live show. To be clear, a mistake is not

a losing trade, as long as the trade was correct per the tradeplan rules that you so carefully tested. A mistake is a trade within the plan that was not executed correctly for whatever reason, or a random trade outside of the plan.

The Power of Quitting again comes into play here. We are not going to keep trading in a mad rush to hit our 25 perfect trades. If you hit your goals with the first trade, you wait until the next session to make the next one. We are not only practicing 25 mistake-free trades, we are also running our business, and closing hours are closing hours. If it takes you three months to get to 25 while also adhering to the Power of Quitting rules, then that's just how long it takes. At the end of the day it's about learning how to run your business, not just trading without mistake. And no business makes money immediately. A foundation must be built. Achieving 25 perfect simulated trades (and achieving them the right way) is another component of the critical preproduction work.

Sim trading is different than live trading. Traders can feel many more emotions when real money is on the line. These emotions can be powerful, can affect decision-making, and cannot be replicated in a simulated environment. But if you pretend it is real money and treat your sim trading as if it were real, you begin to realize what it can feel like when you do go live.

The process begins with a series of perfectly executed trades and will take some time, because you will be starting over when there are errors.

» Set a goal to record 25 consecutive winning trades in a simulated environment.
» If you make a mistake, start over.
» Treat this like your start-up business and take it seriously.
» Continue spreadsheet work and log all your trades.
» Don't be in a hurry.

It is a good idea to make a copy of your backtested Ultimate Trade Analyzer sheet and log the intended tradeplan trades in the original sheet and the actual trades you placed in your sim account in the copy. This is how you can judge whether you made mistakes or not.

The *why* of trading must be established, committed to, owned, and reflected upon. Every action a person takes regarding day trading should lead back to the goal of making money. You must judge yourself honestly by your own actions and decide if those actions are consistent with the goal.

It is not what you say, think, or feel that matters. It is your actions. So, from this point forward, pay attention to your actions and watch to see if they really reflect whether you have accepted and taken full ownership of the reason (to make money) for trading. Do not trade with real money until you are fully committed to this vital concept.

If you have completed this chapter successfully and understand it in detail, you have you have made the rite of passage and can now begin trading real money.

Lwp t atrp

- Backtest or forever fail at day trading.
- A backtest looks at past price action to prove that your trade assumptions have merit and will be profitable.
- Backtesting comes in three basic forms: manual, automated, and hybrid.
- Forward testing helps prove that your backtest results will continue as intended, going forward with never-yet-seen real trade data, from the right edge of the chart.
- The 3-Step Sniff Test, ending with fast-testing, is a way to determine if an approach is worth the time-consuming process of manual backtesting.
- Simulated trading has two valid purposes only: to practice placing trades and to practice running your trading endeavor as you would run a business. Be extremely cautious about venturing outside of those two purposes.
- After 25 perfectly executed tradeplan trades, you will have earned the right to trade with real money.

| 17 |

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- » Serious money
- » JV vs. varsity
- » Advantageous position
- » Starting out small

Simulated trading can help accomplish two important objectives. The first, covered in detail in the previous chapter, relates to learning how to properly place trades, flawlessly and consistently without errors. The second important thing simulated trading teaches is how to run your trading like a business. It gives you the opportunity to follow the mechanical rules of your tradeplan day in and day out until you have perfected every aspect. This is a huge advantage and cannot be underestimated. What other business gives you such an opportunity? You can learn how to be an expert CEO with your hard-earned cash parked safely on the sidelines. Only when you prove that you can run your trading business perfectly, without mistakes, day in and day out, will you finally be ready to risk your real money.

MY TAKE

> If you can't succeed in running your business in a sim account without mistakes, then don't assume that you'll be able to do it with real money.

Think of simulated trading as the dress rehearsal in preparation for the big show. Without rehearsing your script, you are going to bomb. It is improvisation. Trust me, you do not want to improvise when you are trading real money. Take the time to rehearse the key elements of the trading plan before going live. Eventually you will graduate from JV to varsity. That's what this chapter is all about—that important transition to the final level and what to do from that point forward.

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This is the moment you have probably been waiting for; it is time for you to begin trading. You have accomplished 25 consecutive mistake-free trades in a sim account and have meticulously tracked each position in the ever-growing spreadsheet. The strategy is working, and you now fully appreciate the benefits of the two steps forward, one step back (or better) routine that will grow your account. You believe in the plan and have taken ownership of it. All the details of your strategy are written down and you know how to execute orders, thanks to the many hours spent properly applying the tool of simulated trading.

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It's showtime! Start small. Allow yourself to trade one contract or the absolute smallest position you can for your chosen market, and no more, until you make another 25 mistake-free trades. That's right! You need to make another 25 consecutive tradeplan trades without a single mistake. Only this time, you are trading with real money. Just as you did during simulated training, if you make a mistake, then you must start over. The goal is another

25 properly executed trades, this time using real money but with the smallest position permissible. With futures it would be one contract. With forex it would be one micro lot.

Once you complete this step, you will have accomplished 25 consecutive mistake-free trades in both the sim environment and live trading. That is 50 consecutive mistake-free trades in two blocks: 25 in sim mode and 25 with real money at risk, albeit as small a risk as possible.

This process may seem like an arduous task, but it is important and necessary. Thinking about trading with real money is not the same as actually doing it. Completing a second round of 25 consecutive mistake-free trades, this time with real money, will be an invaluable experience. Moreover, you will learn lessons in this phase of the process that can only be taught through experience. To help reflect on what you are working toward, ask yourself these three questions:

1. How much better of a trader will I be after I've completed 50 consecutive mistake-free trades, especially the final 25 with actual real money at risk on every trade?
2. Why would I want to enter the battlefield of trading, facing higher risk levels, without first becoming an expert trader capable of executing my tradeplan perfectly and flawlessly?
3. Is it not wise to prove I can flawlessly execute my trading plan over and over again with real money on the line, before I attempt to do so with my full-size trading position at risk, and doesn't it make sense to put myself in the strongest position I can be in when I decide to "open my doors to the public," all guns blazing?

I want you to really think about these questions and answer them as honestly and accurately as you can.

Trading is difficult enough as it is. Most people fail. Most people do not go through this step-by-step guide to trading success. Do the math. You have the ability to put yourself in the most advantageous position possible prior to risking your real money. I want you to be victorious on the battlefield of trading. Remember, trading is war and you are arming yourself with all the tools and weaponry you need to not only survive, but to thrive and accomplish your financial goals by trading. It is just too darn important to get wrong, especially when you have everything you need, and the plan to follow, to get it right.

I once heard a quotation that left a big impact on me. "If you are presented with two choices, excellent or mediocre, and excellent is a viable and realistic option, then how can you possibly settle for mediocre?" I was quite young when I first heard this, and I'm grateful for that, since it has allowed me to apply this wisdom in my life for many, many years. I have since taught my children this same concept and they have taken it to heart. You have within your grasp the ability to become an excellent trader. Don't let this very real possibility slip through your fingers.

Keep track of all the trades in a win/loss column like the one in the UTA spreadsheet. Some traders keep multiple record sets: one for the backtested trades and another for actual trades, both simulated and real money. Remember to stay honest with your results and track everything you do.

You're still on the JV squad at this point, but you are playing at the varsity level. Once you have proven that you can run your trading business perfectly

and have accomplished the amazing task of trading 25 real-money mistake-free tradeplan trades in a row, then it will be time to move on to using full-risk trading positions.

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You have earned the right to play on the varsity team after you have executed 25 successful consecutive trades in a live account, and now you are ready to increase the contract size per your tradeplan rules. Recall that I recommend following the rule not to risk more than 2% of your trading account on one trade. But that number will vary depending on the trader's risk tolerance and the statistical data that the tradeplan produces. A simple method that I think works for most traders is to calculate the 2% figure using the account balance from the previous day. This will be your average risk per trade. The size of each trade will grow as your account grows, even while you maintain the small risk-to-capital ratio of 2%.

Put yourself in the best position possible with preproduction work and foundation building. Stay accountable to yourself and do not make excuses. Judge yourself by your actions, not by how you think or feel. Focus on staying above the forest and seeing the big picture. Do not be emotionally attached to the outcome of any trade. Instead, focus like a laser on executing your proven tradeplan, because that is your business now. That is the vehicle that gives you the best chance to achieve your financial goals. Remember that the front end, the long runway leading up to finally getting lift under your wings, will be the most challenging and least financially rewarding. Most of your money will be made once the nose of your airplane hits the exponential curve and transforms into the nose of a rocket ship. That is an important image to always keep in the front of your mind.

After you have imagined yourself growing your trade business, keep a journal

that lists your goals. Goals include profit levels that must be reached before triggering the next progression of your trade business. Your goals serve to measure your progress and to mark the rites of passage from one phase to the next in the progression. The goals should address key milestones (the order of which is for you to decide):

- When to begin paying yourself
- When to add another contract
- When to add another market or tradeplan

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Step 9 is about promoting yourself to CEO, and, in many ways, this step bridges the gap between the second and third legs of the stool—money management and psychology. It begins with learning to think of your trading as you would think of your own business and detaching yourself emotionally from the day-to-day trades within the plan.

The CEO is responsible for helping a business stay the course. Say you own a dry cleaning business and have hired a staff to handle the everyday operations. One customer is irate because a stain on her green-and-purple-striped cardigan did not come out. You're not worried about that customer, because the CEO doesn't handle individual transactions. Similarly, the CEO of a tradeplan is not worried about each transaction or trade. Instead, they are making sure that the operating procedures are being carried out correctly.

The goal of a business is to produce value for the equity stakeholders; the goal of *your* business is to grow the equity in your account.

P ı f x”v

The CEO of a successful day trading business operates above the forest—soaring like an eagle. Remember, your trading account is the forest and it

needs to grow. I say that you must be willing to sacrifice one-third of the forest (losing trades) so that you can grow the forest by two-thirds (with winning trades). This is a basic guideline for a successful tradeplan and trading business, and it is quite possible you will learn how to go *three* steps forward to every one step back. It's never a perfect pattern, but that is what you are striving to achieve as CEO.

Don't get lost in the trees and don't try to avoid or save the trees that will fall, despite correctly executed trades. The little grunt running around the woods has no perception of the forest and only sees individual trees. Amateur traders often try to prevent the trees from falling, only to get trapped underneath them, buried and broken. The CEO knows that falling trees are a natural part of the forest, but flying far above removes the fear of falling timber.

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The bottom line is that a CEO must get paid, and you are the CEO of your trading business. How do you pay yourself while also growing your account? That's sometimes a difficult balancing act, because you do not want to withdraw money, suffer a drawdown, and suddenly have much less capital to work with. For that reason, it makes sense to look at the bigger picture.

I came up with a capital growth formula that explains how to get to $10,000 per month in income over two years with a $20,000 trading account. Using the 2% risk level, assume you risk $400 and your average profit per trade, per contract—net wins and losses—is $50. Your first goal is to grow your account to $25,000. That is your first milestone. Once you reach it, you earn the right to begin paying yourself. Perhaps it will take six months or so. You are running a start-up business and will have to work for free for a while. But it will pay off. With roughly 20 trading days in the month, it should not take too long before you reach your first milestone; then you can safely begin

paying yourself $1,000 per month. As time passes, and you maintain the same $50 average net profit per trade, per contract, you will soon be able to give yourself a raise and begin paying yourself $2,000 per month, then $3000, $4000, $5,000, and so on. It will require less and less time to reach the next milestone that triggers your raise, thanks to exponential growth, so long as your $50 average net profit per contract holds up. If you can maintain that average trading result, then you will reach $10,000 per month in income by month 24, while also obtaining the secondary benefit of growing your trading account from $20,000 to about $250,000. Imagine that. Just $50 average profit per contract per trade, net of all wins and losses. Sounds simple enough, right? To put it in perspective, that's just five cents per contract with crude oil futures. Just five little pennies!

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If you are at the stage where you are the CEO of a profitable trading business and are consistently paying yourself by withdrawing money from your trading account, congratulations, you are in the 10% club. The other 90% of day traders who have tried their hand at day trading have either failed or are struggling to keep their noses above water. Despite your success, the work is far from over. A growing day trading business also needs to invest in research and development.

Rı” x” wt Oxt

The one thing that is constant in financial markets is that things change. That's true of everything, right? That is why I am always looking at and learning new systems. I have tradeplans that work, but I know that markets can change and that one approach that has been rock solid in the past might yield mediocre results in the future.

Your personal situation might change as well. For example, maybe you can no longer trade your favorite market in the morning hours because of other responsibilities. This might require creating a new tradeplan and/or using other methods like swing trading or options strategies.

Continually reassess your goals and the milestones you have achieved. If you are not moving in the right direction, it might be time to take a step back, reevaluate, and return to earlier phases of the process, such as making another 25 properly executed winning trades in a sim account or trading smaller sizes like on the JV team. Reevaluate your trading approach, strategies, and overall plan when it is not firing on all cylinders.

bttzx"v pVt" ı

If you are having difficulty as a day trader but are convinced that you could succeed with a bit of help, a mentor might be an option for you. A day trading mentor is a teacher who receives a fee for coaching aspiring traders. There are many out there, and they are not all created equal. It makes sense to check any online reviews before signing up. Word-of-mouth referral is also a great way to meet a good mentor.

A mentor can teach the mechanics of trading and can hold the student accountable for their actions. They can help speed up the learning curve while also helping to set plans, goals, realistic expectations, and key milestones. I have mentored many traders, and one thing I have found is that the same issues tend to prevent traders from succeeding. We have addressed each of those issues in this book. If I had to condense it down to the two top reasons traders fail, I would say that first, the trader isn't clear as to his or her reason for trading as reflected in the things they do or don't do, and second, they do not take responsibility for the consequences of their own actions or inaction.

A good mentor can help you solve these critical problems, but you must be a

willing partner in order to benefit from the mentorship. The trades must still be taken—they do not happen by themselves. If you decide to seek out the right mentor, and you are committed to the process, it could be a valuable experience and the thing that helps set you on the path to success.

This concludes the Step-by-Step Guide to Trading Success. Now that you have the knowledge, it is important that you walk the walk. You may get lazy or find some reason to water down this comprehensive process. I call this "resistance to success." Don't resist. So many would-be traders do resist for one reason or another. It's always a mystery to me as to why. Speaking of why, remember *why* you are trading. Perhaps that will motivate you to go back this time and really do the steps. Nodding your head yes and just moving on is a recipe for disaster. You have to actually *do* them.

Lwp t atrp

» After you have experienced success in a simulated environment, it is time to graduate to the JV team and begin trading small sizes.

» The transition from JV to varsity—the point where you begin using the 2% risk rule—happens after you have completed another round of 25 mistake-free trades, but with a real-money trading account.

» Record and evaluate all your trades to determine if your tradeplan is delivering the anticipated results.

» The tradeplan should also answer questions such as when to pay yourself, when to add another contract, and when to add another market.

» A mentor can help you stay the course when things get tough.

Li”r“ x”

Day traders trade to make money. If you are not yet trading, you are not yet a day trader. If you are trading and holding positions for more than one day, you are not yet a day trader. That's okay.

My hope is that, before you start risking your hard-earned money in a live trading environment, you will take the time to go through the steps outlined in part IV: The Step-by-Step Guide to Trading Success. Although they are listed in a specific order, there is a lot of overlap and the 10 steps work together to help you reach a level of day trading that few people ever attain.

- Step 1: Choose Your Methodology
- Step 2: Practice Money Management
- Step 3: Master Your Emotions (Psychology)
- Step 4: Commit to Making Money
- Step 5: Establish Proof of Concept
- Step 6: Create a Tradeplan
- Step 7: Simulate Error-Free Trading Executions
- Step 8: Trade with Real Money
- Step 9: Promote Yourself to CEO
- Step 10: Support R&D

Remember that humans make terrible traders and that's why we need to separate from the emotions that we feel and that plague all human beings when we are facing real risk in the markets. That's where the 12 Powers (outlined in part III) can greatly help, as they are our compass when we confront the aforementioned challenges. Like the ingredients of your favorite gourmet recipe, these dozen concepts are listed individually but work together to help you avoid common mistakes and grow a successful day trading business over time.

- The Power of Why
- The Power of Foundation
- The Power of the Tradeplan
- The Power of Quitting
- The Power of Numbers
- The Power of Compounding
- The Power of Mechanical Rules
- The Power of Dynamic Setups
- The Power of Structure
- The Power of Surrender
- The Power of Lifestyle
- The Power of CEO

Combining the 10-step action plan and the 12 Powers, along with the introductory information covered in parts I and II, will give you the actionable tools needed to begin day trading forex or futures. Again, my suggestion is to develop a tradeplan that you believe in through diligent fast-testing, backtesting, and forward testing. Find an approach that offers a legitimate statistical advantage, or edge, and then prove you can execute it over and over again before you start trading real money. It might take some time, but it will be time well spent.

Confidence, conviction, and belief in a tradeplan are essential elements that can help you weather the inevitable losing streaks and drawdowns that all day traders face. The human instinct is to avoid loss and quit when things get tough. But successful trading is not about a handful of trades—it is about finding something that works and letting the odds play out over time.

I do hope you win, and that you win big. That is why I wrote this book, and, since you have read this far, I really believe you are heading in the right direction. It is not an easy process, but the potential payoff—in terms of

lifestyle, income, and freedom—is well worth the price of admission for those who find success in this exciting endeavor called day trading.

Appendix I

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Market	Instrument	Symbol	Value/ Point	Value/ Tick	Tick Increment	Exchange
Energies	Crude Oil	(CL)	$1,000	$10	.01	NYMEX
Energies	Natural Gas	(NG)	$10,000	$10	.001	NYMEX
Energies	Unleaded Gasoline	(RB)	$42,000	$4.20	.0001	NYMEX
Energies	Heating Oil	(HO)	$42,000	$4.20	.0001	NYMEX
Stock Indexes (E-mini)	S&P 500	(ES)	$50.00	$12.50	.25	CME
Stock Indexes (E-mini)	Dow Jones Industrials	(YM)	$5.00	$5.00	1	CBOT
Stock Indexes (E-mini)	NASDAQ	(NQ)	$20.00	$5.00	.25	CME
Stock Indexes (E-mini)	Russell 2000	(RTY)	$50.00	$5.00	.1	CME
Grains	Corn	(C)	$50.00	$12.50	.25	CBOT
Grains	Wheat	(W)	$50.00	$12.50	.25	CBOT
Grains	Soybeans	(S)	$50.00	$12.50	.25	CBOT
Financials	10-Year Treasury Note	(ZN)	$1,000	$15.63	1/64 of a point	CME
Financials	5-Year Treasury Note	(ZF)	$1,000	$7.8125	1/128 of a point	CME

Financials	30-Year Treasury Note	(ZB)	$1,000	$31.25	1/32 of a point	CME
Livestock	Live Cattle	(LE)	$400	$10.00	.025	CME
Livestock	Lean Hogs	(HE)	$400	$10.00	.025	CME
Metals	Gold	(GC)	$100	$10.00	.10	COMEX
Metals	Silver	(SI)	$5,000	$25.00	.005	COMEX
Metals	Copper	(HG)	$25,000	$12.50	.0005	COMEX
Softs	Cocoa	(CC)	$10	$10.00	1	ICE
Softs	Coffee	(KC)	$375	$18.75	.05	ICE

Each futures symbol will also end with a letter that represents the expiration month. For example, the letter H is for a March expiration and Z is for December. Therefore, CLZ20 represents crude oil futures contracts with a December 2020 expiration. Many times, the year is omitted and it is simply called CLZ or CL-Z.

Month	Month Code
January	F
February	G
March	H
April	J
May	K
June	M
July	N
August	Q

September	U
October	V
November	X
December	Z

Appendix II

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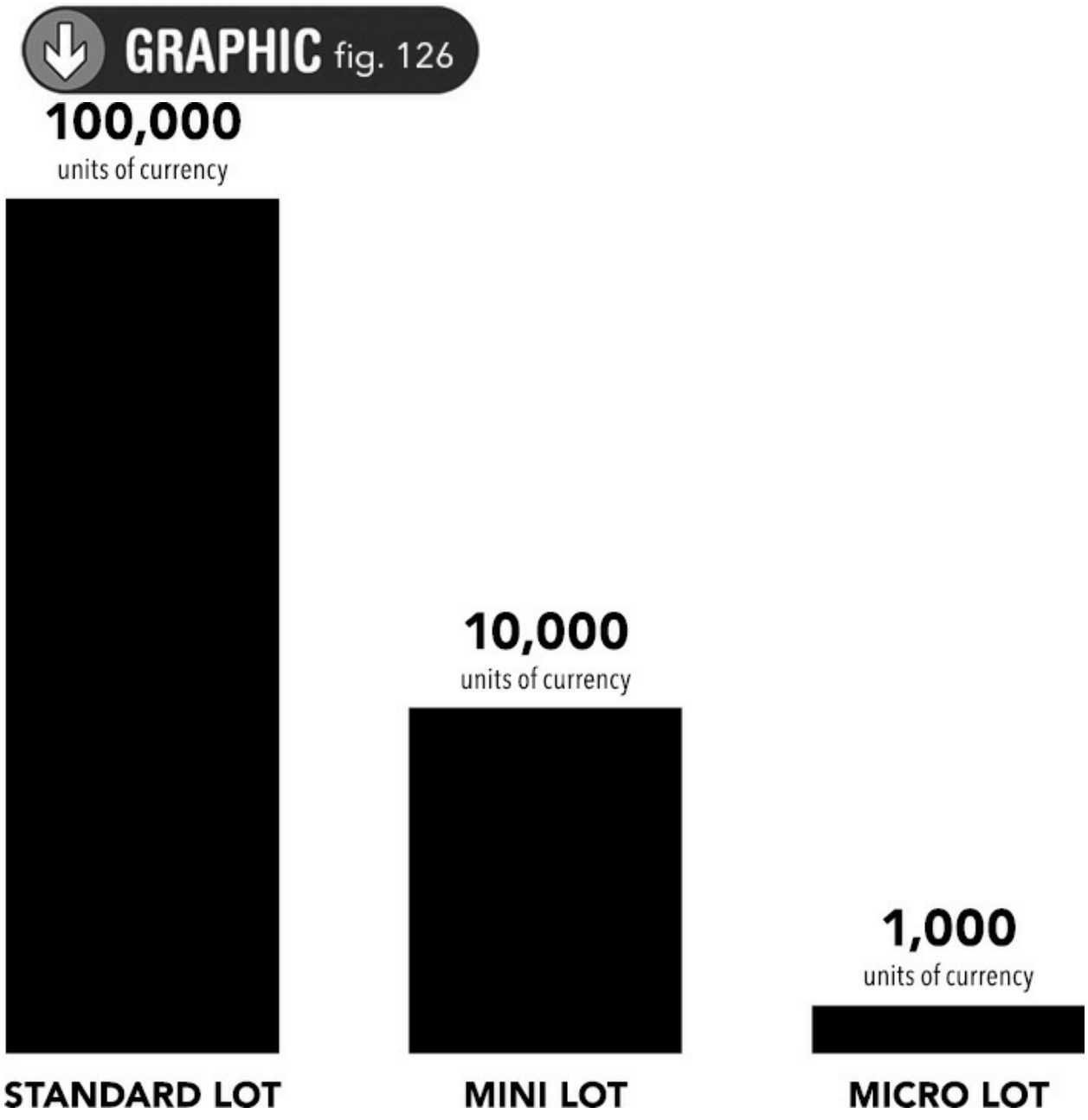
Symbol	Pair	Trader Reference
EUR/USD	Euro/US Dollar	"Euro"
GBP/USD	British Pound/US Dollar	"Cable"
USD/JPY	US Dollar/Japanese Yen	"Dollar Yen"
USD/CHF	US Dollar/Swiss Franc	"Swissy"
EUR/GBP	Euro/British Pound	"Euro Sterling"
USD/CAD	US Dollar/Canadian Dollar	"Dollar Canada"
AUD/USD	Australian Dollar/US Dollar	"Aussie Dollar"
EUR/JPY	Euro/Japanese Yen	"Euro Yen"
EUR/CHF	Euro/Swiss Franc	"Euro Swiss"
GBP/JPY	British Pound/Japanese Yen	"Sterling Yen"
GBP/CHF	British Pound/Swiss Franc	"Sterling Swiss"
CHF/JPY	Swiss Franc/Japanese Yen	"Swiss Yen"

Currency pairs trade in sizes called units or lots. A standard unit or lot size is 100,000 and, in dollar-based trading accounts, equals $100,000. Smaller units (micro and mini) represent 1,000 units and 10,000 units.


GRAPHIC fig. 126
100,000
units of currency
10,000
units of currency
1,000
units of currency
STANDARD LOT
MINI LOT
MICRO LOT

Appendix III

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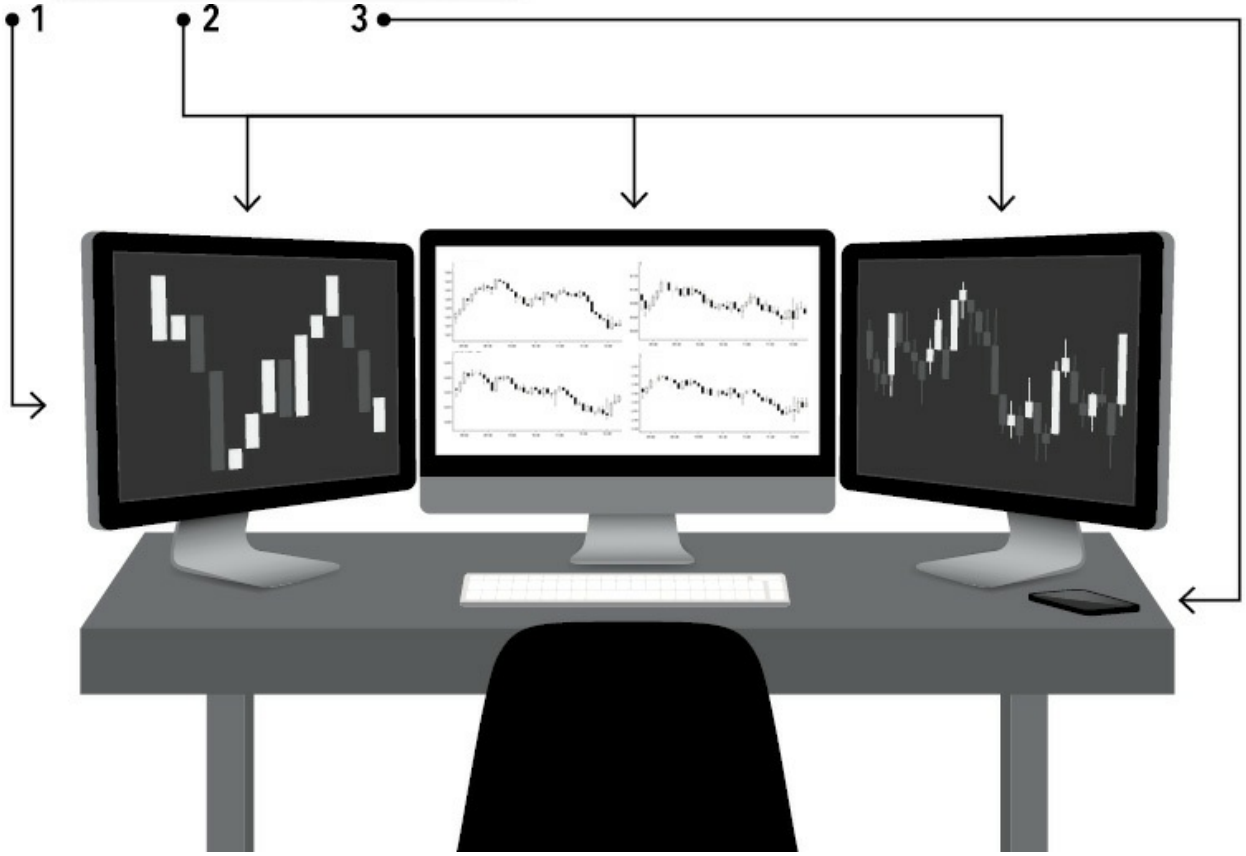
1. Charting Platforms: Charting platforms are essential for your trading (not to mention your preproduction work). Most of them also provide simulated trading, which, if you read the book, you already know is essential for becoming a successful day trader. TradeStation has advanced charting platforms that can also be used in a simulated environment.

2. MULTIPLE MONITORS: As your trading advances, you will probably want larger and multiple trading screens. The more real estate you have in terms of screen space, the greater the number of charts and markets you can watch.

3. Backup Technologies: Backup technologies are important if you are day trading real money. You don’t want to end up stuck in a trade with no ability to exit. You should have a way to contact your broker directly—such as the phone number of the trading desk—in the event your internet goes down or there is a power outage. You might also consider having a backup battery for your computer or a spare laptop. The use of bracket orders (chapter 9) will save you should technology fail.

GRAPHIC fig. 127



MY TAKE

You can easily add to your monitor real estate by investing in a low-cost USB monitor. Most of these can even be rotated to a "portrait style" display, so you get to look at a nice long "matrix" or "dom" (ladder style of order entry). Sometimes your stops and your targets can span long vertical distances, and viewing your trades in portrait style can eliminate the need to scroll up or down. Anything you can do to simplify your order execution will minimize costly mistakes in the heat of battle. By the way, the USB monitors are also great for traveling!

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Never stop learning. Keep this book in your trading room. Mark it up with notes, and flag your favorite sections. Keep adding books to your library to educate and inspire you. Some of my favorites include *Reminiscences of a Stock Operator* by Edwin Lefèvre, *Market Wizards* and *The New Market Wizards* by Jack Schwager, and *Technical Analysis of the Financial Markets* by John Murphy.

Make your trading room a comfortable place in your home that is quiet and free of distractions. Let others know that when the door to your trading room is closed, you prefer not to be disturbed. Turn off your phone or, at the very least, silence it. If you are serious about your preproduction work, you will spend many hours looking at charts, indicators, and trading results. Put yourself in a place where you can accomplish the task at hand.

Appendix IV

K ı z t p”s c psx”v Y“p u –

bt‘t r x”v p K ı z t p”s c psx”v bı u p t

The topic of brokers and trading platforms can stir up a lot of debate among active traders. Some like Interactive Brokers because of the access to many markets, while others like TradeStation for their excellent charts. Many options traders like the thinkorswim (TOS) platform from TD Ameritrade. NinjaTrader will get a fair number of votes as well, as their excellent charting platform integrates nicely with a wide variety of different brokers. If you are using NinjaTrader, then you will need to acquire a third-party data service, which they will most likely recommend to you.

Data is your lifeline, so don’t skimp when it comes to this investment. You have to have quality data to do the backtesting, which, if you’ve read this book, you know is essential. Don’t be penny-wise and pound-foolish.

The process of finding the right broker often involves shopping around and looking for four things: size, reputation, service, and cost. The biggest brokers tend to have the best reputations and the lowest cost, though you might find some nice boutique shops that will provide better service. Do your due diligence and shop around.

It's also a good idea to have more than one broker. If you want to day trade and swing trade the same symbol (or if you want to day trade the same symbol with multiple methods or tradeplans) then you will need multiple accounts to do so. Moreover, having a second broker is a nice backup plan in the event that something goes wrong with your primary broker.

My setup currently includes four brokers:

» **TradeStation**: I use this brokerage for all my charting, backtesting, strategy and tradeplan development, and futures trading. I rely on TradeStation charts to make all my trade decisions, even those executed with other brokers.

» **Oanda**: This is a big reputable forex broker with competitive rates. They provide a free version of a commonly used forex charting platform, MetaTrader 4 (MT4). While I don't use MT4 charts (although many traders do, worldwide) I use FX Synergy to place my trades through the MT4 platform. You can learn more about FX Synergy in the digital asset vault at www.clydebankmedia.com/trading-assets.

» **Thinkorswim (TOS)**: This is a trading platform provided by TD Ameritrade with powerful tools for trading options. I use it for trading equities, options, and occasionally futures. They are also a forex broker.

» **Interactive Brokers**: This brokerage offers a special kind of account that allows you to trade every type of instrument, all from a single account: futures, forex, equities, options, bonds, mutual funds, etc. Interactive Brokers accounts can be connected to NinjaTrader charting and a third-party data feed.

As I noted in chapter 4, I do the majority of my trading in TradeStation. If you cannot backtest then you will probably fail, so it is most important that

you select a broker and platform that provides you with the ability to look back on historical data, so you can prove that your method and tradeplan will grow your account.

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Charts are essential when day trading. Identifying key levels, like support and resistance, would be almost impossible without seeing price action over time on a graph or chart. In addition, the more advanced platforms today allow traders to do most of their trading (buying and selling) directly from their screens with charts.

For those with no previous experience, the best way to learn how to use charts in day trading is with simulated trading platforms that are offered through most brokers, including TradeStation. The exercise is like pilot training in a flight simulator: all the navigation equipment is the same and the simulator is created to replicate the flight of an aircraft.

Using simulators is dangerous if not used for the correct reasons. My music teacher used to tell me, "Practice like a wimp, play like a wimp." Or maybe you've heard the adage "Practice hard, play hard." Simulated trading should be taken as seriously as live trading–this means you do not trade without stops and let positions ride, or trade bigger and bigger sizes to make up for losses, or do anything else that you would not do as part of a real tradeplan. Not following the tradeplan rules in the simulated environment defeats the purpose of doing simulated trading to begin with. It is simulated, but it is not like a video game that is played strictly for entertainment. It is to prove that the plan makes money and to teach you how to trade correctly.

While there are few tools as handy as trading simulators, I need to offer a cautionary note about the differences between live trading and this form of practice trading. In a simulated trading environment, the money in the account is not real. It is a practice account funded with hypothetical dollars. As a result, the emotions associated with winning and losing will be quite different than those experienced when trading with real money.

It is important to realize that not only is the money in simulated trading not real, the actual trade fills are simulated as well and don't necessarily reflect what would really happen in terms of real-world trade execution. The slippage, for example, is simulated.

Kprz t x"v

Simulated trading is the process of practice trading with live market data, and backtests are done with historical data. The simulated trading environment can be a tool for evaluating an approach that has already been backtested. We cover the ins and outs of backtesting and also something I call "fast-testing" in part IV of this book in chapter 16.

Let's consider a simple example for now. Say you notice that every time crude oil advances to an even number like $50, $51, or $52 per barrel, prices tend to move at least 25 cents higher, when the price is also above a 9-day moving average. Thus, you are convinced that every time crude moves to, for example, $50.05, the rally will continue to at least $50.25, a move that would

offer another 20 ticks to the upside.

Backtesting is the only way to find out whether your idea has merit. The first step is to look at bar charts or find a source of historical data. You can probably start with your brokerage firm. You next identify the time periods when crude oil was above its 9-day moving average and the times when it moved beyond the key levels of $50, $51, or $52 per barrel. Then you determine whether your hypothesis was correct and during what percentage of time crude oil reached the price level that you anticipated. Use the techniques we covered in Chapter 16, fast-testing then backtesting.

, EQW VKH , WKQT

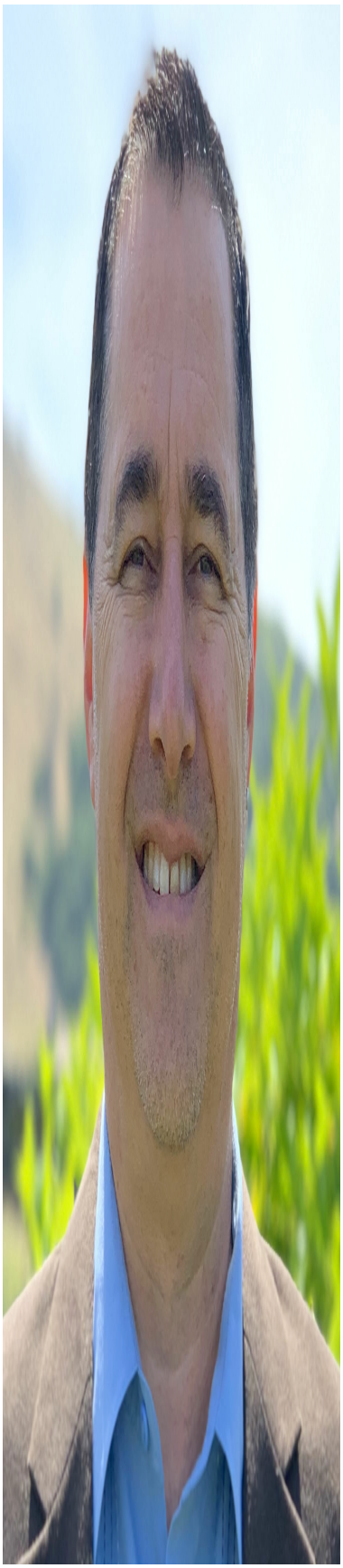
Troy Noonan

Troy Noonan is an author, full-time professional day trader, trade system developer, and trading coach with decades of experience in the study of markets and their behavior. The original Backpack Trader, Noonan cut his teeth executing trades in internet cafés while backpacking through Europe and traveling in South America in the late nineties. Using the freedom that trading provides, he continues to travel the globe and execute trades from the road.

As a teacher and mentor, Noonan has helped thousands of students in more than one hundred countries take the plunge and find day trading success on their own terms. He has single-handedly developed and refined numerous effective trading strategies, including the wildly popular Counter Punch Trader and Spotlight Master Suite methods, to name a couple of his most recent.

His signature strategies are simple, accessible, and highly effective for new and veteran traders alike. The durable and robust nature of Noonan's creations has been tested and proven time and time again—they are just as effective today as the day they were released.

With a professional trading career that spans decades, Noonan has extensive experience in successfully applying and teaching others the art and science of forex, futures, options contracts, and day trading.



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x factor (multiplier)
A variable unique to a specific trade setup used to calculate targets.

Accumulation
The beginning phase of the Wyckoff Market Cycle where prices stop falling, marking the end of a downtrend.

Action move
A dominant movement of price either establishing a new trend or continuing an existing trend.

Ask
A standing offer to sell an asset.

Backtesting
The study of past data and charts to determine if a trading style or approach will produce acceptable results.

Bid
A standing offer to buy an asset.

Bracket order
A special type of order where the target and the stop bracket the entry, usually with the use of OSOs and OCOs.

Chasing performance
A common folly in trading whereby a trader prematurely abandons a strategy in favor of another that has recently shown strong performance.

Chicago Board Options Exchange (CBOE)
The largest options exchange in the Unites States; the site of the first stock option contract listings in the 1970s.

Commission
The fees charged by brokers for buying and selling securities.

Congestion area
An area of stagnant or choppy price action, where an asset price may bounce around but does not breach any support or resistance areas.

Consolidation
When price action fails to break in one direction or another but remains "sideways," choppy, or stagnant.

Continuation pattern

A certain type of chart pattern that occurs in the midst of a larger uptrend or downtrend.

Delivery
The fulfillment of a futures contract through the delivery of physical goods such as crude oil barrels or cattle.

Distribution
The third phase of the Wyckoff Market Cycle where both supply and demand remain strong after a sustained move higher and some players begin selling or "distributing" positions to take profit.

Entry
The price where a trade is initially executed.

Equity curve
A graphical representation of a day trader's account balance, depicting profits and losses over time.

Exchange-traded funds
Prediversified, tradeable securities that can be used to buy or sell representative shares in an entire market, sector, or portfolio.

Exercised
The state of an option contract after the contract owner chooses to purchase or sell the assets in accordance with the contract terms.

Fast-testing
A fast way to test ideas—by quick-counting results—with a premise or question you want to answer in mind.

Fibonacci retracement levels
Specific ratios, such as 23.5%, 38.2%, 50%, and 61.8%, that some traders use to predict the endpoints of reaction moves.

Forex
A massive network of financial centers and global institutions that facilitate the exchange of foreign currencies.

Futures contract
A tradeable contract that guarantees the future sale or purchase of an asset at a specific price.

Initial margin
A deposit made by a trader into a brokerage account for the purpose of trading futures on margin; the initial margin deposit is typically 5% to 15% of the total value of the futures contract being traded.

Key level
A technical level (such as support, resistance, or a whole number) that represents a significant price point on the chart.

Key level adjustment
An adjustment to the entry, the stop, the target, or any combination of the three, based on the location of a key level.

Leverage
The ability to trade a large position using a small amount of trading capital.

Limit order
An order to purchase or sell a security at a specific price.

Liquidity
The extent to which a security is traded frequently and buyers and sellers can be easily found.

Maintenance margin
A specific amount of funds, less than the initial margin, needed to maintain an open futures position.

Margin
A loan from a brokerage firm to a customer for a down payment on a stock purchase.

Margin call
A request from a broker for a customer to deposit additional funds to reestablish initial margin levels, or liquidate a position, after the value of the position drops below the maintenance margin threshold.

Market order
An order to purchase or sell a security at the best available price.

Markup
The second phase of the Wyckoff Market Cycle in which the demand for an asset is driven upward on increasing volume.

Mechanical rules
Rules of a tradeplan that include highly specific parameters, such as specific entry and exit points that are known in advance of the trade setup.

Moving average
A popular chart indicator that depicts the average value of a security over a fixed trailing timeline.

Multiplier
A multiple that defines the value of an options contract.

Net profit (or loss) per trade
The average amount won (or lost) per trade in a tradeplan.

Pattern Day Trader (PDT) rules
Regulations imposed by the Financial Industry Regulatory Authority (FINRA) that limit high-frequency trading.

Pip
Short for "point in percentage," a small measure of price movement in a currency pair, defined by the fourth decimal place in most currency pairs (or the second in all JPY pairs).

Premium
The price paid to own an options contract.

Price action
The ebbs and flows, higher and lower, of the price of an investment security driven by market

sentiment throughout the trading day or period.

Price action confirmation
When a trader waits for price action to push past a certain level in order to confirm a trend or a likely move in a certain direction.

Price rejection point
A point or area where prices stop moving in one direction and begin to move in another.

Profit factor ($ won/$ lost)
The ratio of dollars won to dollars lost in a tradeplan.

Profit target (target)
The goal of a trade, where the trader exits some or all of the position to take profits.

Range bar chart
A bar chart in which each bar has the same range of price from high to low.

Range extension
Each leg of movement higher in an uptrend or lower in a downtrend, extending the range of the dominant trend.

Round turn
The opening and closing of a position, such as buying crude oil futures to enter a trade and then selling them to exit.

Reaction move
Price action that moves in opposition to a dominant trend; the reaction move follows the "action move" and is followed by the "subsequent action."

Reversal
A significant and lasting change in price direction, often predicted by the appearance of a classic chart pattern such as the "head and shoulders."

Risk profile
The distance between a trade's entry and its stop.

Risk/reward
A ratio of how much money is being put at risk compared to potential profit.

Setup bar
A bar on a chart that serves as a critical reference point with the potential to determine where a position is opened, where the stop is placed, and where other important elements of a trade are defined.

Slippage
An added expense on a trade when an order is filled at a price that is worse than expected.

Spot price
Also called cash price; the current price (most recent transaction) at which the underlying asset is trading in the marketplace.

Standardization

The process by which futures contracts are formatted so that their terms are easily understood.

Stop entry
An entry into a trade that usually comes in the form of a stop market or stop-limit order.

Stop-loss
An order that is placed at a certain price point that will limit a trader's losses if the price moves against his position.

Strike price
The price at which shares (or other underlying assets) are bought or sold if an options contract is exercised.

Subsequent action
A predictable movement that follows a reaction move and reasserts the movement of the dominant trend; the subsequent action often (but not necessarily) mirrors the action move in terms of shape and length.

Technical analysis
The evaluation of an asset based not on its underlying value but on its behavior in the marketplace as determined by the actions of buyers and sellers.

Tick
The minimal increment of price movement per symbol.

Trailing stop
A tactic whereby the trader progressively adjusts the stop-loss closer to the target so as to lock in profits.

Underlying asset
A security that has its price and delivery date dictated by the terms of an options or futures contract.

Winning percentage
The percent of winning trades in a tradeplan.

Wyckoff Market Cycle
A theory of market behavior outlined in four phases: accumulation, markup, distribution, and markdown.

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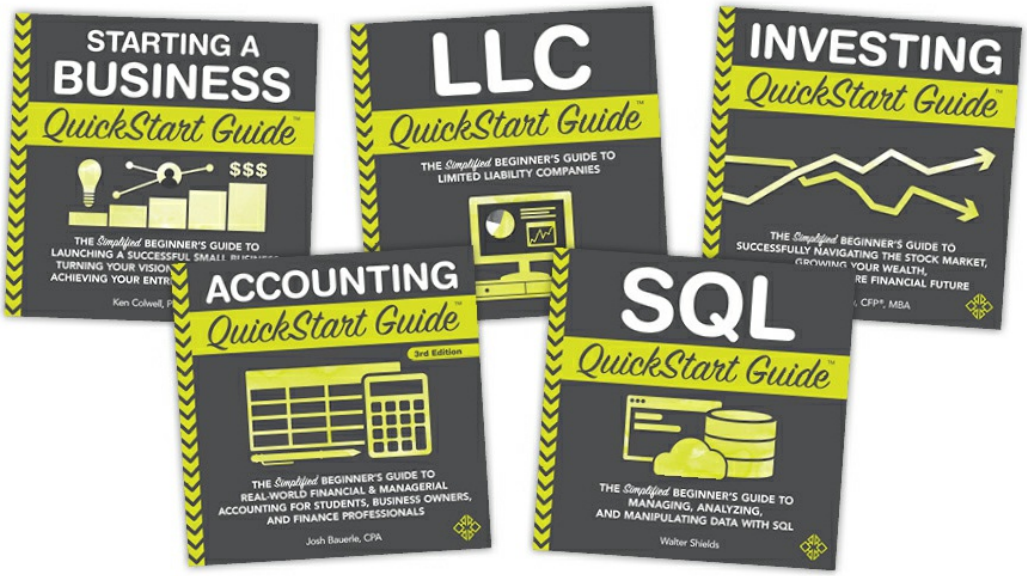

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