Chapter 1: The Principles of Successful Trading

Over many years of trading, I've found certain principles to be true. Understanding and using basic principles provides an anchor of sanity when trading in a crazy world. Whenever I find myself under stress, questioning my judgment or my ability to trade successfully, I pull out these basic trading principles and review them.

Don't Try to Predict the Future

I used to think that there were experts and geniuses out there who knew what was going to happen in the markets. I thought that these traders and market gurus were successful because they had figured out how to predict the markets. Of course, the obvious question is that if they were such good traders, and if they knew where the market was going, why were they teaching trading techniques, selling strategies and indicators, and writing newsletters? Why weren't they rich? Why weren't they flying to the seminars on their Lear Jets?

NO ONE KNOWS WHERE THE MARKET IS GOING

It took me a long time to figure out that no one really understands why the market does what it does or where it's going. It's a delusion to think that you or any one else can know where the market is going.

I have sat through hundreds of hours of seminars in which the presenter made it seem as if he or she had some secret method of divining where the markets were going. Either they were deluded or they were putting us on. I have seen many complex Fibonacci measuring methods for determining how high or low the market would move, how much a market would retrace its latest big move, and when to buy or sell based on this analysis. None has ever made consistent money for me.

NO ONE KNOWS WHEN THE MARKET WILL MOVE

It also has taken me a long time to understand that no one knows when the market will move. There are many individuals who write newsletters and/or books, or teach seminars, who will tell you that they know when the market will move.

Most Elliott Wave practitioners, cycle experts, or Fibonacci time traders will try to predict when the market will move, presumably in the direction they have also predicted. I personally have not been able to figure out how to know when the market is going to move. And you know what? When I tried to predict, I was usually wrong, and I invariably missed the big move I was anticipating, because "it wasn't time."

It was when I finally concluded that I would never be able to predict when the market will move that I started to be more successful in my trading. My frustration level declined dramatically, and I was at peace knowing that it was OK not to be able to predict or understand the markets.

Know that Market Experts aren't Magicians

Some of the experts that try to predict the markets actually make money trading the markets; however, they don't make money because they have predicted the market correctly, they make money because they have *traded* the market correctly.

THEY DON'T PROFIT FROM THEIR PREDICTIONS

There is a huge difference between trading correctly and making an accurate market prediction. In the final analysis, predicting the market is not what's important. What is important is using sound trading practices. And if sound trading habits are all that is important, there is no reason to try to predict the markets in the first place. This is the reason strategy trading makes so much sense.

THEY HAVE LEARNED TRADING DISCIPLINE

I have watched many market gurus continually make incorrect market predictions and still break even or make a little money because they have followed a disciplined approach to trading. More importantly, they used the exact same principles that I will show you how to use in creating your strategy. It is these principles that make the money, *not* the prediction.

To be a disciplined trader, you have to know how and why to enter the market, when to exit the market, and where to place your money management stops. You need to manage your risk and maximize your cash flow. A sound trading strategy includes entries, exits, and stops as well as sound cash management strategies.

Even the market gurus and famous traders don't make money from their predictions, they make it from proper trading discipline. Over the years, they have learned the discipline to control their risk through money management. They have learned to take the trades as they come, and not forgo a trade because they are second-guessing their strategy or the market. These are the same practices that you will learn to include in your trading strategy.

THEY PROFIT FROM SOUND CASH MANAGEMENT & RISK CONTROL

Sound money management and risk control are the keys to being a profitable trader. I will say over and over again, it is not the prediction or the latest and greatest indicator that makes the profit in trading, it is how you apply sound trading discipline with superior cash management and risk control that makes the difference between success and failure.

I often tell the story of the great fish restaurant that opened up just down the street from my office. It opened with great fanfare and was ranked in the top five restaurants in the city. The food was outstanding. But it only took a little more than a year and this great restaurant was out of business. Why? Because the key to running a good restaurant is not the food…it is cash management and risk control. It is making sure your business is run efficiently, keeping your costs (risk) in control, and managing your staff effectively. If you believe that the taste of the food is what makes a great restaurant, think of how great the food is at your favorite fast food restaurant. But, someday, watch how well that restaurant is run.

Just as in the restaurant business, the key to profits in trading is not in the prediction or the indicator, but how well the trading strategy is designed and executed. The ability to achieve risk control and cash management will make the difference between a successful trader and an unsuccessful trader. If you ever have the opportunity to watch a successful trader, you will see that they don't worry about where the market is going or about predicting when the next big move will take place. They aren't looking to tweak their indicator. They are worried about their risk on each trade. Is the trade being executed correctly? How much of their total account is at risk? Are the stops in the right place? And so on.

THEY DON'T HAVE SUPERIOR PERFORMANCE NUMBERS

If you want to have some fun, look at the performance of a successful market expert, one who is known for his or her market predictions and trading expertise. You will find that their performance numbers really aren't any better than an average trading strategy. The percentage of profitable trades, the return on the account, average profit to average loss, number of losing trades in a row…all of these trading parameters are within the average trading strategy performance parameters.

Why is this? Because you can't predict where the market will go and when it will move. But if you use correct strategic trading disciplines, you will make money whether you try to predict the market or just trade a good strategy. You might as well save yourself a lot of time, energy, and mental anguish and trade a good strategy.

Be In Harmony with the Market

We make money trading when we are in harmony with the market. We are long when the market is going up, and short (or out of) the market when it is going down. If we bring an opinion with us while trading, we will end up fighting the market. We keep trying to go long as the market is declining, or we keep shorting a market that it is in a bull phase.

DON'T FIGHT THE MARKET

Fighting the market is not good for two reasons. First, we lose money. How much we lose depends on how well we are managing our money and controlling our risk. Second, fighting the market affects our judgment, and causes us to try to confirm that our judgment is correct, or persist in fighting a trend so that we will eventually prove to be correct. We figure that if we persist long enough, no matter how long it takes, we will eventually be right.

The same can be said for being in a canoe in a river. There is a reason for leaving your car downstream, launching your canoe upstream, and paddling downstream. It is much easier and eminently more fun to go with flow and paddle downstream.

We could do the opposite and paddle upstream. Eventually we may even get to our destination, but the cost would be substantial. It would take much more time, more physical and emotional stamina, and we would be constantly fighting the current. Reaching the goal would not be worth the cost.

Even if you ultimately make money fighting the market, it is not worth the price you have to pay, both financially and with peace of mind.

LET THE MARKET TELL YOU WHAT TO DO AND WHEN

The correct attitude for successful trading is to let the market tell you what to do. If the market says to go long, buy, and if it starts to go down, sell. This sounds easy but it is much more difficult than you think. We always like to believe that we can be in control. We want to be in control of our trading and of the market. If you accept the notion right now that you cannot control the market, that all you can control is your execution of trades, you will take a great step toward being a successful trader.

Instead of trying to control the market, let the market tell you what to do. Let the market and your strategy take you long rather than you personally trying to predict or decide when to go long. Let your strategy take you out or get you short. Once you realize that you can't understand the market, and that you can't predict when the market will move, you will move into that detached state of mind where you let the market take you where it will when it wants to.

THE MARKET GIVES AND THE MARKET TAKES AWAY

To remove your personal biases and let the market tell you what to do is to give up control, to give up the notion that you are actually in charge of how much money you make. For profitable trading, you need to move into the mental state of letting the market determine the profits, not you. It won't be whether you predict the market correctly that determines the profits, but whether your strategy is in a profitable mode or drawdown mode as determined by the market.

So, let the markets tell you what to do based on your strategy. Let it get you long and put you short. Let the market determine how much money you are going to make. Trade your strategy and let the market do the rest. And know that the market gives money and the market takes away money. Your goal should be to develop a strategy that gives you more money than it takes away.

Have a Healthy Time Horizon

One of the biggest problems new traders have is that they think they will make a large amount of money right away. They think they will get rich quick. This type of reasoning is very similar to the short-term thinking in American business in general, usually managing for the current quarter's profits, focusing on short-term earnings at the expense of long-term investment and profit growth.

TRADE FOR PROFITS OVER TIME

Traders tend to get wrapped up in current market conditions, the news of the day and the current trade, usually at the expense of the big picture and profits over time. My grandfather used to have a saying, "You can't go broke taking profits." He was very wrong. You can go broke taking profits. If you take profits before the market tells you to, or you succumb to fear and close out the trade before its time, you are focusing on the short-term and forgetting how to make money over the long haul. Close out no trade before its time.

GIVE YOUR TRADING STRATEGY ENOUGH TIME TO WORK

We tend to be impatient, and we sometimes think that we should get instant gratification. This will not work in trading. The only way you will really know whether you are a successful trader is to be successful over time. A week or a month will not be enough time to tell you how you are doing. You should be trading with the objective of making money in the long run, consistently, and with the confidence that your strategy will make money given enough time.

One of the benefits of trading with a strategy is that having done the requisite historical testing, you should know how long it should take you to start making money. You should have an idea as to the length of time that the strategy has lost money in the past, how much money it has lost, and how long it will take the strategy to become profitable. If the strategy has proven profitable historically, it should be profitable in the future. You just need to give it the necessary time to do its work.

Understand the Psychological Keys of Trading

There are many people who teach the psychology of trading. There have been many books written and effort spent on seminars trying to teach the discipline needed for trading. I don't think trading is that complex. I have developed a few simple psychological rules for myself, and once you accept them, they should greatly enhance your ability to trade effectively.

ACCEPT LOSSES AS A COST OF DOING BUSINESS

Most successful traders will tell you that the most difficult thing about trading is accepting the losing trade. We all have the desire to be to be right, to be correct all of the time. For novice traders, the losing trade means that something is not working and that you have somehow made a mistake. For experienced traders, losses are just a cost of doing business.

Some of the best traders in the world lose money on more than half of their trades. If you look at the performance results of the best traders and money managers, you will see that they all have a large percentage of losing trades. If you trade, I guarantee you that you will have losing trades. Learn to love losing trades. They should be your friend because you will be spending a lot of time with them.

USE HISTORICAL STATISTICS

I don't think anyone has ever traded without first looking at historical statistics. Even some traders who deny they are strategy traders have used historical data. And before EasyLanguage and TradeStation were available, most good traders developed a strategy's history by hand. I can remember countless hours pouring over charts spread out on the kitchen table, writing down trades by hand. Before I would trade it, I absolutely insisted on knowing what the strategy's personality was and how much money it would have made.

Using historical statistics gives you great peace mind, particularly in learning to love losing trades. Knowing the history of a trading strategy can give you tremendous psychological comfort during those tough periods of losing trades and drawdown. Historical statistics tell you how much money the strategy has lost in the past, how many losing trades it has had in a row, and the largest losing trade the strategy has experienced. This is very important information if you are learning to accept losing trades. Comparing historical data with the current string of losses and drawdown can give you much comfort that what you are experiencing now is not unusual and has happened before. Maybe not in exactly the same manner, but it has happened before.

LET THE MARKET AND STRATEGY DETERMINE THE PROFITS

Don't have an opinion, don't try to predict the market, and don't try to second-guess your strategy. It's human nature to have an opinion about things, but this opinion can become a stumbling block if we let it affect our trading. One of the alluring aspects to having an opinion on the market is the exhilaration of being right. Even though we know that the chances of being right are slim, we nonetheless want to prove our intellectual prowess by being right.

Your trading strategy is ultimately a little business. You have developed and tested the product and are now operating the business in the real world. Let the strategy be the strategy. Let it make the money you know that it can. And know that if the market doesn't move in the manner that will allow the strategy to make money, it won't make money. Ultimately, the market determines the profit through its movement. If it doesn't make that move, there will not be profits.

Put the responsibility of making money on the strategy and the market. When they work together, you will have a profitable business.

Don't Trade for the Money

I have met many successful people, and the one thing that they have in common is that they love what they do. Many have told me they can't believe that they actually get paid for doing what they do. They have so much fun they feel guilty taking money for doing it. Many successful people will tell you that they would do what they do even if they weren't paid at all.

SUCCESSFUL PEOPLE DON'T WORK FOR THE MONEY

Work hard and love what you are doing and the money will follow. Successful people work first and count the money later. Sometimes they don't ever count it, and some don't even know (or care) how much they have. They just know that they have enough to allow them to continue what they are doing; working hard and having fun.

LOVE TRADING FOR ITS OWN SAKE

I know that many individuals want to trade because they think that they can make a lot of money easily and quickly. Because of the low start-up costs for trading as compared to other businesses, they think that trading should be the easy road to riches. Their goal is to make a lot of money fast. These are the people who come to seminars and want an indicator that will guarantee profits. They don't want to learn the ins and outs of the business; they want the magic indicator that will get them the money they desire. They are doomed to failure.

I remember a guy named John walking into a seminar I was about to teach. He threw up his hands and said, "Ah, Traders! I am glad to be home." This individual was a successful trader. John loved going to seminars, not so much for the techniques and indicators, but for the camaraderie. He loved being around traders, talking with traders, analyzing trading strategies and techniques, and learning about the latest and greatest trading technology. He loved learning the latest features added to TradeStation and finding out a new way to use EasyLanguage.

He loved designing new indicators, and spent countless hours working on new and different ways to exit the market. He was excited about getting up early in the morning to monitor the overnight market information and checking what the S&P was doing in London. He looked forward to calling his broker and putting in his orders. He loved watching his strategy run on TradeStation. He was exhilarated when he had to call his broker and give him a lot of grief for the latest bad fill. He even loved losing trades. Even when he had to take a losing trade, he was still doing what he loved to do—trade.

John is a successful trader. He loves what he is doing. And as long as he can keep on trading, he will be happy. The money he makes is secondary, but he makes a lot of it. He can't believe that he can have all of this fun and make money as well.

Concentrate on Execution

All of your market and strategic analysis should be done before the markets open. The strategy design should be clear in your mind. You should have the historical Performance Summary of your strategy at your fingertips to remind you of the personality of the strategy, how much money it has made over time, and what its largest string of losses in a row has been. You should know what kind of orders you are going to place, and how you are going to communicate this to your broker.

The last thing you should have to worry about during market hours is where the market is going, and whether to be long or short. Your strategy will tell you all of this. You should not be concerned about the news, or even if you are making or losing money. You should not be concerned with analyzing the market, always reserve this for when the market is closed.

The only thing you should be doing during market hours is concentrating on effectively executing your strategy. If you can't execute your strategy effectively, there really is no point in trading. There are two sides to trading, strategy development and trading execution. During market hours is when you should concentrate on execution and nothing else.

Always Be In the Market

I have always characterized trading the trend as "keeping your costs down while waiting for the big move." We know that to trade profitably, especially for trend traders, you need to be in the market for the big move. Many traders stay out of the market when it's quiet and try to predict when the big move will occur. These people invariably miss the big move.

Instead of trying to predict when the big move will occur, your task becomes to minimize your losses and drawdown while you are waiting for the big move to occur. This is a different way of looking at trading that focuses on managing cash flow and risk rather than finding magic indicators and making good predictions. Trading thus moves from a hobby to a business.

The only way to ensure that you won't miss the big move is to always be in the market.

Buy High - Sell Low

Probably the most interesting rule for successful trading is to "Buy High and Exit Higher, and Sell Low and Exit Lower." This is counter-intuitive to what we all have a natural inclination to do, which is buy low, sell high. Most great trading strategies are counter-intuitive. They are not based on our normal human nature and the normal human reaction to the markets. They consistently make money because they are designed with market sense not human common sense.

In the final analysis, any market is just a collection of individuals making decisions and placing money in the market based on these decisions. Most of these individuals are doing what comes naturally to humans, buying low and selling high. Statistics show that 95% of these people lose money.

To be a successful trader, you have to do the opposite of what this 95% is doing. It isn't easy, because it goes against your human nature. But any strategy that is successful over time will most likely follow the rule of "Buy High, Exit Long Higher and Sell Low, Exit Short Lower."