

Prologue: Where to Begin

Let's begin with the markets themselves, and with fear and greed. We have all heard the clichés about fear and greed. They rule the markets. In fact, that's all the markets are—a reflection of these emotions. In order to make money trading, you must learn to control your fear and greed.

Overcoming Fear and Greed

We all have to deal with our runaway emotions at various times in life, and these emotions *really* begin to run away when we trade. Bill Williams¹ used to say in his seminars that trading was the clearest window into your own personal psychology, clearer than any other endeavor. I think he was right.

UNDERSTANDING THE MARKETS

We give in to our fear when we don't take the next trade because we've just been through a string of losers and fear losing again. We give in to our fear when we put our stop loss too close and get stopped out of a trade without giving the trade enough room to develop. We give in to our fear when we freeze as a trade starts to lose money, and we don't take the exit signal because we're afraid of losing money.

We give in to our greed when we take a profit early, before the regular signal, because we don't want to give back any of the profits. We give in to our greed when we trade more contracts or shares than we normally would because we feel good about this trade.

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So we start with the question, “How can we understand the markets?” If we understand how they work, we can get a better understanding of ourselves, and in turn be better traders.

Controlling greed takes discipline. As far as fear, Peter Steidlmayer² explained in his work with Market Profile that markets exist for one purpose and one purpose only—they exist to facilitate trade. Facilitating trade means that the markets will do anything they can to get individuals to participate in the market. How they do this is through movement. Markets move up and down searching for buyers and sellers.

The crucial point here is that markets must move for their survival. Understanding this literally changed the way I thought about the markets. Think about it. Markets have to move! This concept is major for anyone who has had to sit through a trend-following strategy trading in a sideways market. The knowledge that the market has to move eventually changes the way you look at trading. It gives you confidence that the string of losses can’t continue indefinitely. It eliminates the fear!

You see, Steidlmayer explained that if a market does not facilitate trade, it will die. If it does not continue to bring traders in, to lure the buyers and sellers, the market will cease to exist. And the prime directive of a market is survival. To keep traders interested, the market has to move. It cannot remain in a small trading range or traders will lose money, become disinterested and leave. Eventually there will be less and less liquidity, traders will stop trading, and the market will die.

Knowing that a market must facilitate trade and move, or else die, has given me great confidence in trading. When I am forced to trade through quiet markets, I remember this principle. This principle has reduced my fear and increased my confidence immeasurably.

STRATEGY TRADING: MAKING GOOD BUSINESS SENSE

For me, strategy trading is the only answer to the problem of fear and greed, and it is the only logical way to take advantage of the concept of Market Facilitation.

First, trading a strategy provides the discipline necessary to begin overcoming fear and greed. Trading a strategy that has been back tested on historical, quantifiable data is a major way to inject discipline into your trading and to begin to control your fear and greed. If we think of a trading strategy as a small business, we can design our business to make money based on historical simulations. Then, our job becomes the implementation of the strategy rather than the interpretation of the

market. If the strategy loses money and busts, we change the strategy. It's a matter of good business sense.

Second, if we know that a market must facilitate trade to stay alive, we can devise strategies that guarantee that we will always be in for that inevitable big move. If we know that the big move will eventually come, and devise the strategy accordingly, our task becomes to minimize the drawdown (investment) while we wait. I have never been able to predict when the market was going to facilitate trade and get in for the big move. Instead, I have devised strategies to ensure that I will be in for the big ride and my losses will be minimized while I wait. It's just a matter of good business sense.

As a businessman, I have concluded that the only rational way to trade the markets is to trade a strategy. All of the hocus-pocus about predicting when this market will move, and how far, is just that—hocus-pocus. The people that make the big money are the ones who don't try to predict tops and bottoms but who consistently take a little out of the middle. The only logical way to do this consistently is through a well thought-out, well-designed strategy. It's a matter of good business sense.

THE ADVANTAGE OF TECHNOLOGY

Anyone serious about finding a profitable strategy should use the latest technology and the best software available. This means learning how to use a computer.

When I started trading, all historical testing had to be done by hand. This was labor intensive and very time consuming. It was necessary to peruse charts visually and record the simulated entries and exits by hand.

For intra-day charts, this process was even more time consuming—the charts had to be printed with the indicators on them and for a significant length of time (several months). If these indicators didn't prove to be profitable, the process had to be repeated for the next month with revised indicators. This process continued month after month. It would sometimes take me three to six months to find a strategy that would work under current market conditions.

System Writer, followed of course by TradeStation, was the first computer program to help eliminate this labor intensive historical testing. Using TradeStation to do your testing has three distinct benefits.

The first is the amount of time saved. With TradeStation on a fast PC, it's possible to test in 5 to 30 minutes strategies that literally used to take hours or days to test by hand. If you place any value on your time, this cost savings alone is impressive.

Second, you can avoid mental mistakes. I have, in both myself and in talking to other researchers, found a propensity for making mistakes when performing manual historical testing. On many occasions I have found myself changing the strategy midstream. I have sometimes made the assumption that of course I wouldn't have taken that particular trade, when the reality is I probably would have, or of course I would have moved my stop up, when in reality I probably wouldn't have, and so on.

I can recall many situations where, when testing manually, I got different results on different days with the same data and the same strategy. I was either in a different frame of mind or in a different emotional state and actually made different decisions on the *same* data!

A computer, however, cannot trade a strategy differently tomorrow using the same parameters and data as it is using today. Its logic is consistent and can't play tricks on it. For historical testing, you can avoid this very real problem by using a computer.

Third, you can be more creative. Rather than spend all of your time doing the testing, you can have the computer do the testing and you can spend your time researching new trading ideas.

Strategy development is like any other business. It's very unusual to find a successful business where only one individual has designed the product, does the marketing, is engaged in product development, and runs the machine to produce, package, and ship the product.

It is much easier and less stressful to hire a staff to handle the paperwork and production employees to make the product. The entrepreneur can then spend his or her valuable time in product development and planning the future of the company rather than running day-to-day operations.

In the trading business, TradeStation can be your staff and production employees. The program is indispensable in time savings, cost savings and individual productivity. It frees you from the repetitious side of the business so you can spend your time on the creative side—the side that will ultimately make you the money.

As the futures and securities industry continues to grow, more and more traders will enter this business. The competition for profits will continue to increase. For

example, in the early '80s it was very easy to make a lot of money day-trading the S&P. I used a simple dual moving average crossover strategy on 5-minute bar charts. There were proportionately very few intra-day traders with computers that were competing for profits. But since then, with the increase in the number of traders using intra-day charts, these very rudimentary indicators have stopped working. When everyone started using them, the profits dried up. It is much more difficult in today's markets to make the money that was there in the early years. The standard indicators just aren't that effective anymore.

I believe that the only rational way to be a successful trader is by using the best software available—TradeStation—and learning to be an effective strategy developer and strategy trader. The professional traders are all using sophisticated computers, and most of them are now using TradeStation. The technology resource differential of the past is now gone. An individual trader can afford the same technology as the successful professional. The playing field is now not resource driven but intellectually driven. Knowledge is more important than capital.

Don't Believe What I Say

The final thing I want to tell you before you delve into this book is not to believe anything I say. Check it out for yourself. It would be a mistake for you to accept anything I say without a complete personal investigation, testing it for yourself and either proving or disproving the principles and techniques that I discuss.

Just because I say it doesn't mean that it's true. It's what I believe to be true and has stood the test of time for me. But I urge you to be a skeptic, to think everything through and make sure it makes sense to you. Accept the things that work for you and reject those that don't.

The idea behind this book is to give you enough information so you can be self-sufficient. You shouldn't have to depend on anyone for your trading profits. You can do this yourself.

So we begin with three principles. First, the market must facilitate trade to survive; it must eventually make the big move. Second, you must be state of the art to compete, which means using the latest PC technology and TradeStation. Third, you can do this yourself, and you should not take what anyone says for granted.

You have the tools to be independent—to do this yourself.

Do not believe in anything simply because you have heard it.

Do not believe in traditions because they have been handed down for many generations.

Do not believe in anything because it is spoken and rumored by many.

Do not believe in anything simply because it is found written in your books.

Do not believe in anything merely on the authority of your teachers and elders.

But after observation and analysis, when you find that anything agrees with reason...then accept it and live up to it.

-The Buddha