Everything You Needed to Know About Trading You Learned in Kindergarten

Look Both Ways Before Crossing the Street

I lost a trader today. There's no gentler way to say it. He's gone. This nice man sought my advice many times in the past, sent me regular e-mails filled with charts and I did my best to give him straight advice. But he emptied his trading account several days ago when the S&P futures ran more than 60 points higher in two trading days. I knew he was probably in trouble: He would regularly send me two or three charts during each trading day, showing me his entries and exits—some winners, some losers.

You see, he had a character flaw and it had been eating at him for several years. He hated being wrong! If the market stopped him out, he'd wait for the smallest indication that it might turn and head back again in the direction he had originally hoped and then jump back into the fire. There would be days when he would show me three, four, five, six losing trades in a row, all in the same direction. He was certain the market would finally “get it” and turn around, so he would keep putting his fingers in the fire. And of course, he finally got terribly burnt.

I used to say, “My momma taught me that trees don't grow to the skies.” But I quit saying that because I noticed that people who read what I wrote began to say that, and some would say it when they saw large moves. When I used to say it, I meant that it's best to take your profits and get out clean if you find yourself in a windfall profit situation. But suddenly, people were saying it when they were going over charts and looking at a huge run up in a market and were looking for a counter trend entry, which was not the context in which I had ever applied it.

I was taught to look both ways when you cross the street and to never stop on a railroad crossing. Stepping in front of a fast-moving car or train can be dangerous to your health!

This trader stepped in front of a car, got up, shook his head and then stepped back onto the road and stepped in front of another car. Then he wiped his face on his shirt sleeve, turned around, and without looking, walked onto a train track and got hit square head-on by a fast-moving locomotive. And that was the end of his trading capital.

When he gets up in the morning now, he doesn't get to sit in front of his computer and look at the pre-market charts. Instead, he eats his breakfast, gets into his car and drives down to the landscaping service he works for. He doesn't get to choose which pitchfork he is going to draw on his S&P chart at 8:45 in the morning. He gets to decide if he wants to use a spade or a pitchfork to dig around the bushes he is caring for that morning. His trading life is over.

The NFA statistics say that more than 90% of the retail accounts opened with $10,000 are closed within a year because the traders who opened them have lost the majority of the money. That's a sobering statistic, but it has been a fairly steady number for years. That tells me that people beginning to trade are not hearing that statistic or they don't believe it applies to them. Obviously, it applies to all of us. If you don't find a way to control your losses, they will eat you alive!

There are people out there selling courses or books that tell you they can teach anyone to trade and consistently make money. I'm sorry, but that just isn't true. Some people are not built right emotionally to be successful traders, but then, some people are not built right emotionally to be successful writers, and most people are not built right physically to be NBA stars! But many people who try their hands at becoming successful traders are not getting all the help that is available to them.

Always Consider the Consequences of Your Actions

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Public perception is part of the problem. You would amazed to hear how many people think they can read one book or watch one video and then make money trading against the rest of the world, which includes the best traders in the world. Let's face it, there is no “beginner's league” in trading—we all swim in the same water! I tell people who ask me how difficult it is to become a trader that they should think of it as getting a quality high school and university education. I don't mean it will take seven or eight years, but they need a solid foundation followed by some deep discovery to find their own trading talents, and then they need to develop their own specialization. Once they have found an area of trading they like and might be good at, they need to master the tools of their trade. And of course, did I mention the need to be adequately funded? I am going to leave the question of the minimum amount needed in a trading account to realistically expect to make a living from your trading for another article, but every person considering trying their hand at trading should realize that the smaller their initial account, the less room for errors they have. And the last thing a new trader needs is the pressure not to lose.

But there are things traders can do to take pressure off themselves, cues they can adopt to help get on a winning run and shorten their losing runs, or at least minimize the effects of their series of losses. In my mentoring sessions, one of the things I teach after getting to know a new student is a set of tools that will force them to limit their losses, and equally important, reward them when they really have a nice day.

Let me tell you how it works: If you normally risk $150 per contract per trade and you are trading one contract each time you trade, you should be choosing your trades so that they have a risk/reward ratio of at least two dollars gained for every dollar risked. This means that on average, if you are risking $150 on every trade, your winning trades should average at least $300 at the end of each month. This is simple bottom line risk/reward analysis. If your monthly risk/reward is higher than 2:1 and you make winning trades 50% of the time, you are well on your way to being a profitable trader—but you're not there yet!

Now that we have your risk reward target, we need to talk about maximum sized losses versus maximum sized gains. When I begin to plan out a trade, I use a visual cue that helps me stay within the loss parameters I have set for myself. I view my trading account as a checking account, and when I am planning my trade and filling out my trade sheet (which I always do before I enter any trade), I literally write a check out in the air, right in front of myself, for the amount, per contract, that the potential trade will cost my trading account if my stop loss is reached. If the check that I write out is for an amount more than what is my maximum acceptable loss on any trade, per contract, I do not take the trade. The act of writing the check out in the air forces me to confront the size of the potential loss before the trade is entered.

And writing this check before each trade is entered has an added benefit: As I write the check, I simply consider that I have just spent that amount, per contract, out of my trading account. I assume that money is gone, even before the trade is entered! Sound crazy?

By assuming the stop loss money is gone, I have also dealt with any emotions associated with the trade if it turns into a loser: I've already lost that money, right? But if it turns into a winning trade, I not only get the profits I accrue in the trade, but I get the initial stop loss money check back as an added bonus! I know it sounds crazy, and believe me, when I first started writing out stop loss checks in the air at the proprietary trading room I run in downtown Chicago, the other four traders used to scratch their heads or shrug their shoulders because they thought I was crazy, too. But after watching me do it for a few weeks, they started doing their own version: One of them literally had checks printed out and he writes out a check while considering a trade; another has a check form built into his trade sheet, so he goes through the same ritual right on his trade sheet. Try it. You might find it helps you limit the size of your losses, and also makes it easier to deal with your losses.

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The next piece I always put into place is a series of simple limits:

1. The maximum amount you are allowed to lose in a day.
2. The maximum amount you are allowed to lose on any trade.
3. The maximum number of consecutive losing trades you are allowed in a day before you stop trading.
4. The maximum number of losing trades you are allowed to have in a day before you stop trading.
5. The maximum number of losing trades in the same direction you are allowed to take in a day before you stop trading.
6. If you violate one of your trading rules, you will take "X" days off, staying away from the markets entirely.

Sound restrictive to you? It's meant to be restrictive! There should be hard limits on every aspect of your trading. If you start to lose money and it turns into a series of losers, you want hard limits in place so the damage to your account is limited. If you break one of your trading rules, you are either out of control or you are very tired and ragged and badly need an emotional or physical break.

Let's try to fill in those numbers a bit and see how they might look. If you look at your current trading statistics and see that on a good day, you make an average of $500, and the maximum loss you take as your initial risk is $150 (per contract assuming one contract per trade), the numbers might look like this:

1. The maximum amount you are allowed to lose in a day is $900.
2. The maximum amount you are allowed to lose on any single trade is $150.
3. The maximum number of losing trades in a row you are allowed to have in a day before you stop trading is three.
4. The maximum number of losing trades you are allowed to have in a day before you stop trading is five. (You may have had a win or two between losses, but there is a time to stop trading.)
5. The maximum number of losing trades in the same direction you are allowed to take in a day before you stop trading is three.

You'll note that the maximum amount you are allowed to lose in a day is considerably larger than if you had three losing trades in a row and lost their maximum amount. This is purposely set higher because there are times when you get unusual slippage or have a position on and an unusual event occurs, leaving you with a loss much greater than your planned $150.

You can adjust these numbers up or down, but the key is to have them in place, written down, and in front of you at all times. And *never* violate them. If you do violate them, force yourself to take time off from trading.

Pat Yourself on the Back

Now let me add an additionally important piece to this plan: Rewarding yourself! Let's see if we can define some important ways that might underline the positive events in your trading days:

1. If you are up “X” on a single trade, you will put a profit floor of “X” underneath the current price to protect a portion of those profits.
2. If you are up “X” on a single trade, you will take the money and close out the trade.
3. If you are up “X” for the day, you will take the rest of the day off, stay away from the trading screens, and do something you enjoy doing—other than trading!
4. If you are up “X” for the month, you will put a profit floor of “X” underneath the month's profits to protect a portion of those profits.
5. If you are up “X” for the month, you will take the rest of the month off, stay away from the trading screens and do something you enjoy doing—other than trading! Take a vacation, sleep late and read books, or do something else fun!

Trading is hard work! When you get it right, it is important to internally recognize that you did something special.

I can't tell you how many traders have experienced this: At the beginning of the day, they take a position in their normal market. Unexpected news comes out and before they know it, they have three times as much in potential profit in this first trade than they have ever made in a single day! They assume the trade will keep running because of the news and watch as it tops out and begins to turn. Because they have never had parabolic profits from news before, they don't realize that sometimes, what goes up fast comes down just as fast. Before they know it, they find themselves taking some profits out of the trade, but the profit they end up taking is much smaller than their largest profit in a day, and this trade becomes “the big one that got away.”

Stop and think about this for a moment. Had they simply taken the stupendous profit and walked away, it would have been marked in their trading memory for life! Instead, the trade will always be remembered as “I almost...” and be a disappointment, even if they made a good deal of money on the trade.

And if they then go on and make more trades that day, they often turn what had been a career-type trading day into a flat or losing day. They are so stunned and wrung out from the emotional roller coaster ride of the first trade that they are not capable of trading with their normal discipline. This can be an emotional nightmare for a trader, and in many ways, it can cripple their trading career for life!

Let's see if we can fill in some of those numbers, all assuming you are trading a single contract at a time:

1. If you are up $1,200 on a single trade, you will put a profit floor of $500 underneath the current price to protect a portion of those profits.
2. If you are up $1,800 on a single trade, you will take the money and close out the trade.
3. If you are up $2,500 for the day, you will take the rest of the day off, stay away from the trading screens, and do something you enjoy doing—other than trading!
4. If you are up $15,000 for the month, you will put a profit floor of $5,000 underneath the month's profits to protect a portion of those profits.
5. If you are up $20,000 for the month, you will take the rest of the month off, stay away from the trading screens, and do something you enjoy doing—other than trading! Take a vacation, sleep late and read books, or do something else fun!

I based these numbers on a trader with an average winning trade of $500 per contract, a 50% win/loss ratio, and again, this trader always trades only one contract at a time. The size of the numbers you come up with may be radically different than what I just wrote down. They are only meant as a starting point for your mental exercise! It should take you several weeks of soul searching before you finalize your first set of hard and fast rules, but you should have a set of rules written down and on your trading desk where you can see them at all times. You should also always fill out a trade plan before you enter any trade, and stick to your trade plan without fail! As I noted before, if you violate any of the trading rules, make yourself take a break. If you love trading, having to be away from it should feel terrible! You will avoid being put in the penalty box at all costs!

This trader wasn't in my mentoring program, but he conversed with me via e-mail daily, and often enough that when a day went by when I didn't get an e-mail from him, I would wonder if he had hit a tough streak or if he had taken a day off. After he had one rough stretch, I e-mailed him and spelled out the set of rules I suggest to the traders I mentor. He thanked me for them, told me he thought they were a great idea, and never mentioned them again.

I lost a trader today. It saddens me to think that I was unable to help him overcome his own internal flaws. I truly did my best to help him, but it wasn't enough. One thing I tell people in my free Webcasts, on my Web sites, and in my mentoring programs is this: Your birth certificate does not say “Trader” on it. If you want to be a consistently successful trader, you have to learn a good deal about the markets and about trading tools, but mostly, you have to learn a great deal about yourself!

I wish you all good trading.

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