Tips for Traders | 2/4/2008

The Day I Watched Several Traders Implode–A Bar-by-Bar Account

Societe Generale, one of the largest French banks, recently announced they had recorded the largest trading loss by an individual trader, US$7.2 billion, by a stock index trader named Jerome Kerviel. This incident reminds me of the Sumitomo Corp. US$2.6 billion loss in 1996 by its chief copper trader, Yasuo Hamanaka, Nick Leeson's US$1.4 billion loss that brought down Barings Bank, Allied Irish Banks US$691 million loss in 2002 and similar incredible trading losses by Joseph Jett that brought down Kidder Peabody in 1994. These were once successful professional traders wrapped in safety nets by their institutions and yet they all lost incredible amounts of money. How does a trader get him or herself in such a position?

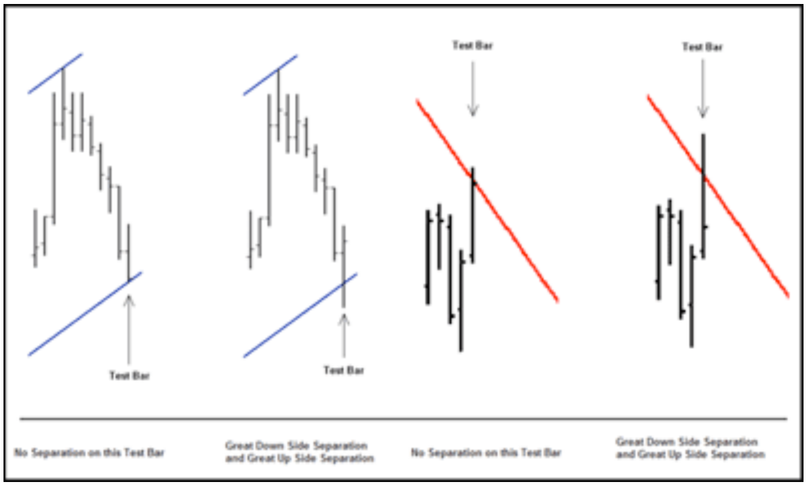
I have been a professional trader now for 35 years. I've probably made every mistake that can be made and broken most of the trading rules that can be broken—except one very important set of rules: :

1. Always have stop loss orders in place when you open any position.
2. Never lie to yourself or anyone else about your losses.
3. When you find yourself out of step with the market, close all your positions immediately and walk away from that market. Then take a break from trading.

I was very fortunate when I first started learning how to trade because I was trading in my elder brother's trading account. He set an amount he would allow me to lose and if I lost that amount, he would end my access to his trading account. He made it very clear that if I could not control my losses and keep them below the level he set for me, he had no tolerance for me using his money and his account. Once I started trading, I couldn't imagine a fate worse than not being able to continue to trade, so the rule was easy for me to follow and was deeply ingrained in me early on in my trading development.

I have had the honor and pleasure of teaching hundreds of professional traders at the CBOT and CME over the past three years. I regularly mentor more than 350 of them and get to see their trades throughout the trading day, which means I see their successes and failures day in and day out. And at times, I see these professional traders make catastrophic errors in their trading judgment. One example sticks in my mind because the group of six traders involved had an office right down the hall from my proprietary trading room. Let me tell you about one trading meltdown situation I witnessed.

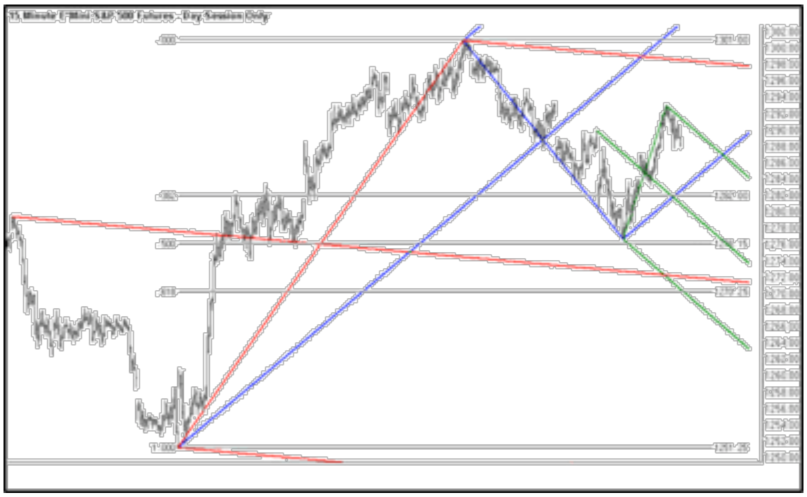
In my own trading and in my seminars and webcasts, I teach that the majority of trading profits come from the "middle" of the market. That doesn't mean traders can't make money picking tops and bottoms, but in my experience, traders that make a habit of fighting the market—by constantly picking tops and bottoms—tend to lose. The market is always right and we are just along for the ride. One of the most useful tools I have added to my tool kit is called "Separation," and it refers to the distance between where price tested a line of support or resistance and where it closed. It can also refer to the distance price spiked past resistance and then closed back below the line of resistance—if price spikes above a line of resistance with good separation but then closes back below the line with good down separation, it is a sign of weakness. Similarly, if price spikes below a line of support with good down side separation but then closes back above the line with good up side separation, it is a sign of strength. Let me see if I can illustrate this important concept:



Separation is an important insight into the market because traders always have to decide what mode they think the market is in. For example, if price has been cascading lower and a small rally climbs above a prior swing high, is this current rally a counter trend rally—the trader should then be looking for an area to get short—or is this the start of a change in trend to the up side? Separation makes the market participants “play their cards” before you commit your capital to a position. If you don't see enough separation to clarify the situation for you, simply wait for another bar to form or pass on taking a trade altogether until price clearly shows you what mode the market is in.

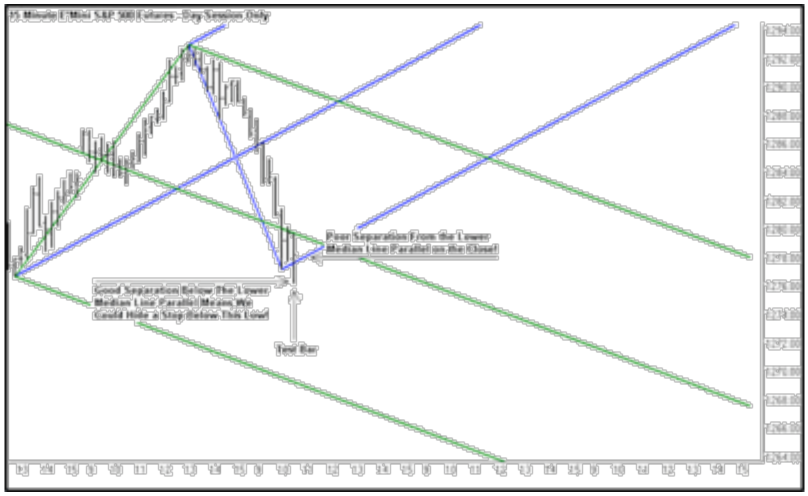
But traders, even professional traders, are often an anxious group and like to anticipate movements. Sadly, when a trader successfully picks a top or bottom, it reinforces this dangerous behavior. At the exchanges, everyone has a story about a guy that picked the exact top in this index or that commodity but the story always ends the same: He “blew out” the next year and doesn't trade anymore.

The six traders I mentioned earlier were very experienced traders. They each averaged about fifteen years of professional floor trading experience before they took my seminar and became students of my methodology. These particular six traders knew each other from the floor and had decided to ‘pool’ their money. They watched the markets together in their trading room and then entered group orders. And they were frequent visitors at the door of my prop room, where the rule is simple: if you have a question, you must bring your trading plan and a chart of the potential trade with you. Then you knock on the prop room door. If I don’t have a position on, I’ll spend time going over your potential trade entry with you, to make certain you’ve applied the course rules, used good money management in your stop loss, entry and profit orders and that your risk reward ratio is not skewed. Now let’s look at an image of a chart of the E Mini S&P futures market taken before the market opened:



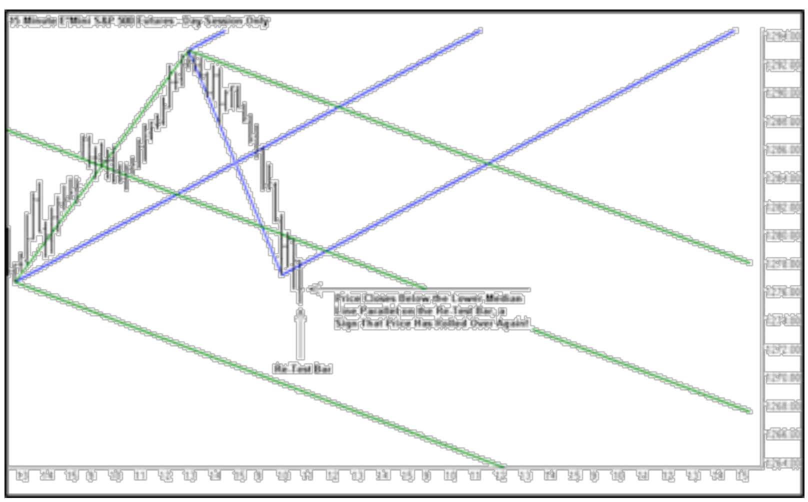
Before the 7:30 am numbers, the market was trading a touch lower. Most of the floor traders decided when they did their morning analysis that this market was beginning a new up side stair step and they were hoping for an opportunity to buy a pullback. One thing they all cited was that price hadn’t even approached the 38.2 percent ‘Fib’ retracement at 1282, which they cited as the sign of a strong market. This market opened weak and ran through the 38.2 percent retracement without looking back. And though that was one of the main signs of strength traders had cited before the open, once this level was violated, they didn’t change their opinion—they simply ignored the violation of the retracement level.

Around 10:30, there was a knock on the door. The six gentlemen from down the hall were at the door and had their trade plan with them, along with a printed chart for me to look at. Here’s the chart they brought me [please note that all written comments on the charts are my own comments]:



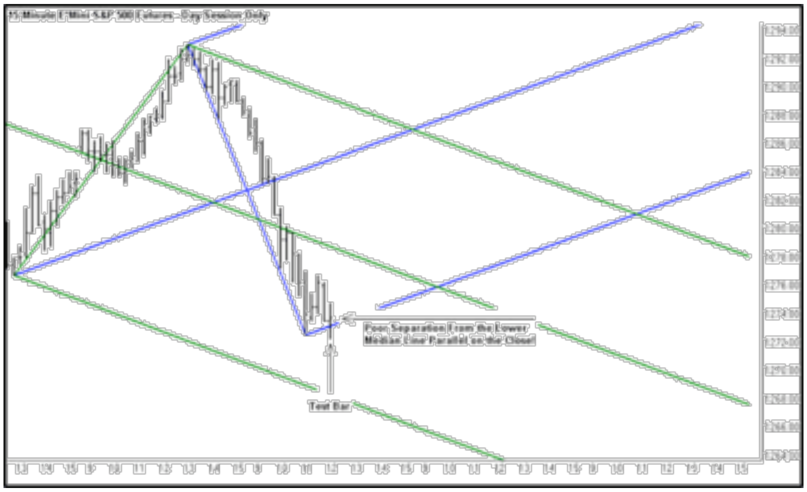
They were looking to buy a re-test of the blue up sloping Lower Median Line Parallel that price had just tested. My response to them was that although price had broken below the up sloping line and then closed back above it, it had not closed above it with good separation. I urged them to 'buy another bar' and let the market show them it was bottoming before they committed any capital to a long position. I didn't see a reason to think this market was turning up yet. It had fallen thirteen S&P points with no pullback. If anything, I was eyeing the green down sloping Median Line as an area that would potentially stop any rallies, but there were no formations to hide initial stops above. They listened to my opinion and then went back to their own trading room to enter their limit buy orders.

Let's see what the next bar brought:



The six traders down the hall entered orders to buy the re-test of the blue up sloping Lower Median Line Parallel and put their initial stop loss order below the low of the test bar. They were quickly filled on their entry order and stopped out before their entry bar closed.

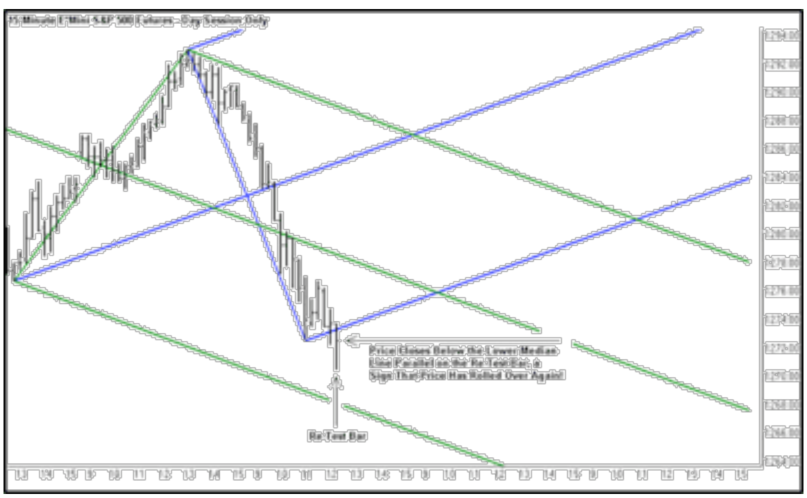
About an hour later, there was a knock on the door again and to my surprise it was the six traders from down the hall, with a new trade plan and chart in their hands. Here's the chart they brought with them this time:



They felt that price had fallen 17 S&P points and had just left 'near double bottoms'. Their trading plan was the same: they wanted to buy a re-test of the blue up sloping Lower Median Line Parallel and put their initial stop loss below the low of the current test bar. They told me, "surely this thing has to stop somewhere! It's down 17 big figures!"

I pointed out the poor separation and also that price had so far failed to climb above one single swing high. To me, this market was showing no sign of a bottom. I didn't have a high probability trader entry to get short, but I had no interest in being long this market—not until price gave me a clear sign that buyers had taken control of the market. I urged them to 'buy another bar', which meant wait for another bar to unfold before making a decision on entering orders. But as they left, I could tell they were likely to walk into their trading room and enter limit orders to get long.

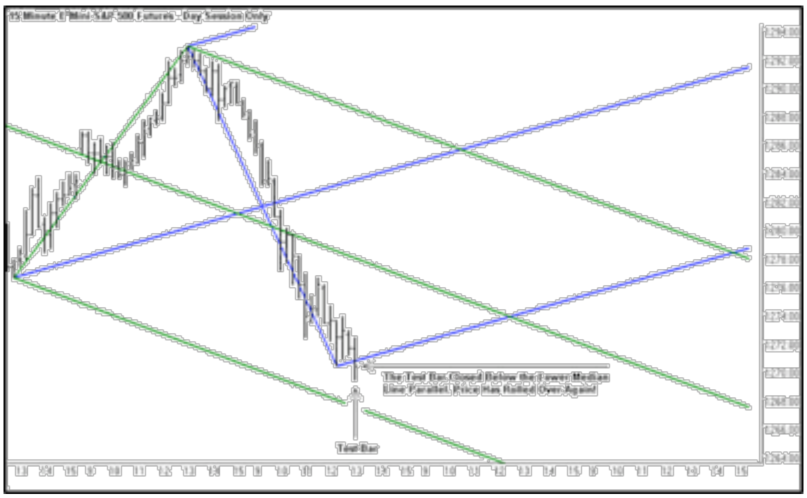
Let's see what the next bar brought:



You can see that once again, the six traders were filled on their limit buy order and stopped out on the same bar. And price was showing no sign of slowing down.

I generally tell traders I work with that if they take two consecutive positions in the same direction and get stopped out both times, they are probably out of step with the market and should consider taking the rest of the day off. Many traders do not listen to this advice, but I've seen over the years that once you get 'turned around' in a market, you can lose a lot of money in a very short time if you just keep entering trades.

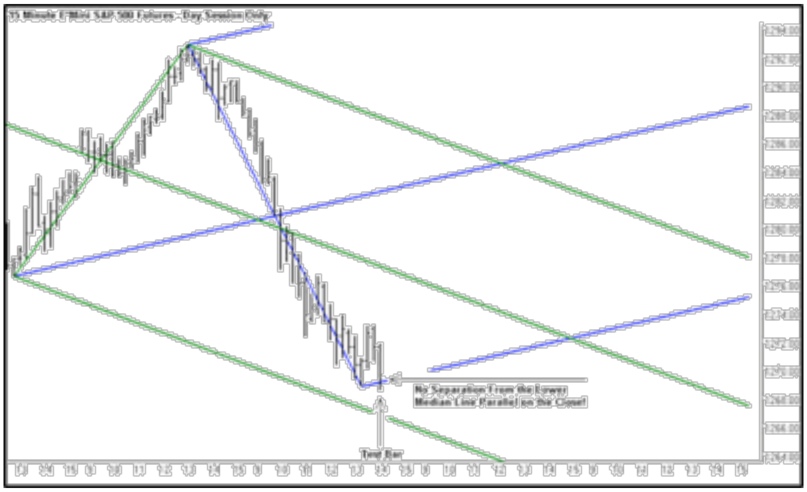
About 45 minutes later, there was a timid knock on the door and as you probably guessed, my six traders were back again with a fresh trade plan and a new chart. Let me show you the chart:



When they entered the prop room, price had not yet moved below the blue up sloping Lower Median Line Parallel and they had just started to explain their new plan to get long when one of them looked up at my screen and mumbled, "Never mind", and once they all saw where price was trading—well below the line—they turned on their heels and walked out without a word.

You can see that they were stuck on an idea and the market was punishing them for inflexibility. This is how traders turn a 'normal' losing trade into a series of losing trades that grow in size and can cripple their account or even cost them all their trading capital! The market is always right.

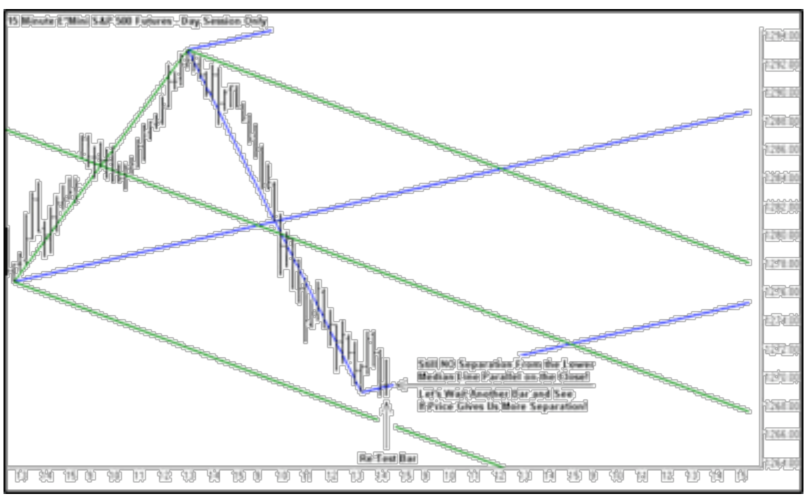
Once again, there was a knock on the door. They were back again, trade plan and chart in hand. I will give them credit for coming back to talk with me before each trade, even though they were having a very bad trade. They weren't willing to take my advice but they did come and ask my opinion of their charts and trade plan. Here's the chart they brought with them this time:



When they showed me this chart, I admit I told them quite clearly that they were out of step with the market and turned around. I saw no sign of anything remotely looking like a sign of strength. In fact, price had just tried to climb higher and had left double tops.

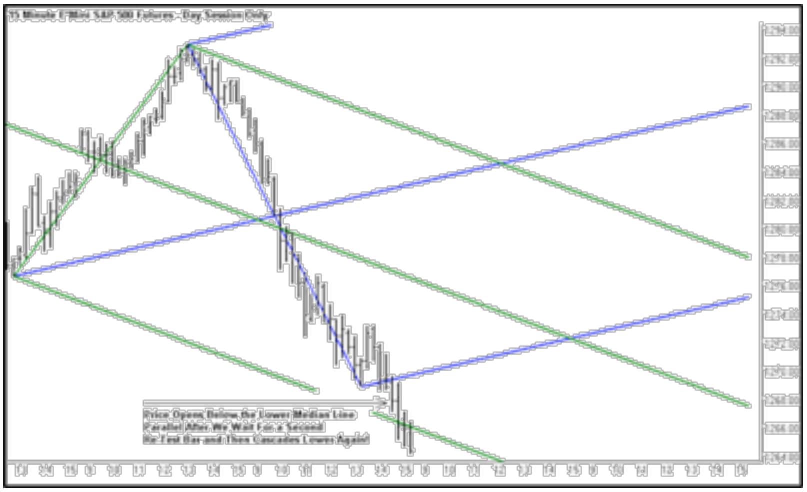
Their response was that price was now down more than 21 S&P points and they thought the chart was starting to look ‘bottom-ish’. The bars I viewed as double tops they actually liked, because they had moved above some prior bars, which they felt showed strength. Clearly, I was not getting through to them. I once again urged them to call it a day or if they decided to keep trading, at least ‘buy another bar’ and wait for the market to show them some true strength. But they were adamant about the charts looking ‘bottom-ish’ and didn’t want to miss the rally that was surely coming during the last 90 minutes of trading day, ‘when the shorts would get squeezed.’

Here’s what the next bar showed them:



As the next bar closed, one of them popped their head into the prop room and gave me a ‘thumbs up’ sign. They were long and hadn’t gotten stopped out. They were excited because price had left a double bottom and in their opinion, had closed above the blue up sloping line two bars in a row [in my opinion, price had closed right on the up sloping line both times, which to me showed a lack of buying].

The trader closed the door behind as he left without saying a thing. Let's see how the market treated them:



Once again, they were stopped out of their long position. And thankfully, no further knocks came at the door that afternoon, because the market continued lower, closing on its lows roughly 35 S&P points lower on the day.

One of the six traders lost all the capital in his trading account that day; several never recovered from the emotional impact this day had on them. The rest are still trading and the emotional and financial beating they took that day seems to have been taken to heart.

When you read about catastrophic losses by professional traders, remember: It could easily have been you! If you enter one trade and don't protect yourself by entering an initial stop, it could be you. If you add to a losing position, it could easily be you. If you are inflexible, entering trade after trade, because the market "must be wrong," it could be you. If you are out of step with the market, by all means stop. There will always be other markets and other days if you keep some of your capital. Unfortunately, even professional traders sometimes find themselves unable to stop trading and walk away, or find themselves unable to close a losing position because "loss is just too big."

If you remember nothing else, please remember this: once your capital is gone, you can no longer trade. If you love trading, you'll treat your capital as the precious resource it is.

I wish you all good trading!

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