

MODERN **TRADER**

PROFITABLE TRADING STRATEGIES IN ANY MARKET

ABOUT

Profitable Trading Strategies in Any Market

Strong trading strategies share one thing in common: They survive the test of time. These strategies are not reliant on a specific market fundamental—in fact market outliers cause them to underperform— but have been tested across various cycles. Here are several strategies described in *Futures* and *Modern Trader* magazine over the last few years that you should know. Included are rules all traders should know.

Futures and *Modern Trader* have presented hundreds of trading strategies over the years. Some we revisited because, well because they work. Some approaches to trading have been so popular, readers have consistently asked for more, as is the case with Al Brooks' price action series.

Here are several strategies, new and old, that deserve another look, including a broad look at evergreen trading rules that have stood the test of time.

DANIEL P. COLLINS,
MT EDITOR-IN-CHIEF



Editor-in-Chief of *Modern Trader* magazine, Daniel P. Collins is a 25-year veteran of the futures industry having worked on the trading floors of both the *Chicago Board of Trade* and *Chicago Mercantile Exchange*. Dan originally joined *Futures* magazine in 2001. In 2013 Collins was named Editor-in-Chief and navigated the publication through the introduction of *Modern Trader* in 2015. His incisive reporting and no-holds barred commentary places him among the most recognized national media figures covering futures, derivatives trading and alternative investments.



Table of Contents

4

Price action trading:
The basics

by Al Brooks

8

Price action trading:
How to trade

by Al Brooks

11

Trend trading the
flat base pattern

by Billy Williams

14

Forecasting with
caliber and affinity

by Bill Ralph

17

The American crowfoot

by Bill DeBuse

20

10 rules successful
traders follow

by Jean Folger



Price action trading: The basics

BY AL BROOKS

This is the first of a six-part series that provides an overview on how to trade using price action on all time frames and in all markets. Although there is no universally accepted definition of price action, I use the broadest one — it is simply any move up or down on any chart for any market.

The smallest move any market makes is one tick (one pip for forex markets). If a market moves up one tick, it is because there are not enough sellers at the current price to fill all of the buy orders, and the market has to go higher to find more sellers. If it falls one tick, it means there are not enough buyers at that price.

Day traders don't have the ability to spend time thinking about anything other than whether the market will go up far enough to make a profit if they buy, or fall far enough to make a profit if they short. I make several assumptions that allow me not to worry about anything other than the price action on the chart being traded. It is impossible to know if my assumptions are true, but they are consistent with how the market behaves; if they prove wrong, change those assumptions.

TWO SIDES

In every major market, no trade can take place unless there is at least one institution willing to take the buy side and another the sell side. Institutions dominate all major markets; individual traders are simply not big enough to have any effect. Although a trader might believe his order moved the market, that belief is almost always deluded. The market moved only because one or more bearish institutions and one or more bullish institutions wanted it to make the move, even though time and sales might show your order was the only one filled at that price.

Moreover, traders should accept that 75% or more of all trading is being done by computers. The math is too perfect

and the speed is often too fast for anything else to be true. Still, every tick is important, especially in huge markets like the E-mini S&P 500. If you spend a lot of time studying the market, you can see a reason for every tick that takes place. In fact, you can see a reasonable trade to consider on every bar during the day.

What about all of those one-lot orders in the E-mini or the 100-share orders in Apple (AAPL)? The majority of them are being placed by computers conducting various forms of computerized trading (including high-frequency trading), and it often involves scaling in or out of trades and hedging against positions in related markets. Some firms are placing millions of orders a day across many markets. Scaling into a trade means to enter more than once, either at a better or worse price, and scaling out means to exit the trade in pieces. They are taking a casino approach, making a big number of small trades, each with a small edge, and this can result in tens or even hundreds of millions of dollars in profits each year.

All profitable traders, whether institutions or individuals, will only buy if they believe the probability of making a profit is greater than the probability of losing money. This is the "Trader's Equation": for a trade to be profitable, the probability of making a profit times the size of the profit (the reward, which is the number of ticks to the profit-taking limit order) has to be greater than the probability of losing times the size of the loss (the risk, which is the number of ticks to the protective stop). The risk and reward are known because the trader sets them; he decides where he will take his profit (his reward) and where he will take his loss (his risk).

The third variable is the one that causes the greatest problem for most new traders. They quickly discover that all of those

books and courses that make trading look so easy hinge on a fallacy that there are a lot of perfect trades where the probability is high and the reward is much bigger than the risk. Perfect or nearly perfect trades cannot exist because every trade needs institutions on both sides.

If a trade is perfectly good for the buyer, it has to be perfectly bad for the seller, which means taking a low probability of winning where the risk is much bigger than the reward. No institution would ever take the other side of a perfect trade because it would lose money over time even if it occasionally won. The result is that no trade can be perfect. There has to be something in the trade for both the buying and selling institutions, the majority of which are profitable.

How can it happen that traders taking opposite sides of a trade can both make money? It comes down to trade-offs among the three variables in the trader's equation: risk, reward and probability. You often hear about risk/reward ratios, but whenever you do, the author is implying the probability is high, which may or may not be the case.

Some trades are very high probability trades. For example, a high probability trade is where the market races up to your profit-taking limit order, but does not fill it, and then pulls back one tick. At this moment, you almost certainly will not change your order and will hold because you correctly believe the strong momentum will result in you getting filled within the next few seconds. That means you had to give up something on one or both of the other variables because otherwise you would have a perfect trade, which cannot exist.

What are you giving up with that high probability trade? Well, your reward is now only one tick, since you are trying to take profits one tick higher than the current price. This means that in exchange for your high probability, you are forgoing a big profit and are willing to take only a minuscule profit (see "High and low probability setups," below). You are accepting a very small reward. Furthermore, you probably are relying on your stop, at least for the next several seconds, and your stop is probably many ticks away. Say your stop is six ticks below the current price. This means

you are willing to assume a risk that is six times greater than your reward in exchange for a very high probability. You need to be about 90% confident for the "Trader's Equation" to make this a worthwhile trade.

Traders never really have enough time to debate whether the probability is 90% at that instant, or if they just feel it is worth relying on the current stop and profit-taking orders for at least a few more seconds. Although it is not conscious, they have to believe they have a 90% chance of success to make this decision because that is the only rational basis for holding it. Does this make sense? Of course it does, and it is a decision all of us make whenever the market gets close to filling our profit objective.

ULTERIOR MOTIVES

While there always has to be an institution taking the opposite side of every trade, it is not as simple as saying that the instant your trade pulled back one tick, an institution shorted with the intention of doing the opposite of you. If such a theoretical institution existed, it would be giving up probability to attain a high profit relative to the size of its risk, which can make sense if the three variables are the right size.

Rather, think of the opposite side as being made up of a pool of institutions, all of which have tested algorithms and concluded that their combination of risk, reward and probability has a profitable "Trader's Equation." Some of those bears want high probability, which means that their reward will be small compared to their risk; they might short and sell higher. A different bear might take the opposite side of your trade by structuring a trade that favors reward at the expense of risk and probability. It does not matter.

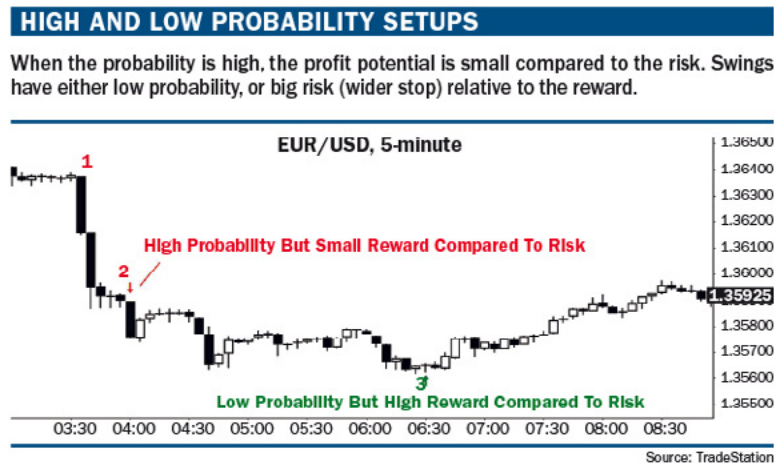
However, it is important to be comfortable believing that at every instant there is a way to structure both a long and a short trade that have positive "Trader's Equations." This is true even in the strongest trends. This frees you from only considering one direction and forces you to remember you are trading in a market where both the bulls and bears make money. It is

possible to either buy or sell at any instant and make money if you structure the trade correctly. You also have to take enough trades; you can even lose on most of your trades if your winners are big enough.

NEW ERAS

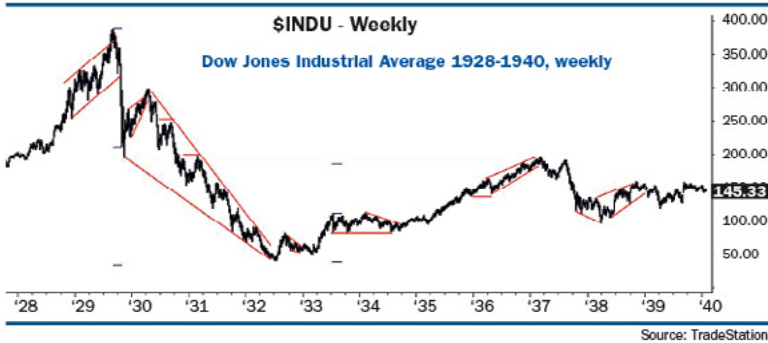
A common topic is whether computers and cultural differences have changed the way markets behave. I have studied charts going back 100 years, and have traded since 1987. If you remove labels from charts, you can't tell if the chart is from 1910 or 2010 or if it is a five-minute forex chart or a monthly Dow chart.

How can computers not have affected the price action? It clearly has some effect, but algorithms simply look for logical patterns and then structure trades where there is a mathematical



TRADING THROUGH TIME

This is a weekly chart of the Dow Jones Industrial Average during the Great Depression. Price action trading will always work because it is based on genetics and logical behavior. Without labels, it is impossible to know this chart is from 80 years ago.



edge. That is what all traders have done in all markets since the beginning of time.

Trading has always been part of civilization and crucial to the survival of society. The more fit traders have an advantage. Trading is genetically rooted, and computers simply move trading further along the evolutionary path. This is why the charts are the same as they were 100 years ago and why the charts of all markets and all time frames look the same and always will.

Traders learn early on that it is difficult to make money and the sense that the edge is small. They then naturally think of ways to increase their edge. One is to use indicators, like the ones they see in all of the ads online and in the magazines.

If trading is moving toward perfection, how can anyone make money? Simple. We live in a competitive world, and some will always be better than others. Better traders will always have an edge, which is a mathematical advantage, and they will make more than everyone else. What about the argu-

WHO'S WHO

Price action trading works on all markets and time frames. Below is a one-minute, five-minute and daily chart of a stock, commodity, and currency. The figure on the left is a daily chart of GE during the 1987 crash; the middle chart is a one-minute EUR/USD forex chart and the chart on the right is a five-minute gold futures chart.



ment that trading is a zero-sum game and that no one can ever really make money long term? Over the next day or two, trading is essentially a zero-sum game. However, the world economy has been growing at about 3% a year forever, and this means there is 10-times more money in the world today than in 1987, and 100-times more than in 1927. The pie will always grow, so everyone can have a piece; the better traders will have the biggest pieces.

REDUCTIO AD ABSURDUM

"If I can make more money on the five-minute than on the daily chart, then I surely can make much more on the one-minute chart."

This logic ignores the practical limitations of the human brain. We are not computers, and we have real time limits for our ability to process information and make decisions accurately. If we do not have enough time, we are more likely to make bad decisions. For most traders, they should trade charts that have no more than 20 bars per hour. Most should trade a five-minute chart or an even higher time frame.

What looks obvious on a printed chart after the close, when you can see all of the bars to the right of your signal bar, is usually not obvious in real time. Also, a bar often looks far different in the second that it closes than it did even one second earlier. This means a trader has much less time than what he might believe when he looks at a chart at the end of the day.

"If I can make money when scalping for 20 ticks, I can make even more if I take far more trades, scalping for one to three ticks!"

This is another fallacy that I see promoted on different websites; it is an example of theory colliding with reality. Not only is there the problem of our inability to process information accurately when we have to decide too quickly, there are the additional problems of slippage, spreads and commissions.

Most traders cannot trade E-minis for less than about \$5 round turn commissions. If they scalp for one point, their net profit is \$45 when they win and their net loss is \$55 when they lose. If they scalp for one tick, then they make \$7.50 on their winners and lose \$17.50 on their losers. They usually have to give up one tick when they enter and another when they exit. This means the market has to move three ticks for them to make one. They almost always have to risk at least two to four ticks.

Let's say a trader is trading the five-minute chart and risks three ticks, \$37.50; he needs the market to move three ticks in his direction before it moves three ticks against him. When he is right, he will net \$7.50, assuming there is no slippage and he never makes mistakes. When he is wrong, he will lose \$37.50, or five times more. He has to be right 80%

of the time just to break even. And that is not just on the next three trades for the next three days. It is for the rest of his career. Yes, theoretically it's possible. Paul Rotter supposedly made millions scalping for three ticks in forex, but it is so difficult and unrealistic that traders should not try it.

FAIR TARGETS

If a three-tick goal is too small, what is reasonable? It varies with every market, but traders can quickly figure it out by looking at the price action. If there are a lot of six-tick moves in the E-mini, then a lot of traders and computers are scalping for four ticks. (If they enter on a stop one tick beyond the signal bar, the market usually has to move five more ticks to secure a four-tick move). If there are a lot of 22¢ moves on crude oil, many are scalping for 20¢. If there are a lot of 12-pip moves in the EUR/USD, then traders are scalping for 10 pips. If a trader is looking at limit order sets, everything will be one tick less. For example, if there are a lot of nine-tick moves in the E-mini, then many traders are scalping for two points (eight ticks).

Because scalping is extremely difficult to do profitably long term, most traders should look for trades where the reward is at least twice as big as the risk. If a trader thinks he needs a 20-pip stop in the EUR/JPY, he should plan to hold for a 40-pip profit. During strong breakouts, the momentum is strong, which means the probability of follow through is high. In these cases, the probability of a profitable trade is 60% or more, which means it is mathematically reasonable to scalp for a reward that is the same as the risk, instead of two times bigger. If he risks \$2 in a gold breakout, he can exit with a \$2 profit and still have a mathematically sensible trade.

There is a little more to this because the initial risk is not the same as the actual risk, and the profit target usually should be based on the actual risk. If a trader initially risks 50 pips in a EUR/USD trade and the market went against him for 12 pips and then quickly went his way, he now knows he had to risk only 13 pips to avoid being stopped out. This means his actual risk was only 13 pips, not 50 pips. All of the computers can detect this, and many will then adjust their profit targets based on this actual risk. This means many will take partial profits at 13 ticks, where you will often see a small pullback from the profit taking.

Why choose a reward that is two times the risk for most trades? Because most traders are never too confident about their assessment of the probability when they enter a trade. Remember, there has to be something in it for the institution taking the opposite side of your trade. It has to be able to make a profit if it structures the trade correctly, which often means it will scale in.

The institution thinks its side is good, and you think yours is good. The result is that we trade in a gray fog. However, at almost every instant in every market, the probability that the next five ticks will be up rather than down is between 40% and 60%. If you buy or sell at any time and hold for a reward that is about the same size as your risk, you will have at least a 40% chance of success. If you plug 40% into the "Trader's Equation," you will see that you will need to hold for a reward that is at least twice as big as your risk to make a reasonable profit over time. Bottom

line: You are always going to be uncertain when you enter, but if you always try for a reward that is twice as big as your risk, the math is on your side.

Also, whenever you have a profit that is twice as big as your risk, you can always exit. The math always is good for this approach. If the trend is strong, the math is in your favor if you hold for a bigger profit, but it is always mathematically reasonable to exit part or all of any trade once the profit is twice the risk. Also, if the trade is a high probability trade (60% or more) it is mathematically reasonable to exit part or all of the position once the profit gets as large as the risk.

The next article will cover the folly of fundamentals and indicators as well as scaling into trades. **▲**

Al Brooks, MD, has traded for his personal account for 27 years. He is a regular contributor to Futures and the author of a three-book series on price action published by Wiley.

Price action trading: How to trade

BY AL BROOKS

There are three phases to the market cycle: Breakout, channel and trading range; and traders use different entries, stops and exits, depending on what the market currently is doing. There are trading opportunities on every bar for traders who understand where in the cycle the market is at the moment.

A strong trend is just another term for a breakout, which simply means a move up or down from an established range with little or no pullback. A breakout can be one big bar, two or more medium bars, or five or more small bars. Once the market forms a pullback, traders then will look for a transition into the channel phase. Sometimes there can be a second or

third breakout before a pullback leads to a channel. Channels are weaker trends and eventually evolve into trading ranges, where the market is once again neutral and the probability of trend resumption drops once the range has 20 or more bars.

In general, when a trend is strong (the breakout phase), traders will look to trade only in the direction of the trend. As it weakens into a channel, traders will be quicker to take profits and more willing to scalp in the opposite direction, especially if they are willing to scale in as the market goes against them. As the channel phase of the trend transitions into a trading range, traders switch to “buy-low, sell-high” scalp trading.

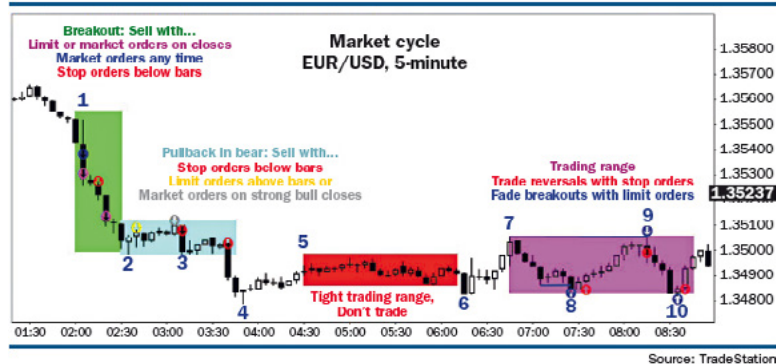
“Range trading” (left), which shows the five-minute EUR/USD forex market, provides an overview. During the strong bear breakout (highlighted in green), traders will look to short for any reason. They will sell:

- at the market,
- any small pullback as the bar is forming or after it closes,
- on the close of any bar, whether there is a bull or bear close,
- above the high of the prior bar using limit orders,
- below the low of the prior bar using a stop order.

The ideal protective stop is above the top of the breakout (the bar 1 high). Some traders are unwilling to risk that much and they might use a money stop, such as 20 pips (ticks) from their entry price. Remember the math. If a trader chooses to risk less, he will have to pay for it with

RANGE TRADING

Here, there is no traditional channel phase, but traders see the three pushes down (bars 2, 3, and 4) as a parabolic wedge channel.



a lower probability of success. Wide stops have a higher winning percentage, but the occasional loser can be as big as several smaller losses with tighter stops. There is no right answer, but some stops are obviously too tight or too wide.

Another way to reduce risk is to trail the stop to just above the high of the most recent strong bear bar. (Trailing the stop in a bear trend means to move the stop down as the market continues to fall.) After each new leg down, traders will move their stop down to just above the most recent lower high.

Once there is a pullback (the turquoise area), the market usually enters the channel phase, but sometimes there will be another breakout or two before the channel begins; at other times, the channel is so small that the market just enters a trading range, as it did here. During the channel phase, traders will be more cautious with their entries. They will no longer short below or above every bar. They will begin to prefer to sell a little higher, like below the low of a bar in a small rally to near the moving average. Many will still be willing to sell above bars and scale in higher if the bar is part of a weak looking buy setup.

The idea is that if the bull reversal setup looks weak, there probably will be more sellers than buyers above the high of the buy signal bar, and therefore selling exactly where these losing bulls buy makes sense. The stronger the bull bars (the more buying pressure), the more the bears will want a strong bear signal bar before shorting.

WAITING GAME

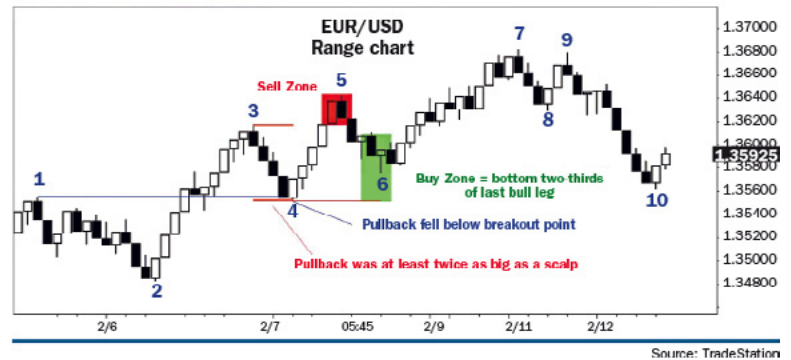
Channels transition into trading ranges, but not all trading ranges are worth trading. When a range is particularly tight, the height of the range is only one or two times the size of a minimal scalp and most traders should simply wait. Some traders will scalp by shorting above the highs of bars in the top third of the tight trading range, scale in higher and then scalp out for maybe 10 pips. They also look to buy below bars in the lower third and scale in lower, looking to scalp out with a 10-pip profit. Traders should never scalp for less than 10 pips or ticks, and most traders should go for targets that are at least twice as big as their protective stops.

Traders trade channels and trading ranges similarly because they both are areas of two-sided trading. Because a channel is simply anything between two lines, a trading range is just a horizontal channel. In a channel, one side is stronger and in a trading range, both are equal.

In general, use the size of a scalp to determine whether to take a countertrend trade. If an E-mini scalp is four ticks, look for a recent move down of eight to 12 ticks before shorting in a trading range or in a bull channel. Similarly, look for an eight- to 12-tick rally in a trading range or a bear channel before considering long scalps. If looking for a 20-pip scalp buy in a trading range or a bear channel in the EUR/USD, look for a

TRADING IN CHANNELS

In a channel, bulls will buy pullbacks that fall to the middle third of the prior leg up. They try to buy a pullback into the green buy zone, around the middle of the leg up from bar 4 to bar 5, and they will scalp or swing. Bears will scalp by shorting above a prior high. However, they will only scalp if prior pullbacks fell below their breakout point and if the pullbacks are at least twice as big as a typical scalp. If they want 10 pips, they need pullbacks at least 20 pips deep. Here, they might scalp for 20 pips as the pullback to bar 4 was 67 pips.



recent 40-pip rally first to show that the bulls are strong enough to move the market up far enough for your scalp to be profitable.

Once the market appears to be in a trading range (the pink area), traders will buy low, sell high and scalp. Buy low can be to take profits on a short or to buy to go long. Sell high can be to take profits on a long or to initiate a short. A pullback that grows beyond 20 bars loses most or all of the influence of the trend that came before it, and the probability of trend reversal becomes the same as that for trend resumption. Once there is a successful breakout in either direction, the process begins again.

BREAKOUT WATCH

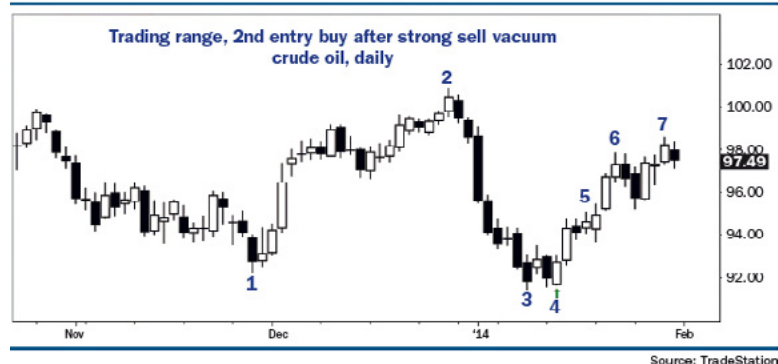
Trading ranges always look like they are about to break out. Strong legs up trap traders into buying high because the traders will assume that the strong leg up will have a second leg up after any pullback. Strong legs down trick traders into looking for shorts at the bottom of the range, again because the move looks so strong that it makes them erroneously believe that there will be a successful breakout. This is the opposite of what experienced traders will do.

People are naturally hopeful, and it takes time to get past the tendency to believe that a strong breakout attempt will succeed. These strong rallies are just buy vacuums that test the resistance at the top of the range, and the strong sell-offs are caused by the support at the bottom of the range vacuuming the market down for a test (see "Trading in channels," above).

When a leg is strong, traders should wait for a second entry before fading. If the market races to the top of the range, maybe with four consecutive bull trend bars, it is usually better not to sell below the low of the prior bar. Instead, wait to see if the market turns up from that pullback. If it then reverses down a second time, traders might sell below the low of the prior bar.

LEG STRENGTH

On a strong leg like the vacuum down to bar 3 that tested the bar 1 bottom, traders will wait for either a second signal or a reversal up before fading the move. The leg down to bar 3 was strong, so most bulls did not buy above the bar 3 high. Instead, they waited to buy above bar 4, which was a bull signal bar and the second reversal from the breakout below the bottom. Others waited to see a strong move up, like to bar 5, and then bought with a limit order below bar 5, and possibly again below bar 6.



This is a second entry short.

A second approach is to wait for a bear breakout (one or more strong bear trend bars). As long as the market is still in the upper third of the range, many traders will short the close of that bear bar. If there are three or more consecutive bear bars, but the market is still in the upper half or third of the range, traders might then short using a limit order above the high of the most recent bear bar. They are betting that the strength of the bear breakout is enough of a surprise that there are now bulls holding longs who want to get out. This usually leads to a second leg down, at least big enough for a scalp (see “Leg strength,” above).

Traders will look to short below the low of a bar at the top of the range and buy above a bar at the bottom of the range, and scalp out (take profits around the middle or hopefully the opposite side of the range). If the move up or down is too strong, they will wait for a second signal before entering. If there is a bull flag at the top of the range, some traders will short above the high of the signal bar or above the high of the highest bar in the range, betting that the bull breakout will fail.

Roughly 80% of breakout attempts up and down in trading ranges fail. Likewise, some traders will buy below bear flags or below the low of the lowest bar at the bottom of the range, betting that the breakout is a bear trap, tricking bears into losing positions.

ALWAYS-IN, LONG OR SHORT

Some traders are constantly afraid of entering because they are waiting for the perfect trade. They have not yet come to accept that perfect trades cannot exist because there always has to be a reason for an institution to take the other side of the trade. The result is that all trades look uncertain.

Once traders accept this reality, their trading lives become

more relaxed. Those who are still struggling with it should consider adopting an always-in approach to trading. If a trader looks at any chart and has to enter either long or short at that moment, his choice is the always-in direction. The choice is not always clear, but he can almost always pick one.

Sometimes a trend is so strong that the choice is obvious and other times it is much less certain. When in doubt, traders should assume that the choice is the direction of the most recent three- or four-bar breakout. If a trader believes that the market is always-in long, he can buy for a swing at the market or on a pullback, and place his stop below the low of the most recent bull breakout. This is the most recent strong leg up, which is the most recent bull trend resumption, and usually is from one to five bars in duration.

Once a trader is long, he can then add to his position as the bull continues, trailing his stop to below the low of the most recent bull breakout.

He can also take partial or full profits at resistance levels or at new highs and then put his full position back on during a pullback. Similarly, if a trader believes that the market is always-in short, he can short at the market or on a pullback, and place his stop above the high of the most recent leg down, whether a bear breakout or trend resumption (see “Always-in reversal,” left).

You often hear traders and analysts say it’s time to buy, sell or hold. This does not make sense because the two choices are really just buy or sell. For example, if your friend has a \$100,000 portfolio of stocks that his advisor says are “holds” and you have \$100,000 in cash, you could simply buy his identical collection of stocks, even though they are rated hold and not buy. You would then have his identical portfolio, which his advisor considers worth holding.

Traders should look at their portfolio at every instant as being made up of either buys or sells. If you have a profit on a stock, it is not someone else’s money. It is in your account, so it is your money, and holding it is no different from someone else simply buying it this instant, if he uses the same profit target and protective stop as you. This is the basis of always-in trading.

If you look at a market and wished that you had bought earlier and now are waiting for a pullback, then you should buy at the market. If you believe that it is good enough to be holding the stock at this moment, using a certain stop and target, you should just go ahead and buy it now. If you think that it is better to look to buy a pullback, then, if instead you were long, you should sell out and wait to buy again lower.

Traders constantly should evaluate their account as being totally available to enter any position or exit any position at any time, and no decision should be based upon when and at what price you or someone else entered. This ignores tax considerations, which should be part of the decision, but are irrelevant to traders because of their small time frame. **△**



Trend trading the flat base pattern

BY BILLY WILLIAMS

The markets attract millions of people who seek to make a fortune, but to succeed you have to have a kind of pragmatic focus. You must determine what works with a single-minded purpose combined with a ruthless ability to discard what is ineffective.

The reason is clear. The stock market is riddled with quicksand and landmines presenting a million ways to make a fortune as well as a billion ways to lose one at the same time.

Worse, humans tend to complicate what is simple and make simple what is complicated. Both paths lead away from the goal they sought in the markets to begin with—making money.

With danger lurking from all angles, you can appreciate the need for personal qualities such as focus, will and determination combined with a winning trading method. Like bricks and mortar, successful trading is built upon a firm foundation of skill and will.

Fortunately, one price pattern offers the necessary simplicity to provide that foundation.

SYMPHONIES & TRENDS

Imagine going to a concert where a talented piano player is giving a solo performance. The player steps to the piano and his hands create beautiful music from the piano's ivory keys.

Consider if the pause between each stroke of the piano keys were taken away. You would be left with just noise. The beauty of the performance would be taken away because without the

pause there is no opportunity for harmony or balance between the notes to exist.

This is like trend trading in the market; you just have to know where to look for a pause in the trend and when to time your move. But to know when to time your entry you have to know where to find the pause in the trend. This is where the flat base pattern can help.

IDENTIFYING ENTRIES

There are dozens of price patterns, but few can match the risk/reward ratio of the flat base pattern. Forming along the directional movement of a price trend, the flat base serves as a low-risk trade with explosive high-reward potential.

During the transition from expansion to contraction, price will trade within a tight, sideways pattern after establishing support and resistance (see “Building a base,” next page). As price enters a period of contraction, it forms support and resistance levels marked by low trade volume. When these conditions are met it creates a fertile field where the flat base pattern can grow.

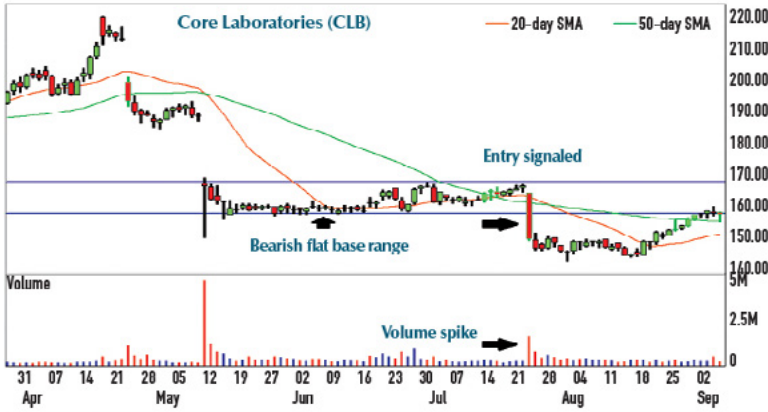
This tight trading range becomes Ground Zero for price to explode into expansion and resume the previous trend. Also, it acts as a reference point for the overall risk you have to assume before ever taking a position.

If a flat base pattern is trading within a five-point range,

“There are dozens of price patterns, but few can match the risk/reward ratio of the flat base pattern.”

BUILDING A BASE

A massive price gap formed on May 12, 2014, in Core Laboratories (CLB), setting off a chain reaction. Both the 20- and 50-day simple moving averages changed direction and began sloping downward revealing a bearish trend. Later, CLB formed a tight trading range within support/resistance levels, where support formed at the \$158.41 low close and resistance formed at the July 1 high just above \$168. A bearish flat base pattern formed from that point up to July 24 when an entry was signaled as price broke through support on volume of 415% of the 20-day average volume. Entry is made at \$159 with a stop above \$168 risking \$9; the price difference of the high and low of the flat base pattern (\$168 resistance – \$159 support = \$9 range).



Source: eSignal

TARGETING GAINS

CLB traded down from its breakout point but then made a failed rally back to its old support level of \$159 before encountering minor resistance on Sept. 4, 2014, and then traded downward. Using a three-to-one profit ratio (3 x \$9 – price range = \$27), the price target was hit on Oct. 15 at the \$132 price point in less than three months. During the next three-and-a-half months, CLB went on to trade to \$87.27 — a potential of nearly \$72 (45% gain).



Source: eSignal

then your stop loss point is at the opposite end of your entry. Knowing where your stop loss is in advance (five points) helps you calculate the size of your position and prevents you from overexposing yourself to risk (see “Targeting gains,” above).

First, you have to understand the two types of price action in play.

EXPANSION AND CONTRACTION

In trading, there are two kinds of price action: Expansion and

“What’s unique about the ‘flat base’ is that the decrease in trade volume that helps to identify the pattern also acts as the trigger.”

contraction.

When an underlying security is experiencing expansion, a price trend is in effect. Price trends take place when one side has control — the bulls or the bears — moving the market in a particular direction.

When the bulls are in control of the trend, price is expanding upward. You quickly can identify a bullish trend on a stock chart by spotting where price is starting and ending. For example, if you’re looking at a yearly stock chart with price beginning on the lower left-hand side of the computer screen and price is trading up to the upper right-hand portion of the screen, then, at a glance, you can identify that a bullish price trend is in effect.

If the bears are in control, price is expanding downward. Using the previous example, if you look at a yearly stock chart with price beginning at the upper left-hand side of the computer screen and moving toward the lower right-hand portion of the screen, then, at a glance, you can identify that a bearish price trend is in effect.

Both types of price movement show that the underlying security is experiencing expansion.

When an underlying security is experiencing contraction, its price is caught between two price points with neither the bulls nor the bears in control. These two price levels serve as support and resistance that acts as a type of gravitational field that keeps price trapped.

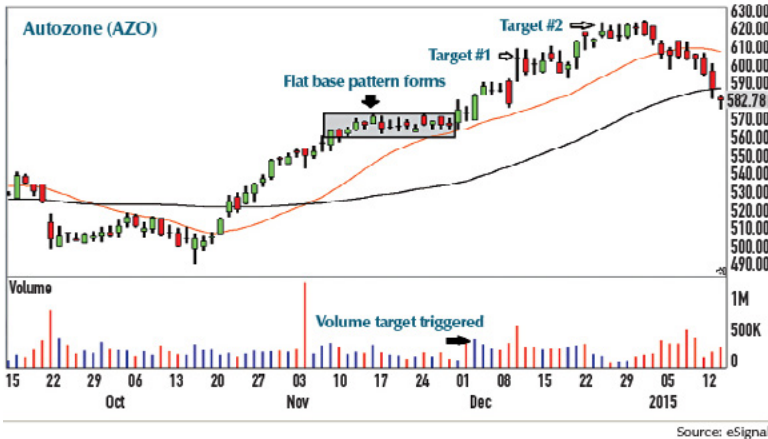
Short-term traders use this to their advantage by trading back and forth, playing support and resistance against each other.

But for those with an eye on the bigger picture, the expansion that led up to this contraction period offers more risk/reward. It’s during this pause in price expansion where more potential opportunity exists.

What’s unique about the “flat base” is that the decrease in trade volume that helps to identify the pattern also acts as the trigger.

ENTERING ON VOLUME

On Oct. 15, 2014, Autozone (AZO) ran up from \$492 to \$571.26 before settling into a tight trading range where a flat base pattern formed. Bullish conditions were confirmed by the 20- and 50-day simple moving averages, sloping upward with price trading well above them. Support formed at \$564 and resistance at \$571.26, setting risk at \$7.26 — the distance of the trading range of the pattern. Using a three-to-one profit ratio, the profit target would be at \$593.04 ($\$571.26 + 21.78 (3 \times 7.26)$). A breakout occurred on Nov. 28, but volume levels were not achieved. Two days later on Dec. 2, price was still trading within the price range and a price surge bar formed breaking through resistance on 178%, above the 20-day volume average. The profit target was achieved the following day and went on to trade as high — a potential \$55-gain.



THE "WHEN"

A spike of trade volume acts as the trigger for an entry signal.

Using a 20-day simple moving average will help you track volume levels leading up to the trigger. When volume spikes by 150% above the 20-day volume average while also trading through support/resistance, then you have an actionable trade.

This volume level provides the necessary fuel so price can break through support/resistance and keep following through (see "Entering on volume," above). Anything less, you run the risk of experiencing a false breakout.

False breakouts can occur at these levels because other traders also can see the flat base patterns form. The risk is that they will bid up price in an attempt to attract other traders into taking a position. They try to create the illusion that there is a move underway, but then quickly sell their positions into the rush of orders from slower technical traders. This creates an artificial move that quickly loses steam, causing the breakout to stumble.

Often, higher frequency traders will also double-dip by taking the other side of the decline, selling into it. After the initial breakout, the false breakout sputters as the scalpers bail out and then turn around and pile on more orders on top of unsuspecting traders.

To avoid being trapped, exercising your patience and timing your entry are critical. At the right time, enter when price breaks through support/resistance and only when the appropriate volume levels are met. This combination of factors will help avoid false breakouts and unnecessary risk.

This will lead to a greater success rate because the higher

volume will give legs to the breakout to follow through and help sustain its move.

PATTERN ENHANCEMENTS

To further put the odds of success on your side, use the 20-period simple moving average and the 50-period simple moving average with the underlying security's price action. This combination of short-term and intermediate-term moving averages acts as a trend filter to keep you on the right side of the trend. To accomplish this, be sure that the moving averages are in the proper order.

Price should be trading above both averages with the 20-period one trading above the 50-period average. This sequence shows that a strong bullish trend is in place once a flat base pattern forms, revealing which direction to trade.

But if price is trading below both averages with the 20-period average trading below the 50-period one, then a bearish trend is in effect. This sequence will tell you that you should be looking for shorts.

If the flat base pattern forms over an eight-week period or longer, then look for the averages to move sideways and intersect. As long as price stays in a tight trading range, this combination of factors could reveal a strong setup once volume triggers an entry.

Just be sure to abort the trade if the pattern falls apart.

ONE FINAL TIP

Flat base patterns offer great reward potential, but they do require a degree of patience. The reason is they take time to form, so when the entry signal is confirmed the move can be sudden and explosive. If you don't maintain good diligence, then you could miss a trade at a critical time.

This can be a bit frustrating when you've been tracking a setup for a while, especially if you're a trader who craves more action.

But keep in mind that these patterns are fairly abundant and form on every time frame.

If you need more action, then consider scrolling through the different time frames to look for setups. Just remember to stay on the right side of the trend and adjust your risk as needed. **▲**

Billy Williams is a 20-year veteran trader and publisher of StockOptionSystem.com, where you can read his commentary and a report on the fundamental keys for the aspiring trader.

Forecasting with caliber and affinity

BY BILL RALPH

The movement of stocks in the New York Stock Exchange (NYSE) is similar to birds flying in one of those spectacular aerial formations that are constantly shifting and evolving in unpredictable ways. As traders, we might look up at this display and wonder if there is some way we could use the past behavior of the whole flock to help us forecast the movements of a particular bird. Approaching this problem with novel mathematics gives us a chance to leverage our past knowledge of all stocks to forecast the behavior of a single stock. The concept behind this method was based on pure mathematics and led to an idea for analyzing data that was so strange and outside the normal range that it was initially rejected. How could it be programmed?

The idea festered, so I wrote the program and tested it on very small array of numbers. The results revealed something

about how the rows of the array were relating to one another. What would happen if the rows were the daily returns of the stocks in the NYSE? After years of experiments, this new approach boiled down to working with two new indicators. The first one, called “Caliber,” is a way of summarizing the overall behavior of the NYSE using a single number. The second number, “Affinity” of a stock, appears to be connected with the future returns of the stock as well. Let’s first have a look at what Caliber can tell us about the market.

CALIBER: HOW LAID BACK IS THE MARKET?

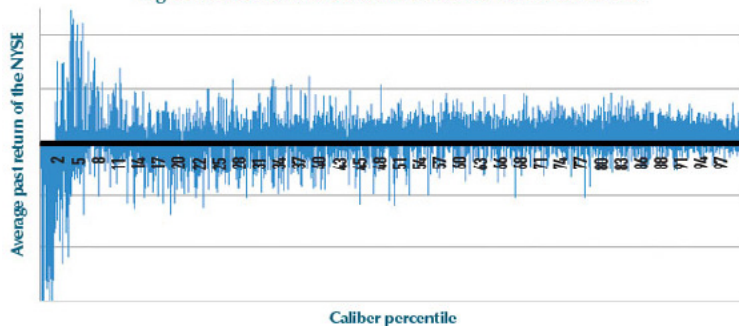
As you watch a flock of birds, it’s easy to make a rough estimate of how tightly or loosely the birds are flying in formation. Caliber describes how loosely stocks are connected to one another. The rule of thumb is that *the higher the Caliber the looser the formation*. More formally, Caliber is a new mathematical measure of how independently stocks are moving relative to one another, which is not affected by the trends of individual stocks. The 3,000 or so stocks in the NYSE are of course highly dependent. Caliber tries to sift through these dependencies to estimate how many truly independent factors are driving the market. For example, a Caliber of 500 would mean that the NYSE is behaving about as freely as a market comprised of 500 completely independent stocks. “Birds of a feather,” (left) shows that the biggest drops in the market often coincided with periods when the Caliber was low, which relates to periods when stocks were moving in a tighter formation.

The chart is not about forecasting. This graph simply suggests that periods where stocks were moving together tended to coincide with peri-

BIRDS OF A FEATHER

Return is plotted against caliber for each 60-day period from the last 25 years. The market performed better during periods of higher caliber.

Higher calibers tend to coincide with better market conditions

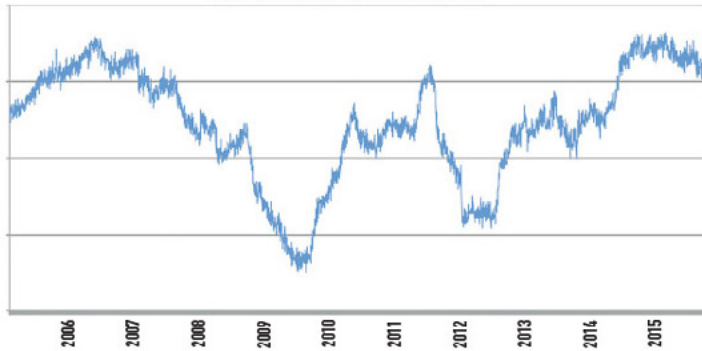


Source: Bill Ralph

BIRDS ON A WING

The Caliber of the NYSE began dropping long before the crash of 2008-2009. Each of these Calibers was calculated using the prior year of NYSE data.

Caliber and the crash of 2008-2009

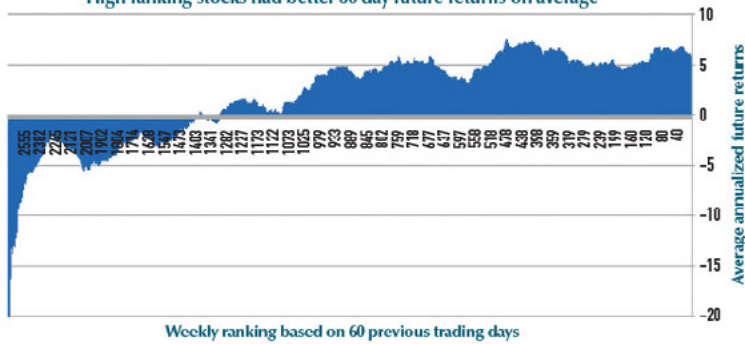


Source: Bill Ralph

FLYING STRAIGHT

Returns are plotted against caliber for each 60-day period from the last 25 years. Stocks with the higher weekly rankings had better returns on average historically.

High ranking stocks had better 60 day future returns on average

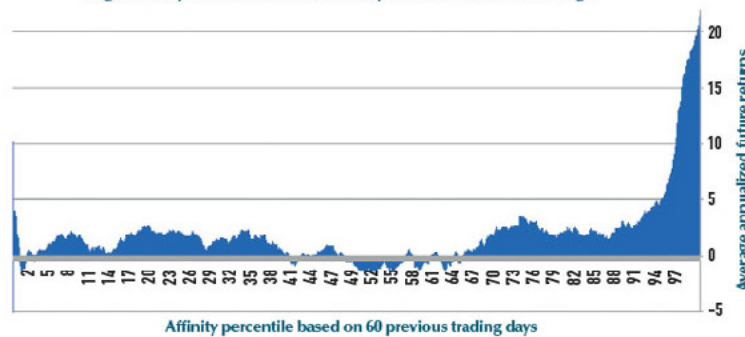


Source: Bill Ralph

FLYING NORTH

Points were obtained by averaging 10,000 60-day future returns and using over 180,000 samples from the last 25 years. Stocks in the highest Affinity percentiles had much better returns on average historically.

High affinity stocks had better 60-day future returns on average



Source: Bill Ralph

ods when the market was falling. In terms of our stocks-as-birds metaphor, *NYSE stocks tend to drop in tight formation and rise in loose formation*. This relationship is clear in the spectacular drop in the Caliber of the NYSE in the three-year period leading up to the crash of 2008-2009 (see “Birds on a wing,” top).

WHAT IT IS

Caliber is a measure of the diversity of a market. To calculate the Caliber, all of the daily returns for each of the approximately 3,000 stocks in the NYSE for some time period, usually 60 days, are inputted. The resulting matrix has roughly 3,000 rows and 60 columns, which can be row-reduced to 60 non-zero rows and 2,400 rows of zeros. Since we would obtain the same result no matter how the market is behaving, this approach is not useful. However, using a probabilistic approach for this reduction, the more dissimilar the rows, the more operations it takes to completely reduce this matrix, which then translates into a higher Caliber. The number dubbed the Affinity of a stock simply measures how quickly a stock is cancelled on average during this process. In other words, higher Affinity stocks are cancelled the fastest because their behavior is the most representative of all the stocks in the exchange. Let’s now consider how Affinity might be used as an indicator to forecast returns.

AFFINITY: IS YOUR STOCK IN THE WINNER’S CIRCLE?

If a stock has a high Affinity number, then its movements are more consistent or consonant with other stocks on the exchange. High Affinity stocks can be thought of as the more typical or mainstream stocks and testing suggests they tend to do better on average over long periods of time. Every week we calculate and share a list of the Affinity ranking of all stocks listed on the NYSE. Over the last 25 years, stocks with a higher weekly ranking had better returns on average (see “Flying straight,” middle). To see this small effect, I had to average a large number of future returns to smooth out the enormous variation in returns which, of course, are often negative even for the highest ranked stocks.

If we use the actual Affinity numbers of stocks instead of their weekly ranking, we get even stronger evidence that high Affinity stocks have better performance (see “Flying North,” bottom). Once again, the enormous amount of averaging is hiding the huge variation in returns.

Further improvement can be achieved in

forecasting returns if we use 120 days of prior data instead of the 60 days (see “Spreading our wings,” right). With 120 days of prior data, the relationship between Affinity and future returns is easier to see because we only have to average 1,000 future returns to generate the large peak that appears at the right of the graph.

A BETTER WAY TO EVALUATE STOCKS?

Some of the most highly regarded stocks also happen to be the most expensive so there does appear to be some connection between a stock’s perceived value and how much it costs. It’s natural to ask what exactly these more expensive stocks are offering us since, historically; they haven’t given terrifically better returns than many lower-priced stocks. A partial answer might be that the more expensive stocks might often, but not always, have higher Affinities because higher Affinity stocks tend to be more expensive (see “Big birds,” right). This observation, coupled with our forecasting evidence, suggests that the Affinity of a stock might be a better indicator of a stock’s value to investors than the actual price of the stock. If you are nervous about the market, you might start looking at a fund holding low Affinity stocks.

SOMEBODY GET ME A SUPERCOMPUTER

Our research shows that when stocks move in tight formation, there is a higher likelihood the market will turn lower. And when there is greater diversity of returns the market generally performs better. Caliber and Affinity are new ways to define relationships among stocks. Specific trading systems based on Caliber and Affinity have not yet been developed to back up our analysis, but the evidence given above shows these indicators hold value. Additional research on other markets would be useful in confirming and expanding these results but to calculate these indicators weekly on NYSE stocks requires 14 hours of computer time.

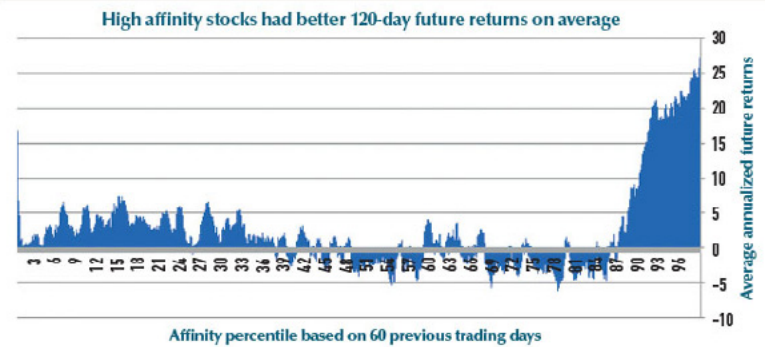
The complexity of the algorithm prevents us from sharing all the calculations but the Caliber and Affinity indicators are calculated weekly and posted online open to everyone at www.portfoliomath.com.

Finally, there are intriguing applications of the Caliber and Affinity algorithms that can be used across various markets. This is just the beginning, smart traders will find new ways to utilize these indicators. ▲

Bill Ralph, PhD, is a Professor of Mathematics at Brock University in Canada and an artist. He works on extracting and visualizing meaningful information hidden in noisy data.

SPREADING OUR WINGS

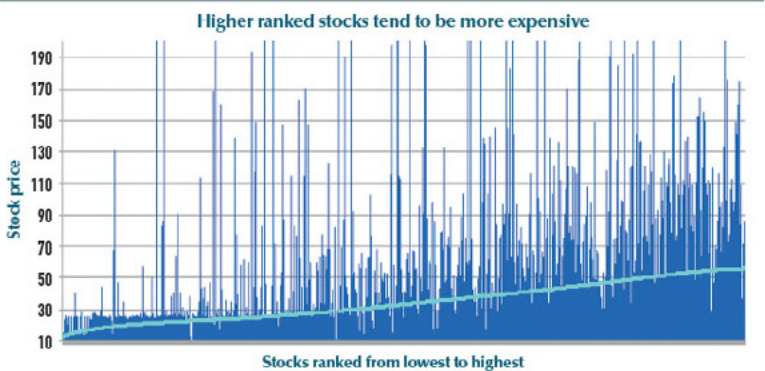
Points were obtained by averaging 1,000 120-day future returns and using over 90,000 samples from the last 25 years. Stocks in the highest Affinity percentiles had much better returns on average historically.



Source: Bill Ralph

BIG BIRDS

There is a positive relationship between Affinity and the price of a stock. Here is the Affinity of each stock in the NYSE for the 60-day period ending on Oct. 16, 2015 (four highest priced stocks were omitted).



Source: Bill Ralph



The American crowfoot

BY BILL DEBUSE

The American Crowfoot is an independent probability signal that is based on price and clearly identifies a change of the present price action. It is like market breath or volume. In other words, it may not always be obvious, but it is always present.

The Crowfoot will normally produce an excellent entry or exit, and it makes no difference if the larger market is long or short. Identifying the Crowfoot will get you in or out long before a change of direction is apparent to the market at large.

Perhaps its greatest value is that because it provides an early execution signal, it helps to hold down slippage.

The Crowfoot is simple and occurs regularly. And when it occurs, it identifies a reliable execution point. Most important, it does so early-on. In fact, it is one of the better anticipatory execution signals you're likely to find. It will get you in or out near the ideal execution point.

The only problem with waiting for this chart pattern to evolve is that the last price paid — a required bit of data for the signal — is not always that easy to identify. Nonetheless, it is an excellent trading tool to use when you see it developing. Whenever the Crowfoot occurs, it is normally effective, and it is relatively safe.

CROWFOOT: STEP BY STEP

1. To draw a Crowfoot, we start from the last price and proceed to the previous move.
2. From that point, we go to the last price extreme and establish our "horn A." This can be anywhere on a chart but is often more clearly defined when the previous move resolves itself (see "Drawing the Crowfoot," left.)
3. We then regress to the preceding extreme to establish "horn B." The horns are best visualized in your mind's eye as what would be "Wave 2" and "Wave 4" of a classic Elliott Wave impulse pattern.
4. We then draw a baseline between them and then extend it to the right.
5. Next, we draw the perpendicular. This will be drawn through "horn A." (Depending on market momentum, you may want to move the perpendicular one or two bars to the right of "horn A.")
6. Then, simply split the angle created between the baseline and the perpendicular. The angle of the split will always vary based on the volatility present in the price action. It's fine to simply "eyeball" the angle of the split. (It should be noted that this angle is almost never 45 degrees. Unless, of course, the horns are a double top or double bottom.)

Note: For the Crowfoot to be valid, the price action must print to the left of the split before it can produce an execution signal. Anytime the price action prints on top of the split, or to the right, it is indicating an indecisive market. In this case, the chances are that price action will just continue and it is just producing another test of the old dynamic trend.

IDENTIFYING THE PATTERN

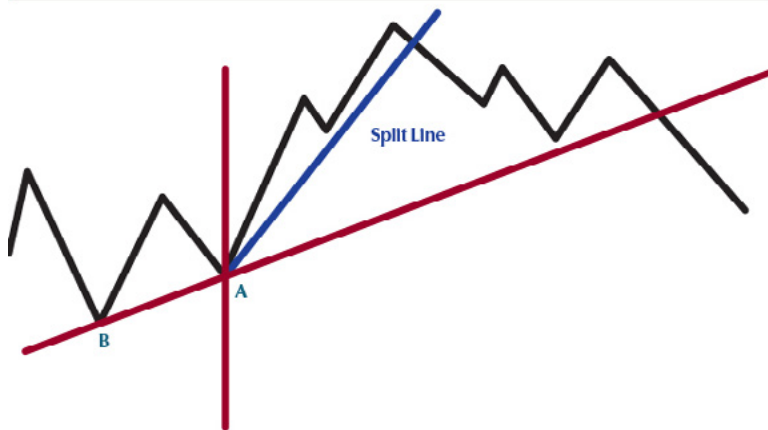
To establish a Crowfoot, the first thing we do is identify what are known as the "horns." These horns represent the last failed price extreme, which is known as horn A, and then regress to the next preceding price extreme that is identified as horn B. The horns roughly correspond to waves two and four of a classical Elliott Wave Impulse pattern. (See "Crowfoot: Step by step," left, for details.)

Anyone who has dabbled with Elliott Wave analysis for any length of time is aware that the biggest problem with the technique is found in identifying the patterns as they occur.

Many "Elliotticians" on the Internet will often predict a "Wave 4," only to watch it fail and then

DRAWING THE CROWFOOT

To draw the Crowfoot, we first identify two failed price extremes, or horns (points A and B), and create a baseline. We then draw a vertical line where the second horn touches the most recent horn. We then split the angle created by this line and the baseline. The angle split line (blue) is the signal line. In this example, when price breaks below that, we would consider short trades.



PREDICTING THE BREAK

Traders who entered short on the break of the split angle line were in well before this recent swift drop in the SPX, which accelerated greatly once the baseline gave way.



Source: StockCharts.com

come back with the excuse that what they meant was it was really a “Wave 2” and the next test is going to be a “Wave 4.” Then, a “Wave 5” will follow. Of such nonsense, negative account balances are made.

The difference between the Crowfoot and an Elliott Wave impulse pattern is that the horns of the crowfoot are restricted to being the last two tests that have occurred in the previous move. It makes no difference how many tests the previous move may have produced.

It is not uncommon to see as many as seven “tests,” each one of which at the time could be classified as an “Elliott Wave 4”—and each one occurred before a strong trend finally resolved itself. The important thing with a Crowfoot is that it makes no difference how many times the previous move tests, only that we keep identifying the last two.

By using the Crowfoot, you are not trapped into the interpretation of waves, or indeed much of anything else. All you

have to do is connect the horns with a baseline, draw the split, and then execute when it is violated. Even when you are wrong — and you will occasionally be wrong — you will not be wrong by much and a good stop-loss order will take care of most of that.

EXECUTION

When price takes out the split, it provides an execution signal. This is well before the world sees a new move developing and thus helps to hold down slippage. In addition, it also is an aid in establishing a hard stop.

The good part of this whole scenario is that even when you are wrong, and you will occasionally be wrong, you will not be annihilated because the previous price extreme provides a good hard stop.

Prognosticating the future direction of the market and having an effective stop loss in place are the key to profitable trading. We should always have a stop in place and know the most we are willing to lose on any trade before we ever execute. Nobody should ever enter a position without simultaneously establishing a hard stop.

In fact, as you stand at the hard right edge of the split, traders should always have two stops in mind:

- The first is a hard stop. In other words, a working order filed with your broker.
- The second is a soft stop. This is actually a trailing mental-stop you should use in conjunction with the ladder.

The crowfoot is a great aid in establishing the hard stop. One of the fringe benefits that we get from using the the Crowfoot is that the previous price extreme always provides every trade with a clear place to set a hard stop. All you have to do is go to the last price extreme and enter it as a stop order with your broker.

LADDER

By immediately placing a horizontal trendline at the point where the price action violates the split, an excellent tool is produced to define the markets directional probability and synergy. This is called the horizontal trendline, or the “ladder.” It is basically a hand-holder that functions as the finger on the pulse of the price action and also serves as an aid in determining your soft stop.

Anytime the price action doesn’t promptly head for the baseline after breaking the split, but instead extends sideways with the ladder, the odds are that any position you might take is usually going to fail, or at the very least will not have much in it.

But beware. If prices trade back and forth across the ladder, and then break strongly up or down, you should consider drawing a new Crowfoot to confirm the move before you enter.

The ladder clearly defines if the price action is going to:

- profitably confirm the violation of the split,
- tread water and consolidate, or
- fail and force a new Crowfoot.

FAILURE

After any execution, only one of two things can ever occur: we are either right or we are wrong.

If we are right, the price action will take off toward the baseline. It is worth noting that good trades usually start out being good trades. The minute that the price action takes out the baseline, other traders will see it as the violation of a trend and the start of a new move that is now apparent to the world.

If we are wrong, we must exit our position as soon as possible. Then, as long as there are no major changes, promptly re-engage as soon as the next Crowfoot develops. It is worth noting that we may be wrong several times before we actually get a position that we may want to keep. The beauty of the Crowfoot is that it usually allows for relatively tight stops.

CONFIRMATION

It is obvious that at times you may enter or exit a position using probability signals other than the Crowfoot. Nevertheless, in such incidences by reverse engineering the Crowfoot you can provide an excellent confirmation signal for any trade. **▲**

Bill DeBuse has been engaged with the markets since 1959 and is presently a proprietary trader for a family foundation.

10 rules successful traders follow

BY JEAN FOLGER

Trading is an easy business to get into: No degrees or specialized training are required, start-up costs are relatively low and it can be done from the comfort of home. The logistical ease of getting started, however, should in no way imply that becoming a profitable trader is simple.

Most experienced traders would attest that success depends on many factors including hard work, research, planning, discipline and being a lifelong student of the markets. As with many businesses, there are certain principles that, when followed, can greatly increase the chances that a trader will be successful.

Here, we explore 10 timeless rules that are an important part of successful trading, no matter the techniques, markets or time frames you trade.



1. TREAT TRADING LIKE A BUSINESS

As a hobby, trading quickly gets expensive: Just dabbling can prevent traders from gaining the proficiency and experience they need to become consistently profitable. As a job, trading can be discouraging because there is no such thing as a regular paycheck: Traders can work 10-hour days all week and end up empty handed on Friday. Rather than thinking in terms of a hobby or job, it is important to approach trading as a business.

Like any business, trading incurs expenses, losses, taxes, uncertainty and risk, and these factors must be taken into account. The key to developing a successful trading business is good planning, both for the overall business and for the actual trading. Traders who want to weather the learning curve and

stay in the industry for the long haul will put in the time and effort to research and develop strategic plans that encompass short- and long-term goals and the details of trading: What will be traded and how it will be traded.



2. ALWAYS USE A TRADING PLAN

A new trader would not have to look far to come across the well-known saying, “Plan your trade and trade your plan.”

The first part — plan your trade — is accomplished through a trading plan: A written set of rules that defines entry, exit and money management criteria. Good trading plans often are based on experience or market observations and developed through research and exhaustive testing. While it is time-consuming and challenging to develop a profitable plan, a major advantage is the consistency it delivers.

The second part of the adage — trade your plan — is, for many traders, as difficult as developing a trading plan. Trade your plan means following your trading plan exactly, without making excuses, second-guessing or otherwise deviating from the rules that were so painstakingly created. Taking trades that fall outside the plan is considered bad trading, even if they turn out to be profitable.

Often, invalid trades are the result of our emotions: Fear, greed, impatience, overconfidence, etc. Other times, they stem from our mistakes, or pilot error as it is often called. Trading your plan is not as easy as it sounds, and most traders must work hard to develop the necessary skills over time. Consistently following the rules of an effective trading plan is part of what allows a trading business to make money over time.



3: RISK ONLY WHAT YOU CAN AFFORD TO LOSE

While traders plan on making money (that's why people trade, after all), it is important to acknowledge that it does not always work out that way. It is essential that the money used to fund a trading account be what can be lost without impeding the ability to meet other financial obligations. Losing money is difficult enough, but it is even more so if it is capital that never should have been risked in the beginning.

It should go without saying that a trading account should not be funded with money earmarked for the kids' college funds, the mortgage or day-to-day living expenses. Aside from being a terrible idea that can lead to disastrous financial losses and unfortunate circumstances, trading with money that is not expendable can put a trader under an extraordinary amount of pressure to succeed.

Often, this type of pressure leads to bad decisions and, ultimately, losses. Prior to trading, it is important to make an honest assessment that the money in the trading account is truly expendable. If it isn't, traders should keep saving until it is.



4: USE TECHNOLOGY TO YOUR ADVANTAGE

Electronic trading has been around for a while, but the tools that are available to modern traders are constantly improving and evolving. Faster computers, high-speed Internet, all-electronic markets and direct-access trading all have helped the independent retail trader. Additional technologies, such as trade automation, innovative market research tools and the ability to test trading systems accurately on historical data have given traders even more powerful tools. Mobile trading apps make it possible to scan for trading setups, enter orders and manage positions from a smart phone or tablet, giving traders a tremendous amount of previously unseen flexibility.

Using outdated technology can put a trader at a severe disadvantage. Trading is a competitive business, and it is best to assume that other market participants are taking full advantage of available trading technology. As with many other businesses, being (and remaining) competitive in trading means keeping up with technology.



5: DEVELOP A TRADING PLAN BASED ON YOUR OWN RESEARCH

A trader's own research, not emotions or speculation, should be the driving force behind developing a trading plan. With so much information readily available in the public domain these days, it may be tempting to rely on someone else's work or research. This can backfire for a few reasons.

First, whatever methodology is being promoted actually

may not be profitable. Second, even if it is profitable to someone else, it does not guarantee that it will be to other traders. Different trading styles and risk tolerances mean that trading plans are not one-size-fits-all.

Finally, traders should fully understand the logic behind a trading plan; otherwise, it is possible to lose trust in a plan, making it easier to deviate from the rules.



6: KNOW YOUR EXIT STRATEGY

Before entering any position, traders should have an exit strategy in place. This should be included in the trading plan and define how the trader will get out of both winning and losing positions. Many traders agree that money is made in the exit. This means that regardless of where a position is entered, it's the exits that determine if it will be a winning or losing trade.

While we often think of trade exits in terms of dollar-based profit targets and stop losses, there are other methods for determining exits. A trading plan could utilize a time- or activity-based exit, such as closing the trade after a certain number of bars have printed, after a specified amount of time has elapsed, or at the end of the trading session ("EOD" or end-of-day close). Exits also can be based on some type of market activity or technical analysis. For example, a trade could stop-and-reverse if a technical indicator gives an opposing signal.

Regardless of approach, it is important to have an exit strategy in place before entering any trade. It can mean the difference between not only a winning and losing trade, but a winning and losing business.



7: MANAGE RISK AND PROTECT CAPITAL

Properly managing risk and protecting trading capital is what keeps traders in the game. They also should avoid risking too much on any single trade. The generally accepted industry standard is to risk no more than 2% on any single trade. Many traders with smaller accounts find this limits their ability to make substantial profits and may, as a result, risk far more. All it would take is a series of losing trades to destroy the account.

Trading with a stop loss is another way to manage risk and protect capital. A stop loss limits the risk that a trader is exposed to for each trade. We all would like to always exit with a profit, but that is not realistic. Because losing trades are inevitable, it makes sense to know how big those trades are going to be. If the trade moves in the wrong direction, it is closed and the trader moves on to the next opportunity.

Being undercapitalized — not having enough money — is perhaps the primary reason why many traders fail. This is for a couple of reasons. One is that traders need money to make money. Imagine a trader makes a 30% gain in

one year. That might be enough to live off if it's based on a \$200,000 account. However, 30% of a \$5,000 account is not enough to pay the bills. Being undercapitalized also is detrimental because it becomes impossible to withstand the inevitable drawdowns. Again, it wouldn't take many losing trades in a row to wipe out a small account.



8: KNOW WHEN TO STOP TRADING

There are two primary reasons to stop trading.

The first is that the trading plan is ineffective and losing more than anticipated in historical testing. Markets change, interest and volume in particular trading instruments vary and trading plans simply may not perform up to expectations. It may be time to take a step back and reevaluate the trading plan, remaining businesslike and unemotional throughout the process. An ineffective trading plan is a problem that needs to be solved; it does not necessarily mean the end of the business.

The second reason to stop trading is that the trader is ineffective. Factors such as emotions, external stress factors and bad health can have a negative impact on trading performance. A trader could develop a winning trading plan, but it still could fail if he is unable to execute the plan properly. It is beneficial to both the trader and the business to recognize any personal challenges and take measures to improve the situation. If a trader has trouble with emotions, for example, he may benefit from using some type of strategy automation.



9: ACCEPT YOUR LOSSES – BUT LEARN FROM THEM

Although most traders inherently focus on winning, trading is mostly about losing. In fact, successful traders think of trading not in terms of how much they can win, but

how much they can afford to lose.

Losses are a certainty in trading, and despite claims that some trading plans or systems are 100% profitable, the reality is that many successful plans win only about 40% of the time. The key is to make more on each winning trade than is lost on each losing trade. This is what allows traders to make money over time.

Although traders must be willing to accept losses, it is important to learn from them as well. One method for this is to maintain a trading journal or diary. A journal can help traders gain important feedback and detailed information about individual trades that performance reports cannot show. Typically, a journal includes the date, time, price, direction, reasons for the trade and individual trade notes. This provides a record of activity that can be used to evaluate the overall performance of the trading plan.



10: KEEP TRADING IN PERSPECTIVE

While it is important to remain focused each and every trading day, it is equally important to remain focused on the big picture. One losing trade (or day) should not be a surprise. It is a part of trading. Nor should one winning trade (or day) be cause for a celebration. It's just one step along the path to long-term profitability. Because trading is a business, it is the cumulative profits that matter.

Win or lose, trading is just another day at the office. Once a trader accepts that wins and losses are part of the business, it is easier to keep emotions in check.

Setting realistic goals is an essential part of keeping trading in perspective. If a trader has a small trading account, for example, it would not be reasonable to expect huge returns: a 30% return on a \$5,000 account is much different than a 30% return on a \$1 million account. It is helpful to remember that the multimillion-dollar traders are the exception, not the norm. Most traders who survive the tough part of the learning curve are able to make a comfortable living.

Some of these rules are directly related. For example, part of Rule No. 1: Treat trading as a business depends on Rule No. 2: Always use a trading plan. And Rule No. 9: Accept your losses can help traders fulfill Rule No. 10: Keep trading in perspective.

Together, these rules make up general guidelines that can be used by discretionary and system traders alike. Traders who have the patience and discipline to follow these rules can increase their odds of success in the challenging and competitive business of trading. ▲

Jean Folger is the co-founder of, and system researcher with, PowerZone Trading, LLC.