Solving the Puzzle: Learning to Trade a Systematic Approach

by Sunny J. Harris

In This Article:

Disclosure

In short, all traders lose money, at least part of the time. Trading is difficult and you can and will lose money. Get your education before you begin. And, don't ever trade more than you can afford to lose. If you intend to trade to make money to live on, the pressure of that alone will cause you to lose money. Click here to go to the full disclosure statement below.

About Sunny

I don't really have much space for this presentation/article, so I'm going to cut to the chase here. You can read all my resume information on my website if you want the details. In short, I've been trading for over 30 years, as my living. I retired from "a real job" in 1981; I'm a mathematician and a programmer, as well as a graphic designer and coder; I've written 5 books on trading, the latest being "TradeStation Made Easy!" (all available at Amazon.com) and am working on number 6 ("Grading the Gurus"); I've written over 30 published articles in magazines like "Traders' World", "Futures", "Technical Analysis of

Stocks & Commodities", "Active Trader" and others; I've written many more articles for my website; I've made countless appearances on TV, radio, and live seminars world-wide; and for 8 years I published my own magazine, called "Traders' Catalog & Resource Guide™".

Start With a Realistic Goal in Mind

In any business, you've got to have a plan. You can't just start with no plan and just hope for the best. Throwing darts is not a trading plan. A trading plan includes not just goals but methods of achieving those goals. You can't just say "my trading plan is I want to make a million dollars a year." You must have carefully laid plans of how to get there, and how realistic your goals are.

For instance, a million dollars a year is just about $84,000 per month. Accounting for a 2 week vacation per year, that's about $20,000 per week. And, with a 5 day week, that's about $4,000 per day. This begs the question, how can you make $4,000 per day? In fact, having gone this far, $4,000 per day breaks down to just over $600 per hour.

To make that kind of money (which is a lot!), you must learn the basics first, just like every other professional. You can't wake up one morning and decide you are going to be a brain surgeon … starting today. There is about 15 years of education that comes first, to be a brain surgeon.

With trading, it's much easier. As I always say: "Education is NOT expensive; LACK of education is!" Learning to trade definitely costs less than Medical School. You can spend your money on having someone else mentor you, or you can spend it on losing trades. Either way, it comes to about $25,000 over a matter of weeks to months, or even years. The trick is finding an experienced mentor, who is actually a trader, and a good teacher as well. There are LOTS of ads for folks who hold themselves out as expert mentors; I mean LOTS. But, there are few who are really good at both. Do your research, and ask for references from their customers.

In a few words, the really good traders make about 30% return on their account. There are only a very few great traders, who make the highly sought after 100% per year, and they are not the same people year after year. Most people don't really want to hear those numbers, but unlike so many others who sell you golden eggs, I'm telling you the truth. A retail business is fortunate when it makes 10% profit per year. Use that as a measuring stick.

So, in summary, we all must start with the education first. Later comes the profit.

Learn the Basics First

All education starts with the basics. You must know them thoroughly. And PRACTICE! You need a strong foundation in the basics. You don't start your mathematics training with Calculus. You start with learning to count. And you do it over and over again. After that comes adding and subtracting. Then comes multiplication and division. And for these you memorize the rules and the "times tables." There are many more steps before you get to Calculus.

Just as in math, to be successful in trading you must start with the basics, memorize them, and practice them over and over every day.

To become a trader, there are a couple of concepts you begin with. These are: 1. Read lots of books about trading; 2. Read charts for at least 1-2 hours every day. Then you will start becoming proficient. At this time I have read nearly 900 books on trading. And, I keep reading new ones every day. And I still read each day's charts over and over to "see" what they tell me.

Read Charts for 1 to 2 Hours a Day

To become proficient at reading charts, here are the main steps:

- Analyze candlesticks (or OHLC bars) and volume
- Identify support, resistance and attractor[1] levels
- Identify chart patterns
- Identify trends and trading ranges
- Identify the various time frames
- Study market and sector indices
- Learn the influence that these have on individual stocks
- And learn the interaction between various equity markets, bond markets, currencies and commodities

Seek out a trading course or mentor that will help you to achieve this. A two-day workshop is not going to teach you all that you need to know, though it is a good beginning. Find the kind that takes 3 to 6 months. You will not learn all the tricks of the trade, but you will gain a good, basic grounding.

Benefit From the Experience of Others

Search trading forums for discussions on various trading courses. Ask a few questions. Who has taken the course? When did they do the course? This is important: recent participants are normally fired with enthusiasm but, how will they feel a year later? How have they benefited? What skills did they learn? Is there any ongoing support? Are there any realistic trading sessions? Would they recommend it?

Don't make the mistake of believing that you are now ready to enter the market. Do so and you may be stretchered off after a few weeks, never to return. Draw up a **trading plan**. Back test it with historical data and then **stick to it** - don't keep fine tuning it. Paper trade

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[1] Attractor: Sunny coined this term to refer to the market's tendency to revert to the mean. An Attractor can be a line of support or resistance, a moving average, or a trendline. The markets tend to return to the Attractors. An Attractor is often a horizontal line or a trendline drawn, not on highs and lows, but at the preponderance of prices. Attractors are drawn around heavy/frequent market activity, not necessarily on extrema.

with this “system” for a month or two—until you feel that you are ready to enter the market. Bennett McDowell recommends that you paper trade in groups of 25 trades, and 5 groups. If all 5 of the groups are successful, then and only then can you enter the market with real money.

If your 5 groupings of 25 trades in each group is not successful, then consider some changes to your system and start paper trading all over again. Don’t worry about starting over, thinking you will miss “the big trade” that we all wait for. If you don’t start over, when you are having significant losses, you will lose your hard-earned capital and not be able to trade at all.

When you have finally reached 5 groups of 25 trades, wherein the 5 groups are successful, take the smallest amount of capital that you can effectively trade with and cautiously enter the market. Concentrate on achieving the best possible return over a 12 month period. Make the commitment. Don't get excited after a few wins and increase your capital. That is a sure sign that you are not in control—the market is controlling you. Monitor your performance every week. Review each trade and assess whether you have stuck to your plan. Make notes for later, as to how you could improve your plan—but don't make any changes now.

Don't Day-Trade in the Beginning

Leave that for the professionals. Day-trading generally produces lots of small wins to make a profit, and they happen very quickly. There is no room for error in trades that take place over 5- or 10-minute intervals. Slippage will eat you up!

Start trading on daily charts, where your trades take place over longer periods and a small amount of slippage will not amount to all of the profit in the trade.

Consider the following charts, one a 1-minute chart, and the other a daily chart. (Figure 1 and Figure 2). If the slippage in each time compression is $50, note that there is plenty of room in the daily chart (Figure 2) for the $50 slippage to only reduce your profit by a small amount and still be profitable. The AverageTrueRange in Figure 2 is about 20 points. This times $50 per point is about $1,000 per trade. Losing $50 on a trade of $1,000 still leaves you $950 profit.

In Figure 1 (the 1-minute chart), however, the AverageTrueRange is only $0.90. This times $50 per full point equals $45 and if you lose $50 to slippage, you will never reach profitability, at -$5 per trade.

I have a student, in fact I have several, who I tell repeatedly to take it slowly. Don’t try to start with 1-minute charts. They promise me they will slow down. Yet, the next time I log onto their computer and they show me their charts, I see lots and lots of little trades—mostly loses. And, they are losing all their capital. Again, if you didn’t get it the first time: slow down at first and begin practicing on daily charts. After you produce consistent wins, then you can move to faster charts.

Figure 1: Daily Chart of EMini S&P

Figure 2: 1-minute Chart of EMini S&P

It’s a huge mistake to believe that you will never encounter slippage. You will!

Review Your Performance

After 3 months of trading (whether it be real-time or simulated, or paper trading), pause for a week. Don't place any trades. Review your performance. Identify any gaps in your knowledge that need additional work (or study). If you know there is a problem but are unsure how to solve it, consult a mentor. Find an experienced (and successful) trader who is prepared to part with a few hours of his/her time to mentor you. Set your trading plan for the next 3 months and continue. Review at regular 3 month intervals.

After 12 months, review your performance and decide whether you are ready to commit more capital to the market. Do this again after 24 months, 36 months and so on. And then, begin to use a well-defined and proven compounding algorithm. Ralph Vince proved that over-compounding will result in total risk of ruin, while under-compounding will result in lower profits, but at least not ruin. Know your compounding fraction. Mine is called Ultimate-F and is available through the shopping cart on MoneyMentor.com.

Trading Books

Reading trading books is like learning how to play cricket by watching television. Trading books are useful for comparing your approach to others and identifying areas where you can improve your game, but they are no substitute for actual experience. Again, most books are sold on the "magic formula" principle: "Unlock the Secrets to ...."; "How to Make Money in the Stock Market"; etc. These type books rarely offer any true and successful strategies. Keep your study of books to those that teach you analysis and various indicators that can be combined to form a strategy. Also, while they are fun to read, the memoir-type books also rarely teach you much about how you can actually trade. Stay with the technical books and learn techniques.

Paper Trading

Paper trading may help to perfect your technique but it is no substitute for live practice. You have to “feel the pressure” in order to learn. If you are not accustomed to the pressure, it will cloud your decisions when you can least afford it. Nevertheless, paper trading is <u>essential</u> to success. When your trading begins to slip and suffer from lower profitability, go back to paper trading for a while to hone your skills again. Don’t begin to trade again until your paper-trading is successful.

If You Can't Stand the Heat

...don't play in the kitchen.

If you do lose money in the market, don't blame your course provider, your broker, the institutions, insiders, the government, OPEC or the UN. They are just some of the factors that you have to take into account in your preparation. You, and only you, are responsible for you mistakes and your successes. You are on your own. No-one except you is going to shed a tear if you burn your capital. So take care ...... and PREPARE!

What's Next?

After you read and study and take courses, then you need to either purchase indicators (and then use them to design a System[2]), or design and program your own.

For this process, you will start with drawings, scribblings and pseudo-code. I like to use Microsoft's OneNote for this process. Pseudo-Code just means you write down the full and complete steps in plain English (plus a few math symbols). Remember to write down every step as if someone else were going to run this system for you.

While designing your trading system, keep in mind that it must work in Bull Markets, Bear Markets, and in what I call Chicken Markets. A bull market moves upward, with higher highs and higher lows. A bear market moves downward, with lower highs and lower lows. A chicken market chops back and forth going generally nowhere. Your system should work in all three environments. You can find these three environments in 1-minute charts and monthly charts, and everything in between.

To this end, it might be helpful to incorporate ADX into your strategy, so that you can tell your program whether to use different sections of code, depending on which type of market we are in. For instance, if ADX is moving upward, we have a trend. That fact alone does not tell us which market it is, only that it is trending. If ADX is moving downward, we are in a Chicken Market, with no particular direction. Notice in Figure 3 how ADX works. (It's the red line in the lower part of the chart.) Compare sections where ADX is moving downward with the price chart above it; it is generally choppy.

Figure 3: ADX movements on a 1-minute chart of the EMini S&P

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[2] A System can also be called: Recipe, Plan, Map, Strategy, Rules

In the sections where ADX is moving upward, you'll find that the market is trending, either upward or downward. Downward ADX indicates sideways markets.

I find that the following code works well for closing in on whether ADX is moving upward or not:

```
if ADX > ADX[1] and ADX[1] <= ADX[2] then
     ADXUp = True else ADXUp = False;

if ADX < ADX[1] and ADX[1] >= ADX[2] then
     ADXDn  = True else ADXDn = False;
```

This code says that if ADX is moving up from one bar to the next, the ADX is trending, and that if ADX is moving down from one bar to the next, then there is no trend.

Full Disclosure Statement

Contact Me

I love to talk with other traders, and especially new traders, so please don't hesitate to get in contact.

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