Top 10 Cardinal Rules of Trading

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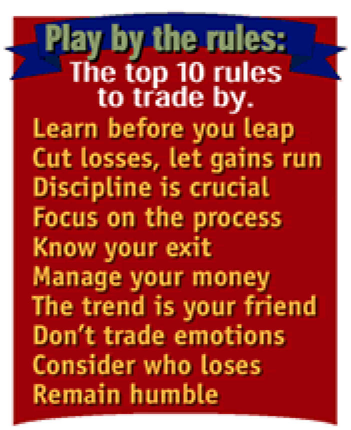
FROM THE ARCHIVES

Moses had his 10 Commandments, and he whipped them at a gold cow when people disobeyed them. The markets may not yield fire and brimstone, but woe to those who violate the 10 rules to trade by. These rules aren't carved in stone and they vary among traders, but at least you don't have to wander in the desert or climb a mountain to find them.

Mom always said to play by the rules, and she was right. Break the rules at home and you get sent to your room. Violate the market's unwritten rules, and they'll bust your piggy bank.
Experienced traders say following these rules is the key to surviving the markets and that the novices who break them will go broke. In the battle between bulls and bears, these rules could keep you from becoming a sacrificial lamb.

"Violating these [rules] is how people remain amateurs instead of professionals. They remain losers instead of winners," says Bill Dunn, chairman of Dunn Capital Management in Stuart, Fla. "The typical novice hardly ever survives the relatively short brutal test of the market because he violates one or more of these rules and it finally gets him."



1. Learn before you leap
A common mistake made by many novice traders is to jump into the markets without knowing what they're doing. They don't take the time to observe how the markets operate before risking their money.

"For most things that people do, they will observe before they step in," says Sunny Harris, president and CEO of Sunny Harris & Associates in Carlsbad, Calif. "If you want to learn to dance, you're going to watch somebody do it before you try it. [But] 80% of the people who start trading today will not be trading in 12 months - some people say it's 90%. That's because they don't start with step one."

She says traders must examine every detail of the system they plan to use so they know - and understand - every possible way it can go wrong and right.

Part of this education must include deciding what your motivation and strategy are going to be and how you will execute trades. Consider how often you will be trading and the transaction costs as part of the plan because frequent trading can eat away at profits through commissions. Also consider your own personality in deciding what and how to trade.

Motivation is a key component, traders say, because the most successful of their lot are in the business because they simply love trading. They don't let a desire for profits cloud their decision-making.

"If you're in commodities because you want to make a lot of money, that's not good motivation," Harris says. "There are very few traders who I know who are in the market because they want to get rich that do well."

Tom Basso, CEO of Trendstat Capital Management in Scottsdale, Ariz., says a strategy must take into account how much time can be given to managing a position. He says those who choose to become system traders must thoroughly test their system to discover how often it will trigger signals and how often the trader can expect to make losing trades.

Patrick Welton, chairman and CEO of Welton Investment Corp. in Carmel, Calif., says, "The most important rule is a trader really needs to know his or her advantage in their methodology, in their work habits, in the area that they choose to specialize or the market they choose to specialize in. If they cannot articulate, know and understand what gives them their advantage, then they are in grave risk of failure."

When selecting markets to trade, Roy Niederhoffer, principal of R.G. Niederhoffer Capital Management in New York, recommends sticking with markets that have a high degree of liquidity as they are easier to move positions in and out of with less slippage.

2. Cut losses, let gains run

"Cut your losses short and let your gains run" is an old saying repeated by many traders and for good reason. They say a mistake made by many new traders is they hold on to losing positions far too long thinking the market will turn around. They also tend to get out of winning positions too quickly to lock in an immediate profit, yet that eliminates the chance for greater gains.

"I'll hold stuff forever if I keep being right, and most amateurs are afraid to hold winners because they're afraid it's going to evaporate," says Dennis Weinmann, partner with Coquest in Dallas.

David Druz, who heads up Tactical Investment Management, a commodity trading advisor in Henderson, Nev., says successful traders rely on a small number of very profitable trades to compensate for several smaller losses.

Harris adds: "The psychological tendency is not to ride profits like you should. It's a very hard thing to do. Taking losses is easy because it's over quickly. Once the [trade] has made a little bit of money, the tendency is to want to capture it so that it doesn't turn into a loss."

To extend their gains novice traders need to fight the urge to take profits quickly.

3. Discipline is crucial

Disciplined traders who stick with a tested trading plan or system will always profit over those who trade inconsistently, the experts say, because constant second-guessing ruins the profitability and eliminates the benefits of having a system in the first place.

"If you have a trading system or a trading plan and then override it or don't follow it, then you don't have a trading system or a trading plan," Dunn says.

Peter Eliades, editor and publisher of Stockmarket Cycles Newsletter in Santa Rosa, Calif., says new traders tend to give up on a system when it is losing money, which is also the point at which a system is likely to start making money.

He says it's also important to maintain consistency on trading behaviors, such as whether to trade during overnight hours as markets behave differently during their nighttime hours.

4. Focus on the process
Focusing on the process of trading instead of making profits may sound like a contradiction, but traders say this is vital because losses are an inevitable part of trading. Those who focus only on making money are likely to lose because they can't cope with inevitable downturns in their investments.

"When you start concentrating on the profits and the losses, you tend to get high emotionally when you're making money and low, frustrated or panicked when you're losing money," Basso says. "That emotional high and low is not a good way to go. You really want to stay fairly steady as a trader and just keep concentrating on the process."

Traders note that they can't control the market's direction and can't always predict what the market will do next so they simply focus on the part that they can control - the trading.

"The biggest problem with the beginner is the way that they keep score is by the number of winners and losers," Weinmann says.

"If you're afraid to lose, why are you trading? I guarantee you will lose on one of your next 10, 15 or 20 trades."

5. Know your exit
Traders should know where they intend to exit their position before entering any market, based on whatever system they are following. Figuring this out ahead of time can help a trader stick with a system and eliminate second-guessing. It also can reduce losses by having a stop loss order in place.

It's important to keep in mind, however, that the market may not always agree with where you place an order.

"You can't tell the market how much money you want to lose. It doesn't care," Harris says. "The market will move where it's going to move so you set your stops according to that movement."

She notes that stop orders must take into account that a position may turn negative before it shows a profit, so stops that are set too tightly could force a trader out of the market at a loss.

"If you know that all profitable trades at some point in the life of the trade had an excursion against you of $200 or $300, you wouldn't put a stop that close would you?" Harris asks. "That trade is likely to turn into a profitable trade and you don't want to be out of it."

Traders recommend taking a market's volatility into account when setting stops and basing the order on a market indicator, such as a moving average.

Sheldon Knight, president of K-Data Inc. in Sunnyvale, Calif., says one method of setting stop orders is basing them on a market's lowest level over a chosen number of days. He says traders who set stops arbitrarily without considering the market's behavior are likely to lose.

"Fixed dollar stops will limit the loss on an individual trade but they will increase the number of losing trades," he says. "The tighter your stop, the more likely you are to be stopped out, which means the more likely you are to have several losing trades in a row."

Part of the reason behind knowing where to exit a position is to avoid "hope trades," whereby a position continues losing ground as a trader prays for a market turnaround.

6. Manage your money
Professional traders recommend risking a set percentage of capital and never altering that percentage. Risking 2% to 3% at a time, for example, maintains a constant level of risk to your portfolio. They say those who think they can make a fortune on one or two big trades are only kidding themselves.

"That's the difference between professional trading and amateur trading - the management of losses," Eliades says. "Making a little bit at a time ends up making a heck of a lot over a fairly short period of time."

Risking a set percentage also is an advantage in times of repeated losses because it reduces their impact.

"You need to scale the size of your trading to match your equity, so as you have a drawdown [it] is cushioned because you are trading fewer contracts on the way down," Knight says.

It's tempting for a novice to risk increasing amounts of capital on a losing position, but such attempts to "double down" typically produce greater losses as the trader throws good money after bad.

"You should be trading more and more as you're getting hotter and the system is getting hotter and it's in a winning streak, and risk less when you're in a losing streak," Eliades says. "People have a tendency to work the other way around, especially on the losing side. They tend to up the amount they're losing to try and get it back quickly and that's the wrong way to do it."

It's also important to have sufficient capital to survive potential losses and keep trading.

"If you're trading an S&P system and your worst drawdown has been $30,000, then you have to start with at least $65,000 to $70,000 so you can have two times the worst drawdown and still be able to trade," Eliades says.

Dan Gramza, president and CEO of Gramza Capital Management in Evanston, Ill., says an often overlooked aspect of risk management is overexposure of a trader's portfolio to a single futures complex. For example, someone risking 2% of capital on five individual currencies is really risking 10% of their capital in the overall currency market.

7. The trend is your friend
This often repeated saying from the trading floor is another key to succeeding in the markets. Rather than trying to predict market tops and bottoms, many traders recommend going with the flow.

"Trade in the direction of the trend until it's over," Harris says. "Never have an opinion about the market. The trend is your friend and you just trade with it. Let the market tell you where it's going."

Basso says it's easier to make money when a market is in a trend, as opposed to moving sideways.

"If the markets aren't trending, don't expect to have a big month," he says.

8. Don't trade emotions
Keeping a calm state of mind is crucial when playing the markets and it's important to remember the market's actions are nothing personal.

"That's a very easy thing to say, but it's a very difficult thing to do," Eliades says. "That's the way losers trade. They trade with their emotions and they forget all the things that they've learned."

He says this causes traders to second-guess themselves and keeps them from thinking clearly.

"[It's] important to develop a method of trading and stick to it. If the methods are correct and it works, discipline and patience are what will make money," Weinmann says. "Beginning traders take trading emotionally, good traders don't."

It's also important to avoid "marrying" a position. This happens when a trader believes a position is the right one and becomes convinced the market must somehow be wrong.

"The market is always right, having nothing whatsoever to do with your opinion or position in it," Dunn says. "If you think otherwise, you are in error."

9. Consider who loses

One interesting way of planning a trade is to think about whom you will be taking money from. Everyone entering the market obviously thinks he's going to win, but that's simply not going to happen.

"Somebody has to be losing to you if you're winning, so we always like to stress that you should know from whom you're going to take profits because if you're buying, the guy that's selling thinks he's going to be right too," Druz says. "They will just assume they are taking money from people who are incorrect about their decisions and that's all right, but it's perhaps not as strong as another way to look at it."

He says trend traders usually take money from hedgers, for example, because hedgers usually sell into a rising market and buy into a falling market.

10. Remain humble

Those who believe they're smarter than the rest of the market and confuse luck with skill won't hold that opinion for long, traders say.

"Be humble in the face of the markets or the markets will see to it that you're humbled," Basso says.

Niederhoffer reminds amateurs that it's unlikely anyone has exclusive knowledge of the markets.

"The conventional wisdom is usually wrong," he says. "When you think you have interesting information, chances are everyone else has it too."