David Jenyns'

Ultimate Trading Systems 2.0

Your Blueprint To Trading Success

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About the author

David is recognised as the leading expert on both MetaStock and profitable trading system design. He earned this reputation after working at Ord Minnett (one of Australia's top brokerage firms) and training hundreds of traders at HomeTrader (Australia's leading stock market education company).

David has authored numerous best-selling trading books and courses including:

Triple Your Trading Profits Workshop – www.tripletradingprofits.com
The MetaStock Programming Study Guide – www.meta-formula.com
The MetaStock Secrets Seminar DVD – www.meta-formula.com
Trading Secrets Revealed – www.trading-secrets-revealed.com
Ultimate Trading Systems – www.ultimate-trading-systems.com
Free Trading Systems – www.freetradingsystems.org

David's tips and advice on trading have been featured in many trading journals and magazines including *Chartpoint*, *Smart Investor*, *Your Trading Edge*, *Short-Term Trading* and the *Guppy Newsletter*. His trading methods give readers immediately actionable strategies.

David now trades professionally, runs seminars, runs a coaching program (www.onlinetradingmastermind.com) and designs mechanical trading systems for commercial and personal use.

David advises, 'Trading is not a get-rich-quick philosophy. It is a profession that takes time to master but the rewards are worth it.' He consistently motivates scores of people to succeed in trading the markets… now it's your turn.

Would you like to ask David a question?
Ask your questions here: www.davidjenyns.com/support

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Introduction

I wrote this book for a very good reason: I have been where you are right now!

If you're like me, you have a burning desire to do something... to build something... to make something of your finances… and develop a better life. All you need to know is what to do next – a step-by-step methodology you can follow.

Doing a simple search for 'stock trading' on the internet, you will find hundreds upon hundreds of results. Each website sells its own books, CDs, courses, not to mention the 'get rich quick' schemes. With so many choices, where do you start?

My education cost tens-of-thousands of dollars in trading losses; I learnt the hard way. I've struggled for many years and spent many sleepless nights toiling away 'in the dark' like a mad scientist in my system-testing lab. Overall, I've followed a lot more trading systems that were 'losers' than 'winners'.

But today, almost every trading system I trade is profitable. Why? Because all my trial and error through testing is behind me now. I know what works and what doesn't. I no longer mess with the hype that does not work; I stick with trading plans that do.

Many people starting out in trading buy into the idea of a 'Holy Grail'. They believe there is a secret which, once discovered, will provide a simple, fail-safe answer to all their trading questions. They believe there are a select few who are privy to this information and all they need to do is find out what it is and all their trading dreams will come true. That, of course, is nonsense. This kind of thinking will just hold you back. Success takes work.

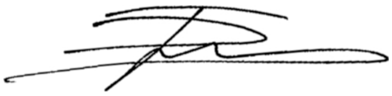
Fortunately, with my ongoing efforts, I have devised a method of creating trading plans that are lucrative and reliable, yet simple to use and develop. And now I want to share that method with you.

Without even realising it, you have just taken the first step to your trading success. You have in your hands the secret that will unlock the door to your financial success – if you're prepared to put in the work.

I'm convinced successful traders are made, not born – traders with enough passion, commitment, education and risk capital can become enormously profitable. Sure, trading is hard work, but the payoff makes it worthwhile.

My suggestion is that you swap your TV time for trading time for the next three months. Once you taste success (financial and emotional), you will find it easy to devote the time and energy necessary to reach your trading goals.

Here’s to your success!



David Jenyns

Professional Trader and Coach

Chapter 1: Why do you want to become a trader?

The secret's out.

Profitable trading is the perfect business. It is capitalism's best-kept secret. Office politics, difficult bosses and tricky employees play no part in trading. The market makes no distinction about your wealth, education level, ethnic background or any other aspect of your identity. You can trade from anywhere in the world. Follow a few simple rules, and you can run your business virtually wherever you like.

Trading is the perfect home-based business.

That said, if trading successfully were easy, everyone would be raking in the profits. The fact is, 80% of people who trade will lose money when they first start. There are many reasons why they won't be successful but, in my experience, the most common reason is that they fail to plan. A well-planned strategy is one that covers all the bases and will be adhered to unflinchingly. This takes guts and determination, but it is the same for finding real success in any other endeavour in life.

Unfortunately, attending countless seminars and reading even more books, without taking any real, calculated action doesn't count as planning. Now don't get me wrong, there is nothing bad about reading books, (you'll notice I recommend a few as we go through these chapters) but there's a lot more to it than that.

Trading successfully is difficult if you don't know what you're doing. I can show you how to achieve trading success and shortcut your learning curve dramatically, but I can only help you if you have a strong desire to succeed. You see, trading requires you to work a little.

To be able to push through, you must start by not only asking yourself why you want to become a successful trader, but actually answering it as well!

Answering the 'why'

This all-important question sounds very obvious, yet most traders never properly consider it. Life coach and world-famous personality Anthony Robbins[1] teaches that, 'If the why is big enough, the facts don't count'.

Think about the following scenario:

> *You arrive home from work one evening and spot a large crowd forming outside your house. You see plumes of black smoke billowing from the roof. Your heart starts to pound…*

[1] More information about Anthony Robbins is available at www.tonyrobbins.com.

what is going on? A neighbour races up to you, explaining that your house has been on fire for thirty minutes. You scan the area but there is no sign of your spouse or two-year-old daughter. Your heart sinks. You realise they must still be trapped in the burning house.

So what do you do?

There's no question you would move heaven and earth to get your loved ones out of the house before it burns down, even if it means risking your own life. In other words, you have a strong enough 'why' to take such a risk for those you care about even more than you care for yourself.

Continuing with the above scenario, if – on the other hand – you arrived to find your loved ones safely out of the house and the only other valuable things inside your house were, perhaps, a laptop or some photographs, then it is unlikely that you would risk your life to try to recover those items. In other words, your 'why' is nowhere nearly as strong as in the first scenario.

The scenario above is an extreme example showing that you must have a strong enough 'why' to act. Trading is the same. You must have a strong enough motivation to succeed, otherwise you will simply give up half way or you will only apply yourself in a half-hearted way.

Let us now come back to the original question: 'Why do you want to become a trader?' The answer must include enough emotional attachment to make sure that you follow through on your promise to yourself. This ultimately depends on you, but some examples of answers might include:

- *I want to ensure I have enough money so my children and family are well looked after.*
- *I want to pay off my mortgage so I can own my home outright.*
- *I want to be able to help those less fortunate than myself.*

You need a clear vision of where you want to be, otherwise how will you know how to get there?

Success in your sights

What's wrong with a vision that says, 'I will achieve financial freedom'?

To me, it's only half-baked.

The sentiment is right, but it's not quite strong enough. Compare 'I will achieve financial freedom' to 'I will achieve financial freedom by 1 January 2020 with $500,000 in assets, creating $100,000 a year in residual income through trading'. More powerful, isn't it? It's amazing how simply giving goals a timeline and other details suddenly gives them a life. They become real, more attainable. And it's just because they're now measurable.

The book and film *The Secret*[2] discuss a fundamental concept known as the law of attraction. It says, in a nutshell, if you can visualise something to the intensity of actually feeling that you already possess it, you eventually will, no matter how hard it may seem.

This law can be applied to all elements of your life – personal, financial, social and spiritual. It is assumed that one of the reasons you have entered the area of trading is that you want to be financially free and as such, you must approach it with the mindset of somebody who *is* already financially free.

This is easier said than done and, of course, achieving your vision requires more than just imagining you already have. For starters, as I've said, you're going to have to do some work. Luckily, there are several courses that offer you the opportunity to learn about yourself and help you become the person you want to be.

Anthony Robbins, whom I mentioned earlier, offers several courses where delegates are taught processes to really create massive change. (I've personally done both *Unleash the Power Within* and *Date with Destiny*). You should also check out the classic book by Napoleon Hill *Think and Grow Rich*. It changed my whole outlook about not only the way I approach trading, but the way I live my life.

Actions

1. Watch (or read) *The Secret*
   www.ultimate-trading-systems.com/secret

2. Read *Think and Grow Rich* by Napoleon Hill
   www.ultimate-trading-systems.com/tagr

3. Most importantly, answer *why* you want to be a trader and write it down. The more specific you can be, the more powerful it will be.

[2] More information about The Secret is available at www.thesecret.tv

'You have to be able to control yourself. You cannot let emotions get in the way of your mind.' – Warren Buffet

Chapter 2: Trading psychology

Let's begin this chapter with a story.

Imagine there is a set of twins, both of whom are traders and who are identical in almost every way. They both have the same trading system, same entries, exits and money management rules. They both commence trading with exactly the same amount of money, using the same broker and receive the same buy signals.

After two months of trading, you would expect each twin to end up with exactly the same amount of money. However, one twin has a 30% increase in her account while the other has a 10% decrease.

So, what causes one trader to be a success and another to fail?

The reason for this difference lies in their psychology. However similar they may be, it must be remembered that ultimately they are different people and therefore think differently. One twin may get too greedy or too fearful, cutting her winning trades short and letting her losses run, while the other twin has a firm commitment to stick to her strategy no matter what, and hence reaps more reward.

How an individual thinks plays a huge part in the way she trades. What's more, every person is different and so the way she approaches trading will also be different.

- The 'good' trader is someone who will respect her tried-and-tested rules, sticking by them no matter what.
- The 'bad' trader is someone who will let her emotions determine when she trades. This will result in inconsistent trading and ultimately failure.

Tharp's chart

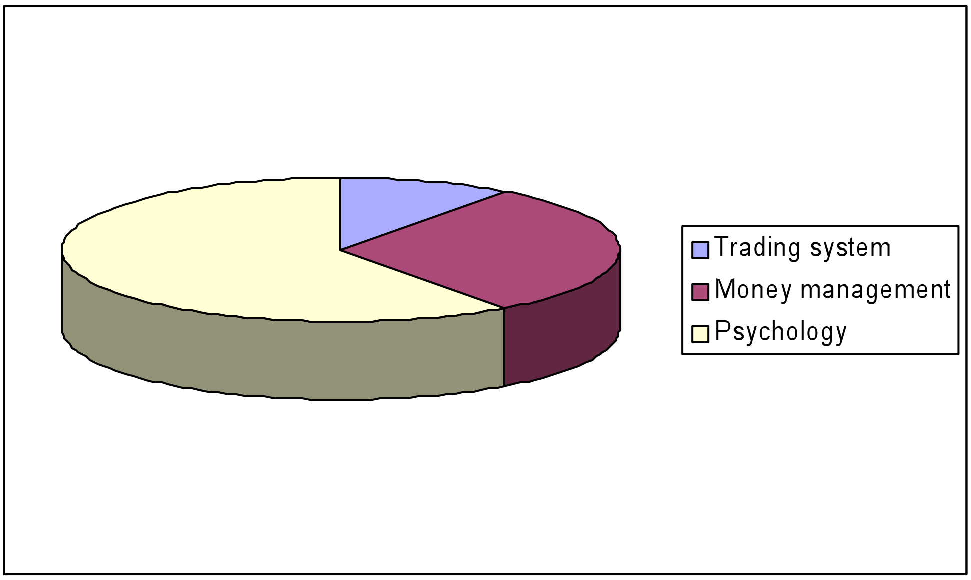
I don't pretend to be the first person to say psychology is an important element in becoming a successful trader. In his book, *Trade Your Way to Financial Freedom,*[3] the renowned American psychologist Dr Van Tharp discusses the role that psychology plays in trading success. He divides trading into three 'ingredients of trading': trading system, money management and psychology.

Using a pie chart to represent a successful trader, Tharp apportions each segment by importance: the bigger the segment, the more importance it

[3] Available for purchase at: www.ultimate-trading-systems.com/tywtff

has to someone wishing to become a successful trader. This pie chart is shown in figure 2.1.

Figure 2.1 Tharp's trading pie chart



As you can see, the way in which she thinks – her psychology – plays more of a part in the make-up of a successful trader than the other components combined. Your psychology is unquestionably the most important factor you will need to address in your quest to become an awesome trader.

What is psychology?

There are many definitions of psychology. The BBC jargon guide defines it as, 'The science that deals with mental processes and behaviour'. These mental processes include thoughts, feelings and motives. Emotions such as fear, greed, vanity, pride and hope affect all areas of our life – especially trading.

Two classic examples where a trader is controlled by her emotions, would be when she closes out a position either too early or too late. Holding on too long demonstrates what is referred to as 'loss aversion' – the trader's tendency to strongly prefer avoiding losses than acquiring gains. This is an emotional response hardwired into our genetic makeup.

In application this means that when facing a losing position, and the price is going down, a trader will hold on because they don't like the idea of losing. They're holding on, hoping the price will turn around. Many times it never does.

On the flip side, you could also say loss aversion causes traders to close out positions too early. When a trader sees a small profit, she is afraid of losing what she already has so she closes out the position too early.

These emotional responses are in direct opposition to what a trader should be doing – cutting her losses short and letting her profits run.

These traders also engage in other forms of irrational behaviour, like attributing success to skill and losses to bad luck. Worst of all, this is just the tip of the iceberg when talking about the other devastating effects of trading with your emotions.

The truth of the matter is this: without controlling their emotions, most new traders lose all their money very quickly in the markets. In fact, most are completely wiped out within the first year of trading. Controlling your emotions really will mean the difference between success and failure.

Discipline

Can you develop a discipline to follow your trading plan that you might not possess naturally? I think you can.

Clearly discipline can be developed, and you only need to look at an army training program for confirmation of this. However, it is one thing to have a vast and experienced organisation bearing down on you, prepared to do whatever it takes to make its point. It is quite another to do it yourself in the comfort of your own home, with all of the distractions of daily life.

So what's the secret to rock-solid, army-like discipline?

One word: confidence. The discipline to follow your trading plan will come as you build your confidence through studying and applying the steps outlined in this book.

To become a successful trader, you must always be learning and practising your decision-making skills, honing them until they become second nature. Only then can you react faster than a speeding bullet, and with unshakeable confidence.

To figure out what's going on in your head, a great place to start is Brian McAboy's *The Subtle Trap of Trading* or *Trading in the Zone* by Mark Douglas. Both of these texts will help you get your head in the game.

Actions

1. Read: *Subtle Trap of Trading*
   www.ultimate-trading-systems.com/stot
   & *Trading in the Zone*
   www.ultimate-trading-systems.com/titz

2. If you think you might need more help getting your head right, check out Anthony Robbins's material, starting with *Unleash the Power Within.*

Chapter 3: Designing a winning trading system

All successful traders have a consistent methodology, whether it be going with the trends, going against the trends, relying on value investing or devising a system based on numerology. Even traders who appear to work on ‘intuition’ – seeming to have a natural knack for trading – in reality, have probably traded so much that their system has become second nature. They’ve already done the hard yards towards mastering their craft. They learnt it. Just like you can.

Your own methodology

Sadly, I cannot develop a methodology for you. I can point you in the right direction and provide you with examples, but you must ultimately devise a system that is your own. This is because you must be able to follow it. In order to follow it, your system has to reflect who you are.

Just as it doesn’t make sense to duplicate my system, it also doesn’t make sense to try to replicate someone else’s. You simply can’t go out and buy a ready-made system and trade it ‘out of the box’. It wasn’t designed for you with your goals in mind, taking into consideration how much cash you’re investing, how much time you have to devote to trading, the level of risk you’re prepared to assume and the returns you expect to make.

Every successful trader has her own winning system and there are as many successful systems as there are traders. Despite their differences, there is one common element among all successful traders: they have a consistent way they approach the market. This approach is unique. In reality, no two people have exactly the same amount of money, tolerance for risk, personality, time or experience. Therefore, the key to success is to design a system that is suited to you.

Many traders fail because they do not assess how well a trading system matches their personality. Instead, they chase fads, searching for the ‘Holy Grail’ of trading success; worse yet, they waste their money on the latest investing software or buying up the CDs of the latest self-proclaimed stock market guru.

There is another very important reason why you must design your own system – so you can take ownership of it. And that means taking ownership of your results. Putting it back on yourself means that you’re in a position to learn from what you do… to perfect your system. If you’re using someone else’s system in its entirety, it’s too easy to blame the system. But, where does blaming someone else leave you? Right back where you started.

Beware of fads. I know it's tempting to jump on the latest craze now and then – especially when you aren't seeing the results you hoped for. These fad trading systems appear too good to be true for one reason… they probably are!

How should you trade?

The fact is there is no *perfect* system. Successful investors succeed because they choose a system that they feel comfortable with, not one that claims to be the cutting edge. A cool, disciplined trader will make money with an 'average' system, while a nervous, arbitrary trader will annihilate a 'brilliant' system.

The key is to develop a methodology that maximises your strengths and minimises your weaknesses. But how do you do that? Firstly, you must define your objectives.

Ask yourself these portfolio objective questions:

- *How much time do you have to spend trading?* It might be full time, part time or hardly any time.
- *How much capital do you have to work with?* Remember, you shouldn't trade money you're not comfortable losing.
- *How much risk are you comfortable with?* The fact is, there will be times when you lose money – in trading this is called your drawdown. You need to know how much of drawdown you are comfortable with? 20%? 30%? You need to decide.
- *What annual rate of return do you want?* This includes what you expect to make and in what timeframe. Be realistic about this. Decide what you honestly think will be returned, based on what you're willing to risk. For example, you're not going to have a system that will return 100% per year if you're only prepared to risk a drawdown of 5%.
- *How do you want to take your money from the market?* Are you looking for cash flow (consistently taking profits out of the market) or capital growth (looking to grow your capital in the market over time, using the magic of compounding)?

Your answers to these questions will have the biggest impact on the style of your trading system. Styles range from aggressive day traders looking to scalp a few point gains, to investors who are looking to capitalise on long-term macro economic trends. In between, there are a whole host of possible combinations including swing traders, position traders, aggressive growth investors, value investors and contrarians.

Answering the objective questions truthfully should eradicate any mismatch between what you want to achieve and the market/style you've chosen to trade in, an example of which follows.

Example

Greg is a 42-year-old father of three who works full time at a city-based telecommunications company. With two children attending a private high school and the other starting next year, Greg doesn't have a lot of spare cash to use for trading. In addition to this, he has limited time to devote to trading, given all the kids' weekend sporting activities and an increasing number of late nights at the office during the week.

When Greg first set out to trade, he set the objective of making the maximum he could in short-term trading to help supplement his income.

It didn't take Greg long to realise that his goals were unrealistic. Shorter term trading requires a higher number of trades, which, for a time-poor person, is difficult to manage. He has little spare cash to invest, so again, this doesn't gel with short-term trading that requires a larger trading float to make any decent returns.

To help you decide whether a short- or long-term trading system will better suit your objectives, see table 3.1 for a comparison between the attributes of both.

Table 3.1 Differing attributes of short and long-term trading systems

	Short-term trading	**Long-term trading**
Trade length	1–30 days	1 month +
Number of trades	More trades taken	Less trades taken
Win–loss ratio	Higher number of wins	Lower number of wins
Trading objective	Income	Capital growth
Time required	More time	Less time
Capital required	More capital	Less capital
Experience required	More skill	Less skill

Given there are pros and cons for each trading style, it is important that you set realistic expectations relative to the level of risk you are prepared to assume. Unfortunately, you can't expect to take on minimal risk and reap maximum profits; it just doesn't work that way.

Moreover, your style will depend on your level of commitment. Day traders are likely to pursue an aggressive style with high activity levels. The goals would be focused on quick trades, small profits and very tight stop-loss levels. Intraday charts would be used to provide timely entry and exit points. A high level of commitment, as well as focus and energy, would be required.

Unlike day traders, position traders are likely to use daily end-of-day charts and pursue longer trends. The goal in this case is to be focused on short to intermediate price movements and the level of commitment would be less than a day trader.

With this in mind, be sure to define your trading objectives as best as you can, since your system must match your own criteria or you will never make big profits (see chapter 1).

What should you trade?

With a few portfolio objectives defined, your next step is to decide in which market you are going to trade.

Please understand, you can't trade everything. Don't be fooled into trying to trade in lots of markets thinking you'll spread your risk; all you'll be doing is lowering your chances of success and floundering at the edges of each market rather than getting to know one really well.

There are many trading instruments to choose from, but to meet your objectives, you must choose only one. Don't be a jack of all trades and master of none. Trade one system, on one market. There are more than enough opportunities in each market so don't worry about missing out.

To select the most appropriate market, I suggest you pick a market you are familiar with or one in which you would ultimately like to trade. There is no right or wrong answer and unfortunately, there is no 'best' performing market. The 'real money' is made by mastering your chosen market.

You can successfully trade any of the markets I have outlined below. Although there are exceptions and different strategies that will alter the characteristics of these markets, as a general rule, below are typical features of each market. They are listed from the most straightforward (stocks) to most complex (forex).

Stocks

Plain and simple, stocks represent a share in the ownership of a company. Stocks trade on a stock exchange, which is basically a venue to buy or sell a stock. In this arena, big players such as Warren Buffet, Merrill Lynch and other big banks dominate. That said, don't be scared off because, if you're new to trading, this is probably the best place to start. It offers the lowest risk because it's unleveraged.

There is a tendency for new traders to go for higher leveraged instruments because of the return, but you must remember that the higher return the higher the risk. If you haven't traded stocks (and made a profit) you're probably not ready to look at leveraged instruments just yet. In short, start with stocks.

Options

Options are leveraged instruments that derive their price from underlying securities (such as stocks). They give the buyer the right, but not the obligation, to buy or sell an underlying asset at a specific price on or before a certain date.

So, unlike stocks, which represent equity in a company and can be held for a long time (if not indefinitely), options contracts have finite lives.

Options are the next step up from stocks in their complexity. They introduce the opportunity to leverage your money and increase profits.

A word of advice on options: make sure you are trading liquid options (those that are well traded). You never want to be dealing directly with the market maker because they will put the odds in their favour by setting a wide spread. Where the spread is the difference between the highest bid and the lowest offer.

Futures/commodities

In a similar vein to options, futures contracts also have finite lives. They are primarily used for hedging commodity price fluctuation risks or for taking advantage of short-term price movements.

The buyer of the futures contract agrees on a fixed purchase price to buy the underlying commodity (wheat, gold or T-bills, etc.) from the seller at the expiration of the contract. This differs from options where the buyer has the right to purchase the underlying commodity but is not obligated to do so.

As time passes, the contract's price changes relative to the fixed price at which the trade was initiated. This creates profits or losses for the trader.

Futures trading is one of the more complex forms of trading, but along with the increase in the skill level required, there are greater rewards (in terms of return on investment). Commodities trading can be a great stepping stone towards trading more advanced markets.

Contracts for difference (CFDs)

CFDs derive their price from an underlying security and can be placed on virtually anything. Nowadays, CFD providers allow people to trade almost whatever they want through their own (that is, the provider's) platform.

The CFD providers, in effect, end up becoming the market, setting the buy and sell prices. They make their money in one of two ways: either (1) they'll set a wider spread – the difference between buy and sell (similar to exchanging foreign currency at the airport) – or (2) they will take equal and opposite transactions to whatever you do (in effect, 100% hedging themselves and making their money on the brokerage and lending rates).

CFDs are popular at the moment because they allow you to trade both sides of the market (long and short). In this case though, there are actually no shares involved; instead, the broker agrees to pay the difference between the starting share price and the price when the contract closes. This method of making or losing money based on a difference is where the name 'contracts for difference' originates.

Forex

Forex – short for foreign exchange – is trading where the asset traded is currency**.** What makes it so unique is that, unlike other financial markets, the forex market trades 24 hours and its daily volume exceeds $3.7 trillion, making it the largest and most liquid market in the world.

This market is extremely attractive because of the high leverage potential. For example, if you put a dollar down, you can control $100 (so, 1% down). It's obvious why this would be a very interesting proposition, but you must remember that leverage is great when you're making money, but it's tragic when you're losing (you'll lose your money a lot quicker!).

While this sounds exciting, it's not for the faint hearted. Forex trading can be fast and furious. If you're just starting out, unless you have your heart set on trading the forex, I recommend that you prove your trading plan can trade profitability in other non-leveraged markets (such as stocks) before entering this market.

Important

When trading any leveraged product, you are faced with a double-edged sword. On the one hand, the leverage will increase your winning trades, however on the other hand, it will also increase your losing trades. The secret to successful trading is to first learn to trade unleveraged markets profitably and then take this system and increase the leverage gradually. In this way you will clearly understand the risks involved and also position yourself for the best possible chance at success.

Now that you're familiar with the different markets available to you, it's time to make a decision. What do you want to trade? Choose just one of the markets I have covered in this chapter. If you're still having trouble making up your mind, *the Triple Your Trading Profits* course provides more detail on these markets. Moreover, what makes this course so invaluable to the beginner, and even the advanced trader, is that you will learn the key principles to trade multiple markets. With this knowledge, you can then choose the market that makes most sense to you.

Actions

1. Answer the portfolio objectives questions listed in this chapter.

2. Affirm: 'I will find a system that fits me and I will become *the* world's best trader at this ONE style of trading'.

3. From the list, select a trading market you are familiar with or one in which you would ultimately like to trade. If you are still not sure what market to choose, check out *Triple Your Trading Profits* – www.ultimate-trading-systems.com/tytp

‘If I have eight hours to chop down a tree, I would spend six hours sharpening my axe.’ – Abraham Lincoln.

Chapter 4: What is a trading plan?

Contrary to popular belief, you do not need to know where the market will top and bottom to make money in the markets. In fact, that is where most people go wrong. The best traders in the world realise that neither they nor anyone else knows what is going to happen. Sure, everyone can point out tops and bottoms after the fact, but no matter what anyone tells you or tries to sell you, *no one* can pick tops and bottoms consistently before the fact. So how do you make money without picking tops and bottoms?

Successful trading is not dissimilar to any other successful business. Every successful business has a business plan and so do successful traders. You may have already realised this from the previous chapter, when I mentioned that successful traders have a systematic way they approach the market.

Plan your way to success

Have you ever really thought about why companies like McDonald’s are so successful? It’s certainly not the taste of their burgers. It’s because they follow a well-tested methodology the world over. The staff in Sydney is following the same regimen as the staff in Singapore. The burgers in Auckland are made the same way as they are in Athens. We can all learn a lot from this approach.

To be successful, you need to treat your trading like you would any other small business. If you were about to invest $50,000–$100,000 to start up a café or a lawn-mowing service, wouldn’t you research the market carefully first? Wouldn’t you write up a business plan? Of course you would. Trading should be treated the same way – given the same respect if you like.

Your trading plan

A trader’s business plan is known as a trading plan – it defines her approach to trading. A properly constructed trading system will leave no room for human judgement because it will define your plan, given any circumstances that may arise. It is a distinct set of rules that will instruct the trader what should be done and when to do it.

The importance of a trading plan cannot be overstated. Without a consistent set of guiding principles to govern your trading decisions, you will most likely hop from one trade to the next, impelled by emotions. By not having a plan, you are planning to fail.

Proof it works

All successful traders that I have come in contact with have written down their exact trading methodology, at one point or another.

Have you ever heard the story about one of the most famous system traders of all time, Richard Dennis? In mid-1983 Dennis was having an ongoing dispute with his long-time friend Bill Eckhardt about whether great traders are born or made. Dennis believed that trading could be broken down into a set of rules that could be passed on to others. On the other hand, Eckhardt believed trading had more to do with innate instincts and that this skill comes naturally.

In order to settle the matter, Dennis suggested they recruit and train some traders and give them actual accounts to trade with to see who was right. To cut a long story short, Dennis taught his trading methodology to a group of students he named 'The Turtle Traders.' This group of traders later became some of the most successful traders of all time, proving that a thought-out and well-documented trading plan is the key to success.

Side note

It must be recognised that Dennis' trading method isn't suited to everyone, with over 60% of all trades taken by the system resulting in a loss. It wasn't the system that made these traders so successful, it was that Dennis showed them the importance of having a plan and following it.

A trading plan is simply a set of rules that addresses every aspect of a trade such as entry and exit conditions and money management. Regardless of how complex it may be, a good test for your trading plan is to hand it to someone else to read thoroughly and then see if they have any questions about it. If they can easily understand all the rules and requirements of your strategy with little to no questions, then you have compiled a sound trading plan.

Write it down

Why is it so important to write your trading plan down? Something magical happens when you commit it to paper and, believe it or not, this will be one of the most important things you can do in your endeavour to becoming a successful trader.

When you take time to sit down and spell out how you perceive the markets, you are beginning to take responsibility. If the market does not behave according to what you wrote, the only conclusion you can arrive at is that your perception is wrong. Accepting that possibility is a huge step towards maturing as a trader.

When you write down how you are going to enter a trade, based on certain events, you are eliminating any possibility of placing the responsibility on anything else but yourself. Now when something goes wrong, as it inevitably will when you're learning a new skill, you're the one to fix it!

Trading plan format

Again – to draw on the business plan analogy – just as there is a standard format for designing any business plan, there is also a format for designing a trading plan.

There are three major components within any trading plan: entry, exits and money management rules. Here's a quick summary.

1. *Tested entry rules.* Entry rules should be a precise set of rules that a tradable instrument must pass before you enter a trade. Entry rules should be simple, direct, and leave no room for human judgement.

2. *Tested exit rules.* Entering a trade is all to no avail if you do not know when to exit your position. Having a set of rules that define your exit is equally as important as a set that defines your entry.

3. *Strict money management rules.* Perhaps the most important and least addressed aspect of trading is the ability to manage risk. A profitable trader is one who has the ability to manage the risks associated with trading. This is achieved with strict money management rules.

While simple in their explanation, these three components together will ensure your trading success. In the chapters that follow, we will go into these in more detail and you will work through a process to design each component.

Action

Make a commitment to yourself to document your trading plan.

‘I don’t think trading strategies are as vulnerable to not working if people know about them, as most traders believe. If what you are doing is right, it will work even if people have a general idea about it.” – Richard Dennis.

Chapter 5: The perfect entry

Every trader needs an entry system. In chapter 3 we covered the first fundamental step of trading, that is, to choose the market in which you want to trade. But, within each market, there is a plethora of trading opportunities to choose from – I call this the *universe of securities*. So how do you choose from this vast universe? Simple. Predefine your entry rules.

Entry rules are a stringent set of conditions that you develop, document and then apply, to decide when you are going to enter a trade. It doesn’t matter what securities you’re trading, you just need a consistent method of entry.

Like sifting through a bucket of sand trying to find pieces of gold, the same approach is used to reduce your universe of securities to a shortlist of those that meet your criteria.

Developing your entry rules

As in all aspects of trading, there are many theories on how to enter and exit trades. I believe the best way to approach entries should be simple, direct and leave nothing to human judgement. This is contrary to the philosophy of many traders who buy stocks based on media reports, ‘expert’ opinion, rumours and/or gut feel. The good news is that by acting contrarily, you will do what most traders never do… make a profit.

Reinventing the wheel

I spent a lot of time in chapter 3 telling you why you shouldn’t copycat someone else’s system, but that’s not to say you can’t take elements of a proven trading plan and stitch them together into something that will suit your personality.

Let’s revisit the example of Richard Dennis and his Turtles. Dennis’ protégés were successful because they were under his direction at all times. Every trade was heavily scrutinised and made according to his strict rules. The students had to follow these rules or be dropped from the project. The fear of loss forced the traders to follow the system no matter what. In the real world, most people would not have the discipline to do this. And nor should they; it wasn’t designed for them.

Furthermore, the Turtles were trading with someone else’s money. When it’s your own money on the table, you need to be completely comfortable with the decisions you make, and you can’t do that unless your system suits your personality.

Dennis' students went on to become successful traders in their own right because they learnt discipline from their mentor, not because they continued to trade his system out of the box. They adapted it to suit themselves. And that's what you should do.

Think of it this way: how many people do you know who have stayed in a job or field of work just because it's what they're used to? They may not love it, but they persist just the same. Maybe you're one of those people. But, while these people might be able to do that job with their eyes closed, they will never excel at it if they're not passionate about it. Their hearts needs to be in it. Trading is the same. If you're not 100% behind your trading system, chances are you won't be able to stick to it, and if you can't stick to your system, you will never reap the benefits you are hoping for.

Keeping entry rules in perspective

Most traders believe the key to success is being able to pick the bottom of the market. This is why 99% of traders spend most of their time fidgeting with the entry; they are looking for that elusive secret, that one setup that will ensure ongoing success. But let me tell you from experience – that setup rule doesn't exist. And, in actual fact, it's not that important.

Spending countless hours optimising your entry rules, trying to find that 'perfect' indicator, can actually do more harm than good. Over optimisation based on historical data actually decreases the profitability of your trading system when trading in real-time. Typically, the more you optimise, the less robust your system tends to be.

Remember Tharp's chart? (refer to chapter 2). He said that the trading system, which includes your entry rules, accounts for only 10% of what it takes to be a successful trader. That means, there is another 90% of 'stuff' you should be concentrating on, such as money management (discussed in chapter 6).

Amazingly, a system can have a very random entry signal and still be profitable as long as money management is in place. Take the following real-life example from Tharp.

> Tom Basso designed a simple, random-entry trading system … We determined the volatility of the market by a 10-day exponential moving average of the average true range. Our initial stop was three times that volatility reading. Once entry occurred by a coin flip, the same three-times-volatility stop was trailed from the close. However, the stop could only move in our favor. Thus, the stop moved closer whenever the markets moved in our favor or whenever volatility shrank. We also used a 1% risk model for our position-sizing system…
>
> We ran it on 10 markets. And it was always, in each market, either long or short depending upon a coin flip... It made money 100% of the time when a simple 1% risk money management system was added... The system had a [trade success] reliability of 38%, which is about average for a trend-following system.
>
> Source: Tharp V, *Trade Your Way to Financial Freedom*
> www.ultimate-trading-systems.com/tywtff

Although a little convoluted in its explanation, this example illustrates that an entry strategy as simple as a coin toss can turn solid profits. Most traders spin their wheels trying to get in at the 'best' price, even though this is not where the money is made.

So what's the take-home rule here? It is easier to copycat your way to success than to try to re-invent the wheel. According to Anthony Robbins, the way to become as healthy as possible is to find the healthiest person you know, ask them how they do it and copy them. Similarly, the way to select your entry rules is to find the best, proven entry system you can for your selected market and model your entry on that system..

Sure, you can waste months and spend thousands of dollars testing different methods, but why put yourself through that? Would you rather be a wealthy copycat or a broke trailblazer?

Trading is one of the few industries where people actively share their methods. In other areas of business, people tend to keep their success secrets to themselves; in trading, there are innumerable proven systems and models out there that you can access. Admittedly, you have to pay for most of them, but they are readily available.

So now you have two choices: you can design your own entry rules (which includes appropriate back testing) or you can apply a ready-made entry system, confident that someone else has done all the hard work for you.

The better choice seems obvious to me, but I'm not here to make your decisions for you. I'm here to pass on as much information as I can and help set you on a course that will suit your situation.

Going it alone

If you have decided to give it a go yourself, here are a few good rules of thumb to follow. Your entry rules should address each of the following:

- trend
- liquidity
- volatility

Let's look at these in more detail.

Trend

The cornerstone of technical analysis is the trend. Remember 'the trend is your friend' and you always want to trade with it, not against it. I believe this to be the most critical component of any entry system. You need a way to measure the trend.

There are many ways to identify trends, and as with most things in trading, there's more than one way to skin a cat. The key is to have a method in place.

One of my preferred methods for identifying trending securities is to find securities trading at their recent highs. That is to say, the highest high price must have been achieved in the past *x* number of days (where *x* is the variable depending on the timeframe you are trading). The longer the timeframe, typically the higher the variable.

> **Example:**
>
> *If I were to trade a medium to longer term approach I might want the highest high price in the past 200 days to have occurred in the past 20 days.*
>
> *I use a charting package called MetaStock (covered in more detail in chapter 8). Using MetaStock, the formula would look like:*
>
> *HHVBars(H,200) < 20*

Liquidity

Liquidity is an important determinant because you want to be trading securities that you can buy and sell quickly and without moving the market. You never want to be caught in a position where you want out but there's no one to buy.

With liquid instruments, such as the forex market that trades billions of dollars each day, trades are happening constantly, so your activity alone will not move the market. In short, avoid illiquid securities.

> **Example:**
>
> *Depending on the size of your float, you might want the average daily trade volume to be greater than $400,000. This could be achieved by requiring that:*
>
> *The 21-day average of volume multiplied by the closing price be greater than $400,000.*
>
> *Using MetaStock the formula would look like:*
>
> *Mov(v,21,s)*C > 400000*

Volatility

Volatility is simply a measurement of how much a security moves. Not whether it goes up or down, just how much it fluctuates.

It is important to trade securities that move enough for you to make a profit. Of course you don't want securities that are so volatile you can't get to sleep at night. On the other hand, you don't want something that moves at such a snail's pace that it is not delivering the returns you are after.

One of my favourite ways to identify volatility is using the ATR method,[4] which indicates how much a security will move, on average, over a certain period.

Here's how I might use this method. A $10 security might have moved fifty cents per day on average over the past 21 days. I can simply divide this value by the price of the security to calculate the average percentage movement of a security over the past 21 days. With this value, I can stipulate a minimum and maximum volatility value.

[4] For more information www.ultimate-trading-systems.com/atr

Example:

If I were a reasonably conservative trader I might want a security to trade between a band of 1.5–6%. That is to say, I want the ATR divided by the average closing price, over the past 21 days, to be greater than 1.5% and less than 6%.

Using MetaStock, the formula would look like:

ATR(21)/Mov(C,21,S)*100 > 1.5 and
ATR(21)/Mov(C,21,S)*100 < 6

Tip: A great place to start when researching your entry rules is to print out all the trading candidates you would have liked to have traded in the past. Next, mark on the charts themselves where you would have ideally liked to have entered. Finally, look for common characteristics among those entry points – these similarities can form the basis of your entry rules.

Adapting a proven system

If you've decided adapting a ready-made and tested system is best – I've done the hard work for you. I have hand-picked the best systems for your chosen market.

These courses will not only educate you about the market you choose but they also provide you with the exact entry rules you need to include in your trading plan. Simply follow the link to your selected market.

1. Stocks - www.ultimate-trading-systems.com/stocks
2. Options - www.ultimate-trading-systems.com/options
3. Futures/commodities - www.ultimate-trading-systems.com/futures
4. Forex - www.ultimate-trading-systems.com/forex

Documenting your entry

Finally, as with everything we do, it's important to document your new entry rules. As I've said, a good set of entry rules are simple, direct and leave no room for human judgement. Take the entry rules discovered through your own research or from your selected program and write out exactly how you will enter a position.

This simple act of documentation puts you among the top 10% of traders.

Actions

1. If you have decided to develop your own system from scratch, plan your entry criteria making sure to do an appropriate amount of back testing – documenting everything.

2. If you're looking for a ready-made entry system to get you started, get yourself the system that corresponds to the market you have decided to trade in:

   - Stocks
     www.ultimate-trading-systems.com/stocks

   - Options
     www.ultimate-trading-systems.com/options

   - Futures/commodities
     www.ultimate-trading-systems.com/futures

   - Forex
     www.ultimate-trading-systems.com/forex

Still not sure what to trade? Purchase *Triple Your Trading Profits* – This course shows you how to select a market that's right for you.
www.ultimate-trading-systems.com/tytp

'Do not focus on making money; focus on protecting what you have.'
– Paul Tudor Jones

Chapter 6: Excellent risk management

Who knows if the market will go up or down? How much will it move? And for how long a trend will continue? In reality, risk management is the only thing you really have control over. That's why it's so vitally important to your trading strategy.

The perfect indicator

Sadly there are no entry criteria that will pick winning trades 100% of the time. As you're about to find out, it takes more than a good entry to make money in the market. Nevertheless, most novice traders undertake a determined search to find the perfect indicator(s) that will lead them to trading success. Even though the idea of this 'holy grail' is obviously far fetched, I too have searched for it.

So why do almost all market traders search for the perfect entry? I believe the reason is a subconscious one.

Focusing on an entry point gives traders a false sense of control. The point at which you have chosen to enter the market is the point at which the market is doing exactly what you want it to do. This can create a sense that you are not only controlling the entry, but the trade itself. Unfortunately, this couldn't be further from the truth. The market is going to do what it's going to do – it doesn't care for your well-thought-out entry criteria.

Repeating what I said just a moment ago, *risk management really is the only thing you have control over.*

In Jack Schwager's book *Market Wizards,* Schwager interviewed some of the world's top traders and investors, nearly all of whom emphasised the importance of money management. Here are a few of my favourite excerpts:

> *'Risk management is the most important thing to be well understood. Undertrade, undertrade, undertrade is my second piece of advice. Whatever you think your position ought to be, cut it at least in half.'* – Bruce Kovner
>
> *'Never risk more than 1% of your total equity in any one trade. By risking 1%, I am indifferent to any individual trade. Keeping your risk small and constant is absolutely critical.'*
> – Larry Hite

'You have to minimize your losses and try to preserve capital for those very few instances where you can make a lot in a very short period of time. What you can't afford to do is throw away your capital on suboptimal trades.'
– Richard Dennis

The difference between winning and profiting

Despite the importance of risk management, I believe traders still under appreciate it. You see most people look at trading as a game of odds. You may be guilty of this too. True, it does involve odds, but odds alone do not tell the whole story.

When you look at trading systems, are you someone who only looks at the ratio of wins to losses? After all, it seems logical that a system that generates eight winning trades out of ten is better than one that only has four out of ten… right? Not always.

Let's take Richard Dennis' Turtle trading system as an example. As I mentioned in chapter 4, this system won 40% of the time and lost 60% – but it was still hugely successful. You see, it's not about how *often* you win, but also about how *much* you win. Winning and profiting can be two completely different things.

Here's what I mean: if your system had an 80% chance of winning $100 and a 20% chance of losing $1,000, in the end you are bound to lose everything, despite the fact that you may experience many winning trades. Stringing together eight winning trades, valued at $100 each, followed by a couple of $1,000 losses will guarantee a trip to the poor house.

On the flip side, a couple of $1,000 wins is far better for your wallet than eight $100 looses, as demonstrated in the following scenario about system biases, commonly referred to as expectancy. Expectancy is just a fancy name for what I have just described.

Expectancy is calculated as:

(% of wins x average win size) – (% of losses x average loss size)

So in our example we can see that:

(80% x $100) – (20% x $1000) or $80 – $200 = –$120

A trading system with these metrics has what is known as a negative expectancy. Compare that with our second example where the system has a positive expectancy and you could lose 80% of the time, yet still be profitable.

(20% x $1000) – (80% x $100) or $200 – $80 = +$120

This loses 80% of the time yet shows a profit of $120 per trade. Which situation would you rather find yourself in?

This is just one example, but learning to roll with the small losses as part of an overall strategy is something that would-be traders find difficult. And it's one reason why they are never truly successful.

As mentioned previously, humans will instinctively take profits the moment they appear and ride losses until they are unbearable. Unfortunately, this is exactly what an 80:20 negative expectancy system looks like: taking lots of small wins, and losing all those profits – and more – to a few very large losses. Without clearly defined risk management rules, you too will fall into this very large trap of trading.

And it's not only traders who apply these rules to their work – all the best professional poker players apply risk management rules to the way they play.

I was once speaking to a player who told me that one of the risk management rules he applies is to never risk more than 2% of his entire gambling float in a single hand. In this way, he knows it is okay to lose a game here or there because it's only a small part of his overall purse. At the time I thought, 'Isn't that interesting? That's one of the rules I follow when trading'. Of course, there's more to it than that.

What is risk management?

Good risk management is simply a set of rules you follow to keep your risk at a level with which you are comfortable. There are essentially four components to setting excellent risk management rules:

- trading float
- maximum loss
- initial stops

- trade size.

Let’s look at each of them in turn.

Trading float

Determine how much money you set aside for trading. Remember, the more you trade with, the more you stand to win or lose. This decision needs to be based on your overall trading goals, while recognising your other financial commitments outside of trading. This was discussed in chapter 3.

Maximum loss

Determine the maximum amount of capital you are prepared to lose in *one* trade. Like the professional poker player I met, you might set your limit at 2%. In *Market Wizard* Larry Hite recommends not going beyond 1%. Other professional traders say 0.25%. You need to find the sweet spot to match your trading float.

Initial stops

Set a predefined point at which you admit defeat and exit the trade. When you enter a position, you never know where you are in the trend. The trend might be in the middle of its run or at its end. That’s why you must set your initial stop. It’s like saying, ‘If a particular trade doesn’t do what I thought it would, I’m going to get out.’

Generally, short-term traders will set their stops closer to the price, while longer term traders tend to give their trades a little more room to move. Note: by setting your stop losses too tight, you’ll decrease the reliability of your system because you’ll get stopped out more often. Plus, the more you’re in and out of trades, the higher your transaction costs.

There are many ways to set initial stops, such as technicals, indicators, percentages and more. Whatever you choose, the important thing is to just have something in place. Sure, you can always drive through that red light, but you risk getting wiped out by a semi-trailer!

Trade size

After setting your initial stop, you need a method for calculating your position size so you never risk more than your predefined maximum loss.

There is a simple formula for calculating this:

$$\frac{\text{maximum loss}}{\text{initial stop size}} = \text{number of units to purchase.}$$

A basic but very powerful equation!

Trading secrets revealed

These four areas are the foundation of any excellent risk management strategy. I learnt much of my risk management through reading Van Tharp’s work. As you can see in the excerpt in chapter 5, Tharp can, at times, be somewhat over-complicated in his language, making it hard to master his strategies.

Part of my process for fully understanding Tharp’s theories was to write them down in my own words. I believe Einstein had it right when he said, ‘Make everything as simple as possible, but not simpler’.

I later published these articles for my private clients in a course called *Trading Secrets Revealed*. You might find it helpful for deciphering what seem like complex and sophisticated concepts.

Remember, money management really is the most important aspect of any trading system. By documenting this step, you have put yourself among the top 5% of traders.

Action

Purchase *Trading Secrets Revealed* and document your risk management rules - www.ultimate-trading-systems.com/tsr. They should include:

- defining your trading float
- setting a maximum loss
- setting you initial stops
- calculating your trade sizes.

'You got to know when to hold 'em and know when to fold 'em.'
– Kenny Rogers

Chapter 7: The perfect exit: profit management

Identifying a good trading opportunity and setting your maximum loss is all to no avail if you don't know how you're going to. Typically, in most trading books, exiting a profitable trade is covered in the discussion on risk management. To me, profitable exits deserves its own category, more aptly called *profit management*.

Before you enter a trade, you should always know how you will exit it. There are at least two possible exits for every trade:

1. how you will exit a losing trade (defined in the previous chapter with the use of initial stops)

2. how you will exit a profitable trade.

Both stops must be written down before you enter the trade – mental stops don't count!

Having these two exits pre-defined ensures you adhere to the age-old rule of trading: *let your profits run and cut your losses short*.

Why stops are so important

As human beings, we are hardwired to fail as traders. What we need to do to be profitable traders really is counter intuitive.

Here's what I mean.

The intuitive reaction when a trade goes against you is to hold on until it turns around. In so many other areas of our lives we are taught to be patient and hang on… *All good things come to those who wait*. But in trading it's different. Unfortunately, and most likely, if you hang on, these losses will be compounded as time passes. The counter intuitive reaction is to cut losses short and move onto the next trade.

Similarly, the intuitive reaction to a trade turning profitable is to sell. Our human nature is to crystallise this profitable trade and come out a 'winner'. Clearly, this is in direct conflict to the rule of letting your profits run. The counter intuitive (and correct) response is to let your profits run.

Trailing stops

So how do you know when to exit a profitable trade? By using a trailing stop.

In short, trailing stops are typically set in a very similar method to your initial stops, that is, based on technicals, indicators and/or percentages. The only real difference is the price at which you calculate.

Your initial stop is calculated from your entry price whereas your trailing stop is calculated from the highest price since entry. In this way, this stop 'trails' price… as price moves up, so too does your stop.

Trailing stops will allow you to ride the trend for longer, while locking in profits should the trend reach its end. The trick is to find the balance between giving your trade enough room to move, while also having the stop tight enough to not give back too much profit.

Again, to echo what was said in the previous chapter: *generally, short-term traders will set their stops closer to the price, while longer term traders tend to give their trades a little more room to move.*

My preferred stop

Despite the fact I always say it doesn't matter so much what you choose – the important thing is just to have something in place, I'm still often asked what method I use for setting my stops.

I personally like a stop I call the 'LL stop'. The LL stop looks for the lowest low (LL) in the past *x* number of periods, where *x* is set based on the style of the system I'm trading. I then set my stop one to two points below this point.

For example, here's how I define this in one of my short–medium-term trading systems. My initial stop is set to be the lowest low (in price) over the past 21 days. As the trade progresses and my trailing stop kicks in, I look for the lowest low in the past 21 days as calculated from the current price.

It's a great little method, since I find it not only respects a security's volatility (setting the stop wider or tighter based on price action) but it also has a great knack for finding support lines and setting your stops one to two points below.

Setting your exits

Think of setting your exits as an ejector seat when things go wrong and a seatbelt to strap you in when things go right. As with entry conditions, exits should be precisely defined and 100% mechanical, with no room for emotional intervention.

Part of becoming an experienced trader is not only learning the markets and developing a discipline for sticking to your strategy, but also preparing yourself to take a loss. Once you start trading, you will learn to not get so attached to individual trades – not to sweat the small stuff. You will be better able to see the big picture and see how small losses are a real and unavoidable part of any successful trader’s system.

You are now ready to document your exit rules. By documenting your exit rules you have just put yourself among the top 1% of traders.

Action

Using both *Trading Secrets Revealed* and the package containing your entry signals, your next task is to document your trailing stop rules. www.ultimate-trading-systems.com/tsr

Chapter 8: Choosing your charting software

A well-designed trading system is useless without the tools to implement it. However, choosing a charting package, or deciding whether to use one at all, can be very confusing for a newbie trader. This is especially true when you consider that there are literally hundreds of software packages available to assist traders.

What to look for

You don't need to spend thousands of dollars paying for good, reliable charting software. Often the price is inflated to capitalise on the belief that the more expensive the software, the better. In truth, most charting packages perform very similar functions and a charting package under $1000 will perform just about all of the tasks required by even the most advanced traders.

When choosing your charting software, here are six things you really need to look for:

1. *Longevity*. Look for a package that's stood the test of time. There are plenty of packages on the market, but some of them are here today, gone tomorrow. There's nothing worse than taking the time to learn a new piece of software only to find it's no longer supported, since the company that developed it has gone down the corporate drain.

2. *Large user base*. Choosing a package that uses a large, established user base and is supported by well-attended forums will mean that if and when you need help, there will be plenty of support channels available to you (outside the developers themselves). What's more, there are great new discoveries made by the community that the developers may have never even thought of.

3. *Flexibility*. Your package should have plenty of flexibility for coding so you can easily define your entry and exit criteria. Avoid packages that are so pre-programmed that you really don't have any control over what they do.

4. *Market scanning ability*. A good charting software package will have the ability to quickly and accurately scan the market for securities exhibiting criteria you define.

5. *Back testing facility*. Choose a package that has a back testing facility within the charting package itself, or one that is at least compatible with a well-established back testing package (further discussed in chapter 9).

6. *Independent data plans.* Beware of software packages that force you to use their data. They may be offering you the software cheaply – or even free – but then they tie you into their (often expensive) data plans. It's best to find a charting package that has third party independent data plans.

And finally, if you're still having trouble selecting between a few different packages be sure to ask about trial versions. It's a great way to see if the package is right for you.

Black box systems

No matter what charting software you do decide to go with, it is important to recognise that software is simply a tool that aids a trader in undertaking her business activity. Beware of software packages that do everything for you. These are commonly referred to as 'black box systems'.

Black box systems are typically computer programs in which the system spits out recommendations based on hidden pre-programmed logic. The problem with these types of systems is that you don't know what's going on behind the scenes, you just get a list of buy and sell recommendations, without any explanation or understanding of how they're created. They're not tailored to the individual and, in my experience, simply don't work.

In general, traders who believe the myth that you can just hand over your hard-earned capital to a computer program, sit back and collect cheques, are living in a fantasy land. Sure, they want to make the money successful traders do, yet they do not want to put in the hard work necessary to develop the skills needed to become and stay successful.

Your time and money is best spent elsewhere.

Recommended packages

The charting software package I use is MetaStock - www.ultimate-trading-systems.com/charting. It's easy to use and ticks all the boxes in terms of the six criteria I've outlined above: it's been around for over ten years, has a strong user base with well-populated forums and offers plenty of user support. (See my website www.meta-formula.com for tips on using MetaStock.)

MetaStock's formulas are based on popular spreadsheet programming language so if you can use Microsoft Excel you've already got a good head start. Its exploration module gives the user the ability to scan through tens of thousands of securities at once, identifying only those that meet predefined criteria. MetaStock has a fantastic back testing add-on and doesn't force you into any specific data package.

While I do recommend MetaStock, these are some other packages worth looking into: *Advanced Get*, *OmniTrader*, *SuperCharts*, *AmiBroker*, *Market*

Analyst and *TradeStation*. I've heard good reports about all of these packages but haven't used them in great detail.

Whichever package you choose, take the time to learn it inside and out. When system designing, you don't want to be limited by lack of knowledge. If you can conceive it, you want your package to be able to deliver it.

Selecting data

No chapter on charting software would be complete without talking about market data. Yes, some software packages offer their own data feeds, but I suggest you look at third party data feeds because they're usually more cost effective. Which data provider you go with will vary depending on which software and market you decide to trade.

Start by asking the following five questions of your data provider:

1. *Do they support multiple markets?* Although you will have selected only one market on which to concentrate, it's important that you have access to data for multiple markets in case you decide to change markets down the track.

2. *Do they provide fast download and data distribution?* Your time is far better spent identifying profitable trading opportunities than waiting for data to download. Choose one that downloads and distributes quickly.

3. *Do they provide automatic database maintenance?* The effects of splits, name changes and additions will drive you crazy if you have to input them manually. Your data provider should be able to provide these updates for you automatically.

4. *Do they provide the ability to quickly and easily create custom folders?* No matter what charting software you're using, this is critical for enabling you to conduct more efficient analysis. It will save you hours of time in the long run.

5. *Is the data provider here to stay?* Changing providers costs time and money. Select one that has a good track record and will be around for the long term.

Want to see our preferred data provider?
Visit: www.ultimate-trading-systems.com/data

Actions

1. Purchase a charting package – to find out more about MetaStock visit: www.ultimate-trading-systems.com/charting

2. Learn how to use your charting package to its full potential - if you chose MetaStock visit: www.ultimate-trading-systems.com/metastock

3. Select a data provider – to see our suggested total data management solution visit: www.ultimate-trading-systems.com/data

'Every day that goes by, without back testing your system, is costing you money.' – David Jenyns

Chapter 9: The art of back testing

As I've mentioned before, one of the things I really love about trading is that, unlike any other business, you can fully test your 'business model' (trading plan) without risking any real money. In trading, this assessment process is called back testing.

Back testing is the area now most neglected by traders. I've talked about the importance of psychology and money management in previous chapters – and so have a lot of other trading coaches. So much so, there is now a bevy of information and awareness around. You only have to surf the 'net to see just how much focus is placed on these areas – as there should be. But all this attention seems to be at the expense of back testing. As a result, back testing, I think, has now become the new least understood and appreciated area of trading.

Why is back testing so important?

Back testing is most important because it directly impacts on your entries and exits, money management and psychology in the following ways.

- *Entries and exits* – back testing enables you to test your entire system's performance using historical data. With that information, you can make the necessary adjustments to produce the results you're looking for.
- *Money management* – back testing allows you to test various money management models to see which works best with your system.
- *Psychology* – as discussed earlier in the book, understanding your system's strengths and weaknesses – even if they *are* only on paper – will improve your trading confidence. This will have untold effect on your performance when you begin to trade for real.

Whatever technical analysis criterion you use to trade with – be it moving averages, candlesticks, volatility breakouts, Fibonacci retracements or any other trading system – you're going to need to back test it thoroughly, in order to remove any possible doubt about it's capability.

Without back testing, a lack of confidence arises and usually forces traders to question their own trading systems. They give in to the temptation to modify their trading plan… often with devastating consequences. This temptation typically comes from a string of losing trades or an opportunity to replace their trading system with a new whiz-bang indicator that is the latest fad talked about in chat forums.

Anything that sounds too good to be true will attract the attention of a trader who is not satisfied with her trading system, simply because she has not properly tested her system in the first place. She has not built up the necessary confidence needed to successfully trade the system she has developed.

Will my trading strategy be profitable?

This is the most asked question in the trading world. Author Mark Jurik had a go at answering it in his book *Computerized Trading*, as shown in Box 9.1.

Box 9.1 Will my trading strategy be profitable?

After having gone through the arduous process of crafting a trading strategy, this is the question you must ask yourself. The ability to answer that question is the great promise that back testing holds out for all traders. A successful back testing procedure will greatly reduce the probability that you will begin trading with either an unprofitable strategy or one that does not meet your expectations. By adopting a sound and rigorous back testing approach, you will:

- *pinpoint which approaches to the market that are likely to be successful and which ones are not*
- *generate good estimates of future performance for each trading strategy you test*
- *create a record of your trading strategy's historical trading performance*
- *produce data necessary for other components of your trading approach such as your asset allocation strategy.*

Source: Jurik, M 1999, Computerized Trading: Maximizing Day Trading and Overnight Profits, New York Institute of Finance, New York.

But what is back testing exactly?

Back testing is the process of testing a trading strategy using historical data rather than testing it in real time with real money. The metrics obtained from testing can be used as an indication of how well the strategy would have performed had it been applied to past trades. Interpreting these results then provides the trader with sufficient metrics to assess the potential of the trading system.

Logically, we know that the results from this type of testing will not be able to predict future returns with pinpoint accuracy; however, it can provide an indicator as to whether you should even pursue a trading system or not. What’s more, if you decide to go ahead and trade the system, it will give you guides on what to expect.

But the question remains: how can you test a trading system's performance over time? There are only two ways to do this – manually or with computer software. To be honest, computer software is the only 'real' option. I have tried both testing methods and manual testing is not only time consuming but very hard to replicate and test effectively.

The benefits derived from back testing software cannot be overestimated. It will save you time and provide an endless opportunity to fine-tune and test your system. A small outlay in capital to purchase good back testing software will potentially save you *thousands* in the market; it is a very wise investment if you are considering designing a successful and mechanical trading system.

Mechanical back testing

Please understand, as long as your mechanical trading system exclusively works with price data (open, high, low, close, volume), you will be able to use back testing software.

For example, say you create a mechanical trading system with the following entry rule:

> *Purchase a security when the 10-day moving average of closing price crosses above the 30-day moving average of closing price.*

This rule can be tested quite easily over historical data. On the other hand, your buy signal rule may be a little more complex such as:

> *Purchase a security when the 10-day moving average of the closing price crosses above the 30-day moving average of closing price and the PE ratio was 75% or lower than its value three months before.*

This rule introduces data that is not often supplied or maintained in a database of price information. To successfully back test this would involve obtaining historical data of a security as well as the price-to-earnings ratio (PE ratio). Typically, historical data on a group of equities would only include the open, high, low, close and volume for each period. Because of this limitation, many mechanical trading systems are designed around purely price technical indicators.

Unfortunately most mechanical trading system based on fundamental data is beyond the scope of retail investors due to the lack of historical data available to conduct a complete back test.

Back testing software

Fortunately, these days, many charting packages have back testing software built in. If you followed the process for selecting a charting package in the previous chapter, you should have either found one with back testing capabilities included or found one that is compatible with another off-the-shelf package.

For those of you who decided to purchase MetaStock in chapter 8, TradeSim - www.ultimate-trading-systems.com/tradesim is probably the most realistic, true trading simulator/analyser I have found. It can quickly back test and evaluate a trading system, whether a single security or a multiple-security portfolio.

I believe back testing is the only way to remove self-doubt. Once you have established that you have a reliable and robust trading system only then will you be confident in trading it.

Similarly to your charting software, make sure you know your package back to front. You won't be able to get the best out of it unless you fully understand how it works and what you can do with it.

Alternative Solutions

Sadly, I have seen many clients never quite 'get it' with regards to back testing. For many, back testing software is simply too technical. If you fall into that category, don't give up. It's a critical step in the system design process.

For the less technical, I have found a solution called the *Trading Performance Analyzer* – www.ultimate-trading-systems.com/tpa. It's easy to use and perfect for analysing your system before trading it real time.

Important note:

If you find yourself testing and re-testing in the hope of stumbling across that silver bullet, remember, you will never create a trading system that has a 100% success rate. Many have tried (myself included) and everyone has failed.

You should be looking for a good trading system with minimal drawdown and a good risk-to-reward ratio. Many trading systems have more losing trades than they do winning and yet they still make money. How? *Money management.* (See chapter 6.)

The final piece in the system-design jigsaw puzzle is to take the trading system you have designed in the previous chapters and test it. By testing your systems you have just put yourself among the top 1% of traders, ensuring your success. Congratulations!

Actions

1. Purchase a back testing package:
   TradeSim - www.ultimate-trading-systems.com/tradesim
   Trading Performance Analyzer –
   www.ultimate-trading-systems.com/tpa
2. Learn your chosen back testing software inside and out.
3. Back test your newly designed system including your entry, exits, and money management rules.

'I'm a great believer in luck, and I find the harder I work the more I have of it. - Thomas Jefferson

Chapter 10: Analysing your trading system

Following the previous chapter you've now tested your system at least once and have the results sitting in front of you. So how do you interpret those results and make informed system tweaks? Read on and I'll tell you.

As I've mentioned before, trading, as a business, is unique in that you can test your business before you ever risk a cent. You can gain a complete and intricate understanding of how your system works. Through testing, you will discover how even a slight change in your system's variables can have dramatic effect. And the more you play around with these variables, the more you will come to understand the relationships between them.

An example of this can be seen in the relationship between risk and reward. Systems that tend to have higher returns also tend to have larger drawdowns (risk). In the past, I have designed systems that return up to 300% p.a. but they have drawdowns of over 100% – that is to say, you're guaranteed to lose your entire float and some when trading this system. In short, the greater the reward, the greater the risk.

With this in mind the astute reader may have realised profitability isn't the only criterion by which you should be evaluating a trading system.

Here are a few other questions you should be asking:

- What percentage of wins are you achieving against the percentage of losses?
- What is the average value of your wins compared with the average value of your losses?
- How much money can your system make, on average, for every dollar that you risk?
- How many losses in a row does your system generate?
- What is your system's maximum drawdown?
- How many trades does your system generate?
- And, of course, how profitable is your system?

To fully answer these, and other similar questions, you must analyse the results from your back testing. Unfortunately, with the overabundance of trading statistics which most back testing programs provide, this can be easier said than done. Let's take a closer look at the key metrics you need to pay close attention to.

1. Win-to-loss ratio

When assessing the performance of a trading system, one of the first statistics that gives you a good indication of tradability is the win-to-loss ratio. Quite simply, this is the ratio of the average winning trades taken against the average losing trades taken. If this ratio indicates you are winning more often than you are losing, you are on the right track.

But don’t get caught up in this statistic on its own, because it doesn’t tell the whole story. It doesn’t consider the size of your winning trades versus the size of your losing trades. Remember the Turtles? Their win-to-loss ratio was 40:60, but they were still hugely profitable.

2. Average wins and losses

In addition to the win-to-loss ratio, you will want to make sure that the average value of your winning trades is greater than the average value of your losing ones. Say your back testing consisted of 200 trades. If 150 are losing trades and only 50 are winning trades, obviously your win-to-loss ratio is 25:75. But that on its own isn’t enough to determine if a system is good or bad.

Understand that, if the average of your wins was, for example, $2000 and the average of your losses was $500, you are still coming out on top ((50x2000)–(150x500)=$25,000).

3. Expectancy

We talked about expectancy in chapter 6 on money management, but I’m going to take this concept a step further. A trading system’s expectancy is perhaps one of the most powerful statistics you can have because it is a way of quantifying the performance of a system that is independent of the size of the trading float.

Expectancy is different to the risk-to-reward ratio and average wins to losses that we described above, in that it defines a return in dollar terms for every dollar that you risk. If your system has an expectancy of +0.75, on average, you would expect to make 0.75 times the amount you risked in the trade. If you risk $1, then you would expect to make, on average, $0.75 profit for every trade you take.

As a guide, if you can achieve expectancy of $0.60, you’re heading in the right direction. Please refer back to chapter 6 for details on how to calculate expectancy.

4. Maximum consecutive losses

Look back through your testing results to see, statistically, how many losses in a row your system sustained while still being profitable. This is important to know upfront, since this statistic will give you confidence during those low times when it feels like you should throw in the towel.

For example, imagine you have been hit with five or six losses in a row. Without knowing your maximum consecutive losses, you might think your system isn’t working. This is where most naive traders go wrong. The truth be known, based on the historical data, your system may have actually sustained ten losses and still been profitable.

5. Maximum drawdown

The maximum drawdown is the worst period of ‘peak to valley’ performance of your system, regardless of whether or not the drawdown consisted of consecutive months of negative performance.

This statistic is automatically calculated, so it’s just a matter of asking yourself: am I comfortable with that size loss? If not, you will need to do more system tweaking to get it to a level that you can live with.

Again, it all comes back to the risk-to-reward ratio. Typically the more risk you take, the greater the reward. I have traded a system in the past that returned 140% p.a. Now that sounds great, but that particular system had a maximum drawdown of 80%. Could you trade a system where it’s likely you’d lose 80% of all your capital at least once while trading it? Could you stomach that?

It’s important you trade a system you’re comfortable with.

6. Number of trades

Then there’s the number of trades a system gives over the course of a year. I find this an invaluable, yet rarely talked about, statistic.

Your trading system should not give too many or too few trades. The number of trades that a trading system gives should be approximately the same as that which can realistically be taken.

The two sides of the coin are equally dangerous. If a system gives too many trades, you will be forced to choose between signals, therefore adding ambiguity to the system. With ambiguity comes human discretion and this often has a detrimental effect on the performance of the trading system.

On the other hand, if a system gives too few trades, your trading capital will not be fully utilised and you may not be taking full advantage of the available trading opportunities.

So how do you calculate the optimal number of trades for a trading system?

This is done with the calculation called ‘opportunity’. Opportunity helps determine your optimal opportunity for a trading system, as demonstrated below.

Example
Opportunity = (240/average days in trade) x (trading float/average trade size)

Any good back testing software will give you the above metrics. For example, the optimal opportunity for a trading system with the following variables would be:

Float = $200,000
Average days in trade = 19
Average trade size = $18,000

Opportunity = (240/19) x (200,000/18,000) = 140 trades per year.

7. Profitability

Profitability is simply the return on investment over a yearly term.

Let's be blunt. We're all in this to make money. At the end of the day, profitability really is the most important metric by which to measure our success. But, while it's important, it needs to be balanced with the other six measures I've just discussed.

Ongoing monitoring

Calculating all these metrics manually doesn't seem too appealing. Thankfully, most back testing software will calculate these measures for you. As I've mentioned, the goal of back testing is to make sure you know and are comfortable with the metrics of your system. The metrics will give you rules by which to trade, but you must continue to monitor your system and compare real-time statistics with your back tested results. If it trades outside of those statistics, when trading real time, you will need to investigate why.

Remember, analysing your trading metrics is critical, however often overlooked.

Action

> To date I'm yet to find a course that teaches, in detail, how to correctly analyse a system – accordingly, I'm now looking to create my own. In the meantime, check out Tharp's *Trade Your Way to Financial Freedom* for more tips.
> www.ultimate-trading-systems.com/tywtff

'The reason brokers are called 'brokers' is because they are broker than you are.' – Robert Kiyosaki

Chapter 11: Selecting your broker

At this point you should have a fully tested system ready to trade. The last piece in the puzzle is to select your broker. Most markets require that all traders place their trades through a broker. There are really only two types of brokers to choose from: the full-service broker and the discount broker.

A full-service broker offers advice to its clients for which a premium is charged. In this set-up, the broker will usually take a proactive role, contacting you with trading ideas and then, with your permission, placing the trades. It is a personalised service that usually has a team of researchers working behind the scenes to back up the broker's advice. You can have access to that data... at a price.

Discount brokers, as the name suggests, are a cheaper option because they don't provide the personalised service you would expect through a full-service provider. Most are faceless organisations that do business over the internet. They don't offer advice (hence there is no need for them to employ research staff), they simply place the trades you direct them to. This reduces their overheads and makes it possible to offer discounted rates. A discount broker relies on you to make all the decisions about how to trade your account.

The best way to decide which option to go for is to determine what you need from your broker. Assuming you have designed your system as outlined in this book, there really is no need to employ a full-service broker. If you are following your trading system, such advice will only confuse your decision-making processes. Sure there are the other benefits that someone is watching your portfolio and that some full service brokers have access to different products, but as a general rule I say stick with the discount brokers.

How do you spot a good broker?

Finding a good broker means finding one that suits you and your trading style.

Here are some questions you should consider when choosing your broker – either online or full-service.

1. What are the real commission rates?

Advertised rates for brokers vary between $0 to $40 per trade for an online broker and up to $100 (or 1–2% of your trade size) if you're accessing a full-service. Look closely at what the company's advertised rate really applies to. In many cases there will be varying brokerage for different trading instruments and higher rates for those using a 'live' broker on the phone. The truth is, you may find that the advertised commission rate may *hardly ever* apply to the types of trades you place.

Also, if you're dealing with a full-service firm, remember their commission rate is negotiable depending on how much business you are running through your account. Negotiate hard and get the best rate you can. Brokerage is a cost of doing business and as such you should always look to lower your expenses.

2. Are there any other extra fees?

Many companies, both online and full-service, charge extra 'hidden' fees, that can add significant costs to each trade. Charges to be aware of include those for transferring funds (both in and out of your account), insurance, administration charges, late payment penalties and more. You really need to look at the company's fine print or e-mail for more details.

3. Can you trade multiple markets, and what are the commissions?

As your trading progresses, you may decide to trade different markets. It's easier to stick with the broker you have come to know and trust. Therefore, you really should plan ahead and choose a broker that can service your needs as you grow.

4. Will they pay you interest on the balance of uninvested cash in your account?

Some online and full-service brokers pay interest in the range of 3–4%. A nice little bonus!

5. Do you need to start with a large deposit?

Beware of high minimum balances required to open an account. While some companies have good rates, you may need $50,000 to start. It's a lot of money to invest with a company you haven't traded with before. Typically full-service firms will require more capital to start an account than a discount online service.

6. How reliable is the service?

Speed and reliability of online trading is of utmost importance. I know of one client with a major online discount broker who watched as his account dropped by $10,000 because a system fault at his end meant he couldn't log on for a whole morning! Which leads to another tip – ensure there is a backup way for you to place trades if needed.

For an online broker, check that they offer STP (straight through processing). This means that trades are placed in the market as soon as they are made. With some discount brokers, trades are placed manually, so your trade may not be actioned until sometime after you've placed it.

On the flip side, a full-service broker will usually enter a trade as the request comes through over the phone.

7. Do they offer any automatic features?

Look at any extras the companies are offering and weigh up if these extras will suit your trading style. (Who cares if they offer an automated feature that you will never use? It's worthless to you.)

One feature I quite like is automated stop losses. This feature enables me to set my exit point and it's automatically triggered. Another one to look out for is 'contingent order' – do they allow you to place conditions that must be met before an order is automatically placed? For example, if the share price breaks out from your specified buy point of $12, you might like to set an automatic buy trigger.

The automated extras are usually more applicable to online brokers, but it's worth asking the full-service brokers what they offer as well.

Settling on a broker

The trick, then, is choosing one. There will be many brokers that seem to fit all your criteria, so how do you decide which one to go for, or, indeed, where to even start?

My advice is to check in your area for local investment clubs and/or online forums – they're a great place to ask for recommendations. You can also do a search for websites that review brokers who specialise in your chosen market. That said, I find recommendations from other traders you know and respect is always the best way to go.

Once you have a short list, give them a call and see what feels right for you. Typically I like to go with the broker that's been around for a while.

Actions

1. Find and open an account with a broker.

2. Begin trading your newly designed system and remember to follow it to the letter.

Chapter 12: Where to from here?

You've got a great trading system, but…

So you've finished reading the book. You've started trading. You've had some wins, you've had some losses. You expected that.

Your losses begin to increase and you begin to falter. You consult your favourite psychological trading book for motivation. You review your list of dos and don'ts. You go at it again but continue to lose.

What's happening?

I'll tell you one thing: if you've followed the method outlined in this book it's probably not the system.

Mindset, mindset, mindset

I started this book talking about psychology. I talked about how important it is to get your head right if you want to be a successful trader. I may have even gone so far as to say if you don't, you will fail. I will end the book on the same thought.

To fully master your trading, you must master the most important aspect of trading… yourself. Unfortunately, for some, the battle to rule their own emotions is one they will never win. You may be one of those people. If this is the case, perhaps trading is not for you. Sadly, not everyone can be good at everything.

I can pave the way by providing information and support, but without the rock-solid determination to stick to your plan and succeed, you may not get there. And that's okay. My advice in this situation is to stop digging that hole. Realise that you are not suited to trading, and try something else – focus on your strengths. Deciding not to trade does not mean that you *are* a failure but quite the opposite. It's a very responsible decision to say trading is not for you. Perhaps the nature of successful trading doesn't sit well with your personality.

Nobody is born with killer trading skills. However, with those few exceptions, if you have passion, commitment and the right advice, you can become a great trader. Trading is not a get-rich-quick philosophy. It is a profession that, when mastered, will turn profits. Seeking the proper instruction, with practice, patience and commitment, you will master the skills needed to make a comfortable living.

Legendary trader Ed Seykota says, 'Whatever you put your mind to, whatever you expect, be it positive or negative, you tend to draw into your life'. Only you control your destiny as a trader. If you are to be a successful trader, you must have the expectation that you are going to be a successful trader.

When you get right down to it, making money trading should be a by-product of adhering to your trading system. It should not be your main objective as a trader; your energy is better spent concentrating on executing your system. A trader's job is to follow their trading system. If it has been thoroughly back tested and is proven to be profitable, a trader will get paid.

It really is as simple as that.

Conclusion

Reaching the end of this book means that it's time to hand over the reins and let you gallop off into the sunset that is your financial future. Congratulations on making it all the way through. Most people pick up books like this one, looking for a quick, simple solution to a short-term financial crisis. You're obviously not like that and that means that your chances of success in the markets have skyrocketed.

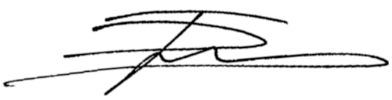
But, as I've said all along, it won't happen without commitment. This means a commitment to maintaining the right mindset, a commitment to your trading plan and a commitment to ongoing learning.

It's customary to wish people luck at the end of a book like this. I won't do that. Luck really has no place in trading. I do however wish you the strength to forge on and to stick to your trading system.

I hope you have found my tips useful. Remember: there is a lot of help out there – read some of the books I've suggested, check out my website, talk to other traders. You can never learn too much. And if you think education is expensive, try ignorance.

Drop me an email to let me know how you're going www.davidjenyns.com/support - I'd love to hear from you. I'd also like to take this opportunity to invite you to join my coaching program. This book really is only an introduction to successful trading. If you're serious about becoming a confident, consistent, disciplined trader you should consider joining my coaching program to move your trading to the next level. www.onlinetradingmastermind.com

Your trading coach,



David Jenyns
Professional Trader, Author and Coach

Appendix A: David's websites

www.onlinetradingmastermind.com

Would you like more advanced training? Join Stuart McPhee & David Jenyns' coaching program and become a confident, consistent, disciplined trader.

www.tripletradingprofits.com

Learn how you can design a powerfully profitable trading system that works in any market, in any time frame - Stuart McPhee & David Jenyns' premier trading package.

www.trading-secrets-revealed.com

Learn David's risk management rules and explode your trading profits – the most critical component of any trading system.

www.meta-formula.com

Visit David's MetaStock website, the largest collection of MetaStock indicators, explorers, experts, tools, tips and tricks.

www.freetradingsystems.org

Learn David's methods for designing profitable trading systems through online training videos. It's fun and free.

www.davidjenyns.com

Visit David Jenyns' blog to keep up to date with all David's up to.