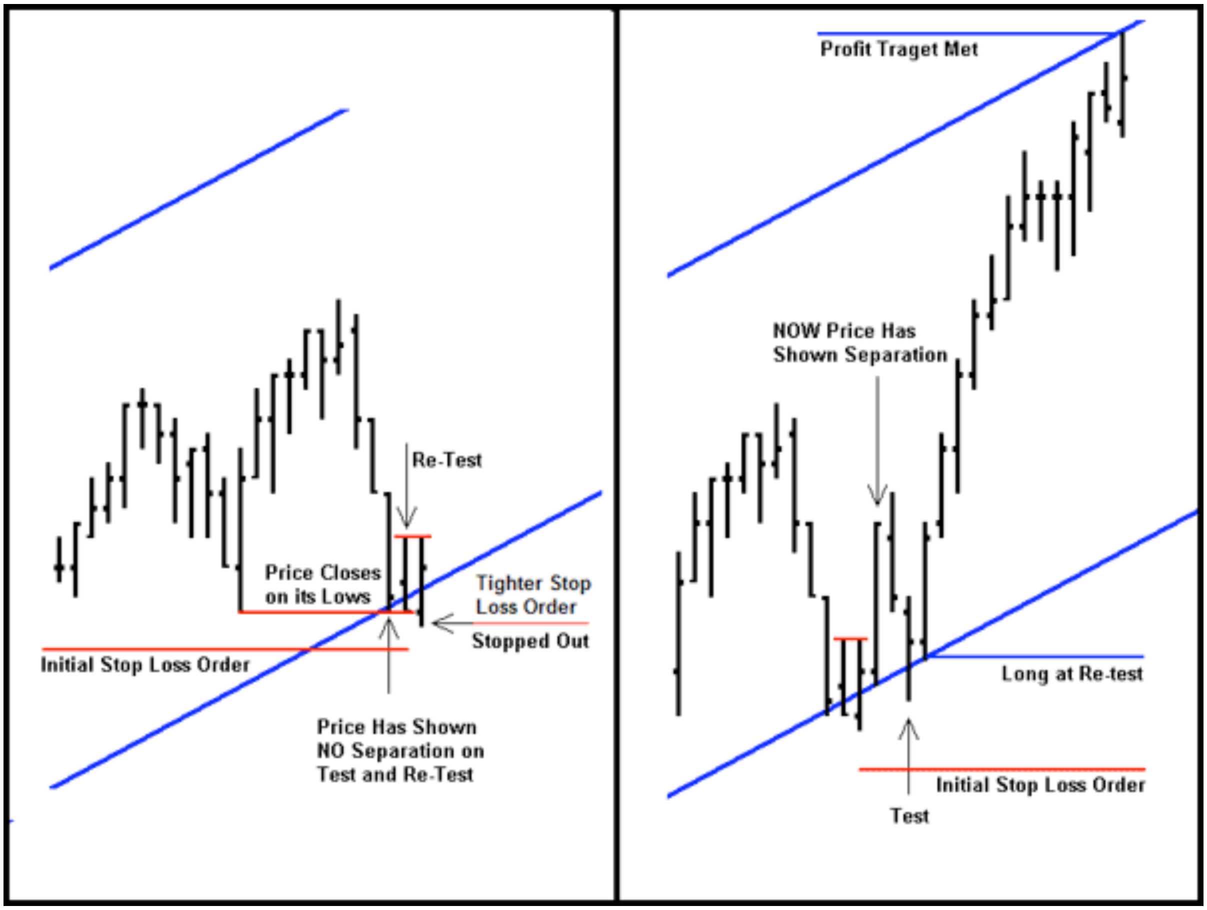
Tips for Traders | 10/26/2007

Making Choices That Put You in a Position of Strength

I have often compared successful professional traders as workmen that have mastered their tools, doing their job; in fact, the term I often use when describing my own trading is 'making the donuts.' Another very successful trader with more than 40 years of professional trading experience describes his trading as 'slicing sausage'. Most people scratch their heads when they hear us say such things, wondering why we are not as excited about making a trade as they are or as the people they see waving their arms on talk shows or selling 'can't miss' systems. After all, don't we enjoy trading?

Of course I enjoy trading! I enjoy the feeling of accomplishment of a job well done. And honestly, it took me years to understand that the choices made in the 'thrill of the moment' are not always the best choices. The best choices I can make as a trader are the ones that give me a position that is grounded in the strength of my research and experience. Too many traders trade for the sake of the thrill of making a trade and find after the fact that they rushed their entry. Or they began with an opinion about where the market was going and then went in search of an entry, no matter what the market was trying to tell them in real time. Remember this always: there are always consequences to your choices. If you choose quickly, with little thought, you might 'catch the ride', but it might not be the ride you are looking for. It costs you no capital to miss an opportunity-and any capital lost must be remade if you are to grow your account! Commit your capital only when you see a high probability entry set up you recognize and are confident you are capable of executing.

Let me show you two sides of the same coin, so to speak: this is the same market and two potential entry points. In fact, both of these entries were taken in my own prop room. One was a small loser and one was a nice winner. Let's examine them up close:



On the entry set up on the left, you can see that though price 'tested' the up sloping Lower Median Line, it closed very near this line, leaving no 'separation'. There is no sign of strength present here, nothing yet to lead you to believe price is about to stop and turn higher. But the trader chose to view this as a valid test of the Lower Median Line Parallel, because his 'view' was that this market was going to move higher on the day. He entered a limit buy order at the area where price would intersect with the same up sloping line and was filled on the very next bar. And note that that very next bar closed on its lows, a tick or two below the up sloping Lower Median Line Parallel. These weak closes led the trader to lose confidence in his entry and although he had placed his initial stop below what were now triple bottoms by about 1 ? S&P points, this close made him tighten up his stop loss closer to the action. And of course, he was quickly stopped out on the opening of the next bar.

It is important to note he did not lose a significant amount of capital on this trade. In fact, he lost less than he had originally been willing to risk on taking this trade entry. But he lost several things that are much more difficult to quantify and to regain: focus and confidence. While it is certainly true that when your account is empty of trading capital, you are done trading, it is equally true that if you have lost your focus, you will not see the high probability trade entries you spent so much time and energy mastering as clearly-if you see them at all-until your head clears. And worse, even if you do see the next high probability trade entry set up, will you have the emotional 'capital' to step up and take the trade?

In the same prop room, several minutes later, one of the other prop traders saw the second high probability trade set up. He pointed out to the rest of the room that this second test had everything the first test and re-test lacked: Price had now shown a sign of strength by climbing well back above the up sloping Lower Median Line immediately following the first test. Price had peeked below the same up sloping line this time, leaving good down side separation and probably running any down side stop orders that were resting in that area and yet had managed to close back above the up sloping line with good up side separation, another sign of strength. And there were multiple market formations below the entry area that should act as buffers, drawing in fresh limit buy orders that could be used to hide an initial stop loss order underneath. If price came back to re-test this up sloping line, this would be a classic high probability test and re-test trade entry set up.

The second trader put limit buy orders and initial stop loss orders in the market, waiting for price to come back down and re-test the up sloping line. If his limit orders were filled, he would have a position rooted in the strength of preparation and patience. The first trader did not have the emotional capital to take the second trade set up, even though he acknowledged it had all the markings of a classic high probability long trade set up. And remember, his view was that this market was heading higher on the day. But his lack of focus and the emotional costs from the first poorly planned trade entry stopped him from taking the second trade.

Both traders got a ride that day. They were using the same charts. Their entries were five bars apart and in the same direction. They were sitting so close their knees were nearly touching. And knowing them as only a mentor knows his students I'd say they were about equal in abilities and experience. But on this day, one fell for the thrill of catching a ride while the other waited until he saw the set up he felt comfortable risking his capital on. And as you can see, one lost money on the day and one had a very nice trading day.

There should be no mystery why I am known for my motto 'Master Your Tools, Master Yourself'. I truly believe becoming a trader is all about finding a handful of high probability trade set ups you can see and identify on a regular basis and then learning them inside out. Then you have to learn to master your own weaknesses and harness your strengths and couple these trade entries with solid money management. One thing is certain: if you trade for 50 years, you will have days when the human element present in all of us clouds your judgment and you will rush a trade or miss a trade or make a trade because you were chasing 'phantoms.' But if you keep it as simple as possible and make it repeatable, while it may seem trading has become like 'making donuts' or 'slicing sausage', you'll find these judgment clouded days come less and less frequently.

I wish you all good trading!

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