Tips for Traders | 7/6/2009 10:20:00 AM

How Successful Traders Manage Their Trades

The clearest thoughts you'll have about a potential trade is before you enter it; once you enter the trade, the clarity of your focus declines for many reasons:

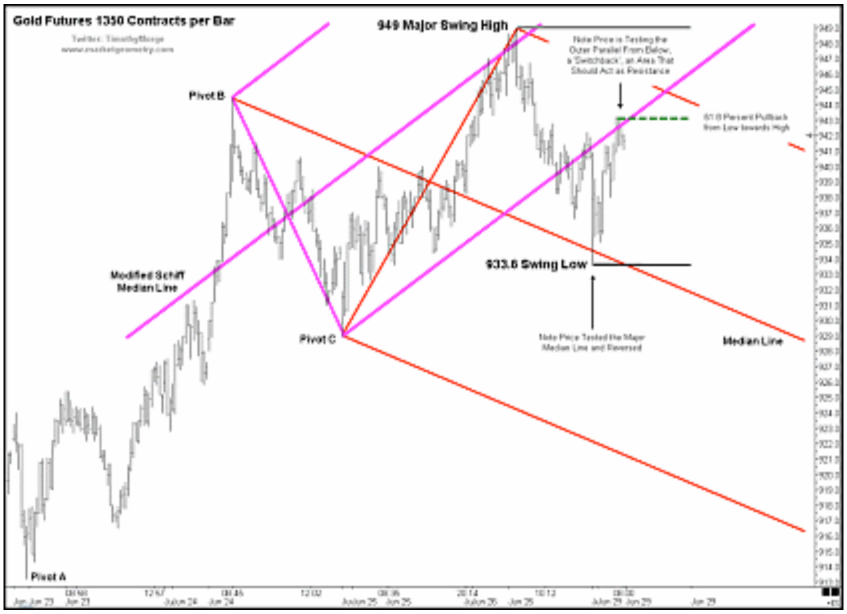
1. You have been staring at the screen for some time, stalking the trade (and of course, once you enter the trade, you are watching the screen even more intently, so the longer you are in the trade, the more focus you have spent).
2. Once you enter the trade, you have a financial interest in the trade; in many traders, that heightens their interest, but at a cost of burning their available focus at a faster rate.
3. Once you have a financial interest in the trade, you feel the weight to make money (some call this the fear and greed factor). You feel elated with each tick in your favor and you feel depressed by each tick that goes against you.
4. As a trade progresses, you are pulled by the price action to intervene and change your original idea; with each ebb and flow of price, a new way to improve your original trading plan pops into your head.
5. If a trade heads towards your stop loss, you become more and more certain you have taken a losing trade and the internal pressure to intervene and cut the loss quicker increases. Even if you have learned to hide your stop loss orders behind market structure, you feel the pressure from these urges to exit these trades earlier, at a smaller loss, even though many of your trades that travel into losing territory often would have survived by a few ticks (because of your use of market structure as protection).
6. As prices move in your favor, you feel the urge to lock in profits at the slightest slowing of price in your favor. You need a win and the thought that this trade may back up and turn into a loser weighs on your mind, clouding your judgment.

In group mentoring and one-on-one mentoring, my students must keep trade sheets that they fill out before they enter a trade. These trade sheets contain simple "maps" of the potential trade: the reason for the trade, the entry price, the initial stop loss price, the type of trade (range, intraday swing trade, longer-term swing trade, portfolio trade) and the realistic profit target (which must be based on current market conditions and the type of trade being contemplated). There are several reasons for requiring traders to fill out these trade sheets before they enter a trade, but the most important are these:

1. ANY trade plan is better than no trade plan; and
2. When a trader has an open position, the moment all these urges and fears begin pulling at him, he can calmly reach for his trade plan, re-read it and then find his way on the "map," getting himself back on course.

One of the least understood aspects of planning a trade is "framing" a trade. Is this a very short-term scalping trade? Is this trade a simple range trade? Is it a trade taken because market structure dictates a change of direction should occur and price is now showing signs this is unfolding (an intra-day swing trade or a longer-term swing trade)? Do you have a longer-term fundamental view and this trade is part of your portfolio? Each of these trades requires very different skills and tactics and abilities. And few traders have the ability to transition a trade from one category to another successfully. Once you have "framed" a trade, play the trade out as you planned it. Remember, you can always find another trade, even another entry into the same market in the same direction; but that first plan of any trade is always your best.

Let's look at two very different trades in the same market and see how "framing" these markets played important roles when planning and executing these trades.



Looking at this first chart, you can see gold futures have been in a slight uptrend and are now rallying after an orderly pullback; in many ways, Gold Futures may be trading in a range between 929 and 949. As I marked this chart up in my live pre-market session, Market Maps, I noticed the confluence of three things: the multiple highs, the 61.8 percent pullback, and the re-test of the magenta up sloping outer parallel (from the outside, which I call a "switchback," because what was support has now become resistance). If price were going to pause or perhaps turn lower, it would most likely do so from this area.

As I talked out loud about the potential for a short entry, I quickly began evaluating areas of support that might stop any decline in price:

1. There are quite a few smaller swing lows in the run up to the left of the current level of price that might act as support.
2. Price had tested the red down sloping median line and bounced up off it quite hard; if price got down to that level, I would expect a good deal of limit entry buy orders to be sitting in the market.
3. The major swing low at Pivot C should act as support and I would expect a good deal of limit entry buy orders to be sitting in the market at or near this level.

As I thought and spoke about the merits of both the long side of this market, at lower price levels, and the short side potential at current levels, "framing" the potential trade brought it into clear focus:

Price was at a perfect level of confluence: If it was going to turn lower, it was going to do so now, from this price. It would require a very small initial stop loss order, because if price began to trade above the multiple highs, there would be stop loss orders executed from traders that were already shorting this run up in the price of gold futures and there would be stop loss entry orders executed by the break out traders; in short, any run up in price from this level would doom the trade, so a large stop loss order was not needed and would not be helpful.

If price sold off from this level, it would probably find support at one of the prior lows-either at the spike low that had tested the red down sloping median line or at the major low at Pivot C; both of these areas would probably hold a good deal of limit buy entry orders that would at least slow the sell-off of price but one or the other may stop the sell-off in its tracks.

Was there a trade or just an interesting area of confluence hidden in the middle of an uptrend?

Framing this trade made all the difference in the world. When I intraday trade gold futures, I generally use a chart that is made up of bars that contain 1350 contracts per bar, rather than a time-based chart. And I use initial stop loss orders as large as $2.50 per contract but I am always looking for a risk reward ratio of 3-to-1 or higher (in all my trades in all instruments, I never take trades with a risk reward below 2-to-1, but in the instruments I do not trade quite as often, I look for slightly higher risk rewards).

Because I planned to use a much smaller initial stop loss on this trade, it would not take much downside movement to capture a respectable risk reward-but could I identify a logical profit target that was realistic and that would give me a risk reward ratio worth taking this trade and would the potential profit be large enough to justify a trade? Let me clarify this last set of conditions: I could put a $0.10 stop on the trade and look for $0.50 profit per contract, but by the time I add in slippage and the noise of the market, this flawed trade idea would have a respectable 5-to-1 risk reward ratio, but I would never consider taking this trade.

Once I began to frame this trade, the levels became easy to identify: I would use a $1 initial stop loss on this trade; the multiple highs at this area of confluence should hold further limit sell entry orders and they would either hold any rise in price or I would quickly be stopped out for a $1 loss. Seeing the multiple areas of strong support below price made it easy to categorize this trade as a range trade. The goal of this trade would be simple: Enter a short position with a small initial stop loss, ride a selloff in price towards the first area of support and then exit before price tested the first area of support. If all went according to plan, would the range trade be worth the risk?

I would be risking an initial $1 and if price sold off fairly quickly, I should be able to lock in a quick $7 before price ran into the likely limit entry buy orders at the first prior swing low. This meant a simple range trade, if successful, would give me a risk reward ratio of 7-to-1 and a quick $7 in profits-a nice profit in the gold futures. Remember that each gold futures contract controls 100 Troy ounces of gold and the minimum tick of 0.1 per ounce is worth $10, so each $1 move would be equal to $100. If I were able to capture the full value of this range trade, it would translate into $700 profit per gold futures contract, with an initial risk of $100 per gold futures contract (less slippage and commission, win or lose).

I could have executed this trade in the mini-gold futures contract market, which features contract sizes and tick values 1/3 that of the larger 100 ounce gold futures contract, but especially when range trading, I want to trade the most liquid contract, because I trade a large amount of contracts and I want in and out of my position as efficiently as possible. And to be honest, with such a small initial stop loss, this range trade called out for the larger contract. I discussed all these issues as I planned out and framed this gold trade in the Market Maps live session.

Once I was certain I had thought through my trade plan, I wrote it down (no easy feat when also hosting an online session with several hundred people watching live, but something I still do religiously), then I "tweeted" my entry order and initial stop loss order to the trading world, and I sent out a chart of the trade as well using the popular financial twitter based StockTwits network. Let me show you the orders I put into the market:

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Let me recap the "frame" of the trade: This is a simple range trade. I want to use a relatively small stop loss order and if successful, get profits out of what I considered to be the easy to identify portion of the range. If prices continued lower, that would be to someone else's benefit. Looking to the left on this chart, I marked the controlling swing of the market. I wanted to get short at a high probability area with a small stop loss and then grab profits from a portion of that controlling swing. When done correctly, this type of trading is near surgical in nature: Get in, get out. Done.

Before entering any orders, I added a new down sloping green Modified Schiff median line and its parallels; it's A pivot was taken from the highest high at 949, it's B Pivot was taken from the lowest prior swing low-just below the low of the controlling swing, and the C pivot was taken from the current area of confluence formed by the multiple tops, the 61.8 percent pullback and the red up sloping outer parallel, now acting as switchback resistance.

This new green pitchfork brought the profit target into focus for me. Here are the orders I entered into the market:

1. I wanted to sell a test of the energy point, where up sloping and down sloping lines of opposing force meet, right below the cluster of prior highs, at 942.70.
2. My initial stop loss order would be $1 above my limit sell entry area, which would still place it above the cluster of prior highs. I expected there would be limit entry sellers at or near this cluster of prior highs, but I also felt that if price breached this area to the upside, there would be stop loss buyers and stop entry buyers that would quickly push price higher. I was willing to risk $1 a contract, but not much more; this trade had to work quickly or I doubted it would work at all.
3. My logical profit target came into sharp focus when I added the down sloping green Modified Schiff median line. I now had an area of confluence formed by two down sloping median lines: This was the area where price should run out of downside directional energy, according to my methodology. I would place my limit buy order, my profit order, just above this area of confluence, at 935.70.

Two bars after I enter my orders, price fills my limit sell order and I am short at 942.70. Price then leaves a double top bar that has a wider range and closes near its lows. So far, the trading plan is going as I expect. But I don't want to get too excited; I want to treat the trading plan like “paint by numbers,” because it really should be executed in a surgeon-like manner.

Price plunges with a wide range lower bar that closes on its lows. This bar is good news and bad news: Price is quickly moving according to plan, but it is also expending a great deal of energy, because it is moving lower vertically.

The vertical nature of the selloff also means price is leaving no lower swing highs for me to hide profit stops if price turns back higher. When the wide range bar lower forms and it closes on its lows, I am more than halfway towards my profit target.

This is where many traders get into trouble! They now feel the adrenaline of being short in a market falling vertically and they begin to wonder if they are underestimating the down side potential of this move. As I said earlier, your best view of any market is before you have these emotions flowing through your head, because you have already used a great deal of focus planning and executing the trade and now your emotions are tugging at you to alter the trade plan (the fear and greed tug!).

At this stage of my trading career (I have been a professional trader for more than 38 years now), I may be much more conservative than most traders, especially those that only daytrade commodities and futures. My first thought is preservation of capital, so when the large range bar closes on its low, I see it as an opportunity to move my initial $1 stop loss order down to a $1 stop profit, what I call a “profit floor.” Price has moved down vertically, and sometimes, it moves in one direction so fast it uses all its directional energy at once and forms a “V” bottom. If that happens now, I have boxed in $1 a contract; I am playing with the market's money and I just need to execute the trading plan sitting right in front of me.

I showed the participants in my live Market Maps session my new stop profit order and explained the thinking behind it and then I “tweeted” the new order and chart out to the trading world, via Twitter.

Price wandered a bit, for more than two hours, and even though my position was always profitable, I was soon glad I had moved from a stop loss order to a profit stop order.

Note that when price did leave a swing high to hide my stop profit order above, the new stop order or profit floor happened to be where I had initially placed it. There should now be a solid group of limit entry sell orders resting at this new swing high, helping slow the rise if price headed back higher and acting as some protection for my profit floor.

As you can see, about 30 minutes after my live Market Maps session ended, price hit my limit buy order at 935.70, my profit target. I immediately tweeted out a chart showing that I had captured my range trading profits. The framing of this trade had been quite clear: Get in with a small initial stop order and if price sold off, grab profits from what I had identified as the “easy” part of the identifiable range. I planned my trade and I executed it in a surgical fashion. I took $700 profit per contract (before commissions) out of what I considered an easily identified range, with resistance above and strong support below.

Now let me tell you why I feel so strongly that your first look at any market is the cleanest and usually best look: Price went just over $1 lower before turning back higher. Believe I was quite happy to be flat as price began to make its way higher within the trading range. But then I began to check my e-mails: At least half the people attending my live Market Maps session also took the trade and most also took their profits where I had diagrammed confluence and a logical area to lock in all the profits in an identifiable range. But some of the people from the live session and many people that had read my "tweets" took one-half their profit at 935.70 (where I took all my position off) and price was now testing the 939.50 area; these people wanted to know my thoughts about how they should now manage their position!

My reply to each of the e-mails was the same: To me, this was a simple range trade. The use of scaling out of one-half of the initial position once price hit its logical profit target at 935.70 and staying short the other half in case price broke through the downside support never entered my mind; I am willing to bet the "scaling out" idea came into play once price was exhibiting weakness, with wide range bars lower. But these types of decisions to change the original trading plan are usually flawed, because they are made in the heat of the moment, when profits or losses are dominating your analytical skills. That is why I religiously make a plan and trade my plan. I advised them to either take the profit left on the second half of the position now or at least leave the stop profit order in place at 941.70.

Let me show you a different trade, in the same market, framed completely differently:

While going through the commodities, I chart live in the Market Maps session, the price action really caught my eye: Price was making higher swing highs and higher major swing lows. Price was pulling back 50 percent off its recent highs (but was still well within its controlling swing) and was approaching the outer parallel and a series of prior major lows from several weeks ago.

As I marked up the chart live in the pre-market session, one of the attendees reminded me that the non-farm payroll numbers would be coming out in about an hour (and this was two days before a major US holiday, so the market may be a bit thin). Now I had a decision to make: Did I want to even consider having a position into such a volatile economic release?

To me, the answer would be decided by how I framed this potential trade. My eyes were drawn to the current price area as a potential area to attempt a long position. But what did the risk reward profile look like and what type of trade would I be looking for? A range trade? A shorter-term swing trade? A longer-term swing trade? A portfolio trade?

Looking at the chart, both in my mind and thinking out loud to those attending the live session, I began to frame the trade: Price is making higher highs and higher lows. It was selling off, but to get to an area where I would want to get long, it had to sell off. The current sell off had done no damage to the current market structure, and if price held, the area of confluence formed by the 50 percent pullback and the outer parallel, this may be a good area to fish for a shorter-term or longer-term long swing trade position.

The initial downside risk, in my mind, would be $2.4 per contract, below the prior minor swing low to the left of price, where there may be some limit entry buy orders that could act as protection for my stop loss order. With a major economic release coming out in an hour, the upside potential could be a test of the first prior swing high at 947 and even the area of confluence formed by the major prior swing high and the up sloping median line, at 949.

- I would be buying a test of the outer parallel and the 50 percent pullback at 931.3.
- My initial stop loss order would be below the prior minor swing low to the left, at 928.9.
- My profit order would be at the confluence formed by the major swing high and the median line, at 949.
- Note that I intended to do all I could to lower my risk profile before the non-farm payroll release, and if price moved higher, I would try to box in profits with stop profit orders, though some of my ability to watch price and maneuver would be hindered because I was hosting my live pre-market session with several hundred people watching live.

I entered my orders and “tweeted” them out to the world and went back to charting the other commodities on my list that morning (crude oil futures, lean hog futures, natural gas futures, and soy bean futures).

Then I went back live to check the gold futures markets:

Price came down and traded a bit below the area of confluence, filling my limit buy entry order at 931.30. Price was closing well above its lows and I had a small profit in the position already, so all in all, the market was performing as I had planned it out in my Market Map.

Remember that in the back of mind, I had a clock ticking: the release of the non-farm payroll report. I wanted to reduce my risk profile as much as possible if I saw the opportunity.

I charted the bond futures and then came back to the gold futures chart. At this point, I had nearly $3 per contract of potential profit, so I moved my initial stop loss order from 928.90 up to 930.30, which left me $1 risk per contract. I didn't want to get too close to the price action, but I did want to reduce my risk profile.

I came back for one more look at gold futures a few minutes before the release of the non-farm payroll numbers and got a pleasant surprise: I had nearly $5 in potential profits in the position and at this point, I employed a risk management strategy I call “making a lotto ticket.”

I cancelled my stop loss order at 930.30 and entered a break-even stop order. Price should be far enough away from my entry price that the normal noise associated with the gold futures market shouldn't wash and rinse me out of my position. If the economic numbers came out and were positive for gold futures, price should be pushed quite a bit higher, maybe even as high as my profit target; but it should at least give me an opportunity to box in profits below higher swing lows if price stair stepped higher after the number.

When the economic number came out, I had now reduced my risk to the loss of commissions and perhaps some slippage.

The risk reward ratio seems infinite at this point but of course it isn't infinite when you figure in commissions and potential slippage, but it was very high and clearly in my favor. I used an area of confluence to find a quality entry area and then carefully reduced my risk profile as much as I could and still give this trade every chance to mature.

Before I move on, let's contrast the way I framed this trade, especially compared to the earlier trade. In the earlier trade, I knew before entering the trade I was going to range trade for a relatively small profit per contract, but had a very small initial stop coupled with a solid 7-to-1 risk reward ratio. The entire profit potential, in my eyes, was $7 per contract. The second trade featured a much wider initial stop ($2.40 a contract) and while the profit target was nearly $20 a contract, I also planned on boxing in profits if price moved higher — and remember, because I am long against up sloping lines, the longer it takes for price to hit the median line, the higher that intersecting price will be, so if I am able to box in profits under swing lows as they form, the profit potential may be more than $20 a contract.

It is extremely important to know what your end game strategy is when planning out a trade, make a plan and trade that plan. Each trade is different and the market structure and the opportunities you have to work with will dictate how you frame each trade. Don't range trade in a strongly trending market, and don't anticipate a trending market while price is stuck in the middle of a well-defined range. No matter what you wish for, price is always right and it will do what it does. Don't enter a trade without a complete trade plan that includes both a solid initial stop loss and a reasonable profit target.

Let's see how the gold futures reacted to the non-farm payroll number:

You can see that my lotto ticket expired worthless when price traded lower after the number, stopping me out of my position at break-even.

Although I did have nearly $5 per contract of potential profit in this trade right before the economic number was released, because I had framed this trade as a swing trade and was looking for about $20 per contract, I was willing to allow myself to be stopped out at break-even. In many ways, this is the opposite side of the coin of the first trade, where I wasn't looking to work myself into a low or no risk stop — instead, in the first trade, I wanted to get to a small profit floor if possible and grab a quick profit and exit clean.

Do I consider the second trade a failure? No, I was able to meet all my goals before the economic number was released. I put myself in a position to have a near risk free run to the upside IF the economic number was positive to Gold Futures; instead, the number was negative and I was stopped out at break even. In my eyes, both trades were executed as well as I could have executed them; the difference was simply price going where it wanted to go. And as I always say, price is always right!

I wish you all good trading.

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