What the Market Told Me

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TraderinCharge.com

Wisdom of the Markets

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Andrew Dawson has been investing and managing his own money for over two decades. His interest in financial markets began well before that and from an early stage he realised that the keys to success were not what most traders believed them to be. A good methodology is important, but the discipline to follow the rules is what really matters. Every trader must learn that it is a trader's ability to build the internal mental strength and discipline that will determine the outcome of their trading. In other words, ever trader must take charge and take responsibility for their performance.

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Introduction

I have been interested in trading financial markets for almost as long as I can remember. During this time I have encountered many fine people both traders and authors from whom I have learned a lot. A lot of what I have learned has been from my own experiences and from simply observing and listening to the market.

Market traders have acquired a reputation for being aggressive and opinionated without any particular virtues to justify these characteristics. But my experience has shown me that the best traders are anything but egotistical. Sure they are usually confident and purposeful, but an ability to put their egos and opinions aside and listen to what the market is telling them is one of the distinguishing characteristics of those I have met.

This is a difficult balance to achieve: a good trader must be confident and determined but must also be willing to accept that their opinions – perhaps beliefs would be a better word – must always be subsidiary to the facts that the markets presents. Perhaps, this ability is itself a sign of self-confidence. It is the mental strength and security of mind that they are not their opinions about the market. They are traders, successful traders. And successful traders listen to the market and act on what it tells them.

This eBook is Part 1 of a full collection of essays, articles and reviews that I have written over the years. The full collection is available to download free of charge from www.traderincharge.com.

General Rules for Traders

I know at last what distinguishes man from animals; financial worries.

Romain Rolland

In rising financial markets, the world is forever new. The bull or optimist has no eyes for past or present, but only for the future, where streams of revenue play in his imagination.

James Buchan

When an economist says the evidence is ‘mixed’, he or she means that theory says one thing and data says the opposite.

Richard Thaler

Obviousness is always the enemy of correctness.

Bertrand Russell

1 Just Starting? Here's 12 Things to Know

Notice the title above. It's not things you have to learn, it's what you need to know before you even start to trade. Because if you don't know these things then you will soon find trading to be a painful process and you will start to look for ways to avoid the pain. There are some pains you just have to be prepared to accept.

1. No one else has all the answers and no one else can make you a successful trader. Neither is there a perfect system or plan. You will have to find one that works for you. But you do not need to do this from scratch. Seek help and accept help.
2. Try to specialise. Stick to one a or two markets or stocks or classes of assets. Get to know your specialism really well because the people you are trading against are likely specialising in only one or two assets. You cannot know everything equally well.
3. Always try to keep it simple. Occam's Razor, an approach to problem solving dating back to at least the 13th century, says that the explanation for an observation that requires the fewest assumptions is probably the right one and should be accepted as such until proven false. It's the same with your analysis and trading. You won't get better by adding more indicators, or more data. Concentrate on making a few simple things work.
4. There is a lot of information in books and you might learn from them. But they that will make you a better trader. Only you can do that by taking what you learn and applying what works.
5. Trade in small amounts relative to your funds. Your trading fund is a proportion of your liquid assets and any trade must only place a small percentage of this at risk. Be careful of leverage. You can lose more than you have invested if you don't do it right. Be wary of

anyone encouraging you to increase your investment. It's your money. More risk may be in their interests, but not in your interests.

6. You are not trading in order to be right about anything. Indeed you will be wrong a lot. Most of the time probably. Accept that. If you have a problem with accepting that you are regularly wrong, even if you don't do anything wrong, then trading may not be for you. You are trading to make money, not to be right. Just don't lose much when you are wrong.

7. You don't need to tell anyone else about your trading. It's not a secret, but if your aim in trading is to gain the respect of others then you should not be trading. And when you are wrong you will start to hide it from them, and perhaps from yourself. You are trading to make money. Nothing else.

8. Don't be looking for explanations for why the market has moved. Just accept that it has moved, unless there is a really fundamental change occurring. There is always plenty of news every day and plenty of people to explain the news and how it is impacting. Ignore them. They will be talking about something else tomorrow because that is their job. It's not your job to listen.

9. Every emotion you experience is a liability if you allow it to affect your trading decisions. You must never, ever trade on emotion.

10. There are an infinite number of opportunities in the future but none at all in the past. So unless you have something to learn from reviewing what you have done then make sure to leave a trade behind when it is finished. Do not let it affect your next trade.

11. You are so unimportant that as far as the market and other market operators care you don't exist. It's not just that the market doesn't care about you and what you do and what you think or hope for; it does not even care to know that you exist. The market will never know anything about you. The flow of information is always one way, from the market to you.

12. Much of what applies in the rest of the world is meaningless in the market. Nothing has worth other than what someone else will pay for it. The market has no memory. Every trade is independent. Unless you lose your money, nothing you do today has any real impact on what you do next. It does not matter tomorrow how good you are today.

2 Trading is a Business

What if you came across a business where you needed no qualifications to get into the business, start-up costs were very low, you do not need to find customers or products, you can work from home any time and for any hours you wish, and the potential profit is huge. Most people would be tempted.

Trading is just such a business. So many people get into trading. Most soon learn that it is very easy to trade. But to trade profitably – well that's a very different story. Because there is a drawback to this business that many forget: the failure rate of new businesses in this sector is extraordinarily high. It's probably in the region of 90 to 95% of people who start trading will fail, with most stopping within the first year.

Of course, most people don't know that before they start. And so they see only the opportunities. Worse, because it's so easy to get started they view it almost as a pastime, not as a business at all. As a result, they forget that you need to apply established business principles and thinking. These are required irrespective of your trading style, or what markets or instruments or timeframes you use.

Trading is too expensive to be your hobby and too insecure to be your job. If you treat trading as a past-time you will find it to be a very expensive hobby. But if you take it on as your job then there is high insecurity and no guarantee of reward, irrespective of what effort you put in. It is a business in which you are making an investment of time and money with no guarantee of a return, but no limit on the potential return either. Look at it this way irrespective of how much time you will put in. And like any other business you need good planning and sufficient working capital. Like most businesses you should not expect to earn profits from day 1. You will need to work hard to earn money.

Know that you will not be treated lightly just because you are a small business or a newcomer. From day 1 you are competing against the most experienced players. This is a double edged sword. You will never have a brand or a reputation to rely on, but neither do they. So you can play pretty much the same game as everyone else, right from day 1.

You must have a good plan. This plan needs to be not just a high level outline of your objectives but a detailed plan of how you will operate the business. If must be written down, but it should not be set in stone from day one. It will need to develop and grow over time while remaining consistent and true to what you set out to do. And it must be realistic and based on good foundations because you have to be able to implement it all the time. The plan must not be based on wishful thinking or emotions.

Have your funding in place before you start to invest. This is good business practice. But don't use debt. Know how much you are willing and able to lose. That's your trading fund.

Be willing to accept yourself as your own boss. You have no-one else. So you must be willing to monitor yourself, accept your mistakes and have the discipline to put things right. This is one of the most difficult things, but it is much the same for anyone starting out on their own in any business.

Capital protection is paramount. Profits will arise over time if you limit losses. But if you lose too much you will never have the opportunity to earn profits. Most people who start trading stop doing so within a few months. It's not just that they are not earning good enough profits. It's generally that they lose their trading fund. You must avoid this.

You need an exit strategy. Know when to take on risk but know also when to exit or back away. Overtrading is a danger as in any business, but you must also know how to get out of a trade, not just how to find an opportunity.

You are not your trades. If you were selling cars you would not identify your personality with the cars you sell. Entering and exiting trades is your business. It is not you. If a trade goes bad it does not diminish you. You simply got it wrong, just like every other trader does. Learn why it went wrong – if you can – accept that you made a mistake, learn from your mistake, and don't make that mistake again.

Trading is your business, it is not your life. Have a life. If you have a bad day trading then that is just what it is. It's no more than that. The same applies if you have a good day. Tomorrow starts again with many opportunities to make it a winning day. In the interim, get on with your life. Trading is just a business to earn you money. Never look for it to be any more than that. There are far more enjoyable ways to spend leisure time.

3 Trading Predictions and Expectations

Look at almost any website about trading. There will probably be 3 elements present: some information about the market; a product that is being sold; and some prediction about a market. This prediction may be the product and make take many forms such as software, a new indicator, or a tip sheet or some other way to see what is going to happen. The impression that is created is that being able to predict what will happen is the way to profits.

Except that it is not. You cannot know what is going to happen in the market so prediction is futile and any trading plan or product that is based on prediction will fail. Following a plan that is doomed to fail is not the way to profitable trading.

About 100 years ago, J.P. Morgan, the famous American bank magnate, was asked by a reporter what he thought the market was going to do. He replied that it would fluctuate, as always. How true. And his answer also shows that even he did not know in what direction the market was going to move. So he made no prediction. And if J.P. Morgan could not say in what direction the market would move then perhaps we should accept that neither can we.

Still, it's easy to see why traders would focus their analysis on trying to predict the market. After all, if you could do that successfully then trading profitably would be more or less guaranteed. But you cannot know and do not need to know how the market will move in order to be profitable. So don't ask: what will happen? Instead, always ask: what is happening in the market? Then ask: how will I react to what the market does?

Focus on what you know and use this information to guide your trading by making decisions regarding different possibilities. Then assess and control the risks that are associated with your decisions.

The market will either move up, down or sideways. By looking at a chart we can know in what direction it has been moving in the recent past. So, it will either continue in this direction, reverse direction, or move sideways. And while we never know for certain which is likely to happen, by observing patterns and other indicators we can aim to assign different probabilities to each possibility.

If a market is in a trend then it continues to move in that direction unless it reverses. And it only reverses once for the trend to be over. So most of the time the trend is going to continue.

A strategy based on this simple observation is quite different from the age old saying that you make money in the financial markets by buying low and selling high. Obviously this is true – but only in hindsight. Because how do you know that the price the market is offering at any point in time is either high or low? If the price has fallen and is below where it was last week, is this a low price? If we buy in then perhaps it will continue to fall lower! This approach will only work if you manage to buy in the short time periods when the price is falling and just about to reverse, or has just reversed. And what are the chances of this given that most of the time the market is not in this timeframe?

Traders make money not by following a buy low and sell high strategy but by buying at the market price and selling at a future higher price – or selling at the market price in order to buy back at a future lower price.

So, there are no mysteries here, no secret formulas, no fancy software. Instead there is a proven strategy which combines easily stated and understood rules with experience to make the right decisions when discretion is required and the mental discipline to keep doing this.

But this is not the end of the process. Indeed, many writers and experienced traders contend that identifying trades is a relatively small part of the process. One of the most important aspects of trading is managing risk and deciding not only what to trade but how much. And most importantly, you need to know when to get out of a trade. After all, no-one ever makes money by entering a trade. You make your profit when you exit the trade. So you have to be able to form an expectation about what the trade has to offer.

Indeed, you have to be able to form expectations about what your trading in general can provide to you. To get a handle, first break the outcome, i.e. the level of returns, down into its determinants and see what might be expected of each element. It's best to consider this in terms of percentages and so, provided the account is adequately funded to provide sufficient liquidity for trading, the size of the account, within reason, is not relevant. The return is determined by three variables:

- The percentage of winners among overall trades;
- The ratio of the average value of winners to loses
- The percentage of the account that is put at risk on each trade.

One interesting factor to note is that, as we go down this list, the trader's ability to control the outcome in relation to each factor increases. The trader has the ability to exercise a high level of control in relation to the final factor, some control in relation to the second, but does not have a lot of control in relation to the first. This is important as most traders appear to place most emphasis on the first as the key to success by aiming to identify a strategy that will produce a high percentage of winning trades. It is understandable why this should be so, but it is also contradictory to place most effort on a factor where there is little chance of success. Far better to concentrate on those elements that can be controlled.

The percentage to risk on any trade should be known in advance and be treated as an absolute rule, never to be broken. A limit of 2% of your trading fund is a commonly stated rule. Control of the second factor will be achieved through setting strict stop losses and targets at appropriate levels – although targets can always be extended – and only taking trades where the identified potential gain is a pre-defined minimum multiple of the potential loss. Most authors on trading recommend that this should be in the range of 2.5 or above. So, a trade is only taken if the analysis indicates that the potential gain given the market's behaviour is 2.5 times the value of the amount that is placed at risk with the stop loss having been set also based on the market's behaviour.

This leaves the first issue in the list: the percentage of winners. At first sight it would appear that a trader who knows nothing will achieve 50% winners and this is true to an extent (ignoring commissions and other costs). However, this expectation ignores a key issue which is that making profits requires not only that a trader gets the direction right i.e. a long trade when the market rises, but that the trader also gets the timing right. A trader may very often find that the analysis that the market will rise over a certain period proves to be correct but it takes a dive first before reaching a target and a stop is hit. The direction was right but the timing was wrong and the trade is a loser.

The only way to avoid this would be to set a very wide stop loss or none at all. The result is that if we do aim to control our risk then we will no longer achieve 50% winners by random trading. Instead, we will have 50% losers due to direction and perhaps in the region of a further 40% of the remaining trades will lose due to timing issues. On the basis of these figures the expectation should be that in the region of 30% of trades will be winners i.e. 50 out of each 100 trades will lose because the direction is wrong and 20 will lose due to timing issues with the trade being stopped out before it moves in our direction.

Only 30% winners! Surely not. And this is where inexperienced traders make the mistake of starting to search for the golden strategy that will provide 60% or 70% winners. But the evidence is that the best traders target and expect that perhaps 35 to 40% of trades will be profitable. The important point to notice is that if they have controlled the factors that they can control they are very profitable.

Assume a fund of $10,000 with 1 trade per day over the course of a year of 240 trading days, with 2% risked per trade, 35% winners and a ratio of winners to losers value of 2 to 1. These seem like quite conservative assumptions. A total of 156 trades lose money with each one losing $200. There are 84 winning trades and each one wins $400. Total profits for the year are $2,400 or 24%. If maintained over a prolonged period this would be a very profitable business with the fund at the end of 10 years having risen to $86,000. Far from being conservative, this would be a hugely successful outcome.

However, new traders find it very difficult to accept that losing on over 60% of their trades should be considered to be normal and concentrate on trying to improve their analysis rather than their risk control and trade management. If this results in them paying for systems that promise higher wins rates then they will increase their costs and will be distracted from what is really needed. Even more seriously, many traders focus on trying to improve returns by relaxing the risk constraint and increase their position sizes. This is the greatest danger to their accounts.

4 Myths and Clichés that Will Hurt Your Trading

The financial markets love pithy sayings to convey complex ideas. Many of these get reflected in mainstream commentary. Some are useful but not all. And there are many sayings and commonly held beliefs around investing that are simply wrong and should be dismissed. Here are some that you should avoid.

- **Investing in the markets is just gambling.**

A share of common stock is ownership in a company. It entitles the holder to a claim on assets as well as a fraction of the profits that the company generates. There are many variables involved but, over the long term, a company is only worth the present value of the profits it will make. In the short term a company can survive without profits because of the expectations of future earnings, but eventually a company's stock price can be expected to show the true value of the firm.

A future is a contract for ownership of a physical product. Commodity contracts are worth the value of the commodity based on its use value in the real economy. Gambling, on the contrary, is a zero-sum game. It merely takes money from a loser and gives it to a winner. No value is ever created.

- **Markets rise and fall for a reason.**

Sometimes there is a clear reason why a market has moved, but not always. Markets fluctuate. Either way, what does it benefit you to put effort into knowing why a market rose or fell on any particular day? Usually there is no benefit. It’s much better to just accept that a price changed and act accordingly.

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