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CHAPTER 13: THE ONLY MAGIC IN TRADING—EMOTIONAL STABILITY

As an industry insider, I am repeatedly confronted by those looking for a magic indicator, trading system, or newsletter. They want somebody, often me, to tell them where to buy and where to sell, and do it with impeccable accuracy. Regrettably, I am forced to bring them into reality.

> "If all the economists in the world were laid end to end, they still wouldn't reach a conclusion."
> – George Bernard Shaw

In my years as a broker, I have come across droves of retail and institutional traders and just as many trading strategies and methodologies. I have yet to discover any individual system or style that is capable of making money in all market conditions all of the time. Those who find a way to make money more often than not require excessive dedication to research and adjustment. In other words, there is no Holy Grail or easy money. Simply reading a few books on trading or subscribing to a signal service isn't going to ensure that you will trade profitably, but doing so could point you in the right direction. If you are looking for magic, go to Disneyland; you will not find it in a trading seminar, a book, or a newsletter—at least, not without putting your blood, sweat, and tears into it.

The only "magical" tool I have found in trading is the ability to keep emotions under control; without that, the best indicators or trading recommendations in the world won't be helpful. For instance, if in March 2009 I told you to buy the E-mini S&P futures at 688 and continue to roll over the position to avoid delivery until you have the opportunity to sell it back at 2,450 in mid-2017, do you really think that you would have had the emotional stability to hold the position through all the peaks and valleys—or, better yet, the faith in my recommendation to do so?

Clearly, very few people, if any, would have the fortitude to execute a trade of this magnitude. Even if psychic powers were involved, in 2009, it would have been difficult to imagine that the value of the S&P would nearly quadruple in value. After all, to reap the entire reward of 1,762 points in the S&P ($88,100 in the E-mini or $440,500 in the full-sized contract), the trader would have had to resist liquidating the trade prematurely at any point in the roughly eight-year time period that it took to complete the recommendation. All the while, surviving massive corrections such as those seen in mid-2011 and mid-2015 in which many TV pundits were calling for the S&P to revisit the 700 level, or worse. Further, most rational thinkers would have looked at the March 2009 S&P and thought the upside potential was massive relative to the downside risk. Yet, at the time few were in such a frame of mind. In fact, many individual investors were converting what little was left of their retirement accounts into cash.

> "Nothing gives one person so much advantage over another as to remain always cool and unruffled under all circumstances." – Thomas Jefferson

This is obviously an extreme example, but the same difficulties and emotions are involved in following a trading signal, recommendation, or idea of your own. The argument I am trying to make is that perhaps trading success is equally, or more so, reliant on psychology because it has a large influence on the implementation of the actual trading technique, philosophy, and indicators used or systems purchased.

The majority of trading literature emphasizes the impact that fear and greed can have on trading decisions and, ultimately, the bottom line. However, I believe that another emotion has the potential to wreak havoc on traders and their account balances: frustration. Each of these emotions is necessary but, in excess, can be catastrophic.

Warren Buffett's take on the subject is incredibly insightful. According to the "Oracle of Omaha," traders should "Be fearful when others are greedy and greedy when others are fearful." This is simply saying that traders should buy low and sell high in terms of market sentiment rather than price.

Traders who flock to the latest craze or newsworthy buzz are likely to get burned. This is because after a market has attracted attention, there is a good chance that the move has run its course. On the contrary, the best opportunities can often be found in markets that have fallen out of interest with the general public.

> "When everybody starts looking really smart, and not realizing a lot of it was luck, I got scared."– Raphael Yavneh

The study of emotion and trading is ongoing, and an unlimited number of theories focus on managing the sensations that one feels before, during, and after any given trade. Believe it or not, as a broker I have seen many futures and options traders get more satisfaction out of the rush of being exposed to the markets than they do making money. I have to admit, part of what sparks me to get up in the morning is seeing what the markets have in store for our clients and me. Whether it is good or bad, it keeps us all coming back for more. Nonetheless, my motivation will always be money rather than thrill.

More to the point, studies have shown that traders with the ability to stabilize their emotions, in both winning and losing situations, see more positive trading results than traders who are less capable of managing their feelings. Unfortunately, unless you are born with a natural ability to effectively cope with the excitements of trading, the ability to do so will come only with experience.

THE THREE EMOTIONS IN TRADING: FEAR, GREED, FRUSTRATION

In this chapter, I briefly discuss a few of the most influential emotions that traders experience. Expecting that you will walk away from this book with all the insight that you need to control your emotions while trading is impractical. Yet, I do believe that by getting a broad-based overview of what you can expect and some of the common traps that traders fall into, you will at least be able to identify such emotions; this is the first step toward managing them.

FEAR

If you have ever participated in the financial or commodity markets, you are well aware of the fears associated with them, such as the fear of losing money, being wrong, or leaving money on the table. Fear is a natural and necessary emotion, especially when money is involved. After all, if you are completely fearless when it comes to your trading, the odds are in favor of taking excessive risks and eventually losing your trading capital. Despite the financial theory that suggests additional risk is equivalent to additional profit potential, the correlation diminishes when a certain threshold is met. The line in the sand is difficult to draw, but when you cross it, you will know—and at that point, it might be too late.

In my experience, fearless traders might have intermittent success simply because they are swinging for the fence and will achieve their goals from time to time. However, long-term success for such traders is unlikely because unnecessary risks will eventually haunt irresponsible traders.

> "A market is the combined behavior of thousands of people responding to information, misinformation, and whim."
> – Kenneth Change (*The New York Times*)

Instead, traders should give the markets an appropriate amount of respect and approach them with a modestly fearful attitude. I believe that some fear of loss can work to keep traders humble and emphasize that, regardless of the countless hours of research performed and even an Ivy League education, traders can lose money trading commodities. In theory, a controlled fear of the markets and the devastation they are capable of can encourage more objective and sound trading decisions.

Although I speak of having a moderate amount of fear as though it is as simple as hitting a switch, managing that fear is far from being this easy. The general public and even seasoned traders often have difficulties managing their emotions. Thus, keeping feelings of fear at a controlled level is much more difficult than it sounds. In reality, many traders need years of practice before they can avoid the feeling of panic in an adversely moving market or even a profitable trade in which they are wrestling with the fear of giving back some of the gains or missing out on potential earnings.

Now that I have established that fear of the markets can be positive, if kept at a reasonable level, and addressed the difficulty in managing such emotions, I point out the influence of being too fearful. Traders who aren't capable of properly managing feelings of trepidation are prone to making irrational trading decisions, such as panic liquidation or failure to act. Either scenario has the ability to cause considerable financial harm.

As a broker, I have had the unfortunate experience of having a front-row seat to the carnage that ill-timed panic can cause and of course, I've experienced it in my own trading endeavors. Many traders have a strong tendency to exit a trade "gone bad" at the exact worst possible time. For example, they often ignore the well-known reality that prices are inclined to overshoot their equilibrium level before coming back to a more sustainable price. In the heat of the moment, fearful traders might exit their trade prematurely only to find the market traded favorably without them.

UNDERCAPITALIZATION BREEDS FEAR

Traders who are underfunded are typically more prone to fearful trading and, thus, poor results. This is because the less excess margin in a trading account, the less room for error there is. Whether the lack of breathing room is the result of too many positions, not enough money on deposit, or a combination of the two, one big mistake could take the trader out of the game, and he knows this.

As a result, the trader is more likely to liquidate positions prematurely, causing unnecessary losses and, in many cases, avoidable transaction costs. Inexperienced traders have been known to rack up a large commission bill trying to trade in and out of a market while being dominated by the fear of loss or even fear of missing an anticipated price move.

This is not to say that it is necessary to deposit hundreds or even tens of thousands of dollars in an account. Regardless of the funding, traders should trade within their means. Thanks to products such as mini and micro futures and options on futures, this is possible even for the smallest of accounts. I remind you that this is not unlike the concept of living within one's means when it comes to budgeting personal finances. There is no shame in trading small!

GREED

As Gordon Gecko would say, "Greed is good." Without greed, you wouldn't be reading this book, and in all likelihood, the futures markets wouldn't exist. Greed is the emotion that inspires speculators to enter the markets in hopes of abnormal profits as opposed to investing in Treasury bills. However, with all the opportunity that greed creates in the world of trading, it also breeds misery.

Greed is a word that is used frequently to describe the personal desire for monetary wealth. In fact, the formal definition of greed is the excessive desire to acquire or possess more material wealth than one needs or deserves.

> "It is an unfortunate human failing that a full pocketbook often groans more loudly than an empty stomach." – Franklin Delano Roosevelt

Anyone who has ever had money at risk in the market understands that greed works in two ways. On any given trade, the goal before entering the position is to bring profits to the trading account. Nevertheless, when the trade becomes a losing proposition, the yearning for profits quickly turns into the need to be right, or at least not wrong, by avoiding locking in a loss. At this point in time, greed turns from being solely monetary based to also involving ego. The combination of these two types of greed can be extremely powerful and often leads to financial ruin—or at least a depleted trading account.

Those who cannot accept humility have the odds of productive trading stacked against them. There is little room for ego in the markets because it can be the biggest enemy to a trader; it can prevent a trader from cutting losses when wrong and taking profits when right. A trader driven by greed and ego tries to justify losses as being too early as opposed to being wrong and, therefore, is susceptible to an account-draining defeat on a single trade. Similarly, traders might also believe that the winners will obtain infinite gains, deterring them from taking profits while they are available. This outlook often leads to a scenario in which winning trades turn into losers.

A perfect example of greed in the marketplace is the internet boom of the late 1990s. Investors with a get-rich-quick mentality were flocking to any stock that had a .com at the end of it. Greed and speculation drove share prices to unrealistic and unsustainable levels. As we all know, those who allowed greed to suck them into the euphoria paid dearly when the tech party ended.

Commodities are not immune to the same irresponsible price swings. The commodity rally that began in 2007 and consumed much of 2008 before coming to a screeching halt was arguably the result, at least in part, of greedy speculation as stock investors who were bored of flat-lining returns looked to the commodity markets for alternatives. A similar occurrence took place in 2011 in the gold and silver markets. Although strong commodity fundamentals lured money into the metals, irrational greed and ego kept the money flowing to a point at which unsustainable prices were reached. Similar to the dot-com craze, the commodity bubble eventually popped, leaving many market participants wishing that they hadn't taken part in the latest investment trend. Unfortunately, this is a long-term recurring phenomenon, and few markets have been spared its wrath.

FRUSTRATION

The influence of frustration on trading decisions is often overlooked, but having the ability to avoid letting disappointment take over is priceless. This is perhaps the single most important difference between a profitable trader and the masses.

Frustration can be a part of any trading scenario but primarily stems from one of two events: exiting a position with a loss or exiting a position with a profit but leaving potential gains on the table. An irrational trader repeatedly allows the emotions experienced in these scenarios to trigger an attempt to recoup what he believes the market "wrongfully" took from him. Such conduct is often the beginning of the end of a trading career.

THE ANGST OF TAKING PROFITS "EARLY"

For those who have never executed a trade, it might seem odd that aggravation could arise from a profitable speculation. However, imagine being a trader with the insight and gumption to sell crude oil short in mid-2014 at $105 per barrel, and subsequently taking a profit on the trade at $95 per barrel to lock in a gain of $10,000 minus commissions and fees. This was clearly a great trade. Conversely, the personal anguish felt by the same trader who later watched crude prices plummet to less than $30 per barrel by early 2016 is indescribable.

From the outside, a $10,000 winner is a triumphant victory, but from the inside, a trader who hasn't developed the ability to control her emotions might see it as a loss. After all, had the trader continued to hold the position, she might have walked away with a six-figure winner. I have personally witnessed many traders who simply could not deal with the reality of cutting a winning trade too early and, as a result, began making unfounded trading decisions in their quest to get back what was lost—or, at least, not won.

A trader in this frame of mind isn't considering what it would have taken to hold the position to the end. She might react similarly to a contestant on the TV game show *Deal or No Deal* who just realized the million-dollar prize was in her briefcase after settling for a deal of $235,000 by putting herself through the mental agony of questioning the decisions that led to the winnings earned.

The reality is, there is no way to predict how far a market will go, just as there is no way to know which case you are holding on *Deal or No Deal*. In addition, it is unfair for a trader to agonize over what could have been, simply because it is impossible to predict what decisions would have been made as the market moves from point A to point B.

Going back to our *Deal or No Deal* analogy, few contestants can take the game all the way to the end because there are a lot of tough decisions to make in the meantime. Those who do take it to the final two cases often come up empty-handed. The same is true in trading. From my experience, the successful traders are those who can live with the fact that they will almost never pick the top or bottom of a market but are happy to take a piece out of the middle.

THE PAIN OF TAKING A LOSS

One of the most difficult things to do as a trader is to exit a losing trade. This is because doing so confirms incorrect speculation, timing, or both. Accordingly, locking in a loss not only does damage to a trading account but also takes its toll on the psyche of the untrained trader.

While a position is still open, regardless of the size of the paper loss, the trader is consumed with hope that the market will turn around and the losses will be erased. There is a sense that if there is no harm in the end, there is no foul. However, large losses often don't correct themselves; instead, they get even larger. Although taking a small loss is financially and mentally painful, don't forget that large losses can be nearly unbearable from both a mental and a monetary standpoint.

The biggest fear that traders have in taking a loss is the possible subsequent market reversal that might have eventually allowed the position to be profitable. In a situation such as this, the frustration can be multiplied to a point at which an out-of-control trader can cause a lot of harm via poor trading decisions and maybe even poor personal decisions.

As a broker, I often communicate with other traders and brokers, some of whom are located on the floor of the exchanges. Over the years I have heard some heartbreaking stories of traders who couldn't deal with their losses and chose to take their own lives. One in particular that sticks out took place in October 2008, during the infamous equity market crash. A CME local trading his personal account took his life after sustaining losses to the tune of several millions of dollars on a short S&P play. The trader's account was force-liquidated by the clearing firm due to a margin deficiency. As it turns out, he was correct in being short the market but unwisely had too many positions on and was unable to ride out the volatility simply because he ran out of money. Subsequent to the premature liquidation of his positions, the market moved in the anticipated direction without him in one of the most treacherous bear markets in history.

Clearly, this is an extreme and unfortunate case. However, all traders who have taken a substantial loss can relate to the emotions involved. The most common reaction is an irrational attempt to get back losses from the very market that took them. This mindset can wreak havoc on a trader and, although we will never know for sure, might have been the catalyst causing this trader to over-leverage his account.

After a devastating loss has occurred, the trader might have difficulty analyzing the market objectively and sticking to the original trading strategy or theory. Too often the story ends in out-of-control and mindless trading that benefits the brokerage firm, thanks to excessive commissions, but does, even more, damage to the trading account and the trader's ability to behave rationally.

Another instance in which I have noticed that traders allow their emotions to get the best of them is subsequent to being stopped out of a trade. Describing a filled stop order as premature is appropriate if, after the order is filled, the market moves in the intended direction. Unfortunately, this is a common occurrence and is one of the biggest arguments against using stop orders.

For example, a trader who is long a March crude oil from $45.60 per barrel with a stop loss placed at $44.60 in an attempt to limit the potential losses on the trade to $1,000 plus slippage is anticipating higher prices but is also allowing the market some amount of freedom. The emotional turmoil caused by a situation in which March crude futures drop to exactly $44.60 to trigger the working stop order, forcing the trader out of the market, and then stage a large rally can destroy the emotional stability of an untrained trader. Although the total loss on such a venture would be $1,000 plus transaction costs, assuming that the stop order was filled at exactly $44.60, in the mind of an undisciplined trader, the loss is considered to be that which was realized plus any potential profits that would have occurred by being long during the successive rally.

This type of market approach creates the dismal odds that retail traders face. An unseasoned speculator, and even a well-experienced and successful trader, can easily fall into the trap of vengeful trading. However, doing so generally leads to unreasonable trading decisions and even more losses. In my opinion, traders can take a step toward bettering their odds of a particular trade and eliminating the potential emotional turmoil caused by premature liquidation through the use of long and short options for managing the risk of a futures position rather than a stop loss order. Once again, I cover this topic extensively in *Higher Probability Commodity Trading*.

VENGEFUL TRADING IS COUNTERPRODUCTIVE

The act of revenge is described as inflicting punishment in return for injury or insult and is typically sparked by an event that leaves a person feeling as though he was wronged. It isn't hard to imagine why or how a trader would feel victimized by the market, causing vengeance to emerge.

Traders who have experienced one of the preceding scenarios or have been part of similar incidents in suffering losses, or potential gains foregone, often seek revenge. Feelings of revenge typically begin as losses are mounting, well before the damage is realized by exiting the trade. However, in many cases, the yearning for retribution never subsides. Even those "lucky" enough to recoup what was lost from the very market that took it have a hard time satisfying their craving to settle the score. As you can imagine, traders who allow emotions to dictate the market they trade and influence the way they trade it will have a difficult time achieving financial success.

A symptom of the vengeful trader is a phenomenon known as *marrying* a trade. Traders often fall into this trap when they have done a great deal of research in a given market and feel overly confident in their speculation. As the market begins to move against the open position, the trader is susceptible to becoming attached to his opinion and dedicated to recovering lost capital, based on the premise that he is right and the market as a whole is clearly wrong. I have found that egotistical traders with the opinion that they are somehow smarter or are armed with more knowledge than all other market participants tend to be destined for failure.

> As stated by Max Amsterdam, "Business is the art of extracting money from another man's pocket without resorting to violence." I believe that the same can be said of trading.

In turn, I believe that the most effective means of combating feelings of ego and revenge in trading is humility. In my experience, successful traders are those who allow themselves to be humbled by the markets. We are all working with the same resources; unless you have a much faster internet connection than everyone else on the planet or you have somehow figured out how to fast-forward your television, you and all market participants are equipped with the same fundamental news. Additionally, it is unrealistic to assume that you are capable of interpreting the news more accurately than everyone else. Although there is, without doubt, a pool of unsophisticated traders lurking in the futures markets, to achieve profits, you must compete with the well-informed and even better trained. After all, each trader is in competition with the next. You might recall Gordon Gecko's view of market completion in the movie *Wall Street*: "It's a zero sum game. Somebody wins, somebody loses. Money itself isn't lost or made; it's simply transferred from one perception to another."

CAPITAL PRESERVATION, A.K.A. RISK MANAGEMENT

A majority of trading books and courses refer to the idea of capital preservation as risk management. The concepts are essentially the same, but my perception of the practice is slightly different. In my view, risk management is the practice of actively identifying and managing risk of loss in trading, whereas capital preservation takes it a step further.

In its simplest form, capital preservation is the acknowledgment that one bad day can end a trading career. Making money in the markets is impossible if you risk all your trading capital on one speculation. If you don't live to trade another day, you might as well hang up your trading hat; all speculative decisions should be made with this premise in mind. The bottom line is that markets can stay irrational, or what you believe to be irrational, far longer than most people can stay solvent. Therefore, trading them requires a certain amount of humility.

> "You can't grow long term if you can't eat short term."
> – Jack Welch

Accordingly, my belief is that traders are best off entering a market with the assumption that the position will likely lose money. Doing so could entice them to take profits and avoid running losses.

In Chapter 14, "Trading Is a Business—Have a Plan," I discuss the use of trading plans in capital preservation.

CHAPTER 14: TRADING IS A BUSINESS—HAVE A PLAN

Trading is not a passive investment; trading is a business. Any activity engaged with the purpose of profits should be treated as such. Confirmation of this comparison can be seen in the odds of success. It has been said that approximately 80% of all traders fail to trade profitably, and some studies have suggested that the odds are even worse. For example, I have seen estimates that as many as 90% of all traders fail within the first six months. We can argue over the percentages, but it is clear that most traders are destined for an undesired outcome. Nevertheless, those who achieve success can be rewarded handsomely.

> "The average man desires to be told specifically which particular stock to buy or sell. He wants to get something for nothing. He does not wish to work."
> – William LeFevre

The probabilities of profitable operations are similarly stacked against small business owners; a large majority of new business ventures fail within the first year. Accordingly, whether your ambition is trading or starting your own business, you owe it to yourself to become familiar with the marketplace and organize a plan of attack. After all, those who can find a way to make money in business or trading often enjoy a considerable amount of success. The journey can be long, but if reached, the destination can be highly rewarding from both a financial and a psychological standpoint.

THE TRADING GAME PLAN

Contrary to what your perceptions might be, there are no right or wrong ways to trade in terms of strategy. However, I do believe that there is a right outlook and a wrong outlook on the risks and opportunities the markets present, and this is ultimately judged by profits and losses.

> Trading isn't black and white, but making money is.

Despite your strategy, risk tolerance, or trading capital, having a plan is one of the most important components of achieving success in these treacherous markets. Without a plan, traders are left to rely on their emotions and instincts. Let's face it—the average person isn't born with a knack for trading or for controlling feelings of fear and greed.

With that said, based on my observations, I have concluded that, along with the ability to keep emotions in check, one of the most important characteristics of a profitable trader is the ability to adapt to ever-changing market conditions. Being nimble is key; being stubborn is detrimental. Keeping this in mind, it seems logical to establish a game plan with the premise that rules are meant to be broken in some, but not all, circumstances. Thus, a trading plan should not be considered concrete, and in many circumstances, deviating from the original intentions of the trade is prudent.

Much of what you read about a trading plan involves specific entry and exit rules and risk management tactics. Nevertheless, in my opinion, a trading plan must be flexible to accommodate altering environments and unforeseen events. For instance, I have witnessed too many traders fail to take a profit on a successful trade because a target price had not been reached. This type of mindset can often turn winning trades into losing trades and make constructive emotions into feelings of revenge that can be detrimental to trading decisions.

Simply put, I believe that a trading plan should, on occasion, have some human discretion for market entry, exit, and assumed risk. This is not to say that traders should make it a habit to completely disregard their trading rules or strategy, but they should have an open mind about making small adjustments. For instance, it is against the law to speed, but if you are rushing a loved one to the hospital, being heavy-footed might be justified.

AUTOMATED TRADING SYSTEMS

> "What technology does is make people more productive. It doesn't replace them." – Michael Bloomberg

Throughout this chapter, I play devil's advocate when it comes to system trading. I'm not trying to brainwash you into believing that you should avoid system trading at all costs; this simply isn't the case. In fact, my brokerage (DeCarley Trading) offers clients access to several hundred developed and tested algorithmic trading systems that can be implemented with the click of a mouse. Nevertheless, I want to open your eyes to the advantages and disadvantages of various approaches. In addition, it is important to realize that even a proven system on autopilot should be monitored, and you might want to consider adjusting parameters or even actively trading the system itself by turning it off and on as it produces drawdowns and profits.

Without involving some cognitive decision making, a trading plan becomes known as a trading system, which is the use of stringent and automated trading rules with little or no outside intervention. Assuming that the shorter the time frame of the system, the less vulnerable it is to changing market conditions might make sense. For instance, subtle price distortions might create arbitrage opportunities that the naked eye wouldn't identify, nor would a human be quick enough to react to them. If a programmer was capable of accurately creating something that could exploit such opportunities, a profitable system might have little intervention necessary, or even possible. On the other hand, system creation (or, at least, profitable system creation) takes a lot of time and dedication.

Although trading systems, as opposed to trading plans that can be modified on the fly, have grown in popularity due to technological advances and the availability of such system software to the general public, the odds of success facing retail traders haven't seemed to improve. This leads me to believe that, even in the absence of human emotion, significant challenges stand in the way of creating a profitable trading model. I am not implying that profitable trading systems don't exist, but I believe that, as is the case with any other type of market approach, developing such a system takes extensive time and trial and error. Further, chasing performance tends to be a poor approach to system trading. Perhaps the best systems to implement are those with a strong long-term track record but are in the midst of a drawdown.

A TRADING SYSTEM ALONE ISN'T A "BUSINESS PLAN"

Opposing the views of many, I don't believe that a trading system is necessarily synonymous with a trading plan. Again, a futures trading system is a defined set of technical rules and parameters that ultimately determine entry and exit points for a given contract. If all the stipulated technical events occur, a buy or sell signal is created and a trade is automatically executed *without* human intervention. In essence, system traders are putting their trading profession on autopilot. I have yet to find a business owner willing to hand over operations to hired staff and, therefore, can't imagine a trader doing the same. That said, there is an undeniable amount of interest in system trading and there are some glaring advantages to partaking in such a strategy. After all, some large hedge funds and proprietary trading desks rely solely on system trading, and I am sure they wouldn't allocate resources to such strategies if they didn't see the potential for profit.

System developers spend an incredible amount of time optimizing the system to manage risk and increase the odds of profitable results in any environment. Each system consists of specific ingredients and circumstances, but they most commonly involve moving averages, stochastics, and other computer-generated oscillators. As you can imagine, the results are highly dependent on how well the rules perform in various market conditions; consequently, changing market conditions could prove to be a disaster. What worked for a purely technical system in one time frame might not work in the future due to changing market characteristics. With little human intervention or discretion, the losses could be staggering. However, as we know, large profits and losses are the reality of any trading strategy or market approach.

Systems aren't all bad. They offer some distinct advantages, such as the elimination of emotion, time saved by the freedom to leave the computer and the markets during the trading day, and the convenience of letting the system do all the work.

For some, system trading is the best fit for their personality, risk tolerance, and strategy; for others, the thought of being out of control can lead to high levels of anxiety and the tendency to detrimentally interfere with the system parameters. Going back to the small-business analogy, you probably wouldn't trust your employees to handle and account for all the money, so why would you behave this way in your trading? Instead, I believe system traders should take a more proactive role; I discuss this idea in further detail later in the chapter.

WHERE SYSTEM TRADING CAN FAIL

Systems don't have common sense and, in the long run, might not have the capability to be profitable without some type of intervention. This is because technical systems are driven by specific parameters that were determined well in advance of trade execution. As a result, mechanical trading systems often generate signals that might be considered low-probability trades. For instance, a technically driven system might trigger a sell signal at or near the all-time low of a contract. Likewise, a system might look to buy a market at an exuberantly high price.

> Purchased trading systems should be viewed as a trading tool, not the "be all, end all" solution to making money in the markets.

Although system trading is intended to eliminate the emotions involved in deciding whether to enter or exit a market, there might be unintended psychological consequences. For instance, enduring a trade that contradicts your opinion can be challenging. This could mean a system going long a market in which you are highly bearish or short one in which your opinion is bullish. Either way, the turmoil that system trading is meant to avoid can easily be rekindled. Such emotions have been known to cause traders to interfere with the system and, in many cases, greatly affect the performance—often in a negative way.

Another disadvantage to trading systems (as opposed to discretionary trading, which relies on some combination of technical, fundamental, and seasonal analyses paired with common sense) is that system traders rely on historical market activity to dictate their current and future trading.

Futures trading systems are often developed through a process referred to as back testing. In other words, they filter through historical price changes in search of system parameters that would have provided profitable results.

However, doing so gives the system developer information on what the mechanical strategy would have done if the trader had implemented it in the past.

It isn't reasonable to assume that similar results would be obtained in real-time trading or, even more so, at any point in the future. After all, market conditions are dynamic, whereas the parameters of a trading system are constant. Even system developers dedicated to tweaking the elements of the trading system can sustain considerable losses before recognizing the need to adjust parameters. Also, temporary events or market behaviors can lead to an unnecessary alteration of the system. In such a case, proactive adjustments to the system ingredients can result in needless losses.

Despite what software and system vendors want you to believe, if making money in the markets were as easy as buying or leasing a trading system, there would be no need for you to be reading this book. In fact, I would have no incentive to write it. Instead, we would all quit our day jobs and let our money and our newly acquired trading system lead us to a life of luxury.

I am sorry to report that being a profitable market participant is much more complicated than purchasing a trading system. Although an unlimited number of sales representatives will do whatever it takes to convince you that their product can provide consistent returns, I have yet to find the Holy Grail of trading that many claim to be selling. That said, those willing to fund an account with a considerable amount of excess margin and approach a well-research system with realistic expectations in regards to painful drawdowns might be pleased with the results.

Two important factors are at play when it comes to system vendors. First, if their systems were magical and successful in all types of market conditions and throughout all time frames, they likely wouldn't be selling them. There is much more money to be made in the markets than there is in selling products (although the hefty price tags of many suggest that it is possible for some to make a great living doing it). On that note, the higher the price of the system, the more you should be wary of claims.

Second, the Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA) regulate the futures industry. For the most part, the jurisdiction of these two agencies does not extend beyond those registered or required to register with the agencies. Those required to register are brokers, commodity trading advisors, and futures commission merchants. Many authors, software vendors, and system developers are not registered with the NFA and CFTC, nor are they required to be. Accordingly, they are not necessarily held to the same regulatory standards that those registered with the regulators must be. In some cases, no third party has verified the performance history disclosed by system vendors, and because they have not registered with industry regulators, they enjoy freedoms of speech that pave the way for possible deception.

I can't caution you enough about trading systems that promise spectacular returns. Just as anything else in investing and trading, if it sounds too good to be true, it probably is. You owe it to yourself to get the facts before putting your money on the line. As a consumer, it is imperative that you know who you are dealing with and what is realistic in terms of performance.

> "If there is something that you really want to do, make your plan and do it. Otherwise, you'll just regret it forever." – Richard Rocco

Despite my cautions, there are legitimate systems in existence that have proven to be productive over time and in the right circumstances. Additionally, some software and system vendors are honest and forthright with their products and what to expect from them. In all fairness to those who are not required to be registered with the regulatory bodies, certainly, some registered members don't conduct business with the integrity that is expected of them, just as some who aren't registered with the NFA and CFTC *do* follow ethical practices. In short, when seeking out automated trading systems, keep your mind and eyes open but always keep a healthy amount of skepticism.

THINK OUTSIDE OF THE BOX: TRADING A TRADING SYSTEM

In my opinion, the success of any individual trading system cycles along with the market. Therefore, it seems as though trading systems might be best used as a trading vehicle rather than a long-term strategy.

Speculators can actively trade a futures system performance by implementing and ceasing trading of the system based on the peaks and valleys of returns. In essence, this is similar to buying or selling any financial instrument. As always, the goal is to buy low and sell high. For example, it might be an opportune time to begin trading a system that is experiencing a drawdown and call it quits after a good run. This is because market conditions often fluctuate in cycles in which the performance of technical futures trading systems also oscillates. In other words, when it comes to technical trading systems, traders might be better off avoiding a buy-and-hold mentality.

Also, automated trading systems are probably best used as a small component of a trading portfolio. Rather than relying on the success of a single trading system, it is a better idea to have a handful of trading systems running simultaneously as well as some other type of discretionary (non-system) trading approach. Not unlike the need to diversify stocks between market sectors, it is a good idea for futures and options traders to diversify among trading strategies; if one trading approach is underperforming, hopefully, another is outperforming.

CONSTRUCTING A BUSINESS PLAN IN TRADING

The process of creating a trading plan should be based on the same premise as constructing a business plan. Just as a business develops a blueprint of its intended operations and the possibility of success, traders seek to make predictions on the likelihood of a particular event occurring and they use risk-management techniques to improve the odds of success and limit the chances of a devastating blunder.

The preparation of each individual trade should include a relatively detailed outline of the structure of the trading strategy and a contingency plan in case the market deviates from the original speculation. As I have previously mentioned, I don't believe that trading plans should necessarily be set in stone because of the evolving nature of the markets. From my perception, trading with overly strict trading rules could lead to financial peril. Nobody is perfect, and neither is any trading plan; therefore, being nimble but wise is ideal. Conversely, this is my viewpoint, and other books or courses might give you a completely opposite impression. The truth is that trading is an art, not a science; what is right for one might not be right for the next. I hope that the various opinions in this book give you the background you need to determine what types of trading styles work best for you.

A trading plan has two primary components: price prediction and risk management. Price prediction is simply the method used to signal the direction and timing of trade execution. This can involve fundamental or technical analyses or both. Risk management, on the other hand, specifies when to cut losses, when and how to adjust a position, or, better yet, when to take profits.

NOT Financial Advice. Only for Education/Entertainment/Research Purposes.