a good low-risk idea. Instead they are highly leveraged because they want to recoup their lost money äs quickly äs possible.

Seykota's trading rules are:

1. Cut losses.
2. Ride winners.
3. Keep bets small.
4. Follow the rules without question.
5. Know when to break the rules.

The last two points appear to contradict each other, but Seykota, like other great traders, has a passion for self-improvement. He believes that a trader should be totally at home with his approach and with the rules that govern that approach. However, part of the self-appraisal process involves evolution, and this in turn means breaking the rules and substituting new ones. This subject is covered at the end of Chapter 12.

Seykota summed up his success this way: "I feel my success comes from my love of the markets. I am not a casual trader. It is my life. I have a passion for trading. It is not merely a hobby or even a career choice for me. There is no question that this is what I am supposed to do with my life."

Paul Tudor Jones

Paul Tudor Jones represents another incredible success story. After a successful career in the New York cotton pits, he retired to form a money-management firm in 1984. At the end of 1988, each original $1,000 Investment had risen to $17,000. Funds under his management grew so large that he has made a habit of returning profits to clients. This reduces his management fees but enables him to do a better Job of managing money. It is to his credit when so many in the business try to grab money for management at virtually any cost. This impartiality and detachment from money

is part of the characteristics of several market wizards that we have considered.

In his interview with Jack Schwager, Jones sums up his trading rules äs follows:

> Don't ever average losses. Decrease your trading volume when you are doing poorly; increase your volume when you are trading well. Never trade in situations where you don't have Control, e.g., in front of a major economic report.
>
> If you have a losing position that is making you uncomfortable, get out, because you can always get back in. There is nothing better than a fresh start.
>
> Don't be too concerned about where you got into a position. The only relevant question is whether you are bullish or bearish on the position that day .... Who cares where I was long from? That has no relevance to whether the market environment is bullish or bearish right now, or to the risk/reward balance of a long position at the moment.
>
> The most important rule of trading is to play great defense, not great offense. Every day I assume the position I have is wrong. [If my positions] are going against me, then I have a game plan for getting out.
>
> Don't be a hero. Don't have an ego. Always question yourself and your ability. Don't ever feel you are very good. The second you do, you are dead.

Thus we have in five paragraphs not only the essence of Jones's thinking but a concise account of the characteristics of other great traders. The idea of only playing defense, for example, is another way of saying the number one objective is to protect your capital. So too is the Statement, "I always assume every position I have is wrong." When later asked to provide advice to a novice trader, Jones replied in the same vein. "Don't focus on making money," he said, "focus on protecting what you have." He considers himself to be a market Opportunist developing an idea on the market and pursuing it from a low-risk standpoint until he has been repeatedly proven wrong or until he changes his viewpoint.

Pride of opinion, äs described in Chapter 4, can cause devastating financial losses. When questioned by Schwager about what made him different, Jones said, "I don't really care about the mistake I made three seconds ago. What I care about is what I am going to do from the very next moment on. I try to avoid any emotional attachment to any market. I avoid letting my trading opinions be influenced by comments I may have made on the record about a market."

This last Statement is somewhat remarkable for there are few people who do not worry about what they are on record äs saying. It shows the investor's ability to change his mind and not be married to a particular Situation merely because he once held that belief. After all, flexibility is a virtue that keeps appearing in the psyche of great traders. Whereas loyalty to people is a great virtue, disloyalty to a market that does not act well is also to be recommended. To quote Jones once again: "[Cutting emotional attachment to a market] is important because it gives you a wide-open intellectual horizon to figure out what is really happening. It allows you to come in with a completely clean slate in choosing the correct forecast for that particular market."

Bob Prechter

Bob Prechter does not conveniently fit into the great trader category, because his primary career has been in the business of writing a market letter. Nonetheless, he won the U.S. Trading Championship in 1984, setting an all-time profit record with a four-month gain of 440% in a monitored, real-money options account. This does not compare with the consistent long-term gains of a Büffet, Seykota, or Jones, but many successful traders subscribe to his market letter and follow his Elliott Wave Methodology. More to the point, he is lucid and has provided his subscribers a list of trading requirements (äs opposed to a list of trading rules).

I have already outlined several of the roles recommended by Prechter but this merely underlines that certain characteristics

or requirements contribute to making a great trader. The more times we can see them surface in different successful individuals the more we will appreciate their relevance. The following are Bob Prechter's trading requirements:

1. *A Method.* By a "method," he is referring to an objectively defined mechanism that helps you to make a trading decision. Buffet's and Templeton's methods focus on the simple concept of buying undervalued companies that possess good potential for growth. Seykota has a short-term mechanical/technical System. All the money masters and marked wizards have some kind of method or philosophy on which to base their decisions. None is perfect, but when properly applied they earn their practitioners substantial profits.

2. *The Discipline to Follow the Method.* We have talked about discipline earlier in great depth so there is no need to elucidate further, except to say, äs Prechter puts it, "Without discipline you really have no method in the first place."

3. *The Mental Fortitude to Accept That Losses Are Part of the Garne.* Most people blame outside forces for their losses: Insiders, unexpected news events, stock manipulators, and the like are often singled out for abuse. Rarely are losses accepted äs part of the game. We do not expect a baseball player to hit every ball so why should we expect to win on every trade? Prechter's point is that we should not only accept losses but also should anticipate them through sound money management.

4. *The Mental Fortitude to Accept Huge Gains.* This is his way of saying, "Let your profits run." The concept theorizes that you make a series of small trades with mixed results. Then a big one comes along where you make twice the usual profit. Your best friend and your broker teil you not to be greedy, but your System or method says to stay in. You get out but find that when the System goes negative you have lost the potential of the trade of a lifetime.

No doubt there has been some repetition in this chapter, but that's all to the good. The more emphasis placed on the characteristics that contribute to the makeup of a great trader or Investor, the more believable they will become. And the more believable these attributes become, the more likely you will be to put these rules into practice and to adopt the characteristics. The most difficult hurdle is understanding that these money masters are in the game less for the money than they are for the challenge of the game and their passion for that challenge. This factor probably distinguishes most of us from these exceptional players, because we usually play the market for the money first and the challenge and love of the game second.

12
Nineteen Trading Rules for Greater Profits

J. revious chapters have described how markets have a habit of finding out our weaknesses and exploiting them to the füllest. Successful traders are those who not only know the workings of the markets but who also have the *will* to put a plan into action and follow it religiously. Since trading in the market is basically a process of dealing with probabilities and beating the odds, anyone who participates in the market must make a conscious effort to set up some kind of structure that will help him master his emotions. If you recognize that you have a problem before taking on a trading position or making a long-term Investment you will be in a better position to spot potential pitfalls. In this chapter, we will outline some rules that will help you do this. But remember that *reading and understanding the rules is not enough. You must also put them into practice.*

The rules described here are not the only ones, but they are generally considered to be the most important. It is assumed that at this stage you already have some rudimentary knowledge of how markets work and also a method for making trading decisions. It could be a technical, fundamental, or behaviorist approach. The vehicle is not important äs long äs it has been tested and äs long äs you feel comfortable with it. All the
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place (i.e., discovery of the truth), but their paths are different. So it is with methods and markets. All approaches have greater profitability äs their objective, but each individual has to choose his own path. It is no good using a method practiced by a prominent trader or market newsletter writer if you do not feel completely comfortable with it, because when things become difficult, äs they will surely do, you are far less likely to stay with it. Also, if you are lucky enough to choose a trading style or approach with which you feel totally at home, the chances are good that you will find the incentive to work a lot harder at it.

Selecting a methodology is usually not hard; executing it is. Mastering emotion is precisely what the rules are designed to do. Once you have a position in the market, it's easy to play mental games to avoid the pain of losing. Let's say you buy one gold contract at $350, expecting it to rally to $370. Instead, the price of gold falls to $345. This decline is justified by the media (which always has to have an excuse for price movements) äs being due to Russian selling. An immediate emotional response by most people is to rationalize that the selling is probably over. After all, why would the Russians announce they were major sellers if they had not already sold? Consequently, *hope* for a rally would now replace the original analysis äs a basis for being long in anticipation of a rise in the price. The rationalization and the hope are really protecting the trader from the dual pain of having to admit he was wrong and has to take a loss. This process also involves some denial of the reality of the Situation. After all, the market did not move in the expected direction, and this implies that the original decision to go long was incorrect.

Another example of denying reality may occur where a trader, to get in with less risk, stalks a possible trade for several days, waiting for a small correction. Let's say that the item in question is the deutsche mark. Each day, the price works its way slowly and tantalizingly higher. Finally, a very bullish news story appears in the wire Services saying that the German balance of payments has moved into surplus. This is the last straw for our now impatient trader. He can no longer Control his enthusiasm and plunges into the market at substantially higher prices than he was prepared to pay only two or three days previously. It's a good bet that this represents an exhaustion move, since the market had been rallying in the previous week in anticipation of this good news. Naturally, the mark peaks out and leaves our trader with a nasty loss and the need to make an objective decision of where to limit the damage. It is very difficult to obtain an objective viewpoint in an emotionally charged climate. Better to establish and follow some rules that are aimed at preventing such a Situation from arising.

Rules won't eliminate losses, but they will help reduce the level of emotion äs they increase objectivity and consistency. If you can be more objective, there will be far less room for hope, greed, and fear to crowd out your better judgment. In Chapter 14, we list trading rules proposed by many different but knowledgeable sources. No one can truly learn the benefit of any set of rules or principles except through actual experience in the marketplace, so the listing and explanation of some of the guidelines in this chapter are really starting points to which you will hopefully return. Studies show that advertising is far more powerful when it is repeated on a sustained basis than when it appears in one or two isolated ads. The message being portrayed then Stands a better chance of being embedded in the mind of the consumer. The inclusion of the trading rules in Chapter 14 is a way to mount a sustained advertising campaign on you. These same principles have been expounded by history's great traders and investors, all of whom have struggled with the difficult task of mastering their emotions. Because each person has his own style and approach, the lists are slightly different. But they all have the same objective, namely, maintaining objectivity, and clear independent thinking and achieving sound money management practices. That these same principles come from so many different sources, separated by time and professional pursuits, cannot be discounted äs a mere coincidence. They are on the list because they work. They worked for legends such äs Jesse Livermore and Bernard Baruch äs well äs successful traders practicing today. They can and will work for you, but only if you give them a chance. You are encouraged to refer to Chapter 14, but the remainder of this chapter will •

summarize the rules I think are most important. Before we begin, please remember that *no rule will work unless it is put into practice.* If the road to hell is paved with good intentions, almost certainly the road to financial ruin is, äs well.

The following 19 rules can be roughly categorized into those that help you to master your emotions and those that aid in risk Control. In other words, personal psychological management and money management.

Psychological Management

Rule 1. When in Doubt, Stay Out

When trading the markets, it is important to have a certain level of confidence in what you are doing. Too much confidence will lead to carelessness and overtrading and is unwelcome. On the other hand, if you enter a position with little or no enthusiasm, you are setting yourself up for some knee-jerk reactions when bad news breaks. If there is the slightest doubt in your mind about entering a trade, then you should not initiate it, because you will not have the emotional fortitude to stay with it when things begin to go wrong. For instance, if you are in doubt, you will tend to concentrate on any negative breaking developments. As prices decline, you will get more and more discouraged. Consequently, when the price falls to a support, or buying, zone, you will be in more of a frame of mind to seil than to buy.

Alternatively, you may get into a position based on some solid research and in a confident, but not overly enthusiastic mode. Later, some new evidence comes to the fore that causes you to be less optimistic than before. In short, some doubt about the validity of the original rationale for getting in begins to creep in to your mind. It does not matter whether the position is above or below where you got in. The important thing is that you now begin to doubt your original rationale. Under such circumstances there is only one logical course of action — get out. You no

This means that you will most likely head for the exits at the first sign of trouble.

It is important to remember that the *principal* reason that you are in the market is to make a profit. If the odds of that happening have decreased, then you have little justification for maintaining the position. After all, this is not your last chance to trade; there will *always be another opportunity down the road.*

Rule 2. Never Trade or Invest Based on Hope

This topic was covered in Chapter 2. It bears repeating äs a trading rule since so many of us hold on to losing positions well after the original rationale for their initiation has vanished. The only reason for not selling is hope, and markets usually reward the hopeful with losses. When you find yourself in this Situation, seil promptly.

Rule 3. Act on Your Own Judgment or Eise Absolutely and Entirely on the Judgment of Another

It was established earlier that if you do not enter a trade or investment with total confidence, you are likely to be spooked out at the first sign of trouble. If you find yourself relying on your broker or friends for tips and advice, the chances are that you will not have carefully considered all of the ramifications. This means that you will not have the emotional fortification to be tptally committed to the trade if things appear to go wrong. It is much better to consider all the arguments, both bullish and bearish, prior to making a commitment. In this way, you will be in a good position to judge whether the latest price setback is a result of a fundamental change in the overall Situation or if it is merely part of the normal ebb and flow that any market goes through.

Brokers, friends, and others that you respect can be helpful in providing you with ideas but you are the one who should make the final decision. This means balancing out the pros and cons, to thi<; oninion anH that hoforp rornin<r to a

considered independent conclusion of your own. After all, if things go wrong, it's you who lose the money, not your friends.

This rule also cautions you from following tips or insider information. I have found that people invariably lose when they trade on such information. In the case of Stocks, such tips usually revolve around takeover activity, the announcement of better-than-expected corporate earnings, or a lucrative contract. In a publicly held Company, the chances that you äs an individual will be privy to such information will be remote. Others will usually have been there before you, the news being already factored into the price. Moreover, the "good" news often gets exaggerated äs it gets passed around. Quite often, the story is false or the event in question fails to materialize. Even if you do manage to obtain some insider news from which profits can be obtained, it is basically unethical and unfair to buy stock from someone who would not be selling it at that price had he been privy to the same information äs yourself. This is far different from two people deciding to make an exchange based on an honest difference of opinion concerning the outlook for the Company in question.

If you cannot make a decision based solely on your own judgment of the facts, and opinions of colleagues, friends, and brokers, you are better off turning your portfolio over to someone whom you have checked out thoroughly for integrity and competence.

Rule 4. Buy Low (into Weakness), Seil High (into Strength)

Everyone knows that if you buy low and seil high you are bound to make money. This is clearly not äs easy äs it sounds otherwise you wouldn't be reading this book. The idea that I am trying to get over here is something a little different; it might be better expressed äs "Buy on weakness, seil on strength." When prices rise, so does confidence. Prices that progressively fall, on the other hand, attract a greater and greater amount of concern. The reason is that rising prices are usually accompanied by positive news making us feel more comfortable. We tend to downplay our

fears at such times and therefore take on more risk. In his classic book, *Psychology of the Stock Marktf, G. C.* Seiden explains it so: "The greatest fault of ninety-nine out of one hundred active traders *is* being bullish at high prices and bearish at low prices. Therefore refuse to föllow the market beyond what you consider a reasonable climax, no matter how large the possible profits that you may appear to be losing by inaction." These words are äs true today äs in 1912, when they were originally written. This is the way both the crowd and individuals tend to react. However, äs discussed in Chapter 7, it pays to go the opposite way to the crowd whenever you can. Generally, this means buying on weakness and selling on strength. This rule is applicable for both initial positions and when adding.

Rule 5. *Don't Overtrade*

This topic was covered in Chapter 2, so there is no need to repeat the detailed explanation except to say that overtrading leads to a loss of perspective and considerable transaction costs.

Rule 6. After a Successful and Profitable Campaign, Take a Trading Vacation

Many traders find that accumulating profits is relatively easy; the difficult part is keeping them. I am confident if most traders were to show you a graph of their performance, it would look like the oscillator in Figure 8-1, that is, a series of giant sine waves running up and then falling down, because they failed to recognize when their luck and trading skills had peaked. In short, they did not know when to walk away from the table.

No person, however talented, can maintain a super trading performance forever. People operate in cycles in virtually every endeavor. Take baseball players—even the best have their off days, off weeks, and even off seasons. The same is true for traders. Therefore, make sure that you take a break after a successful campaign, returning to the markets six or eight weeks later. Your outlook is likely to be less overconfident, and you will also be able to take a more objective view of the markets.

Rule 7. Take a Periodic Mental Inventory to See How You Are Doing

Quite often we get so engrossed in our trading and investing that we lose sight of where we are going. It therefore makes sense to reflect occasionally on where we are headed and to make sure that we are doing the right thing. As part of this process, you might want to ask yourself some questions on the lines of the following. Am I able to afford the risks I am taking? Am I speculating or investing intelligently or am I gambling? Am I following the right System? Am I trying to bück the prevailing trend? Am I too close to the market? Am I overtrading?

There are many more questions you could ask, including the other rules cited in this chapter. This simple little exercise will help to draw your attention to any mistakes you might be making or rules that are being broken. In addition, it will serve to reinforce those rules in your mind so that they have a better chance of eventually becoming good habits.

Rule 8. Constantly Analyze Your Mistakes

When we are successful, we tend to think that this process arises from hard work or good judgment. Rarely do we attribute it to chance or the luck of being in the right place at the right time. On the other hand, when things go against us, we often blame our setbacks on bad luck or some convenient scapegoat. Of course, we should be questioning our own judgment first because that is the most likely source of any mistakes that may have been made. It is only when we have made a mistake that we can begin to take responsibility for our own actions and learn from those mistakes. You can read books on the psychology of markets ad

infinitum, but only when you have gone through the pain of losing money and attributing it to a mistake are you likely take remedial action so it doesn't happen again.

This process of self-critique has to be a continuous one. After a brief time, chances are that you will be lulled back into a false sense of security äs profits begin to roll in once again. In this type of Situation, most people will again fall back into their old ways. It will therefore take more losses to reignite the self-examination process. Either the lesson will eventually sink in or your account will be so depleted that you will no longer be trading.

The greatest benefit of analyzing your transgressions therefore arises because failure is often the best teacher; it brings you back to the reality that if you had faithfully followed the rules, you would not be in your current predicament. What more natural course than to follow them next time around? Most mistakes arise because of emotional deficiencies—the fear of being wrong or of feeling a fool at having to having to face your broker or some other person with the loss. This is also true of professional money managers who not only have to deal with the vagaries of the market and with their own emotions but those of the client äs well. This latter battle—the fear of losing the client—can often be the most devastating of all.

The first step is to face up to such fears, recognize that they are a destructive force, and take some Steps to rectify them.

Rule 9. Don't Jump the Gun

In any investing or trading Situation, there is always the temptation to put on a position before the particular discipline or methodology that we are using has given the all clear. Enthusiasm replaces prudence. This is a poor practice because it means that we are not, in actual fact, following the discipline but have decided that we know better. Rarely does this type of policy pay off. After all, why go to the trouble of researching a methodology or approach and setting up the rules if we are not prepared to follow them? When tempted to do so, you may debate with yourself that this is an exceptional Situation and that it justifies taking immediate action. The problem is that these "exceptional" situations will keep occurring until they become an everyday experience. In effect, the discipline will have been totally abandoned.

Rule 10. Don't Try to Call Every Market Turn

In our natural desire to be market perfectionists, it is quite understandable that we should feel the need to call every market turn. Unfortunately, that task is quite unobtainable. If we find ourselves trying to guess every twist and turn in the price action, not only will it lead to frustration, but we will totally lose any sense of perspective.

^ *Money Management*

*Rule 11. Never Enter into a Position without **First** Establishing a Risk Reward*

It is not possible to set out a specific mathematical ratio of expected profits to maximum acceptable losses in all cases. The decision should be taken with regard to the proportion of capital being risked in a particular trade or Investment. Another factor would relate to the character makeup of the person concerned. Risk-averse individuals should not go into a high-reward high-risk venture and vice versa. Risk is always relative. What is a financially life-threatening risk for one person may be beer money for another. Generally speaking, you should use a good dose of common sense, making sure that the ratio is normally at least 3-1.

Rule 12. Cut Losses, Let Profits Run

This is probably the most widely known rule of all. It is also one of the most important. We enter any trade with the objective of

making a profit, so when the position goes against us, it is natural to feel some kind of emotional pain. Many of us choose to ignore the loss, rationalizing that the market will come back. Sometimes we can justify the decline because the market came down "on low volume," or "it might have declined, but the action was good so I will hold on." Another favorite comes from rationalizing the reason for the decline. "That was a bad piece of news, but it was amazing how the market only came down 50%; it's obviously very strong technically." Occasionally, we wait for an event to take place äs justification for making a decision. I remember getting very badly burned in the in the spring of 1980. The commodity markets were under pressure because Jimmy Carter had told people to stop using their credit cards. A morale-building announcement was expected any day, but in the meantime commodity prices kept on slipping and the announcement kept on being delayed. In the end, I sold out, but waiting for the announcement cost my account dearly. I should have considered the market's action in relation to my game plan when deciding whether to liquidate. Instead I allowed my losses to compound.

It's amazing how we can play games with our emotions by justifying almost anything. This is because we want prices to go higher (or lower if we are short), but we either forget or chose to ignore that the market is going to move in the direction that *it* wants to, not the way we desire. The market is totally objective, it is the participants who are emotional. We may *wish* for a rally but that has no bearing on the Situation except that our wishes are bound to cloud our judgment.

We need to remember that if the market has gone down when we expected it to go up, it is a warning that the original analysis is flawed. If this is so, then there is no *rational* reason for still being in the position. We should cut our losses and liquidate.

This does not mean that every time we enter a position and see it go against us, we should seil. A good trader will establish a potential reward and acceptable risk before putting on a position. Part of this acceptance of risk involves the possibility and even probability that the market will decline before it advances. It would certainly be extremely optimistic for us to expect every trade to become profitable immediately we put it on. No, the rule about cutting losses really refers to the point at which these acceptable risks are exceeded, for it is only then that the market is telling us that our original analysis is probably at fault. Even after these predetermined benchmarks have been exceeded and you have been stopped out, there is still room for the element of doubt to creep back. Even though the market has now given its decision, some of us do not like to accept that our hopes and expectations will no longer be realized. In such circumstances, the temptation is to break away from this self-imposed discipline and get back into the market. This is often done at a higher level than the level at which the liquidation took place. Rising prices, remember, build confidence. However, my experience has been that if a carefully chosen stop point has been executed, it rarely pays to get back in. More times than not, it would have been more profitable to have taken the opposite side, but very few people possess the mental agility to do so.

Cutting losses is a fundamentally important money management technique, because it helps to protect capital and therefore enables us to fight another day.

Letting profits run really involves the same principle äs cutting losses. When the market exceeds your downside cutoff point, it is a warning that you have made a mistake. On the other hand, äs long äs the general trend moves in your favor, the market is giving you a vote of confidence, so you should stay with the position and let your profits run. There is a famous saying that "the trend is your friend." In effect, this is another way of telling us to let our profits run. Trends, once in force have a habit of perpetuating but no one on earth can forecast their magnitude or duration, despite what you may read in newsletters and the media. As long äs your analysis or methodology indicates that the trend continues to move in your favor, you have few grounds for selling unless it is to lock in some partial profits. Markets spend enough time waffling back and forth in confusing, frustrating, and unprofitable trading ranges to allow the trader the luxury of prematurely getting out of a good trending market.

The problem is that when many people have a profit, they want to take it there and then. The rationale is based on the theory that it is better to cash in now, otherwise the profit will get away. It is certainly true that you can never go broke taking a profit. Unfortunately, every trader and Investor cannot avoid losing positions. A net profit Situation can only be achieved if the profitable trades outweigh the negative ones, and usually a few highly profitable ones carry most traders. Taking profits too early therefore limits this potential.

It is interesting how most people are risk averse when it comes to taking profits and risk seeking when it comes to losses. They prefer a smaller but sure gain and are unwilling to take a wise gamble for a large gain. On the other hand, they are more willing to risk their capital for a large uncertain loss than for a certain small one.

Rule 13. Place Numerous Small Bets on Low-Risk Ideas

Since a high proportion of trades unavoidably will be unprofitable, it is a wise policy to make bets small so that a significant amount of capital is not risked on any one transaction. As a general rule, it is not advisable to risk more than 5% of your available capital on any one trade. This goes against the natural tendencies of many of us. In our quest for a large and quick profits, it seems much easier and more logical to put all our money on one horse.

It is also important to make sure that any trade or Investment that you do make is a carefully thought out low-risk idea. The estimated potential reward should always be much greater (at least 3-1) than the maximum acceptable risk.

Rule 14. Look Down, Not Up

Most people enter a trade by calculating its probable upside and building that assumption into their expectations. As a result, they are setting themselves up for a disappointment. The question to ask when putting on a position is "What is the worst that can happen?" By looking down, not up, you are addressing what should be your number one objective: preserving your capital. If you erode your capital base, then you will have nothing left with which to grow. Almost all traders lose äs many times äs they win. The successful ones make more on the winning trades but more importantly lose less on the bad ones. By looking down, they are, in effect, assessing where they should cut their losses ahead of time. If this potential margin of error proves to be too great, they walk away from the trade.

I can remember many instances when I was extremely optimistic about the prospects for a trade. I knew in my mind that the market would teil me I was wrong, but the chart point would be considerably below my entry point. My expectations would be so positive that I would fool myself into believing that the market would "never go down that far because the trend was bullish." Invariably it would, and so I would pay a heavy price for not taking the worst possible scenario seriously. A series of painful experiences have taught me that it is better to look down first and look up later.

If you know that about half the trades that you put on are going to go against you, then it makes sense to try to make those mistakes äs inexpensive äs possible.

*Rule 15. Never Trade or Invest More **Than** VOM **Can** Reasonably Afford to Lose*

Any time that you risk capital that you cannot reasonably afford to lose, you are placing yourself at the mercy of the market. Your stress level will be very high, and you will lose all objectivity. Decisions will be emotional because you will be focused on monetary gains and the painful psychological consequences of a loss and will not be based on the facts äs they really are.

Rule 16. Don't Fight the Trend

There is a well-known saying that a rising tide lifts all boats. In a market sense, it is äs well to be trading in the direction of the market since a rising market, in effect, lifts all long positions. Going short in a bull market therefore entails considerable risk; for by definition unless you are agile enough to take profits at the appropriate time, a loss is certain.

The opposite is true in a bear market where rallies are often unpredictable and treacherous. If you study the results of most trading Systems, you will see that the negative results inevitably come from positions that are put on in the opposite direction to the main trend. Obviously, you do not always have a firm opinion about the direction of the primary trend, but when you do, it is much more sensible not to trade against it.

Rule 17. Wherever Possible, Trade Liquid Markets

In general, you should always trade liquid markets, that is, where the difference between the bid and ask prices are usually narrow. Trading in illiquid or "thin" markets means that in addition to broker commissions, you are also paying some form of cost because of these wide spreads. You may think that this can be overcome through patiently waiting to buy at a specific price, äs opposed to placing a market order. Nevertheless, when you decide to seil, you are more likely to be doing so under pressure, so the wide spread will make the cost of an immediate execution work against you. Illiquid markets can be ascertained by the amount of average daily volume transacted. Normally, anything less than 2,000 contracts per day is considered illiquid. It is also important to remember that in the futures markets, deferred contracts (i.e., those due for settlement some time into the future), can also be extremely illiquid even with such widely traded items such äs Stock Index Futures or gold. It is therefore usually a better idea to trade in the nearby futures since the commission costs of "rolling over" into the next available contract on expiration is normally less than the cost of dealing with the wider spread.

Liquid markets imply a wide variety of participants with differing opinions, so there is usually someone with an opposite opinion to your own who is willing to take the other side of the trade. Illiquid markets can be very profitable if you happen to be on the right side, but if you are caught on the wrong side when some unexpected bad news materializes, the results can be devastating. This is especially true in the futures markets that are subject to daily price limit moves. Most of the time, markets trade within the limits, but it is amazing how they seem to exceed those limits when you personally have a position. When we talk of "liquid" markets, we mean that it is relatively easy to get in and out of a position most of the time. This does not imply that so-called liquid markets are always liquid. There are times when even the most liquid of all, such äs the S&P Composite, bonds or gold move at such a frantic pace that it can be impossible to obtain an execution at anywhere close to the expected price. This Situation often develops after the release of a government report. If the market has factored in, say a bullish number, but the report is bearish, then for a few moments there may be no liquidity whatsoever äs the market adjusts to this new reality.

These situations seem to arise when most participants are positioned on the same side and the market has factored in seem very favorable expectations. When the bad news comes out, there is virtually no one to take the other side and yet seemingly everyone wants to get out at the same time. Only when the price has made a rapid and, for the majority, painful adjustment, does liquidity return to the marketplace. It therefore makes sense for those who have a short-term horizon to avoid potential situations of this nature, for you really have no Control over the outcome. You are literally gambling on the content of a government report that will probably be revised anyway.

Rule 18. Never Meet a Margin Call

This important rule applies only to leveraged traders. Margin calls arise for two reasons. First, the market may have gone against you, which means that the equity in your account has fallen below the required level. Second, the margin requirement for the commodity or financial futures in your portfolio may have been raised. When your broker calls you with a margin call, you have two alternatives. The first is to send in sufficient funds to bring your account up to the required equity level. The second is to reduce the margin requirement by selling all or part of your position.

To make the correct choice, we have to examine why your account is in this unfortunate condition. If the call is being made because the market has gone against you, it means that either you have too much leverage and will therefore be on emotional tenterhooks with each twist and turn or your original premise for getting into the position no longer holds. Either way, meeting a margin call will have the effect of *increasing* your emotional commitment and is therefore undesirable. If your original decision was based on a false assessment, then the margin call should be viewed äs a gentle reminder that you should deal with this problem by liquidating all or part of the position. The margin call may also arise not so much because your current position has gone against you but because the account has been allowed to dwindle slowly. The call then follows in the wake of a string of losses. In this type of Situation, the prognostications are worse because the call does not reflect an isolated incident but the culmination of a deteriorating trend. A strenger dose of medicine is then called for. The best thing to do is to exit the markets completely for an extended period so that your emotional wounds can heal and objectivity can return. The length of the period will differ for the individual and the seriousness of the losses, but in general, a "vacation" of at least three weeks is appropriate.

Alternatively, the margin call may arise because you have just added some new positions. This implies that you have been overtrading or at best that you have not taken the new risk-reward potential into consideration. Whatever the reason, the finger points to poor money management.

Sometimes the equity in the account rises a little from the initial balance, but a margin call is still generated because the exchange minimums have been raised. You may think that such calls should be met because the market has moved in your direction and you were, in fact, correct. The raising of margin requirements is merely a technicality. This type of reasoning is incorrect, because margin requirements are raised for a reason. Ideally, the exchanges prefer to set low margin requirements, because this encourages more trading and therefore more commissions for the members. However, when conditions become more volatile, they must also take into consideration that traders are more likely to run into financial difficulties. The raising of the requirement is therefore a hedge against such losses. If conditions become more volatile, then it makes sense for you äs a trader to take some more precautions. Quite often, a raising of the requirement is a signal itself that the prevailing trend is in the process of reversing.

Consequently, whatever the reason for the margin call, the rule remains the same: Never meet it by sending in more money.

Rule 19. If You Are Going to Place a Stop, Put It at a Logical, Not Convenient, Place

Traders often follow the discipline of predetermining where their downside risk might lie and place a stop-loss Order slightly below that point. If the stop point has been determined with resort to some sound technical or fundamental analysis, this represents an intelligent method of Operation. However, if you initiate the trade on the basis that you cannot afford to lose more than $300 and so place the stop at a point that limits the loss to $300, your odds of a winning trade will be greatly reduced. In this instance, you are

not making decisions based on price action, where the market has the opportunity to teil you if you are wrong. Instead, you are picking an arbitrary point based on your own assessment of how much you can afford to lose. If the stop is triggered, it is not a vote by the market that you misjudged the trend, for quite clearly the market was not given enough leeway to come to such a verdict. Such stop points represent nothing less than a gamble that the price would not slip to such a level. The chances are that, having been stopped out, you would then see the market reverse direction to a degree that the trade would have ended up in the profitable camp.

Even traders who recognize this fallacy can be drawn into complex mental games where the sheer degree of their optimism causes them to rationalize incorrectly that their Stops are in fact logically placed. It is not a bad habit therefore to ask yourself, "Is this really the best place to put the stop, or am I placing it here äs a convenient place to limit my losses?"

$ *SUMMAKY*

We could add a 20th rule, which would be to follow the other 19 rules without question. It makes little sense to learn about and develop a set of rules if you fail to put them into practice. You would forfeit any sense of objectivity, independent thinking, perspective, and risk Control that the rules are designed to deal with. To make sure, let's add a 21st rule: Follow the other 20 without question at all times!

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Making a Plan and Sticking to It

xf you have studied the ideas in this book, you now have a good understanding of the underlying psychological forces that drive markets and the kind of pitfalls you can easily stumble into if you are unable to master your natural emotional tendencies. All the reading in the world, though, will be of little use unless you can put it into practice. That's the difficult part: Execution involves tremendous effort. Starting out is often relatively easy because you gain strength from the initial enthusiasm gained from fresh ideas. The really hard part is the continual application of these ideas äs the novelty wears off and some losses develop. The struggle to maintain newly learned disciplines is then at its most difficult.

This chapter has two objectives. The first is to help you organize your thought processes in a way that will better equip you to do battle with the markets (and therefore yourself). The second is to emphasize the necessity of constantly reminding yourself to follow up and review your activities. In this respect, it is vital to remember that it is the function of the market to search out and exploit your every weakness. To overcome this challenge, you have to be constantly on guard to limit those opportunities äs much äs possible. Only with constant surveillance and continuous review can you accomplish this task successfully. Eventually, such perseverance will be rewarded with a change of habit and thinking, but this will take several years to accomplish.

The remainder of this chapter is organized under the following headings, which we will consider in turn: "Setting Up Your Personal Investment Objectives," "Adopting an Investment or Trading Philosophy," "Establishing a Plan to Maximize Objectivity and Minimize Emotion," and "Establishing a Review Process."

This overall, four-point plan is relevant to both traders and long-term investors. The principal difference will be the amount of time between progress reviews. Obviously an active trader, in the market on a daily or even intraday basis will need to review his progress on a much more frequent basis than someone who makes transactions äs infrequently äs three or four times a year. Even on the latter schedule, it is important not only to review the progress you have made but also to monitor any major economic, financial, or technical changes that may have occurred. It is easy to slip into complacency by getting into the habit of closing your mind to what goes on in the markets.

^ *Setting Up Your Personal Investment Objectives*

When we are uncertain about our goals, our minds become a battlefield of conflicting desires. In this mental environment, the result will be total paralysis that will make it impossible to achieve investment success. Therefore, it is necessary to develop specific objectives for our trading and investment activities. If correctly done, setting up investment objectives helps to transfer our energies from the external forces where we often allocate blame to the real source of our problems, namely ourselves. For example, if an individual has a large position in the stock market and some random event such äs the 1991 summer coup in the Soviel Union comes along to push prices down significantly, it is natural to blame "the market." In such circumstances, we can rationalize the Situation because we have no apparent Control over it. The real issue, though, is ourselves, and until we can learn to come to grips with that problem, it will keep resurfacing.

Arnold Toynbee, the great British historian, recognized that fact in his principle of challenge and response. He spent a great deal of time studying the characteristics of rising and falling civilizations. He noted that all civilizations faced challenges from time to time. The difference between a civilization that was on the rise and one that was in decline was that the rising civilization was able to meet challenges successfully and move on. The declining civilization, on the other hand, either failed outright or inadequately met the challenge, which then would continually resurface and become a even greater bürden.

An example of a classic challenge occurred in the fifteenth Century. The Western world faced the dilemma of how to trade with the Orient when the land routes were barred by the Islamic Ottoman Empire. The challenge was met by Columbus. Although he failed to find the elusive route, he instead discovered a new continent, thus paving the way for others to develop it later. When it comes to meeting challenges, the position of an Investor or trader is no different. If you continually make the same mistakes and do not learn (i.e., fail to overcome the challenges put forward by the markets), you are doomed to fail. Setting some realistic objectives can help to put some of these problems in perspective and lay the groundwork for success.

Investors

The starting point of any plan is to establish a set of objectives. After all, if you do not know where you are going and how long it is likely to take, how can you possibly make the correct investment decisions? These objectives should be established, keeping in mind your Status in life, financial Situation, and ability to tolerate risk.

The three principal investment objectives that almost everyone has are liquidity, income, and growth. The term "liquidity" refers to that portion of the portfolio that can easily be turned into cash to meet an unexpected expense. Both equities and bonds are liquid in the sense that they can be easily turned into cash. However, it is not always convenient to seil them. Perhaps there is a taxable gain that you do not wish to realize at present.

Alternatively, the market may be down, and you do not want to take a loss because you feel that prices will soon recover. Liquidity, therefore, has a broader meaning than just realizing a sale to make a payment. It implies that the principal amount will not materially change. In short, it can be counted on. Hence, you need to balance your portfolio to provide sufficient funds to meet such obligations without jeopardizing the overall investment plan.

Occasionally, you will need funds, for example, two or three years down the road, to pay College fees. In this sense, a liquid investment would be one that matures at a much later date. In this way, it would still provide the ability to make a payment, but the principal value could also be counted on, thereby meeting the dual test for a liquid asset.

The second investment objective, income, will depend a great deal on your own financial requirements. For example, if you are retired and are relying solely on social se'curity payments, your income requirement will be a great deal higher than if you have your whole career ahead of you. You may also be quite young and in the process of taking a higher degree. With no other income source, the need for earnings from your portfolio will be of paramount importance. Once you have earned the degree and have a good income stream, you would then be wise to change your investment objective toward one of growth. A heavy income requirement is not therefore confined to widows and orphans.

The final objective is growth. Here we are faced with a trade-off. As a rule of thumb, the greater the potential reward, the more substantial the risk and the uncertainty. If you are young and earning a good living, you are clearly in a better position to assume more risk than someone who is retired. The young person not only has more time to recoup a lost investment but will also be blessed with a potential cash flow that can make up for past mistakes. The retired person does not have that luxury.

For most people, the objective of liquidity will be relatively unimportant, so the decision will rest on an appropriate balance between bonds and Stocks. It is important to assess your particular stage in life and your financial requirements in setting goals. Equally äs significant is the need to make sure that your goals are not only realistic but also consistent with your temperament.

For example, if the stock market has appreciated by 15% in the past five years, you may decide that you want your portfolio to grow at a more conservative rate of 12%. This may appear to be realistic on paper, but the problem is that the market has experienced a compounded annual growth rate closer to 9% historically. Since the return over the past few years has been way above normal, it is likely that the next few years will see average or, more likely, below average growth. Over time, market performance has a habit of regressing or returning to the mean, so after a few good years, it is reasonable to anticipate a couple of poor ones. Unrealistic expectations therefore can lead to disappointment when they are not met.

Temperament is another factor that should be considered when establishing Investment objectives. For example, we know that the average return on equities historically has been about 9%. However, we also know that this increase did not take a straight line and that the rate of return was not consistent; there were peaks and valleys along the way. In some years, the gain can be äs high äs 25%, and in others, there can be an equal amount on the loss side. If you are unable to live with the loss years and find the stress too great, you will not be able to stay the course and so you will not achieve even a modest Investment objective. This is why you must recognize your own ability for risk tolerance and build it into the plan at the outset. It may be unrealistic to expect an unduly high rate of return, but it is even more unrealistic to expect such a performance if you cannot live with the pressures and Swings in the market.

The degree of risk that can undertaken comfortably will depend on your own character. It is a personal decision, for you are the only person who knows when worries about Investments cause a knot in your stomach or result in sleepless nights and so forth. If anything, you should lean on the side of caution, because the loss of principal due to an overly aggressive stance will be far

rally does not take anything away from you, whereas losses **in** the market do.

Traders

Since positions held by traders are of much shorter time horizon than those of Investors, their objectives will also differ. Liquidity and income are not important; the prospect of growth is the uppermost objective in the minds of traders. In this respect, the danger of unrealistic expectations and the concept of risk tolerance should be of primary importance. For instance, you could rationalize that because of the leverage potential for futures trading, the expected return should be equally äs great and the results ought to be that much better. If the S&P Index gains an average of 9% per year, it should be possible working on 10% margin to average 90% (i.e., 10 times äs much). In reality, it doesn't work that way because to earn the 9% return, it is necessary to sit through some pretty big bear markets that would more than wipe out the equity in the account. The smallest gyrations in markets can have a tremendous effect on the equity in leveraged accounts, so the ability of the trader to know his limits of risk tolerance is that much more crucial.

Since traders are in and out of the markets every day, often on an intraday basis, their need to establish a campaign plan is even greater than someone who has a longer time frame because such a highly volatile environment has little margin for error.

Adopting an Investment or Trading Philosophy

Establishing Investment objectives helps to teil you where you want to go and how long it will take you to get there. Adopting a philosophy or approach to trading or investing is the vehicle that will enable you to reach that destination.

As I have said, there are many religions in the world, each markets, there are also many different Investment and trading approaches, each seeking the realization of profits. Your Job is not to find the best, because they all have weaknesses. Instead, you need to choose an approach with which you are comfortable, provided, of course, that it works. Because of the leverage involved and the life-saving requirement of not permitting losses to continue, traders usually favor using technical analysis; this enables them to set objective "stop-loss" points. A long-term Investor, on the other hand, can afford the luxury of buying a stock with a low price-earnings multiple and patiently waiting for the price to increase. Others prefer to buy companies with high growth rates and high price-earnings ratios, believing that the fast growth of the Company will result in higher stock prices. Still another might involve the adoption of the Theory of Contrary Opinion, discussed in Chapters 7 and 8.

Your chances of success will be higher if you combine some concepts of contrary-opinion principles with your chosen approach. For example, if in using technical analysis, you use oversold conditions äs a basis for making purchasing decisions, contrary analysis will represent a useful confirmation. If your indicators are pointing out that the market is oversold, but you cannot find much in the way of bearish sentiment, the chances of a meaningful bottom will be much less than if a negative or pessimistic story was splashed on the cover of a major magazine.

The most important thing is to satisfy yourself that your method works. This does not mean researching it back over a few months but making sure that it operated profitably over many different types of market conditions. This is far different from expecting it to work perfectly. We have already established that there is no holy grail. Every market participant, however, needs some kind of foundation for making informed and objective decisions. In practice, individual decisions should not be made in isolation or solely on gut feel, but äs part of an overall approach. The outcome will then be a consistent series of rational judgments.

The second principle involved in the adoption of a philosophy is comfort in its use. If you feel perfectly at home and enjoy

your adopted philosophy or approach, two benefits will accrue. First, enjoyment implies interest. Interest in turn will encourage you to explore and expand your knowledge of the subject. Second, you will not be receptive when the approach Signals the need for action. For example, you may be sold on the idea of buying Stocks with low price-earnings multiples. However, if you don't believe in the approach wholeheartedly, it's a good bet that you will find a reason *not to buy* when all your conditions for purchase have been met. The very nature of a market bottom is that it presents a host of reasons for not getting involved. You will need total confidence in your adopted approach, otherwise you will be unable you to overcome the psychological obstacles placed in your way.

An additional consideration is to make sure that your chosen approach is consistent with your temperament. Suppose, for example, that you like the idea of trading the markets on a leveraged basis using a simple 20-day, moving-average crossover system. You buy when the price crosses above the average and seil when it falls below. However, if you do not have the stomach to endure the losses that are bound to arise from losing Signals, there is little point in your following the system because you will be certain to lose money. In a similar but opposite vein, you may find some appeal in the idea of buying low multiple Stocks that are out of favor and waiting for them to appreciate over a long period of time. However, if you have a trading mentality and lack the patience to wait out the long time interval that is usually necessary between buying and selling, then this perfectly legitimate approach will not work for you, either. You should therefore make sure that your approach or philosophy is not likely to conflict with your personality. Bear in mind, it is much easier to change the methodology than your character makeup.

Another factor worth consideration is your innate abilities and how they might be applied to a specific methodology. Everyone has a different character makeup, where strengths and weaknesses are emphasized in a unique combination. You need to examine your own balance because doing so will help you to choose an appropriate Investment or trading approach. For example, if you have an affinity for tape reading or charts, it makes a great deal of sense to adopt a System that incorporates these tools. Alternatively, you may pay a great deal of attention to details and require a substantial number of facts before coming to a decision. In that case, use a methodology that takes advantage of those skills.

The essence of any approach, whether from a trading or investing aspect, is to develop a low-risk ider Only when you have figured out the odds of winning or losing can you approach the markets with any hope for success.

^ Establishing a Plan to Maximize Objectivity and Minimize Emotion

The first step in establishing a plan is to adopt a method for distilling a multitude of ideas into one low-risk one. In a sense, the methodology is the framework under which you will be operating. The next step is to set up a written plan that anticipates and overcomes the psychological conflicts that inevitably lie ahead. (See Figure 13-1.)

The advantage of a written plan is that it enables you to be precise. Once it is written, you can easily review its various aspects to make sure that it is consistent, comprehensive, and logical. Having it laid out on a sheet of paper will also reveal whether it has any biases and make it easy to check whether you have taken all the Steps.

Most people object to a written plan on the basis that they do not like following rules or that they are far too "intuitive" for such a thing. Others, with the best of intentions, choose to postpone writing the plan, which, of cpurse, never gets written. Intuitive market participants often make good moves but then give back their gains in a series of poor decisions. Results are therefore inconsistent and haphazard.

The benefits of a clearly written and logical plan in such cases are self-evident. Those who do not like to follow rules and

The following quick test can help you decide your Investment temperament and ability to take risks for the purposes of asset allocation. It was designed by William G. Droms, a professor of finance at Georgetown University. Value the seven Statements on a scale of l to 5, from "strongly disagree" with a rating of l to 5 for "strongly agree." Then add up your points.

1. Earning a high long-term total return that will allow my capital to grow faster than the Inflation rate is one of my most important Investment objectives.

2. I would like an Investment that provides me with an opportunity to defer taxation of capital gains and/or interest to future years.

3. I do not require a high level of current income from my Investments.

4. My major Investment goals are relatively long term.

5. I am willing to tolerate sharp up-and-down Swings in the return on my investments in order to seek a higher return than would be expected from more stable investments.

6. I am willing to risk a short-term loss in return for a potentially higher rate of return in the long run.

7. I am financially able to accept a low level of liquidity in my Investment portfolio.

The following are Mr. Drom's asset allocation recommendations:

Total Score	Money Market	Fixed Income	Equities
30 to 35	10	10	80
22 to 29	20	20	60
14 to 21	30	30	40
7tol3	40	40	20

Equities include real estate, venture capital, international Stocks, gold, domestic Stocks. Fixed income investments include American and international bonds.

Figure 13-1 Test for Investment Temperament and Ability to Take Risks for Purposes of Asset Allocation. Source: William G. Droms, Georgetown University.

are unwilling to develop a written plan clearly lack the discipline for profitable market campaigns. Moreover, financial success in the markets requires consistency and you can achieve this only by religiously following a set of predetermined rules.

The establishment of a plan is not *a* one-step procedure unless by pure chance you hit on the exact formula. The chances are good that your plan will require modification äs you learn more about yourself and how you deal with various market situations.

One of the most competent market psychologists, Van K. Tharp, has worked with some of the world's most accomplished traders and has published a course called "Successful Investing" based on his experiences. The course is intended to help traders overcome their weaknesses. Tharp states: "Most people tend to avoid working on themselves. It's too painful. Instead, the issue they have with themselves (e.g., security, self-worth) becomes an issue they have with the market (e.g., profits, losses) .... [the trader] simply transfers his problem, transmutes it and then has the same problem [but with a different manifestation]." As an aid in overcoming these very human problems, Tharp recommends that his students establish a plan that involves what he calls "the ten trading tasks." His ideas are essentially meant for traders, but the principles are equally valid for Investors and others with a long time horizon. Tharp points out that your mental state and the kind of preparation you undergo before you put on a position will determine whether you are likely to win or lose on a consistent basis. Remember the task of developing a plan is to help you to become äs disciplined and objective äs possible.

Tharp's steps are a good basis on which to formulate a written plan. Seven of these steps are listed next.

Step 1. Self-Analysis

If you are planning to take a run on a familiär track and want to beat your previous record, logic would teil you not to attempt

such a feat if you are sick with a fever. You would be much better advised to make the attempt when you were at your physical peak. The same principle holds true when dealing with markets. If you are psychologically run down due to illness or personal problems, the chances are that you are not going to be able to withstand the psychological turmoil that the markets will cause you. You will still be able to make decisions, but your confused state will reduce your ability to make sound ones at the margin; and it is at the margin that the dividing line is drawn between winners and losers. Consequently, whenever you feel overly stressed because of factors outside the market, you are advised to stay away or to make äs few decisions äs possible until your condition improves.

We learned in the section on crowd psychology that going against the crowd at the right time can be very profitable. These types of decision by their very nature demand great courage. Anyone who has experienced a profitable trade or Investment from such circumstances knows that they are usually the most rewarding. This approach does not come without its contradictions, though. How do you know whether your discomfort in making these difficult decisions stems from simply going against the crowd or whether it's a result of an emotional family dispute?

One obvious solution is to reexamine the contrary case to see whether it makes sense. Tharp also suggests that people should develop a rating scale from l to 8 depending on how you feel about yourself on the day in question. Under this System, l is terrible and 8 is great. The idea is to spend a quiet 30 seconds in deep thought äs to where you stand on the scale that particular day. Over a period of 30 days, you should then compare your daily ratings with your trading performance. Working on the assumption that there is a rough correlation, you are then in a position to establish an objective Standard below which you should not trade. The principle of this method can be applied to market participants with a longer time horizon, but clearly the Control period would have to be much lengthier äs well.

Step 5. *Action*

Once the guiding criteria have been established and the required conditions have materialized, it is important to take action. The market will often move quickly at this point so it is important that you act decisively. If you have done your homework, you will have a fairly good idea of what your potential loss will be should the market go against you. In particularly volatile or "fast" markets, it is usually a good idea to place limits on your orders. Limit orders put a cap on how much you are willing to pay for an item. For example, you may have been stalking Company ABC and decide to buy on the day the earnings come out. It may well be that the results are better than the market expected and an order imbalance causes a delayed opening. If you have been doing your homework properly, you would have already established a ceiling price for your low-risk idea, so you need to incorporate this price in your purchase order to make sure that you do not overpay. Remember, even if the stock "gets away" from you, there will always be another opportunity at a later date. Do not under any circumstances allow the emotion of the moment to interfere with a well-thought-out, logical plan.

Step 6. *Monitoring*

Complacency is the enemy of traders and investors alike. Once the initial position has been taken, there is a temptation to relax in the belief that the task has already been accomplished. Of course, it is not over until the position has been closed out with a profit or loss. The nature of the monitoring task will depend to a large degree on the time frame under consideration. If you are a day trader, then 10 trading tasks will be executed perhaps two or three times a day. For the *long-term investor,* the process will be slower. Even for a person taking the long view, it is still mandatory to follow your position. Many people think that the long-term is a comfortable place to be and that they can hide from the market and not worry about their position. Nothing

could be further from the truth. Tharp divides the monitoring process into detailed monitoring for traders and overview monitoring for others with a longer time horizon.

Detailed Monitoring. If the low-risk and stalking exercises have been correctly completed, the trade should move into the profit side more or less right away. Tharp suggests traders should rate the trade to see how it "feels" in a manner similar to the rating exercise in Step 1. This time instead of "1-8," the benchmarks are "easy to difficult." He suggests that the trader undertake this rating three times a day for the first three days at the opening, close, and midpoint of the trading day. If the trade does not feel "easy" after the third day, it will probably turn out to be a bad one.

Overview Monitoring. This level is more suitable for long-term traders and investors. This type of monitoring involves a periodic review of the broad trends in the market or stock in question. Is it responding favorably to good news? Is there any change in your outlook for the economy? Is the technical picture still strong? During this process, it is important to make sure that you can remain as objective as possible. The natural tendency is to emphasize the favorable aspects and turn a blind eye to the negative ones. Expectations have a tendency to be based on hope rather than rational arguments supported by solid facts. Therefore, do not under any circumstances interpret signals according to your expectations. Try as best as you can to look at them objectively. Pretend that you do not have the position you hold and see how it looks from that aspect.

As the monitoring process gets underway, survey the overall environment. As market events unfold, compare them with your original plan and study the implications of these events. You may find, for example, that the market moves against you, bringing the price back to a breakeven point. This need not be an unfavorable sign. Perhaps the news is unexpectedly bad, and the market sells off but holds at support and rebounds. A market that can do this is in good technical shape and should give you encouragement. On the other hand, a stock that sells off on a surprisingly good earnings report is to be questioned, and so forth. The monitoring process is no more than one of risk control. It is telling you to stay with a position, or it throws up reasons why you may need to sell. If you substitute monitoring for complacency, this healthy second process of self-enquiry will result in a far sounder campaign.

Step 7. Getting Out

In this phase, the rule of cutting your losses and letting profits run really begins to apply. Cutting losses applies when you have reached your point of maximum loss. One thing you cannot afford to do is take a big loss. Not only will it affect your mental balance for the next transaction but it also is the fastest way to lose principal. As I mentioned earlier, the first objective of any trading or investment program is to preserve your capital. Only risk capital when a low-risk/high-reward opportunity comes along.

A second reason that justifies liquidating a position occurs when the original rationale for entering the trade or investment market no longer exists. After all, if you bought XYZ Company because you were expecting profits to improve and they actually deteriorate, there is no reason for holding it any longer. In our minds, though, we often have difficulty in accepting this. Perhaps the price is down and we are unwilling to take a loss. Perhaps we feel uncomfortable in calling our broker and letting him know that what was a long-term investment is actually a short-term trade. Where pride of opinion is concerned, our minds can play many tricks on us.

Uncertainty is another factor that should influence you to get out. There is an old trading adage: "When in doubt get out." In any situation, there is always going to be some element of doubt. What we are talking about in this instance is a degree of doubt and uncertainty that is far greater than when the position was initiated. If you are unsure, then you have lost a great deal of

the confidence and objectivity needed to continue. Under such circumstances, it is appropriate to reconsider whether it is in your best interest to continue with the position.

Letting profits run is a commendable objective, but you must remember that prices do not move up forever. It is therefore a good idea to establish some objectives at the outset as to what level to take profits. Originally, the position would have been initiated because the risk was considered to be low. If, because of a price rise, the risk is now judged to be correspondingly high, the position should be at least partially liquidated. Moreover, if you have run into some personal emotional problems, it means that your judgment will hampered. After all, if a poor psychological condition can be used as a justification for not entering the market, surely it is equally valid for protecting profits.

The task of taking profits should also be a natural consequence of following the plan. If you plan to buy a stock when it has a price-earnings multiple of 8 and sell it when it gets to 15, then the plan calls for liquidation when it reaches that point. Of course, the situation can be reassessed when the objective has been reached. Perhaps there are very good reasons for maintaining the position for greater gains, but you should at least go through the exercise.

The main thing is to focus on setting realistic goals and being consistent in trying to achieve them. This means staying with the plan and modifying it when necessary. Low-risk ideas are so few and far between that this fact in itself will protect you from the pitfalls of overtrading. Even when you have put the plan into action and have achieved some degree of success, you still must implement one more procedure.

^ *Establishing a Review Process*

The principal objective of the review process is to establish whether you have faithfully followed the plan and to see whether it may have to be modified. This process has nothing to do with whether you made or lost money. It is there to examine whether you followed the rules. If you didn't follow the rules, then you have made mistakes. You need to ask yourself why you were unable to follow the rules. Perhaps you anticipated what the market was going to do rather than waiting for the market to give its signal as called for by the rules. Perhaps the plan did call for a specific purchase, but when you called your broker he was able to talk you into buying something else. The reason is not important so long as you are able objectively to examine what went wrong and make a mental effort not to repeat your folly. This is a much better approach than going through a self-recrimination exercise, pointing out how much money you would have made by doing such and such. Reviewing your progress in that way does not teach you anything, and, moreover, it doesn't change the past. In short, it is a waste of mental energy. What has happened has happened, and all you can do is try to learn from the experience and use it as a base on which to build profits for the future.

Another alternative is to go back to the point at which you made the mistake and ask yourself what your options were at the time. Then mentally go through those possibilities, working them through to their possible outcomes. When you have discovered two or three scenarios with positive outcomes, remember them for the next time you are faced with a similar market condition.

This review process should be written down, for it is very easy to forget or to distort what actually went on at the time.

The second part of the review process critiques the plan and the rules themselves. It is a good idea to do this when you are not reflecting on a previous transaction or campaign because it is unreasonable to critique your performance and the plan at the same time. If you feel, with good reason, that the plan and or your objectives need to be changed, then by all means go ahead. Perhaps market conditions or your financial position have changed; perhaps you discover that your tolerance for risk taking is greater or less than you had originally envisaged. Alternatively, you may have just been exposed to a new

kind of investment or trading philosophy that you have researched and feel comfortable with. There are many reasons why you might want to change the plan. Be warned against flippant and thoughtless changes, because they will do more harm than good. Treat your plan rather like the U.S. Constitution. It is a solid document, which can be amended only through an arduous process as times and conditions change.

—14——

Classic Trading Rules

If you are intelligent the market will teach you caution and fortitude, sharpen your wits, and reduce your pride. If you are foolish and refuse to learn a lesson, it will ridicule you, laugh you to scorn, break you, and toss you on the rubbish-heap.

—Frank J. Williams

Ten Rules from Bernard Baruch

Baruch listed these rules in his autobiography *Baruch: My Own Story*. Starting as an office boy at the age of 19, Baruch made his first million by the age of 35. He then went on to be a trusted counsel for several Presidents. He states that he was skeptical about the usefulness of advice and was therefore reluctant to lay down any hard and fast rules. He offered the following as some points learned from his personal experience that "might be worth listing for those who are able to muster the necessary self-discipline." The rules are simple and self-explanatory.*

•This excerpt is taken from *Baruch: My Own Story* by Bernard M. Baruch, 1957, New York: Holt, Rinehart and Winston. Reprinted with permission.

"Being so skeptical about the usefulness of advice, I have been reluctant to lay down any 'rules' or guidelines on how to invest or speculate wisely. Still, there are a number of things I have learned from my own experience which might be worth listing for those who are able to muster the necessary self-discipline:

1. Don't speculate unless you can make it a full-time job.
2. Beware of barbers, beauticians, waiters—of anyone—bringing gifts of 'inside' information or 'tips.'
3. Before you buy a security, find out everything you can about the company, its management and competitors, its earnings and possibilities for growth.
4. Don't try to buy at the bottom and sell at the top. This can't be done—except by liars.
5. Learn how to take your losses quickly and cleanly. Don't expect to be right all the time. If you have made a mistake, cut your losses as quickly as possible.
6. Don't buy too many different securities. Better have only a few investments which can be watched.
7. Make a periodic reappraisal of all your investments to see whether changing developments have altered their prospects.
8. Study your tax position to know when you can sell to greatest advantage.
9. Always keep a good part of your capital in a cash reserve. Never invest all your funds.
10. Don't try to be a jack of all investments. Stick to the field you know best."

0 Eleven Rules from Robert Meier

Bob Meier has spent many years writing about and trading futures. He is a personal friend and has given me much encouragement in writing this book. He offers several simple but important rules. Number 10, "Never trade with serious personal problems," is extremely sound. In this day of fast moving technology and high stress, the potential for personal problems is much greater than it ever was. It is impossible to maintain a sense of objectivity when you are down emotionally. Far better in the long run not to trade at all until you can regain a sense of psychological well-being; confident objective decisions are then easier to make.*

The following rules are by Robert H. Meier:

1. Ask yourself what you really want. Many traders loose money because subconsciously their goal is entertainment, not profits. If you are serious about becoming a successful speculator, carefully examine your trading to eliminate destructive compulsiveness such as constantly calling your broker when there is no legitimate reason, and putting on trades "just to be in the market."

2. Assume personal trade responsibility for all actions. A defining trait of top performing traders is their willingness to assume personal responsibility for *all* trading decisions. People who habitually blame their broker, the market itself, bad order fills, or insider manipulation for losses, are never successful.

3. Keep it simple and consistent. Most speculators follow too many indicators and listen to so many different opinions that they are overwhelmed into action. Few people realize that many of the greatest traders of all time never rely on more than two or three core indicators and never listen to the opinions of others.

4. Have realistic expectations. When expectations are too high, it results in overtrading underfinanced positions, and very high levels of greed and fear—making objective decision-making impossible.

5. Learn to wait. Most of the time for most speculators, it is best to be out of the markets, unless you are in an option selling (writing) program. Generally, the part-time speculator will only encounter six to ten clear-cut major opportunities a year. These are the type of trades the savvy professionals train themselves to wait for.

•Robert H. Meier & Associates, Inc., 335 College Avenue, P.O. Box 667, DeKalb, IL 60115 (815) 758-3808. Robert Meier is a widely published commodity broker, associated with the Rosenthal Collins Group, Fox Investments Division, in Chicago, Illinois. Reprinted with permission.

6. Clearly understand the Risk/Reward Ratio. The consensus is that trades with a one to three or one to four Risk/Reward Ratio are sufficient, but this is not true unless you are a floor trader in the pit. There are trades with Risk/Reward Ratios as attractive as one to ten that periodically present themselves to those willing to exercise the ongoing market monitoring discipline required. That is what professionals do.

7. Always check the big picture. Before making any trade, check it against weekly and monthly as well as daily range charts. Frequently, this extra step will identify major longer-term zones of support and resistance that are not apparent on daily charts and that substantially change the perceived Risk/Reward Ratio. Point & Figure charts are particularly valuable in identifying breakouts from big congestion/accumulation formations.

8. Always under-trade. It is easy to forget just how powerful the leverage is in futures and options. It is not uncommon to find speculators holding positions two or three times larger than is justified by their account size. By consciously under-trading, that is taking positions much smaller than you might be able to, you will gradually learn to hold back until you find the real money-making opportunities and stay with major trends.

9. Define your broker relationship. A full-service commodity broker can be a valuable ally, but should not be pushed into the position of making your final decisions. Never tell a broker "do what you think best and call me later."

10. Never trade with serious personal problems. Ignoring this rule is a prescription for disaster. The clarity of thought and emotional control required even for part-time speculator is so great that it is impossible to handle along with serious personal problems. Likewise, trading should not be attempted during periods of ill health, even including a bad head cold.

11. Ignore the news media. The true goals of the national news media are to shock, agitate, entertain, and editorialize a socialist agenda—not provide usable information. Manv of the

finest traders avoid all contact with public news, knowing how profoundly it can undermine a trading plan. The more important trading profits are to you, the less you can afford to follow the "news."

< *Seventeen Rules from S. A. Nelson*

S.A. Nelson wrote around the turn of the century. Some of his rules relate to concepts that are different from today's; trading in "10 share lots" for example. Nevertheless, human nature remains more or less constant, so the general undertone of these rules is as valid in the current environment as it ever was.*

1. Bull markets and bear markets run four and five years at a time. Determine by the average prices, which one is under way.

2. Determine the stock or stocks to trade in. They should be railroad stocks, dividend payers, not too low, nor too high, fairly active, and for the bull side below their value; for the bear side above their value. Values are determined roughly by the earnings available for dividends.

3. Observe the position of your stock with relation to recent fluctuations. In a bull market, the time to begin to buy is when a stock has had four or five points decline from the last previous top. In a bear market, the time to begin to sell is when such a stock has had three or four points rally from the bottom.

4. Stick to the stock bought until a fair profit or until there is good reason for deciding that the first estimate of value was wrong. Remember than an active stock will generally rally from ^{3}/s per cent, to ^{5}/s per cent, of the amount of its decline under adverse conditions and more than that under favorable conditions.

5. Have money enough to see a decline through without becoming uneasy or over-burdened. $2,500 ought to take care of a

•This excerpt is taken from *The A B C of Stock Speculation* by S. A. Nelson, 1964, Wells: Fraser Publishing Company. (First published 1903; copyright S. A. Nelson.) Reprinted with permission.

ten-share scale every point down—that is to say, supposing the first lot to be bought five points down from the top, $2,500 ought to carry the scale until the natural recovery from the low point brings the lot out with a profit on the average cost. It will not do to expect a profit on every lot, but only on the average. In a bull market it is better to always work on the bull side; in a bear market, on the bear side. There are usually more rallies in a bear market than there are relapses in a bull market.

6. Do not let success in making money in ten-share lots create a belief that a bolder policy will be wiser and begin to trade in 100-share lots with inadequate capital. A few hundred-share losses will wipe out a good many ten-share profits.

7. There is not usually much difficulty in dealing in ten-share lots on the short side. If one broker does not wish to do it, another probably will, especially for a customer who amply protects his account and who seems to understand what he is doing.

A close student of speculation in all its forms as conducted on the exchanges of this country has arrived at the following conclusions, which, he says, in application to speculation are "universal laws." He divides his conclusions into two groups, laws absolute and laws conditional.

Laws absolute. *Never overtrade.* To take an interest larger than the capital justifies is to invite disaster. With such an interest, a fluctuation in the market unnerves the operator, and his judgment becomes worthless.

1. Never "double-up"; that is, never completely and at once reverse a position. Being "long," for instance, do not "sell out" and go as much "short." This may occasionally succeed, but is very hazardous, for should the market begin again to advance, the mind reverts to its original opinion and the speculator "covers up" and "goes long" again. Should this last change be wrong, complete demoralization ensues. The change in the original position should have been made moderately, cautiously, thus keeping the judgment clear and preserving the balance of mind.

2. "Run quick" or not at all; that is to say, act promptly at the first approach of danger, but failing to do this until others see the danger hold on or close out part of the "interest."

3. *Another rule is,* when doubtful *reduce the amount of the interest;* for either the mind is not satisfied with the position taken, or the interest is too large for safety. One man told another that he could not sleep on account of his position in the market; his friend judiciously and laconically replied: "Sell down to a sleeping point."

Rules conditional. These rules are subject to modification, according to the circumstances, individuality and temperament of the speculator.

1. *It is better to "average up" than to "average down."* This opinion is contrary to the one commonly held and acted upon; it being the practice to buy and on a decline buy more. This reduces the average. Probably four times out of five this method will result in striking a reaction in the market that will prevent loss, but the fifth time, meeting with a permanently declining market, the operator loses his head and closes out, making a heavy loss—a loss so great as to bring complete demoralization often ruin.

But "buying up" is the reverse of the method just explained; that is to say, buying at first moderately and as the market advances adding slowly and cautiously to the "line." This is a way of speculating that requires great care and watchfulness, for the market will often (probably four times out of five) react to the point of "average." *Here lies the danger. Failure to close out at the point of average destroys the safety of the whole operation.* Occasionally (probably four times out of five) a permanently advancing market is met with and a big profit secured. In such an operation the original risk is small, the danger at no time great, and when successful the profit is large. This method should only be employed when an important advance or decline is expected, and with a moderate capital can be undertaken with comparative safety.

2. To *"buy down"* requires a long purse and a strong nerve, and ruin often overtakes those who have both nerve and money. The stronger the nerve the more probability of staying too long. There is, however, a class of successful operators who "buy down" and hold on. They deal in relatively small amounts. Entering the market prudently with the determination of holding on for a long period, they are not disturbed by its fluctuations. They are men of good judgment, who buy in times of depression to hold for a general revival of business—an investing rather than a speculating class.

3. In all ordinary circumstances my advice would be to buy at once an amount that is within the proper limits of capital, etc., "selling out" at a loss or profit, according to judgment. *The rule is to stop losses and let profits run.* If small profits are taken, then small losses should be taken. Not to have the courage to accept a loss and to be too eager to take a profit, is fatal. It is the ruin of many.

4. Public opinion is not to be ignored. A strong speculative current is for the time being overwhelming, and should be closely watched. The rule is, to act cautiously with public opinion, against it, boldly. To so go with the market even when the basis is a good one, is dangerous. It may at any time turn and rend you. Every speculator knows the danger of too much "company." It is equally necessary to exercise caution in going against the market. This caution should be continued to the point of wavering—of loss of confidence—when the market should be boldly encountered to the full extent of strength, nerve and capital. The market has a pulse, on which the hand of the operator should be placed as that of the physician on the wrist of the patient. This pulse-beat must be the guide when and how to act.

5. *Quiet, weak markets are good markets to sell.* They ordinarily develop into declining markets. *But when a market has gone through the stages of cjuiet and weak to active and declining, then on to semi-panic or panic, it should be bought freely.* When, vice versa, a quiet and firm market develops into activity and strength, then into excitement, it should be sold with great confidence.

6. In forming an opinion of the market the element of chance ought not to be omitted. There is a doctrine of chances—Napoleon, in his campaign, allowed a margin for chances—for the accidents that come in to destroy or modify the best calculation. Calculation must measure the incalculable. In the "reproof of chance lies the true proof of men." *It is better to act on general than special information* (it is not so *misleading),* vis.: *the state of the country, the condition of the crops, manufactures, etc. Statistics are valuable, but they must be kept subordinate to a comprehensive view of the whole situation.* Those who confine themselves too closely to statistics are poor guides. "There is nothing," said Canning, "so fallacious as facts except figures." *"When in doubt do nothing." Don't enter the market on half conviction; wait till the convictions are full matured.*

7. I have written to little purpose unless I have left the impression that the fundamental principle that lies at the base of all speculation is this: *Act so as to keep the mind clear, its judgment trustworthy.* A reserve force should therefore be maintained and kept for supreme moments, when the full strength of the whole man should be put on the stroke delivered.

Thirty-Two Rules from Peter Wyckoff

Peter Wyckoff was a well-known Wall Street research analyst of the 1960s. In his book, he lists a number of rules at the end of each chapter.* Those presented here are just a few of the most useful ones. Rule 15 concerning the conversion of weak points into strong ones is particularly compelling and unusual. Anyone wishing to establish a personal set of rules would be well advised to consider the 32 listed here, especially as they emphasize the need to combine technical and fundamental analysis.

1. Speculation demands cool judgment, self-reliance, courage, pliability and prudence.

'This list is taken from *The Psychology of Stock Market Timing* by Pfeter Wyckoff, 1968 (fifth nrinfini^ Ftwlpwood Cliffs. Ml: Prentice-Hall. Reprinted with permission.

2. A person's planned buying policy should always dovetail closely with a predetermined selling policy.

3. When in doubt about what to do in the market, do nothing. Nothing can destroy the cool temperament of a man like unsystematic speculation.

4. Look after the losses and the profits will take care of themselves.

5. If you wait too long to buy, until every uncertainty is removed and every doubt is lifted at the bottom of a market cycle, you may keep on waiting . . . and waiting.

6. The worst losses in the market come from uninformed people buying greatly overvalued stocks.

7. Whenever hope becomes a chief factor in determining a market position, sell out promptly.

8. Never buy or sell merely on the basis of background statistics. Technical market considerations and psychology must also be taken into account.

9. Don't believe everything a corporate official says about his company's stock.

10. Check over all the facts carefully yourself and view them .conjunctively with other known market factors.

11. Never speculate with the money you need to live. If you can't *afford* a possible loss, stay out of the market.

12. One way to win in the market is to avoid doing what most others are doing.

13. When opinions in Wall Street are too unanimous—BEWARE! The market is famous for doing the unexpected.

14. Never cancel a Stop, or lower it, as the stock nears a trading point in a fast sliding market.

15. Try to analyze your weak points and convert them into strong ones.

16. Forget the idea that speculation depends entirely upon luck, and guard against blind faith in the suggestions of other men.

17. Eliminate trust in any system you do not understand, but still believe in the basic idea of the system.

18. You should consult other market aids besides charts.

19. Never be sentimental about a stock.

20. Before investing in a stock, look into its history.

21. You should be impervious to external forces and have no preconceived opinions to be a successful tape reader. Only the price changes appearing on the tape with attendant trading volume will tell you what to do and when to do it.

22. Always try to look and plan ahead, rather than considering just the last sales bobbing in front of you. The printed prices you see may have already largely discounted the news as it generally is known.

23. Tape reading is no exact science. You cannot form any definite rules, because all markets differ. Therefore, you must work out your own operational methods.

24. Be pliable at all times, but don't overtrade. Plan each campaign carefully, and never blame the tape for any error *you* may make.

25. You should be able to differentiate between what has been, what is now and what the future will be in planning a trading program.

26. Before taking a position, determine exactly where the stock you are watching, or the general market, stands. A study of price, breadth, activity, time and volume will be helpful in this respect.

27. Whatever is hard to do in the market is generally the right thing; and whatever is easy is usually the wrong thing to do.

28. Take an occasional mental inventory to find out exactly where you stand.

29. Do not press yourself! "Speculitis" is malignant!

30. When buying a stock, you should consider how far down it might carry in the event your judgment about it is wrong.

31. Try to avoid holding postmortem examinations of the

32. Buy the stocks of companies that have shown gradually increasing earnings in industries making articles that people cannot well do without.

^ *Twenty-Eight Rules from W. D. Gann*

W. D. Gann wrote a great deal about the markets. These rules were taken from his book *How to Make Profits in Commodities,* first published in 1942.* Gann had an active trading career but was not particularly successful. His work has become a lot more popular since the 1980s than when he was alive. In the book's foreword, he stated, "Trading in commodities is not a gambling business . . . but a practical, safe business when conducted on business principles." His rules are aimed at traders. I particularly like Rule 11, "Accumulate a surplus . . . ." One of the most common mistakes made by traders is not knowing when to quit. If you put some profits to one side, this guarantees that you will walk away from the table with at least something, however many mistakes you might make elsewhere.

In order to make a success trading in the commodity market, the trader must have definite rules and follow them. The rules given below are based upon my personal experience and anyone who follows them will make a success.

1. Amount of capital to use: Divide your capital into 10 equal parts and never risk more than one-tenth of your capital on any one trade.

2. Use *stop loss orders.* Always protect a trade when you make it with a *stop loss order* 1 to 3 cents, never more than 5 cents away, cotton 20 to 40, never more than 60 points away.

3. Never overtrade. This would be violating your capital rules.

•**These rules are taken from** *How to Make Profits Trading in Commodities* by W. **D. Gann, 1976, Pomeroy: Lambert-Gann Publishing Co. (Original copyright** 1942 **by Edward Lam-**

4. Never let a profit run into a loss. After you once have a profit of 3 cents or more, raise your *stop loss order* so that you will have no loss of capital. For cotton when the profits are 60 points or more place *stop* where there will be no loss.

5. Do not buck the trend. Never buy or sell if you are not sure of the trend according to your charts and rules.

6. When in doubt, get out, and don't get in when in doubt.

7. Trade only in active markets. Keep out of slow, dead ones.

8. Equal distribution of risk. Trade in 2 or 3 different commodities, if possible. Avoid tying up all your capital in any one commodity.

9. Never limit your orders or fix a buying or selling price. Trade at the market.

10. Don't close your trades without a good reason. Follow up with a stop *loss order* to protect your profits.

11. Accumulate a surplus. After you have made a series of successful trades, put some money into a surplus account to be used only in emergency or in times of panic.

12. Never buy or sell just to get a scalping profit.

13. Never average a loss. This is one of the worst mistakes a trader can make.

14. Never get out of the market just because you have lost patience or get into the market because you are anxious from waiting.

15. Avoid taking small profits and big losses.

16. Never cancel a *stop loss order* after you have placed it at the time you make a trade.

17. Avoid getting in and out of the market too often.

18. Be just as willing to sell short as you are to buy. Let your object be to keep with the trend and make money.

19. Never buy just because the price of a commodity is low or sell short just because the price is high.

20. Be careful about pyramiding at the wrong time. Wait until the commodity is very active and has crossed Resistance Levels before buying more and until it has broken out of the zone of distribution before selling more.

21. Select the commodities that show strong uptrend to pyramid on the buying side and the ones that show definite downtrend to sell short.

22. Never hedge.If you are long of one commodity and it starts to go down, do not sell another commodity short to hedge it. Get out at the market; take your loss and wait for another opportunity.

23. Never change your position in the market without a good reason. When you make a trade, let it be for some good reason or according to some definite rule; then do not get out without a definite indication of a change in trend.

24. Avoid increasing your trading after a long period of success or a period of profitable trades.

25. Don't guess when the market is top. Let the market prove it is top. Don't guess when the market is bottom. Let the market prove it is bottom. By following definite rules, you can do this.

26. Do not follow another man's advice unless you know that he knows more than you do.

27. Reduce trading after first loss; never increase.

28. Avoid getting in wrong and out wrong; getting in right and out wrong; this is making double mistakes.

When you decide to make a trade be sure that you are not violating any of these 28 rules which are vital and important to your success. When you close a trade with a loss, go over these rules and see which rule you have violated; then do not make the same mistake the second time. Experience and investigation will convince you of the value of these rules, and observation and study will lead you to a correct and practical theory for successful Trading in Commodities.

^ Rules from Frank J. Williams

Frank Williams book, originally published in 1930, contains numerous rules. One important area he seems to emphasize is sound money management through such suggestions as "Pay all bills before speculating," "The broker who demands a large margin is your friend," and "Don't take fliers." He reminds us of an important point that we all tend to forget: "The market moves up slowly, but comes down fast." It is another way of warning us to take precautions against the unexpected.*

Pay all bills before speculating.

Don't speculate with another person's money.

Don't neglect your business to speculate.

If the market makes you irritable or interferes with sleep, you are wrong.

Don't use in the market money that you need for other purposes.

Don't go "joint account" with a friend—play a lone hand.

Don't give a broker "discretionary powers." If you can't run your own account, leave the market alone.

The broker who demands a large margin is your friend. Only a bucket-shop wants you to trade on a slender margin.

Don't buy more stock than you can safely carry. Over-trading means forced selling and losses.

Get accurate information. Demand facts, not opinions.

Don't take advice from uninformed people—they know no more than you about the market.

•This excerpt is taken from // *You Must Speculate Learn the Rules* by Frank J. Williams, 1981 (second printing), Burlington, VT: Eraser Publishing Company. (First published 1930.) Reprinted with permission.

Such advice as "I think well of it" or "It is a cinch" means nothing.

Use only a part of your capital in speculation.

Don't buy "cats and dogs" (unseasoned stocks).

Buy good standard stocks that have stood the test of time.

Remember that good stocks always come back—unknown stocks may disappear.

Don't buy in a hurry—there is plenty of time to buy good stocks.

Investigate each stock thoroughly before you buy.

Remember that it is easier to buy than to sell. The **salability** of a stock is very important.

The market moves up slowly, but goes down fast.

Be prepared to buy your stock outright if necessary. **If you** can't do this, you are taking chances.

Buy in a selling market—when nobody wants stock.

Sell in a buying market—when everybody wants stock.

The market is most dangerous when it looks best; it is most inviting when it looks worst.

Don't get too active. Many trades many losses.

Long-pull trades are most profitable.

Don't try to outguess the market.

Look out for the buying fever; it is a dangerous disease.

Don't try to pick the top and the bottom of the market.

Don't dream in the stock-market; have some idea just how far your stock can go.

Remember that the majority of traders are always buying at the top and selling at the bottom.

Don't worry over the profits you might have made.

Don't spend your paper profits—they might turn into losses.

Watch the news. Remember that the market actually is a barometer of business and credit.

Don't buy fads or novelties—be sure the company you are becoming a partner in makes something everybody wants.

Don't finance new inventions unless you are wealthy.

Ask who manages the company whose stock you want to buy.

Don't follow pool operations. The pools are out to get you.

Don't listen to or give tips. Good tips are scarce and they take a long time to materialize.

Don't take flyers.

Don't treat your losses lightly; they are **serious.** You are losing actual currency.

When you win, don't get reckless; put your winnings in the bank for a while.

Don't talk about the market—you will attract too much idle gossip.

Sniff at inside information; it is usually bunk. The big people don't talk about their operations.

Don't speculate unless you have plenty of time to think about it.

Fortunes are not easily made in Wall Street. Some professionals give their lives to the market and die poor.

There is such a thing as luck, but it does not hold all the time.

Don't pyramid.

Don't average unless you are sure you know your stock.

Don't buy more stock than you can afford, just to look big. If you are a ten-share man, don't be ashamed of it.

Beware of a stock that is given an abundance of publicity.

Use your mistakes as object-lessons—the person who makes the same mistake twice deserves no sympathy.

Don't open an account at the broker's just to oblige a friend. Charity and speculation don't mix.

Remember that many people believe they can find better use for your money than you can yourself.

Leave short selling to experienced professionals.

If you must sell short, pick a widely held stock or you may get caught in a corner.

Money made easily in the market is never valued—easy come, easy go.

Don't blame the Stock Exchange for your own mistakes.

Don't shape your financial policy on what your barber advises—hundreds of experts are waiting to give you exact information.

Don't let emotion or prejudice warp your judgment. Base your operations on facts.

Ten Rules from H. J. Wolf

H. J. Wolf's two-volume book *Studies in Stock Speculation* was originally published in 1926. In the introduction to the 1966 edition Jim Fraser, the book's publisher, reminds us, "Success means adapting Wall Street knowledge to one's individual needs and emotional make-up." He was no doubt influenced in making this statement by some of Wolf's rules, which are strongly oriented to the maintenance of trading discipline through money management controls.*

1. Do Not Overtrade. Maintain a margin of not less than 10 points on stocks quoted under $50 a share, not less than 20 points on stocks quoted from $50 to $100 a share, and 20% on stocks selling above $100 a share.

2. Limit Losses. Place stops at technical danger points on all trades, and if the location of the danger point is uncertain use a 2-point or 2-point stop, or await a better opportunity.

3. Follow the Trend. Do not buck the trend, and do not hedge. Be either long or short, but not both at the same time.

4. Favor Active Issues. Do not tie up funds in obscure or inactive stocks, and avoid thin-market issues except in long-pull operations.

5. Buy during Weakness. Buy only after reactions confirming higher support.

6. Sell during Strength. Close out on unusual advances at first sign of hesitation; and sell short only after evidence of distribution with lower support followed by lower top.

7. Distribute Risk. Do not concentrate in one issue, but trade in equal lots of several different issues, aloof which are definitely attractive. Avoid spreading over too many different issues.

8. Protect Profits. Never let a 3-point profit run into a loss, and never accept a reaction of over 5 points unless the favorable trend of the stock has been definitely established.

9. Avoid Uncertainty. When the trend is in doubt, stay out. Avoid a trader's market when the ultimate trend is uncertain unless the trade can be protected by a small stop and justifies the risk.

'These rules are excerpted from *Studies in Stock Speculation, Volume II,* by H. J. Wolf, 1985, Burlington, VT: Fraser Publishing Company. (First published 1926 by Ticker Pub-

10. Discount Fundamental Outlook. Never ignore fundamental conditions, and always favor the trade wherein fundamental and technical conditions cooperate. Avoid a trade wherein fundamental and technical conditions are opposed, except in cases of imminent liquidation, or overextended short interest.

^ *Eight Rules from T. T. Hoyne*

Thomas Hoyne's book on speculation was first published in 1922. The main thrust of his rules tells us to think for ourselves, which is by no means a bad idea.*

1. Speculation is an art. The first principle of every art is to have at the outset a clear conception of the end aimed at.

2. The second great general rule for successful speculation is, Never enter upon any speculation without clearly conceiving precisely the amount of profit that is sought and exactly the amount of loss that will be submitted to in the effort to secure that profit.

3. Every speculator must think for himself.

4. A person must at all times strive to maintain the correct point of view towards the market in which he is trading. This contemplates the effect of the market on himself and other speculators; and their effect upon it.

5. A speculator should first determine never to do anything at all with a haste that precludes forethought.

6. As the first aim of every speculator should be to hold himself free from all crowd influence, he should not, because of greed, at the very outset make his speculation so large in proportion to his available capital that a comparatively small fluctuation against him puts him into a group of speculators psychologically

•This excerpt is taken from *Speculation: Its Sound Principles and Rules for Its Practice* by Thomas Temple Hoyne, 1988, Burlington, VT: Fraser Publishing Co., a division of Fraser Management Associates, Inc. (Original copyright 1922 by Thomas Temple Hoyne.) Reprinted with permission.

on the verge of fear and on the point of being swept into crowd action.

7. Never should you accept as authoritative any explanation from any other person for a past action of the market. Think out that action for yourself.

8. A speculator must think for himself, and must do his thinking rigidly in accordance with the method of reasoning he has laid down.

^ *Nineteen Rules from Victor Sperandeo*

These rules are taken from Victor Sperandeo's excellent book *Trader Vie—Methods of a Wall Street Master*.* His claim to fame is a successful trading career spanning more than 23 years. The rules are designed principally for short-term traders although many of them could be profitably adopted by people with a longer time horizon. Number 17 is unusual: "Never trade if your success depends on a good execution." This reminds us that if a trade has such a small potential, it should not be done at all. I particularly like number 19, "Know and follow the Rules." After all, what is the point of having rules if you don't use them?

Rule Number 1: Trade with a plan and stick to it.

Rule Number 2: Trade with the trend. "The trend is your friend!"

Rule Number 3: Use stop loss orders whenever practical.

Rule Number 4: When in doubt, get out!

Rule Number 5: Be patient. Never overtrade.

Rule Number 6: Let your profits run; cut your losses short.

'These rules appeared in *Trader Vie—Methods of a Wall Street Master* by Victor Sperandeo, with T. Sullivan Brown, 1991, New York: John Wiley & Sons. Reprinted with permission.

Rule Number 7: Never let a profit run into a loss. (Or always take a free position if you can.)

Rule Number 8: Buy weakness and sell strength. Be just as willing to sell as you are to buy.

Rule Number 9: Be an investor in the early stages of bull markets. Be a speculator in the latter stages of bull markets and in bear markets.

Rule Number 10: Never average a loss—don't add to a losing position.

Rule Number 11: Never buy just because the price is low. Never sell just because the price is high.

Rule Number 12: Trade only in liquid markets.

Rule Number 13: Never initiate a position in a fast market.

Rule Number 14: Don't trade on the basis of "tips." In other words, "trade with the trend, not your friend." Also, no matter how strongly you feel about a stock or other market, don't offer unsolicited tips or advice.

Rule Number 15: Always analyze your mistakes.

Rule Number 16: Beware of "Takeunders."

Rule Number 17: Never trade if your success depends on a good execution.

Rule Number 18: Always keep your own records of trades.

Rule Number 19: Know and follow the Rules!

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