THE FOUR CARDINAL PRINCIPLES OF TRADING

How the World's Top Traders Identify Trends, Cut Losses, Maximize Profits & Manage Risk

BRUCE BABCOCK

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To Larry Regg, who for many years has helped me get to the place where I could write this book

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CHAPTER 1

Introduction

Profitable commodity trading is one of the most difficult endeavors known to man. It must be, as so few are able to achieve success at it. When I first started trading over 20 years ago, there was a dearth of information about how to trade properly. There were only a few books, half a dozen advisory letters, and several chart services. Mechanical trading systems were virtually unknown. There were no personal computers.

In the last 20 years, hundreds of books have been published. Personal computers have been invented, and their cost has dropped to make them available to everyone with the capital to trade. Thousands of computer software programs have been created to assist traders. Trading systems have gone from a curiosity to commonplace. It used to be that primitive, futile trading systems were advertised and sold for thousands of dollars. If you wanted to test your own trading ideas on a computer, you had to learn how to program yourself or pay high fees for custom programming. Now traders with no programming ability can buy software for a few hundred dollars that enables them to create, test, and trade their own mechanical systems.

You would think that this avalanche of information and assistance would make it easier to trade correctly and profitably. Not so. Much of what has been published is simply wrong. It is not easy to separate the good from the bad in futures trading literature. Even well-received books by respected authors are full of useless ideas that don't work. The only way to be sure your trading ideas really make money is to conduct rigorous historical testing, preferably on a computer that doesn't make mistakes. You must also understand the testing process because even computer testing can be misleading if you don't know what you are doing.

Another substantial barrier to profitable trading is the human mind. Even when people know how to trade correctly, it is still very difficult actually to do it. Our human emotions constantly tempt us to violate the principles we know to be correct.

In an effort to achieve perfection, traders constantly strive to complicate the trading problem. Yet experience has shown this doesn't help. Simple trading approaches are invariably superior to anything you can invent using calculus and complicated equations.

In spite of outward appearances, successful trading is not intellectually difficult. One of my favorite commodity quotes is from Richard Dennis, perhaps the first really big trading success (he made hundreds of millions of dollars in the early 1980s): "Commodity trading is a lot less complicated than meets the eye."

I believe you can reduce successful trading to four key principles, which are the basis of this book:

1. Trade with the trend.
2. Cut losses short.
3. Let profits run.
4. Manage risk.

I cannot imagine any successful trading approach that does not incorporate each of these principles in some way.

While almost everyone pays lip service to these concepts, almost no one actually implements them correctly in their trading. This may be because while they know the principle, they don't know what it means. Or they may think they are applying the correctly understood principle when in reality they are not. Or they may rationalize that a particular principle is not important in their unique situation.

Another reality of trading is that there are different ways to implement the principles correctly. As Jack Schwager said in *The New Market Wizards:* "There are a million ways to make money in the markets. The irony is that they are all very difficult to find."

In an effort to help traders understand the four key principles and at the same time see different ways to implement them, I interviewed a number of trading experts I have come to know as editor and publisher of *Commodity Traders Consumer Report*. Each of them trades for his or her own account. I asked each one how important each principle was in his or her own trading and specifically how it was implemented. These interviews originally appeared in five installments in *CTCR*. I have re-edited and expanded the material for this book. I have also included here substantial parts of the interviews that for space reasons I was unable to fit in *CTCR*.

I asked each expert about the theory and practical application of the principles. Everyone seems to have his or her own interpretation of these axioms and the procedures for implementing them. The result is a broad cross-section of opinions and trading ideas that are bound to provide great food for thought in helping you create a complete trading plan for yourself.

I did not interview Courtney Smith as part of the project. However, I have included his comments on risk management in this book. They came from a separate interview I did of Courtney for a previous *CTCR* cover story.

I have presented the four key concepts in the order most people generally list and discuss them. This does not imply any hierarchy of importance. As you will see, there are differences of opinion about that as well.

Since I assume you already have a basic knowledge of commodity trading, there is no need for any further introduction. In the next chapter, we'll get right to the first cardinal principle. I start with the concept that is most basic to the trade selection process.

CHAPTER 2

Trade with the Trend

I have argued for many years that because of the nature of markets, to be successful trading commodities, you must trade with the trend. Mathematical analysis has shown that in most commodity markets price action is primarily random with a small trend component. It is the trend component that allows a trader to achieve a long-term statistical edge that translates into profits. If there were no trend component, everyone would eventually lose because the costs of trading would overcome any random short-term profits. In order to exploit the trend component, however, you must trade with the trend.

Trend is only relevant in a particular time frame. The shorter the time frame, the more difficult it is to obtain a statistical edge. This is because short-term price action is the most random and because the shorter the time frame, the greater the costs of trading become as a percentage of the return on the average trade.

I assert that those who consider themselves "countertrend" traders are really trend traders in a shorter time frame. They also tend to anticipate rather than wait for a confirmation of trend change. This is a matter of semantics rather than trading wisdom, however.

The key issues are whether you know what your trading time frame is, whether you have a specific means of identifying the trend in that time frame, and whether you apply your rules consistently. For help in considering these questions, I turn to some friends of mine, all of whom are experienced professional traders. Biographies appear in this chapter along with their comments.

RISK-SELECTED TREND TIME FRAME

Two people with whom I spoke advocated trend selection as a part of the money management process rather than just for creating entry rules: Steve Briese and Jake Bernstein.

Steve Briese

Steve, what is your concept of trading with the trend?

Trading with the trend is a truism. Nobody intentionally trades against the trend. You lose money trading against the trend. The critical factor is identifying which trend you intend to trade. You might trade the hourly or daily or weekly or a very long-term trend. Then you select your indicators based on that trend.

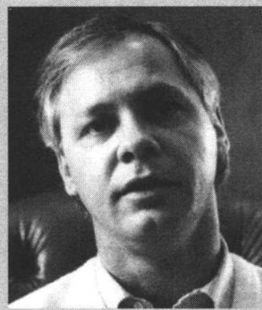
For instance, if you're trading an hourly trend, you don't take your entry points or stop-loss points from monthly charts. Determining that length of trend is inextricably tied to the other three principles: cutting losses, letting profits run, and managing risk. If you don't identify which trend you're trading, you can't accomplish any of those.

If somebody is trying to identify what trend they want to trade, how do they go about doing that?

Other than trader preference, the selection of the trend is often dictated by account size. If you begin with the idea that you want to manage risk by limiting the potential loss on any one trade to a percentage of your account size, that would affect the time frame you choose to trade. You could start looking at monthly charts and determining entry points through standard chart formations. You could decide where the stop-loss point would have to be to justify that trade based on standard chart trading techniques. Using monthly charts, you may well find the amount of loss to be too high a percentage of your account to accommodate your risk management rule. Therefore, you couldn't trade such a long-term trend. Most traders end up on daily charts as a maximum.

Each chart pattern has an objective and a stop-loss point where you know that the chart pattern has failed. That is the point at which you must exit your losing trade. You have to determine the size of the chart patterns you can

Steve Briese



Steve Briese is editor and publisher of the *Bullish Review of Commodity Futures Markets* newsletter. Published biweekly since 1988, it reports on and analyzes the data in the *CFTC Commitments of Traders Reports*.

Briese, now 46 years old, retired from his successful home construction business on his 40th birthday to pursue his futures trading interests. He trades for his own account as well as publishing his newsletter, systems, and software for traders.

In addition to writing about trading, Briese is also an accomplished computer programmer. He has been programming since the personal computer started to become popular in the early 1980s. He has created a number of unique and successful software programs for traders. He is currently working on a Windows version of *Autopilot*, a charting program. He also sells two system programs: *Cross-Current* is a currency spread trading system and *Private $tock* is for stock futures.

You can write to Steve at Bullish Review, 14600 Blaine Avenue East, Rosemount, MN 55068. Phone: (612)-423-4900. Fax (612)-423-4949.

trade based on what the projected entry and stop would be and relate that to your account size. How long a trend to trade is based on how big that loss is in relation to your account.

What you seem to be saying is you can't determine the real trend that you're trading until you see what your entry and stop are?

That's right.

If that's so, you couldn't include a trend indicator with your trade selection filters because you wouldn't know what length to use.

As a practical matter, if you're just getting started, identification of what trend you're going to trade is the first priority. You look at various methods and systems and see where typical entries, exits, and risks are.

Every system trades some sort of trend. How they enter with that trend can vary, but every system is designed to trade some sort of trend. You can see by the history of the system what the average risk is. If the risk is such that you're not risking more than 5 percent of your account (and preferably only one to 2 percent of your account), that's the length of trend you should be trading.

Do you then use some sort of trend indicator as an entry filter?

Entry into the trend is a separate matter. Let me use chart-based trading as an example since nearly everyone starts there. Assume a triangular chart pattern and that you'll be going long on an upside breakout. You can identify where your stop-loss should be. It will be the point below the triangle where you could say the triangle pattern had failed.

If that projected potential loss is too large a percentage of your account, there are only two things you can do: (1) pass the trade entirely or (2) wait for a better entry. You can't change the stop. You've already determined the stop based on where you know the trend will have turned against you. So you must adjust your entry or pass the trade.

A breakout-type entry often entails too much risk. Another method is to anticipate the breakout and enter at a price that keeps your risk to a reasonable percentage of your account. In our example you might enter while price is still within the triangle, possibly even close to the lower end of the triangle, where your risk is going to be smaller because your stop-loss is going to be closer. That's a method you can use to trade a longer-term trend than you could otherwise afford to trade.

Beginning traders who start with $5,000 or $10,000 accounts can't really afford to trade standard patterns on daily charts in the accepted manner. The solution is to find a way to anticipate, either by anticipating the pattern the chart will complete or using oscillators to buy on weakness or sell on strength.

What about using standard entries and adjusting your risk with money management stops?

That's not the best way to set a stop. You're not waiting for your trend to reverse itself before abandoning the trade. I find myself in this kind of predicament all the time because I'm not willing to risk more than $500 per contract on a trade regardless of my account size. In order to respect that limit, I set the stop point first. Then my entry point can be no more than $500 above the stop point (for longs).

I'm buying as the market is coming to me. The short-term trend has not fully established itself. I count on other factors to make that trend turn up. One of those other factors is the next longer-term trend. The longer-term trend should have an effect on a market. When the short-term trend becomes oversold, the longer-term trend will move the shorter trend back up. You can use different length oscillators to measure the longer-term trend.

Another indicator I favor is the Commitments of Traders data, which I analyze in my newsletter. In a sustained uptrend, a reaction will often run its course when prices react back to a point where commercials start aggressive accumulation. When I see this accumulation, it is a confirmation that the major trend is about to reassert itself.

When you say you look at the next longer-term trend to see if it's in line with the trade, how do you determine what the next longer-term trend is?

I go from a daily chart to a weekly chart.

How do you determine what the trend is on a weekly chart?

You can use trendlines, or the longer-term oscillators shown with the commercial weekly charts, or regression (the best-fit line). There are many methods to determine trend. You can draw a trendline under the lows or above the highs to see what direction prices are going.

If your trendline points down, you assume the trend is down and vice versa?

Yes. One tool that I use that isn't available anyplace else other than in my own charting software package is moving average trading bands. J.D. Hearst wrote a book about these back in the early 1970s called *The Profit Magic of Stock Transaction Timing*. My trading bands are similar to his except that they are fixed in height.

Jake Bernstein

Another expert who incorporates trend selection into the risk management process is Jake Bernstein.

Jake, where does trading with the trend fit into your approach?

Of all the common market principles, I put "trade with the trend" at the very top. It's a lesson I've had to learn and relearn practically every year. All traders have the tools to find trends. That's what makes it especially frustrating when we go contrary to the trend or when we try to pick tops and bottoms. I would add to the principle of determining the trend, if the trend is up, buy at support and if the trend is down, sell at resistance. If traders could do just those simple things, they would (*a*) stay out of trouble and (*b*) make money. That's the bottom line.

When you talk about trading with the trend, how do you define the trend?

The trend is relative to the trader's time frame. A five-minute uptrend in bonds may be a lifetime to a floor trader, whereas it's totally meaningless to a longer-term trader working in a bank.

You have the intraday trend, daily trend, weekly trend, monthly trend, and yearly trend. It's not possible for a trader to trade all trends or even to determine all trends at once. To attempt that would be to invite total confusion.

A trader must pick a meaningful trend length for him. Do you have any guidelines for people as to how they might do that?

That part is all psychological. Through experience or trial and error each trader has to find the time frame within which he or she is comfortable. I'm reminded of a story in *Reminiscences of a Stock Market Operator* where a man came to Jesse Livermore and told him he was long a great deal of stock and was having trouble sleeping. He asked what to do. Livermore said, "You've got to sell down to the sleeping level." Finding the right time frame for your trades is very much like that. You have to find out which time frame causes you the least anxiety. In having the least anxiety, you're going to make the fewest emotional decisions.

Jake Bernstein

Jake Bernstein is an internationally recognized futures analyst, trader, and author. He has written more than 25 books on futures trading, stock trading, trader psychology, and economic forecasting. Bernstein is publisher of the *MBH Weekly Futures Trading Letter,* which has been in continuous publication since 1972. With over 20 years of trading experience, Jake has lived through all types of markets and has tested and traded literally hundreds of trading systems. His expertise is in the area of seasonality, cycles, timing methods, trading systems, economic forecasting, and market patterns.

Jake has appeared regularly on national radio and television and has been a guest on *Wall Street Week*. His forecasts and opinions are quoted frequently in the financial press the world over. He is a much sought after speaker at financial and investment conferences.

As a former clinical psychologist, Jake has developed a keen understanding of trader behavior. He brings his understandings of human nature and trader psychology to his technical work as a market analyst and trader.

In addition to his expertise in trader psychology, Jake has pioneered numerous technical and seasonal methodologies in the futures markets, including the following: Key Date Seasonal Analysis, the Daily Sentiment Indicator, the MAC trading method, the Stochastic Pop Indicator, numerous market patterns, and a variety of short-term and intermediate-term trading systems including the Critical Time of Day system, which is a method designed exclusively for day-trading.

Among Jake's more well-known books are *The Investor's Quotient*, *Seasonal Concepts in Futures Trading*, *The New Investor's Quotient*, *Market Masters*, *Why Traders Lose—How Traders Win*, *The Handbook of Commodity Cycles, The Handbook of Economic Cycles,* and his latest, *Seasonal Trader's Bible.* He has also published a number of unique systems and software programs.

You may write Jake at MBH, P.O. Box 353, Winnetka, IL 60093. Call (708)-291-1870.