MASTERING TRADE SELECTION and MANAGEMENT

Advanced Strategies for Long-Term Profitability

JAY NORRIS WITH AL GASKILL

BESTSELLING COAUTHORS OF *MASTERING THE CURRENCY MARKET*

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ADVANCED STRATEGIES FOR LONG-TERM PROFITABILITY

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PREFACE

Our first book, *Mastering the Currency Market* (McGraw-Hill 2009), was written to provide a foundation for learning the art of discretionary trading, and it should be a prerequisite for this book. *Mastering Trade Selection and Management* focuses on helping you to collate and balance the earlier information, and to refine the trading techniques that you are likely to use for the rest of your career. Along with covering the all-important topics of trade selection and management, this book also addresses the necessity of being able to draw up a plan and stick to that plan. By helping you understand the necessity of developing your "trader's mindset," reading this book will help to protect you from your previous opinions and belief system.

The best way I know to teach someone to trade is to demonstrate to him how to trade. That's what I do three hours a day, three days a week during the London/U.S market overlap. By conducting live, interactive market exercises for my clients, pointing out trade setups and triggers in the currency markets as they are occurring during such a busy time of the day, and demonstrating how to manage these trades, I lend clients the confidence and expertise to demonstrate to themselves that they can learn to trade. That is what this book and our courses are all about: teaching you the steps and lessons it will take to prove to yourself that you can succeed in the world's most financially rewarding arena.

There is no doubt among high-level traders that you must have a subconscious belief that your trading method is going be profitable. However, no matter how much positive attitude you bring to the table, you have to have a trading method first. A trading method is a procedure that you will follow to identify first a market to trade, then the direction that the market is moving in, then a set of circumstances that lead you to focus in on a particular price level at a particular time, and finally a definite signal to initiate a position in that market. How and when you use this method to enter, manage, and exit trades will be spelled out explicitly in a document you create called a trading plan. The method you employ and your trading plan will be what many experienced traders call "your edge."

The method you choose should be robust, meaning that it needs to work in any economic environment, and it should be scalable, meaning that it will work on time frames from the shorter-term intraday on up to the monthly and weekly time frames. It needs to work in both bull and bear markets, and it needs to work in the multitude of markets that are available to investors and traders today. The method also needs to be completely independent of what you, or your friend, or your friend's broker thinks about the current or future direction of the market in question.

The method you employ needs to be able to give you the current trend for whichever slice of time you are looking at. And if by definition the method can define direction on any time frame, then it must also be able to point out at what time and at what price the direction changed. With this information, we can now measure a market's direction at any given time, particularly around those times when significant economic events are unfolding or have already taken place. This book will teach you such a method and give you the framework to measure a stock, commodity, or currency trend on a yearly, monthly, or weekly basis, or on any other time frame, in the context of the current economic environment.

Think about that for a moment. After studying the techniques taught in this book, you will be able to quantify the effects that fundamental developments such as employment, government interest-rate policy, or consumer confidence actually have on the markets you follow. You will know ahead of time what levels would need to be breached to signal a change in trend. At week's end or month's end, you can check the trends in the markets or investment vehicles you follow and know whether the current trend is holding or has changed. When the market is approaching historical support or resistance levels, such as yearly highs or lows, or long-term retracement levels, you can monitor it down to the daily or even intraday time frames to help you make decisions such as to take a portion of your position off and move your stops closer, to hedge your position with options, or to exit your position and wait for more favorable circumstances. If a sudden change occurs in the financial markets, you will have a reliable means of gauging the effects of it on any market that is of interest to you. Before any of this can happen, however, we need to demonstrate these techniques to you so that you can go on and prove to yourself how effective they are. Once you see that what we teach works, you can decide for yourself whether you want to use our methods to trade.

Doing so will entail writing out a trading plan in detail, back-testing that plan extensively, then demo trading that plan in live markets for a time that is measured not in days or weeks, but in months or even years. We know that many students will not succeed because they aren't willing to listen or write up a trading plan or patient enough to manually back-test in an organized manner by recording trades for honest evaluation. A large percentage of retail account holders fail because they don't know that they need to do all these things. However, many fail even after they know this because they won't or can't risk the resources and time required to achieve the reward, or they just aren't suited to an endeavor in which the outcome of each individual trade is unknown 100 percent of the time. A professional already has the will to succeed before she chooses the specific goal or method. It is unlikely that anyone can teach you to have that desire.

What we give you in this book is detailed step-by-step instructions on how to select a market to trade, how to determine which direction to trade that market from, what to look for prior to trading, and when to initiate a trade. We also help prepare you for the emotional challenges you will face in trading, such as letting a profit run and not exiting a trade too early, or being fearful of taking a trade signal and losing money, or, more to the point, fear of being wrong. We will teach you how to know whether you are trading with the long-term trend or counter to it, and show you how to differentiate between a trending and a countertrending market. We will also teach you what to expect when managing a trade, and prepare you for the different market scenarios that can occur while you are in a trade. You need to know exactly what to do when a trade is going your way; what to do when it's pausing, which happens often; and what to do when it seems like it's failing.

Before you move forward on your own journey, though, it's important that you absorb this book. Then move forward at a relaxed, sure pace, and use the tools and tactics we'll be teaching you as they were meant to be used. You should be in no hurry; rather, you should be comfortable in knowing that this is your journey and you can move forward at a pace that suits you. And most important, realize that the only person who can get in the way of your success is you. There is no doubt about it: trading is well over 90 percent mental, which is why we must address your own thought process and belief system before we get into methodology.

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PART ONE

Market Analysis

Chapter 1

BEFORE YOU TRADE

Most new traders realize after only a few live trades that they are terrified of the markets, and this fear is a major reason why so many traders fail.

Fear and Trading

Most people aren't able to execute under the pressure that their fear creates. I've had plenty of clients admit that putting on a live trade, particularly after a losing trade—or worse, a string of losers—is one of the hardest things they've ever had to do. Is it the money that causes them so much fear? To a degree yes, particularly if they are under-capitalized to begin with, but plenty of traders tell of being just as fearful while trading micro contracts, or even when executing trades in a demo account. So it's not just the money that brings out such strong emotions. What about fear of failure? We're probably getting warmer. Failing at a vocation is a fearful thought. However, we feel that it is actually thoughts about your future that cause so much emotion.

The idea of a future life in which your computer has become your personal cash station, which is essentially what will happen if you master the art of discretionary trading, is truly the equivalent of heaven on earth for most of us. Can you imagine not having to worry about money? Imagine being in a position to help out your family, your friends, or any charity that you thought worthy. That would certainly be a good position to be in! Your life would be like one of those car commercials around the holidays where your loved ones look out the window and there is a brand-new luxury SUV parked at the perfect angle in your marble-lined driveway with a big red bow on top.

That's what you want. That's what you've been dreaming about since fourth grade, when you first found out that your parents had to work all day to get paid money to buy you shoes, put gas in the car, and save money for your tuition. And now you've found a way to get beyond all the work and worry. Now you can pay for your family to come along on your Hawaiian vacation in January. Whether you know it or not, this is how your subconscious thoughts work. Moments after you find out how trading works and how you have control over every decision and can make unlimited amounts of money, you start dreaming the near-impossible dream. But it's no longer impossible to you. There are people who do it—granted not many, but you realize that it is possible.

From that moment on, you start mentally blocking out anything that could possibly get in the way of your achieving that dream of total freedom. And that's when, rather than coming up with a sound plan to achieve such a lofty goal, you start taking wrong turns. Rather than addressing the roadblocks along the way—inexperienced mindset, improper method, no back-testing information, no trading plan, overpaying for educational services and transaction costs, and so on—you pretend that they are not there, because too often the people you go to for help in achieving this fantastic dream of total freedom are the same people who make a living from cashing checks written by you and people like you. It's human nature to agree with someone who is telling you what you want to hear, and it's not an easy thing for the average person to back up and change course once he's made even a modest investment of either time or money.

Usually it's right about the time that you actually start trading live that you start to realize that you are a long way from that dream of the holiday

Lexus in the driveway and the Hawaiian vacation, and, worse yet, you are out a bit of time and money. That cash station that you thought your computer was to become is more like a Pandora's box, with e-mails coming from this training service and that signal service about every 12 minutes. You realize that the trading course you bought didn't come with a phone number that you could call when you have questions, and your e-mail questions keep coming back with another sales pitch to upgrade to the next-level course for only $5,995.00. Are you scared? Terrified is more like it because instead of making incremental headway toward a lofty goal, you're starting to realize that you're in a position where common sense (and your spouse) is telling you to stop throwing good money after bad and accept your place in life, which is where you were before you cooked up this dream of being a trader. You now have three choices: stay scared, be depressed, or keep going down the dark, narrow tunnel you find yourself in.

Do you still want to be a trader?

If the answer is still yes, you'd better get on the right path, which means a lot of manual back-testing and then demo trading with different methods until you settle on the right method and finalize your trading plan. And while this is a good road to be on, you're still going to face mental hurdles that may be based on conditions you probably are not aware of.

Your Belief System and the Markets

"No talking politics at the dinner table" is something that many of us heard often while we were growing up. It was sound advice because it's healthier to ingest a meal in a calm, relaxed state than it is to do so while trying to fortify a political opinion or defend against someone else's. A similar statement would be appropriate for trading: "No thinking about politics when investing or trading." This is sage advice because what you happen to believe can cost you a lot of money in the marketplace. Many of you are going to have to learn to ignore your opinions if you are going to make money as a trader. While this may sound simple, it is not. Whether you realize it or not, you have an internal belief system that started developing when you were just a toddler and has been reinforced at every major event in your life.

It sounds so simple to say, "Lose your opinion, not your money," but it is not easy to do. Just ask any investor or trader who failed to act on buy signals in the U.S. stock market in the late winter of 2009 because from a political or economic standpoint, she didn't have confidence in the then-new U.S. president's administration and policies. Imagine being a professional money manager and having to explain to investors that your "opinion" kept you on the sidelines while the S&P 500 ripped off a 50 percent rally from the March 2009 low through year-end. Or worse, you tried to trade counter to the monthly trend and went short stocks or the carry trade in mid-2009, and you didn't heed the "buy" signals quickly enough when the market turned higher in mid-July of that year. Either way, if you were a professional, you would probably be out of a job.

What historical price behavior has always highlighted is the importance of using trading methods that remove the liability of your opinion. You need to understand that it would be extremely difficult, if not impossible, to keep track of every current or future event or organization that can affect a market. This is why you need an edge, or a method, that you can count on to identify the market's direction following influential events, or at the end of the day, week, or month. The trading techniques we cover in this book will provide that, and they are straightforward and simple to grasp. But we know that many traders will complicate them unnecessarily by judging them in the context of their own belief system regarding the current economy or political environment.

Another way of saying this is to say that certain readers will be looking for the tools of technical analysis to confirm their own fundamental outlook, or vice versa. Most of the time this will not work, because your own outlook—that is, your opinion—will generally shade your analysis, causing you to overlook what the chart is telling you. Nor does that approach dovetail well with Baron Rothschild's classic market advice: "Buy when there's blood in the streets," which proved apropos in 2009 and means that when you absolutely feel like the market is going to zero and you can't imagine that it can ever recover, do the hardest thing imaginable and take the next buy signal, even when your mind is screaming "Sell!" We prefer to leave it at: trade when structure—that is, support and resistance—complements price pattern. The buy signal in Exhibit 1-1 following the 2009 low in the Dow Jones Industrial Average validates this statement.

The monthly chart in Exhibit 1-1 is as black and white as it gets. The only information on the chart, other than the dates, is derived from price. The monthly open, high, low, and closing prices are the only input we have, yet look at how effectively this information can be used. The 2002

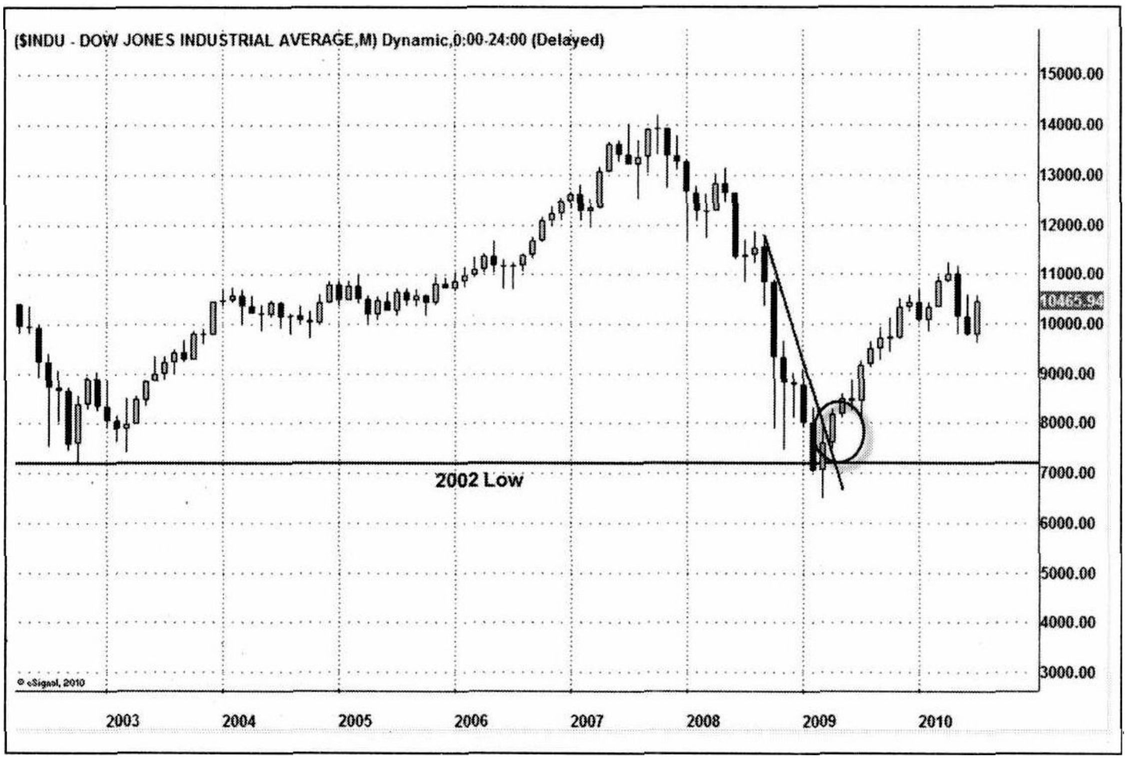

Exhibit 1-1
Source: www.esignal.com.

low is marked as potential support, and a trendline is drawn connecting the monthly highs in the second half of 2008 during an accelerated down move. Once price closes above structure—both the 2002 low and that trendline—it indicates a potential change in the price pattern, and a buy signal is given. Despite everything that was going on in the global economy, debt markets, and various governments around the world, all you really would have had to do was buy based on the knowledge that previous trendline penetrations of similar duration had, more often than not, led to sizable price moves.

This would have by no means ensured that price would move higher, because the only guarantee in trading is that the outcome of every trade is uncertain. That truism should not be discouraging, though, because the current direction of a market is definitely measurable on any time frame. While we may not know what the future holds, we do know what direction a market is moving in right now. But before we can show you that, we have to make sure that you're prepared to recognize that whatever you see will be through the lenses of your existing belief system.

We worked with a trader in 2005, and despite his having a sound understanding that oil inventories were decreasing while demand was increasing, he just couldn't bring himself to get long. Every time we showed him a buy trigger following a correction, he had a reason not to take the trade. One afternoon we were discussing the situation with the nation's strategic oil reserve, and out of the blue he started cursing the U.S. president for not releasing the reserves to try to keep down prices. "It's the right thing to do," he kept saying. I reminded him that even if that were to happen, it might have only a very short-term effect because of the substantial demand for oil from the U.S. military alone at that time, not to mention the Chinese demand. This really set him off, and as he cursed on, it suddenly hit us why he couldn't bring himself to get long oil in one of the biggest commodity bull markets of our lives.

His belief system was opposed to what was happening in the current economic environment for this commodity. Even though he had been in the energy business for many years and understood that reserves were questionable while demand was not, he was politically opposed to the prolonged war in Iraq. The fact that the U.S. president at the time was a former oilman himself only exacerbated his anger. He couldn't separate his goals as a trader from his subconscious perception (belief) that by profiting from rising oil prices, he would somehow be "a part of the problem." The moral of that story is that from a trader's perspective, "ours not to reason why."

Another example of traders getting attached to their beliefs, along with a particular market outcome, and not seeing the writing on the wall, this time on a larger scale, is what happened to so many of the "bond-market vigilantes" of the 1990s. In Chicago and New York, many proprietary trading shops that specialized in training young traders to take advantage of price movement in the U.S. Treasuries and related markets sprang up around the exchanges. Because of economic uncertainty and fear of inflation, the Treasury bond and note markets were susceptible to sell-offs that created interest-rate spikes, which were often heightened by the trading activity of these "prop" traders, who became known as "bond-market vigilantes". They called themselves this because they saw themselves as helping to establish the "true" interest rates, despite what Washington politicians said interest rates should be.

These bond-market sell-offs created volatility, which was good for the prop traders who worked on the "screen" and, like all traders, relied on market movement. It was also a boon for the futures and options traders on the floors. No one in the Treasury trading industry was complaining about the higher interest rates this collective trading activity was causing, although they created problems for the rest of the economy. However, Robert Rubin, the incoming Treasury secretary and an astute Wall Street trader himself, did notice and specifically targeted higher interest rates and the bond-market vigilantes. It did not take long for Rubin's and