CHAPTER 11

The Trading Plan and Game Plan

If you wake up in the morning, grab some coffee, and wait for the market to open to start figuring out what to do, you won't get very far. A good trader will have done his homework and will be prepared for what the market has to offer before it opens. His trades won't be made randomly; instead, they will be part of a trading strategy and will abide to some risk parameters. He will be ready because he will have made a trading plan that includes these things. He also will have made a game plan for the day so that no matter what the market throws at him, he will know how to react.

WHAT IS A TRADING PLAN?

A trading plan is a guideline that a trader uses to concentrate on consistently making good trading decisions. It consists of two parts: First, it's a trading system or trading methodology that generates buy and sell signals; second, it contains money management parameters. Within those categories there are entering a trade, exiting a trade, stop placement, position sizing, and general risk levels. It also includes what markets will be traded and takes into account a trader's emotional makeup and trading style. It also should include a frequently forgotten part of trading: how a trader will review his performance. You can't improve unless you learn from mistakes, and so reviewing is important. Individually, these are all important aspects of trading, but when one combines them all successfully, one is ready to be a winner.

A trading plan is something that needs to be custom-built, as each trader has a different trading and risk style. If a trading plan

doesn't fit one's trading style and thoughts, it will be hard follow it. A good plan will help a trader focus on his strengths while letting him avoid conditions that are unfavorable. A trading plan won't change much from day to day, as it consists of a trader's systems and money management plans. What will change, however, is a trader's game plan, which he should make every day so that he can be prepared to take advantage of the market. This may include moving stops, knowing what to do after an unemployment number is released, and waiting for a market to reach a trendline before getting in.

A trading plan is a trader's business plan. Just as almost every successful business has a business plan, a trader should have a trading plan. The best way to picture what goes into a trading plan is to think of it as if you were trying to persuade someone to give you money to trade with. When a commodity trading adviser (CTA) makes a disclosure document, he is in effect making an elaborate trading plan, as everything that should be in a trading plan is in the disclosure document.

MAKING A TRADING PLAN

Making a trading plan can be time-consuming and difficult. Since some people need immediate gratification, they would rather trade than write a trading plan, and so they ignore it. This is a mistake because without one they have no guidance. Having a plan on paper will help you establish and keep to concrete rules while helping you avoid emotional decisions made when the market is heated up or you are losing.

A trading plan doesn't have to be written on paper, but it does help to write one out and periodically review it. If you don't have one written out, I strongly recommend doing so. Even a simple plan is better than no plan. At the very least you should know how much to risk per trade and what market scenarios to trade. A trading plan could be as simple as the following:

> Buy one contract whenever the market gaps lower at the open and is in the top half of its range after 30 minutes; exit if the market breaks the low of the day, or at the close.

Though simple, this is a trading plan: It includes a trading strategy, a money management parameter, and position size. A trader can follow this every day and not have to think very hard about what he is doing. But for a more elaborate and professional-looking trading plan you should go back to the idea of trying to persuade someone to give you money. People who would give you money to trade with want to have a concrete idea of the following things:

- How you will trade
- What type of system you will use
- Which markets you will trade
- How much you will risk
- How much you can lose
- What you can reasonably expect to make
- How much the trading costs are
- The possibility of unexpected variables
- How you will prevent yourself from losing all the money
- How much you will risk at once
- How many markets you will trade
- What your hold time will be

Just think how much better your trading would be if you knew all this in advance. If one follows a plan, trading decisions are made during nonmarket hours, clearing the market hours to time entry and exit points and adjust risk. Taking the time to make a good trading plan will make trading easier.

WHY HAVE A PLAN?

The two main reasons for having a trading plan and a game plan are to ensure that you make high probability trades all the time and to make sure that you know what you are risking before making a trade. The trading plan will include trading strategies that you should have tested to ensure that they are high probability ones with a positive expectancy. Without a plan, one could go long one day and short the next, yet the market may be doing the same thing. By having a plan that generates trading ideas you will have a real reason to be in a trade and will reduce the possibility of making emotional and spur-of-the-moment decisions. Emotional trading decisions are rarely any good. By making your trading decisions during nonmarket hours and not during the ups and

downs of the trading day, you will increase your chances of success. Without the help of a trading plan, it's too easy to get sloppy, chase the market, and not have any idea when to get out. A plan also will keep you from overtrading. By not sticking to a plan, it becomes easy to fall into the trap of overtrading or making bad trading decisions when one is losing in hopes of recouping losses. A trading plan will keep you focused throughout the day, as you will never have to go searching for ideas. Finally, with a plan you will know how much to risk and when you should take a loss. You'll know your maximum loss in advance, and so it shouldn't affect your trading if the worst case happens.

TRADING PLAN INGREDIENTS

Trading Methodology or System

The first thing you may want to include is a trading system you will use to trade with. A trading system stripped to its bare essentials is a set of rules and conditions that will get you in and out of the market. The next two chapters discuss how to make and back-test a system. A trader need not have just one system; he can have different trading systems for different markets or conditions. Systems do not have to be mechanical, but they should lay the groundwork for when you should be long or short. Pick the trading style and indicators that best suit you and start tossing out ideas until you find something that works.

Test your systems against historical data. If they didn't work in the past, odds are they won't work tomorrow. Or you can learn the hard way: by losing money in the market. More important than getting you into a trade, a system will have rules for getting you out of the market. Don't ignore the exit; it really is the difference between a winning trade and a losing trade. A good system will have options for getting you out of winning, losing, and breakeven trades. Before entering the trade make sure you know where or why you would get out. The nice thing about having a predetermined set of exit rules is that once in a trade, a trader can relax a bit; he doesn't need to micromanage and worry about every tick in the market. By having a system you will know how and what you will trade every day, and nothing should come as a surprise; if a certain condition is met, you know you will be in the market. Unless these conditions or criteria are in the market you shouldn't do anything.

Again, this doesn't have to be a formal, computerized, mechanical system; it can be any trading idea that you use, but it should be the same all the time. It could be as simple as the following:

> Buy whenever the market gaps lower at the open and is in the top half of its range after 30 minutes, exit on a stop if the market breaks the low of the day, exit with a profit if the market has traveled 80 percent of its average true range, or exit at the close of the day.

You can have a dozen systems like this that you use. The important thing is that they are in your trading plan and work.

Money Management

Though having some sort of trading system is important, the foundation of all trading plans should be a money management plan, as I'll discuss in Chaps. 16 and 17. Without one, regardless of how good a market technician one is, the odds of becoming a losing trader are high. A trader needs to know how to use his capital, how much he can risk, how many contracts or shares to trade, when to increase position size, and which stocks or markets he can afford to trade. A money management plan also will tell you how many markets you can trade at once and how much you should risk in each one.

When making a money management plan, take your time and concentrate on detail. Be specific about what percentage of capital to allocate and how many contracts to trade in each market or market group. Knowing how to use the proper position size is a large part of money management and is important in determining how well you will do. If you trade more than you can afford to lose, you can easily get into trouble, and so that is something you need to watch.

Having a money management plan is something that should be done before starting to trade. Unless the risks are understood beforehand, one is looking for trouble. Many traders lose because they don't have enough money to trade the way they want to and end up overexposing themselves without realizing that they are doing it. By making a money management plan you will know how much you can afford to risk at any given time and how much you can afford to lose. You also should be able to prevent yourself from losing all your money if you calculate the risks beforehand.

What Markets Will Be Traded

Some traders may have a good trading strategy but don't know which markets or stocks to trade. Markets move differently from each other: Some trend more often, while others are choppy. Some are more volatile and have wider ranges, making them more suitable but dangerous for day traders. Some markets are too illiquid and should be avoided. Part of your trading plan will be to pick a core of stocks or commodities you want to trade. For some it's as easy as trading just crude oil; for others it may be trading only semiconductor stocks, while for still others it may be trading every stock that has more than a $2 average true range and over a million shares a day traded. Whatever you plan on trading, know it in advance so that during market hours you can focus on those markets and not have to worry about finding markets. You should also make sure your system backtested well on these markets. I trade a few sectors, and then within those sectors I look at about 5 to 10 stocks. I pretty much trade the same stocks every day. The only exception is that I will look at a stock that is in the news to see if it is worth trading. As far as futures go, these days I look only at bonds, crude, and the stock indices.

Hold Times

As part of your trading plan you will determine what your main trading time frame and average hold time will be. The main time frame will be the one you feel most comfortable trading from. Hold times normally depend on the time frame in which you are trading. If you are Warren Buffett, you may want to hold a good position for 20 years; if you are a scalper, you may hold good winners for 6 to 10 ticks. Everything in between can fit someone's trading style. If you feel comfortable with 60-minute charts, you may have a hold time of 3 to 5 days and may want to limit losses to 1 day. If you use a 5-minute time frame, you can have hold times of 45 to 90 minutes while exiting losers after 30 minutes. These times aren't written in stone; they are just guidelines for what works best with your trading style. Trades should be gotten out of when they merit it, but at least you'll have a reference point. I know that my typical good day trades last about 90 minutes to 2 hours, and for my longer-term trades I'll hold for about 3 to 5 days. I may hold trades longer or shorter, but this is about the average.

The Risk Factors

As with everything in life, you should always be prepared for the worst that can happen. As part of a trading plan try to think of everything that could go wrong with your trading whether you can control it or not. At least by knowing the risk factors involved you can be prepared to do something about them. If you haven't thought them through, you will not know what to do if they arrive. You can have everything planned nice and perfect, and then a terrorist attack changes the market's dynamics. There is little you can do about it; just know that anything can happen in trading.

Some Unexpected Things That Can Happen

You can lose your money if you trade; don't even think about trading if you aren't prepared to lose.
You have a system that works great in trending markets, but then you can't find a trending market.
The Fed unexpectedly cuts interest rates.
The market gaps below your stop.
The markets experience extreme volatility, and the risks triple.
The market locks limit, and you can't exit for 3 days, costing you $3000 more per contract than expected.
Your commission costs become astronomical.
Your computer system crashes right after you put on 20 long positions, and then the market crashes.
A rat bites through a cable on the exchange, shutting down trading.
A stock gets halted for 2 days when you have a position in it.
The seventh largest company in America goes bankrupt.
You become emotionally upset about personal issues and lose focus on trading.

By the way every one of these things has happened to me over the years.

Costs

When you make a trading plan, you have to consider the cost of trading. In Chap. 13 on backtesting systems, I'll discuss just how

much of an effect trading costs can have on a trader's bottom line. For now you should know that costs should not be ignored. As part of your plan, make sure you can reduce costs as much as possible. The most commonly thought of cost is commissions, but don't forget slippage and all the little trading fees that can add up. One also should take into consideration how much money will be spent on other trading-related expenses, such as live quotes and software. How do you plan to pay for these things? Through your trading account, or will you have money set aside for this?

Reviewing the Trades and Your Performance

Have a place in your plan for how and when you will review your trades and performance. It doesn't need to be a written journal (though this is recommended), but you should have a method of monitoring positions as well as going over trades to figure out what you did right or wrong. Start with open positions, keeping the focus on whether a trade is still within the parameters in which it originally was made. If it is not or if the reasons the trade was made have changed, you may have to watch the position more closely or get out. How often you will review trades depends on the time frame in which you trade. A long-term trader may need to look only once a day, while a scalper has to do it nonstop.

Some Things That Should Be Reviewed All the Time

Has it reached the target area?
Is it close to the target area and thus should be watched more closely?
Should you add to it or cut back?
Is it not working as planned?
Is your money better spent elsewhere?
Should a trade be closed now or held longer?
Is it approaching a stop level?
Did you ignore stop levels?
Has volatility changed?

After you have reviewed the open trades, go over your losers. I like to review losing trades that I exited correctly with a small loss. To me these are the most important trades of all, and this is a behavior I want to reinforce. I am more proud of getting out of something with a small loss that could have turned out to be worse than I am about having a winning trade. I consider these to be good trades because I did the right thing. I'll remember what I saw to make me get out quickly, and if I see that setup again, I hope to act correctly again. Having had a propensity for letting losers get too big, I like to see that I'm improving in this area. If I let a trade get really bad, I try to see why I did it so that I don't do it again. The next trades I'll review are the ones that I let get away or just acted stupidly on regardless of whether I made money. I'll try not to repeat the same mistake in the future (easier written than done). The last thing I review is my winning trades and again try to learn from them. This doesn't take long to do—just a few minutes after the close—and it is worth much more than the effort one puts into it. Those who never review their trades never learn what they do right and wrong. Don't just review the trades but constantly check the plan for validity. You may be losing money, and the reason may be that your plan is faulty.

THE GAME PLAN

After coming up with a trading plan, a trader should devise a game plan to use on a daily basis. The game plan includes the day-to-day decisions one makes when trading and is what a trader uses to execute the trading plan. The difference between a game plan and a trading plan is that a trading plan may be to buy two contracts when a market is within half a point of a trendline and risk half a point on the other side of it if it breaks through. The game plan will be to identify which markets meet the criteria each day and then how you would time entry into the trades.

Trading decisions are best done during nonmarket hours, and this gives the trader something to work with when the market opens. I go home every night and review the market. I make a list of which stocks I want to buy and which ones I want to short. I look for areas such as support and breakout levels where I want to be involved, and I also know where I'd be out. The next day, when I'm trading, I already have a list of what I want to trade and at what levels; this is my game plan for the day. My trading plan still tells me how much I can risk and what technical indicators I will use to confirm these trades, but on a day-to-day basis I use a game plan. I reevaluate the game plan at lunchtime and make adjustments to

it if the market has changed. I try to identify new opportunities to trade in the afternoon and reevaluate my risk levels and stops on open positions.

Lately, part of my game plan has been to buy oil driller stocks at 10 a.m. and then technology stocks at lunchtime, holding them for about 90 minutes each. If it's not working after 30 minutes, I get out. It has been a steady pattern that occurs more days than not, and until it stops working I'll keep it in my game plan.

A game plan helps you stay focused. Without a game plan one can be compelled to trade on whims, out of boredom, because of a news event, to recoup losses, or because some other trader liked a trade. These types of trades are the result of not having or not following a game plan. With a game plan one will have different strategies for different scenarios and will know how to react regardless of what the market does. If something happens, one will be prepared for it, making only anticipated trades instead of trades made for the excitement. Of course there are times when I'll look at the market in hindsight and wish I had been in the move I just missed. But unless the trade is part of my plan, I try to restrain myself and wait for what I find to be better trading opportunities. So what if you miss a few trades? There will be many more trading opportunities, and so it's okay to miss some.

DISCIPLINE

Though not part of the trading plan, discipline is the glue that makes it all come together; a trader needs discipline to stick to his plan. Once you start deviating from a plan, it's easy to start losing and making emotional trading decisions. You start trading markets you shouldn't, you overtrade, and you risk too much, hold too long, and overall make low probability trades.

It is easy to lose discipline on a winning or a losing streak. You should never allow losses to change your trading plan. If you've had a few losses, continue following your plan. Don't change your trading style and become more aggressive or stubborn. A loss is a cost of doing business; ignore it and move on to the next opportunity. The worst thing one can do is to start trading more heavily to make back losses. If you are losing continuously, stop trading until you've examined your trading plan, as it may be the cause. However, don't lose discipline and ignore your trading plan after a winning streak. Many traders get too cocky after a good streak and, thinking they are invincible, make careless trades with too much size. If you have been trading well, it might be the plan that got you there; don't ignore it.

BECOMING A BETTER TRADER

Becoming a better trader involves making a trading plan and having a game plan to trade with. You shouldn't trade without some sort of overall plan that encompasses both risk and strategy. Besides the trading plan, have a game plan for each day that will help you focus on high probability trades. Don't leave home without it, or your trading may be a bit random. A trader should know what he will do every day before the market opens. Whether it goes up or down, he should know what he wants to do. By having a plan that includes a backtested trading system, you will be able to make the same trades over and over without thinking very hard about what to do. If your strategy worked when backtested, there is a good chance it will work in the future. By following the same strategy in the future you can make money consistently.

Becoming a better trader involves having a solid money management plan and risk parameters that will tell you how much to risk. Unless you know what you can afford to risk, it is easy to go bust with only a few bad trades. You need to know how much you can risk, how many contracts or shares to trade, when to increase position size, and what you can afford to trade. This is not something that should be done during market hours. It should be done well in advance, preferably before your next trade if you haven't made a plan already. Don't just think about it; sit down and write it out on paper. Having the discipline to write and follow a trading plan will without a doubt help you. A perfect trading plan is one that you can give to someone and that person will understand exactly how you want to trade.

The other thing I want to mention is that to become a better trader you need to review your trading results on a regular basis. As part of your trading plan you should make a habit of reviewing your trades and trading plan. Review and monitor first your open trades and then your closed trades. Learning from the past is the best way to improve, so don't forget to do it. You should not ignore the plan itself: Keep reviewing it every now and then for weaknesses or ways to improve it. A trading plan is a valuable asset to a trader, so make sure you have one.

Problems Caused by Not Having a Trading/Game Plan

1. Trading off the cuff
2. Straying from good trading strategies
3. Never knowing how much to risk
4. Not knowing which markets to trade
5. Not knowing how many contracts to trade
6. Overtrading
7. Blowing out
8. Being unprepared for what the market has to offer
9. Not knowing where you will exit a trade
10. Not having anything to rate your performance with

Using a Trading and a Game Plan to Your Advantage

1. A trading plan should be treated like a business plan.
2. Together they tie all aspects of trading together.
3. They should fit a trader's style of trading.
4. They keep you focused on proven trading strategies.
5. They let you be prepared.
6. They give you a reason for every trade.
7. They help you keep to a money management plan.
8. They let you relax a little.
9. You'll know the most you can lose.
10. A game plan lets you make well thought out trades.
11. You have pre-established exit points.
12. You will learn to review your trading.
13. They help you avoid emotional decisions.
14. They let you know what markets to trade.
15. You should be disciplined about following them.

Helpful Questions to Ask Yourself

Do I have a trading plan?
Do I have a game plan?

Do I have a trading strategy?
Do I have a money management plan?
Do I stray from my plans too easily?
Am I disciplined?
Do I review my trades?
When was the last time I evaluated my trading plan?