The Definitive Guide to Mastering the Psychology of Trading

How to use a comprehensive understanding of price movement to transcend the mental obstacles that prevent you from achieving consistent results

Mark Douglas

Award-winning author of "Trading in the Zone™"

Introduction by Paula T. Webb

Author of "Simple Wisdom for Prosperous Trading"

This book is dedicated to every person who wants to be a successful trader.

In this book, I have given you my lifetime of knowledge, expertise, and trading experience to help you do just that.

Choose to step into your higher self – and you will achieve your greatest trading goals.

Table of Contents

Introduction by Paula T. Webb *8*

Chapter One

To Produce Consistent Results, You Need to Learn to Think like a Pro
14

CHAPTER TWO

The Psychological Complexities of Trading 25

CHAPTER THREE

Analysis is Not the Key to Achieving Consistent Results
34

CHAPTER FOUR

The Mechanics of Price Movement – It's All About Order Flow
47

CHAPTER FIVE

The Anatomy of a Trade
63

CHAPTER SIX

The Various Sources of a Buy/Sell Order Flow Imbalance
75

CHAPTER SEVEN

Understanding Technical Analysis from a Buy/Sell Order Flow Perspective
88

CHAPTER EIGHT

The Inherent Limitations of Technical Analysis
95

Chapter Nine

Understanding the Illusion of Analysis
113

Chapter Ten

Why It's So Dysfunctional to use Analysis to Assure ourselves of Winning and Avoiding Losing 123

Chapter Eleven

In The Trading World Mental Perspectives are Considered Primary Skills
139

Chapter Twelve

Building a Mental Foundation to Produce Consistent Results
156

Chapter Thirteen

The Slot Machine Perspective
165

Chapter Fourteen

Are Traders Who Use Analysis to Speculate on Price Movement Gambling?
181

Chapter Fifteen

Review
186

Chapter Sixteen

Installing a Probabilistic Mindset
191

Chapter Seventeen

Mechanical Trading
222

Chapter Eighteen

Subjective Trading
235

Chapter Nineteen

Intuitive Trading
252

Chapter Twenty

The Importance of Keeping a Trading Journal
by Paula T. Webb
266

Introduction

Hello, my name is Paula T. Webb, and I am very honored to say that I am Mark Douglas' wife.

Mark and I were partners, husband and wife, and best friends for over 30 years. During that lifetime together, we shared every aspect of his work, as well as my own, each and every working day. He was just as an integral part of my books and coaching, as I was with his. For many of you out there in the trading community, this may come as a surprise because most of you have never heard of me. That was our intent – as both Mark and I are private people; but more importantly, even though our work is related in many ways, we each had our own perspective and coaching approach for traders.

With that said, let us take a moment here to reflect on the career of such a great man and this book. Yes Mark was, and is great – and one of the few people in the industry that gave from his heart as well as his mind. He was always there to listen to any trader's challenges, and many times did not charge those who called our office – even though he may have spent quite a bit of time on the telephone with them. Mark believed in the inherent goodness of everyone; sometimes to a fault – but that is what made him who he was. A man who lived and worked completely with integrity; a man who followed his own path to the best of his ability, and by living that, was an example for all those who knew him, or of his work.

Mark was not one to brag about his unique abilities. That was and is my job, and has been from the first weeks we starting working together. We met in the Fall of 1984 when I began working for him part-time as a typist. His regular secretary had taken a vacation to go to, as they used to call it years ago, a "fat farm" to lose weight, and Mark had an upcoming presentation due in a few days and needed his hand-written notes on legal pads typed up for that conference. I arrived at his office at the request of his business partner at the time who was a fellow trader, around 3:30 p.m., was introduced to Mark and began typing that very afternoon. We worked until midnight that first night, and the rest is, as they say, history. I was so impressed by Mark's specialness, his thought processes and how he put ideas and concepts together in ways that appeared so easy (but were in actuality extremely difficult for him to create for traders to 'easily' understand, which is why it took him years to complete his books) – and I have to say, if I am honest with myself and you readers here, I think I fell in love with him that night. I fell in love with his brilliant mind.

What was most interesting to me as well, was his perspective on trading. We came from two different worlds – at the time we met I was working on the Chicago Mercantile Exchange trading floor as a phone clerk for Shatkin Commodities, while learning how to trade the "big" boards, and he was a retail futures broker. Two different perspectives that came together that day in 1984, and began a collaboration that still continues to this day. (There are a number of joint projects that Mark and I completed that will be available in the coming months; he wanted this book to be produced first.)

Again, for those of you who do not know me, and since there seems to be some confusion as to who I am, why I am part of Mark's work, and what my professional background may be, let me fill you in so there are no more questions.

In 1980, I left college and headed to Chicago for a new job. After interviewing with a number of good companies, banks and organizations such as Oppenheimer Securities, the American Dental Association, Uptown Bank, and the great retail store Marshall Field's – I took a job as Administrative Assistant to the Vice President, Donald Nash, (retired) at the MidAmerica Commodity Exchange.

The MidAm, as it was affectionately known, was the first independent futures exchange to offer "mini" contracts, 1/5th the size, to the smaller investor. At the time, I had no idea what a "futures" contract was, having only played around picking stocks from the newspaper with my father when I was young, occasionally during the evenings as a game. Mr. Nash, who I worked for at the MidAm, was in charge of all the trading floor operations, and I learned how the exchanges worked from the ground up. I learned what a "bid & ask" meant, learned what "volume" and "open interest" was, and along the way met quite a few traders who were learning how to trade at the MidAm, and who were happy to share their knowledge of the markets with me. Richard Dennis, the infamous creator of the "Turtles" began his own career at the MidAm during the time I worked there. Of course, this was along with many other "non" famous traders that became friends of mine, who went on to continue with successful trading careers at the Chicago Board of Trade, the Options Exchange and of course the Chicago Mercantile Exchange. It was a fascinating time and job for me.

Most of these traders I knew then were young and passionate – they loved the game of trading, and I have to say, their passion was very seductive, and I knew that someday I would be a trader as well. Even when they had losing days, or weeks, there was never a thought in their minds of leaving and doing something else for a living – and that was also fascinating to me. I mean think about this – who stays at a job where they lose money? Their passion for learning, their passion for personal expression through their trading, was so captivating, that I knew this is where I wanted to be.

So I began listening to traders who had charting services, who had a "system," who had a "hunch," and even those traders who simply had no idea where the markets were headed, but stepped into the trading pit each and every day anyway. This, of course, was long before personal computers or electronic trading came into play; a lot of charting was done by hand (I can still do a 5-15-minute bar chart in my sleep, I did so many of them for the mini-Treasury Bond futures back then), and although there were computerized charting services at the time they were very expensive and mostly used only by brokerage firms; and of course any trading system that I reviewed was written out longhand.

Many of the systems that I reviewed were extremely complicated (especially those with "butterfly spreads") and really made little sense to me. I didn't understand why a system needed to be so complex – but if it worked for whoever created it, I tried it out. (I was fortunate that since most of these traders who created systems were friends, I did not have to pay for the systems I reviewed.) And within months of reviewing numerous systems, I came to the conclusion that for me, the more simple the system, the better that was for *my particular perspective*. And after feeling I had learned all I could working for the MidAm, I took the job at the CME working for Shatkin as a phone clerk to learn while watching, as they used to call them, the "big boards" and begin to learn how to trade full-size contracts.

What I found was that there wasn't much difference between the mini-contracts and the full-size contracts, (account size notwithstanding), *the game was the same*. The system that I had come up with for my own trading, worked just as well with one full-size contract, as it had with five mini-contracts. Why? Because at the time, since I was only trading part-time, and still had a job to pay my bills, I felt no pressure to do anything else but "learn."

And I did. And I had a heck of a lot of fun while doing so!

I worked on the CME trading floor for several more months after first meeting Mark, and then he asked me to start working for him full time. He had a number of conferences coming up that he had been asked to speak at, and his secretary decided to retire, and he had begun writing "The Disciplined Trader™" so thus began our collaboration at the beginning of 1985.

Over the next several years, as Mark's consulting business and writing his first book "The Disciplined Trader™" slowly began to take shape, there were times when he did not need me full-time, and so I worked for other executives such as the Senior Partner at Baker & McKenzie (the world's largest law firm), and the National Fundraiser for the Democratic Senate, but always came back to work with Mark, eventually completing that circle working for him full-time in 1991 to today. What I learned from Mark as well as those other executives was simple – to create prosperity, and sustain prosperity in any type of career – *you have to believe in yourself*. And I can categorically state that every U.S. Senator that I met and worked with, every executive that I met during those early years, every successful trader I dated or knew or met, believed he was worth every penny he made. With regard to the U.S. Senators, this is not a political statement here, just simple fact. We all know that senators take time off more than most people, and I think the average person would agree that a lot of senators do not work 40 or 60-hour weeks as many other Americans in the workplace have to do.

But, again, what I learned from these senators as well as any other executive or trader I met during those years, was that unless you believe you deserve any amount of money you want, then you will never achieve your financial goals – no matter how many, or how few, hours and/or effort you put in each day, week, or year.

Here is a good example of what I am talking about.

When I worked for the National Fundraiser for the Democratic Senate, (this was back in the late 1980s) there came a point in one annual review where I felt I had not been given the most appropriate percentage of a raise given the amount of work I felt I had done well during the past year. When I expressed this disappointment to my boss, he said to me, "When you truly believe that you are worth making $50,000.00 in salary a year, then you will get it. But right now, you don't believe you are worth it, you are just trying to convince me you are. And that doesn't work in my book."

And he was right. And from that day forward I set out on my personal path to explore what it meant to me to be prosperous and "worth" any amount of money. Today I am an award-winning author of 10+ books, creator of professional prosperity programs for educational institutions, co-owner of a publishing house, and a respected performance coach in Behavioral Finance since 1999. (See my books on Amazon.com or contact me for more information.)

The point I am getting at here is that if you do not know what you are "worth" then it won't matter what system you have, what platform you use, how good your analysis is – if you don't know who you are, what your mindset is, and what you specifically want to achieve. And one of the best ways to begin to learn just what it is you want to achieve is by reading this book, and understanding how price movement affects your perspective, and your trading – which is key to you creating and maintaining an upward equity curve with each and every trade.

One thing to keep in mind here is that *there is a live person on the other side of each and every trade you make!*

Trading is not a computer game! You will never know "who" is on the other side of your trade, or set of trades, but there is an actual live person, another trader quite possibly such as yourself, but with a different idea as to where the markets may be headed – on the other side of your trades. And by understanding what price movement is, *price movement created by another live person*; and how it correlates to the markets will assist you in knowing that this is a "live" game – this is a moving energy field – the markets are "alive" shall we say, with each and every trader's perspective giving the markets constant motion through their own unique creative expression and opinion.

This book was a labor of love for Mark – he wanted to share his expertise, rather all that he had learned during his storied career, especially for those of you new(er) to the markets, and those of you who have never had the luxury of seeing, or being on, one of the exchange trading floors. He hoped that this book would dispel many myths about trading for you – as well as propel you into a higher sense of yourself and your personal trading accomplishments.

I hope you enjoy the book as much as Mark enjoyed writing it for you. And if you have any questions, please feel free to contact me! Mark and I continue to be partners, and it was his wish for me to move forward with his materials and so I am here to assist you.

All the best in your trading,

Paula T. Webb
www.paulatwebb.com

THE DEFINITIVE GUIDE TO MASTERING THE PSYCHOLOGY OF

TRADING

Chapter One

To Produce Consistent Results, You Need to Learn to Think Like a Pro

Why would it be important to learn how to think like a professional trader? The simple answer is, if you can think like one, you can trade like one. And if you can trade like a professional, it means you have aspired to the point where you can produce a consistent income over an extended period of time.

To be more specific, I am referring to generating the kind of equity curve that rises at a nice steady angle. One that is free of inordinately large drawdowns or any drawdown that is not a normal consequence of one's trading methodology or style. And most importantly, the kind of equity curve that engenders a sense of confidence that causes one to believe that not only can I make a living as a trader speculating on price movement, but I'm also good enough to manage other people's money, if I so desire.

For those of you reading this book who have been trading for a while, what I am about to say will probably come as no surprise. On the other hand, for those who are just getting started, you may be a bit shocked to learn that out of the total population of people who actively trade, only a very small percentage of them would fall into the category of consistent winners as I described above. And when I say small, I mean very small, somewhere around three to five percent.

Now, I'm not claiming three to five percent to be a hard statistic, because it would be almost impossible to verify. But it’s also not just a random guess either. It’s an assessment based on over 30 years of experience in the business as a trader, retail commodities broker, trading coach and consultant to several of the major exchanges, banks, hedge funds and trading firms throughout the world.

More importantly however, over the years I've had the opportunity to meet and get to know the owners and management of several retail brokerage and exchange clearing firms, whose customer base would certainly be representative of the general trading population as a whole. Many of these companies contacted me to find out if there was anything that could be done to improve their customers trading results. With the idea in mind, that if they can find a way to prevent their customers from consistently losing they would experience two major benefits.

First, they wouldn't have to invest so much time and money in the infrastructure necessary to replace these customers when they tapped-out; meaning, when they lose the entire value of their account or more. Second, the longer they could keep their customers trading, the more commissions they would generate for the firm.

My ensuing conversations with these companies were usually quite candid and most revealing. There were some firms where as many as five percent of their actively trading customer base were consistent winners. Others, where virtually none of the traders were consistent and quite a few that fell in-between zero and five percent.

Now, there are a couple of things I want you to keep in mind when considering these numbers. First, companies that train and hire professional traders like banks, hedge funds and commercial hedging operations would not fall into the zero to five percent categories as I described above. It is certainly not unusual for their traders to have problems that could have an adverse impact on their results, but, over-all, if they don't generate consistent returns on their equity, they won't keep their jobs.

Second, even though the over-all percentage of consistent winners is quite low, if you consider there could be as many as one hundred million people, or more, around the world who would call themselves active traders, it would mean five million of them are achieving consistent results. Why am I pointing this out?

To offer some encouragement that in spite of the low statistic, there's a substantial number traders who are accomplishing their objective. On the other hand, if we assume that every trader at some point aspires to provide a reliable income for themselves, it would mean that the vast majority are not achieving their objective.

Why is the Percentage of Non-Consistent Traders so High?

I'm sure everyone has heard the trading adage that to be successful you have to "cut your losses and let your profits run." This is one of those gems of trading wisdom that sounds simple enough, but it's anything but simple to learn, and can be quite challenging to implement. At the most general level I would say that the reason why so few traders produce consistent results is simply because they haven't mastered the dynamics behind what it means to keep the average loss of their losing trades much smaller than the average profits of their winning trades.

The 95% of the trading population who haven't mastered this principle of success would fall into two broad categories. The first and probably the largest are what I call the boom and bust traders. For the most part, their equity curve would be characterized by erratic swings between profits and losses. It is not unusual for traders in this group to put together sustained periods of consistent success, often with several winning trades in a row. But these periods of consistency are always followed by huge or dramatic drawdowns or a substantial string of losing trades.

The good news for the boom and bust traders is they have at least part of the equation of success. Since their equity reflects sustained periods of upward movement, it does demonstrate, to some degree, an ability to accumulate profits. What they haven't learned is how to counteract all of the overt or subtle ways a person can convince themselves not to cut their losses. For example, today’s traders have access to a plethora of trading methodologies and systems that will give them the technical expertise to determine whether or not a trade is a loser. Or to put it another way, that the profit potential of the trade is so greatly diminished in relationship to cost of finding out if it’s going to work, that it’s not worth staying in any longer.

However, to make this assessment "objectively," on a consistent basis, requires learning some specialized trading skills the ‘boom and bust trader’ is either not aware of. Or if they are aware of them, they don't have a sufficient enough of an understanding to effectively implement these skills into their trading regime. Because when the boom and bust trader experiences a dramatic drawdown, they will usually find a way to blame the markets. And also quite characteristically, not take into consideration they had any number of opportunities to exit the trade for a smaller loss and for whatever reason, convinced themselves not to.

The second group, are the relatively consistent losers. If you charted their equity it would look like the reverse mirror image of the traders who are consistent winners. Unless they're at the point where they are ready to call it quits for good, the traders in this group still have the notion that trading is easy. But just can't figure out why they're having so much difficulty making it work for them. It's the occasional winning trade and near miss that gives them cause for hope that maybe they have finally turned the corner and their situation is now going to get better. Only to be followed by another disappointing string of losing trades.

Breaking Into the 5% Group

Another statistic the trading industry would rather not reveal is the substantial turn-over rate. Besides the percentage of consistent winners being so low among active traders, the vast majority of them will give up long before they experience anything close to being consistent.

Some, meaning people who are especially tenacious by nature, will hang on for years. Typically spend tens of thousands of dollars on coaches, seminars and trading systems only to find themselves floating in a sea of endless possibilities, often completely confused about what to do next, or completely immobilized even when they do know. And to make matters worse, the harder they work at it, the further behind they seem to get. As their frustration grows into complete exasperation many of them will also eventually call it quits.

What's left, are the ones who eventually do make it into the five percent category. Besides going through usually years of frustration themselves, they also have one notable distinction in common. Most of the really successful traders have had the experience of losing one or more of what they would define as a fortune before they finally broke through into what I call the "threshold of consistency."

As discouraging as all of this may sound, my purpose for saying it is not to imply that you have to go through years of frustration or lose what you define to be a fortune to finally make it in this business. Because, and I want to state this as emphatically as I can, you don't!!! And I promise you'll understand why as you read on. But at the same time, before you succumb to an overwhelming compellingness to give up a good high-paying job or successful profession to be a trader, you should know that are a lot of really intelligent, accomplished and otherwise very successful people who consistently fail at this, and moreover, probably never figure out or ever find out why.

What Exactly is the Problem?

Now, what's really interesting here is, it would be quite natural to think that people are getting frustrated and giving up because they're finding that mastering the principles of "cutting ones losses and letting their profits run" is just too challenging. And in some cases, this undoubtedly would be true. But here again the statistics defy logic. The skills required to consistently cut losses and let profits run, in and of themselves, are not that difficult to learn. And certainly not difficult enough to warrant such a high failure rate among people who are otherwise very accomplished.

The problem is not a universal inability among people who trade to learn certain skills. Rather, it’s an almost universal inability to realize that they have to be learned in the first place. There's a very perplexing psychological phenomenon at work here that I call "trading's perfect storm." Where a combination of psychological and market forces converge in a way that actually block us from perceiving the skills required and the most efficient developmental path to becoming a consistently successful trader.

I am describing this trading phenomenon as a "perfect storm" because from a psychological perspective there are some similarities to circumstances portrayed in the movie "*The Perfect Storm*" that came out in 2000 starring George Clooney and Mark Wahlberg. Comparing the two will provide some good illustrations that will help you understand what I am trying to convey about the nature of trading.

From what I recall, the movie characterizes the emotional and financial difficulties of New England commercial fishermen who are struggling to maintain some balance in their lives. The George Clooney character owns his own business, but financially he is in a desperate situation. If he and his crew don't catch a record number of fish on the next outing, he'll probably lose the boat along with the business.

They leave port for their normal fishing grounds, but after arriving things don't so well. So they decide to go another area where they know the possibilities for greater numbers of fish are very high. The problem is, this more fertile area is so far away that it will put them well past their margin of safety. They decide it’s worth the risk and go anyway.

In the meantime, there are a couple of separate storm systems developing in the adjacent areas surrounding their new location. The Coast Guard sends out warnings of the impending storm. But they had a big incentive to ignore or discount the warnings of the dangerous weather. There were so many fish; they were practically jumping the boat themselves. As the guys haul in the biggest catch of their lives, they naturally assume their financial problems are over.

Not quite, because what they didn't know is the multiple systems storms converging upon them will combine into one mega system. It would turn out to be a once in a century storm of truly phenomenal proportions. Unlike anything anyone has ever seen or heard about. The movie ends with the guys getting exactly what they were after, hundreds of thousands of dollars' worth of fish. But they also get caught in this ferocious "perfect storm" and never get home to enjoy the benefits of their efforts.

CORRELATING THE MOVIE WITH TRADING

First, the guys on the boat didn't know what they were getting into. It appeared to them as if they were in a normal storm situation. However, their circumstance was anything but normal. They didn't have a framework, or base of experience to draw upon to tell them the effect of the converging storm system would be exponentially greater than anything anyone has ever experienced or could imagine as possible. So, even though initially it seemed as if the decision to go to the alternative fishing grounds was perfect. There was no way they could have known that by doing so they sealed their fate to ultimate failure.

By the same token, most people don't have the slightest concept of the magnitude of the challenges they face when they decide they want to make a living as a trader speculating in price movement. And there really isn't any way that they could. Trading has some unusual and very perplexing characteristics that make it quite different than any other occupation most of us will ever encounter. It may appear on the surface to be normal, but this just isn't the case. The cliché that "appearances can be deceiving" applies to the point where almost nothing about trading "is" as it seems to be.

To further complicate matters, many of these differences or abnormalities are very subtle, and as a result not easily recognizable. For example, many of the principles we use and take for granted to be successful in other careers don't work in trading. At least not in the way we are accustomed to.

Principles of success, such as, analyzing a situation so that we can assure ourselves of winning, being right and eliminating the risk or putting in our time and working hard, are all tried and true ways of achieving objectives in our everyday lives. However, as strange or perplexing as this may sound, in trading all of these common principles of success can actually have an adverse effect on our ability to produce consistent results.

Since trading has this "appearance of" being relatively normal, it generally doesn't occur to us to think anything out of the ordinary is going on, or that we're contemplating stepping into an environment where very little of our current life experiences or resources will apply.

The exception would be the small percentage of people fortunate enough to start out with a genuinely good mentor or grow up in a successful trading family; where one is taught from the outset how to navigate these unusual waters.

Otherwise, the rest of us, like the guys on the boat will also find ourselves in a perfect storm situation, with one huge difference. We won't be dealing with physical forces like the wind, rain, waves, thunder and lightning that kept them from getting home with their treasure trove of fish. Rather, as trader’s, our storm is composed of forces that are all mental or psychological in nature. These forces take the form of:

- *a profound lack of understanding of the fundamental dynamics of price movement, especially among people whose only exposure to the markets has been through a computer screen;*
- *a number of dangerous misconceptions and erroneous assumptions about what works or how to be "consistently" successful;*
- *the fear of losing, being wrong, missing out and leaving money on the table;*
- *any number of self-sabotaging beliefs about how much money we deserve; and*
- *the energy behind the feeling of omnipotence as a result of flipping into a state of euphoria.*

All of the above mental forces, acting individually or in combination with one another have the potential to affect our perception of market information and our resulting behavior in ways that will:

- *prevent us being objective or trading from a care-free state of mind;*
- *make us susceptible to a number of potentially dangerous illusions about the level of risk associated with any particular individual trade; and*
- *cause us to make a plethora of common execution and money management errors, over and over again.*

Even if you're completely new to this business, I don't think it would be too difficult to see that if there are forces associated with trading that can cause us to trade with a distinct lack of objectivity, create illusions about the nature of the risk that cause us to make execution and money management errors, then the likelihood of producing a consistent, reliable income is not very good, to say the least.

Now before you start getting overwhelmed or think your dream of becoming financially independent from trading is slipping away, you need to understand that none of the forces mentioned above present us with challenges that are insurmountable. All of the potential problems implied by the effects of these forces can be dealt with quite effectively, because there are awareness, specific skills and developmental processes that will circumvent or neutralize all of them, and in some cases, quite easily.

The Real Challenge

Learning the appropriate skill sets to deal with these various psychological forces is not the major obstacle preventing us from producing a consistent income. The real challenge is coming to the realization that they have to be dealt with in the first place. In the movie, storm forces combined in a way that the guys in the boat didn't have the resources to perceive what was possible, ultimately causing their demise. But, they did, at least know they were in a storm. They just didn't know the magnitude.

Trading's storm forces converge in way that disguise their very presence. What makes trading's perfect storm "perfect" is that, it's composed of forces that have a profound negative impact on our ability to be produce a consistent income, while simultaneously making the source of that negative impact virtually imperceptible. In other words, we won't even know we're caught in a storm. Or realize the reason why we're not achieving the kind of success we desire, even though it is clearly within sight and seemingly possible, is due what I am going to call trading's "invisible barriers."

The barriers are invisible in the sense that psychological forces, in general, have an intangible quality that can make them difficult to understand and detect. They're barriers because they have the effect of blocking from our awareness the actual skills or skill-sets we need to learn to produce consistent results. In other words, if you can't properly identify the source of a problem, it’s a bit difficult to find the right solution.

What are the Invisible Barriers?

What exactly are these invisible barriers I am referring to? They're simply the assumptions we make about how to be successful in this business. People can have a number of underlying reasons for getting into trading. But, for the most part, trading’s broad and over-whelming appeal stems from the perception that it offers a great deal of potential for financial success. By pointing this out, I am not implying there is anything wrong with this perception. Quite the contrary, the potential is probably far greater than what most people even imagine it to be.

However, to realize any degree of this potential we have to make some assumptions about what works and steps we're going to take to make it work. As we know from our everyday lives, once we make an assumption, unless it’s invalidated immediately, it will stick and presumed to be the truth. Anything presumed to be the truth becomes a belief that by definition is self-evident and beyond question. Or we wouldn't have accepted it as true in the first place.

Once an assumption is accepted as true and becomes a belief, it generally doesn't occur to us to go back and question how we got it, or make an objective evaluation as to its validity. It usually takes a great deal of frustration, emotional pain and suffering for us to get to the point where we would be willing to make this kind of an assessment.

The key to achieving a consistent income is starting out with the most appropriate assumptions. It makes all the difference in the world, especially in trading. If you start out with the correct assumptions about how all of this works, you'll eliminate the potential to experience the kind of financial pain and emotional suffering that eventually plagues all but a very small percentage of people who get into this business. And this is true regardless of what you hear from other traders in chat rooms, at trading conferences or what you are lead to believe from infomercials. Trading is the kind of endeavor in which people tend to glorify their winning trades and hide the fact that they're over-all results are very erratic, or, at the very least, inconsistent. No one wants to admit they're the ones not making it, especially when it seems as if everyone else is.

On the other hand, if you're already trading and find yourself caught in a "frustration zone;" take heart, because I'm going to show you a way out. Metaphorically speaking, we're going to transform trading's "perfect storm" into a warm, comforting tropical breeze. And we're going to do it by dissecting and untangling the many erroneous assumptions, misconceptions, and dysfunctional beliefs that the very nature of this business makes so easy to acquire, and without the proper guidance at the outset, almost impossible to avoid.

By the time you are through reading this book, you will know exactly what you need to understand and what skills you'll have to develop to think like a professional trader. Remember, when you can think like a pro you will be able to trade like one. And when you can trade like one, it means you have aspired to the point where you can assure yourself of producing a reliable income.

Chapter Two

The Psychological Complexities of trading

The nature of trading presents us with learning challenges that from a psychological perspective I have characterized as a perfect storm. There are a number of complex individual psychological and market forces that converge in a way that make it almost impossible for the beginning trader to have any kind of a realistic idea of what they are getting themselves into; much less, be able to recognize what they really have to learn to be successful at it.

My objective is to help you recognize the most efficient developmental path to producing a consistent income. By efficient, I mean a path that completely avoids the kind of erroneous assumptions, misconceptions and dysfunctional beliefs that, at best, will make you a boom and bust trader, and worst case, cause you leave the business completely exasperated, wondering what went wrong.

To start the process of discovering and understanding what you "really" need to learn to trade like a pro, I am going to explain trading's many "psychological complexities" within the context of three broad categories:

- *contradictions and paradoxes in thinking,*
- *perplexing characteristics, and*

- *illusions*

When you look at the nature of trading from the perspective of its psychological complexities, you will quickly see why it can be so challenging to produce a consistent income; especially if you don't get at the essence of what the business is all about, right from the start.

Trading is the Hardest Easy Money You Will Ever Make

The first psychological complexity we are going to examine is a paradox and a contradiction in thinking all rolled into one. There's a truism about the nature of trading familiar to seasoned traders that "trading is the hardest, easy money you will ever make."

If I were just getting started as a trader and read a statement like this, the first thought that would come to mind is that it doesn't make any sense. Why would someone say trading is easy money, and then in the same sentence imply that it's difficult to make money by also saying that it's hard? The statement is an obvious contradiction that I would probably dismiss as meaningless and irrelevant, without giving it any further consideration.

Well, if you also have the same inclination to dismiss this statement as irrelevant, please don't. Because as we untangle and reconcile this paradoxical contradiction, you are going to discover that packed within its meaning is an enormous amount of insight and wisdom that gets at the very heart of what you need to understand to make it in this business.

Is Trading Really Easy Money?

Absolutely! In fact, to say that trading is easy money is a vast understatement. I don't think there is any other profession where we can make money as easily and quickly as being a trader. At its simplest level, all we need to participate is a personal computer, an internet connection, an electronic trading platform, and enough money to open a brokerage account.

Beyond that, all it takes to put on a trade is the eye/hand coordination necessary to move the cursor to the appropriate place on the screen and a simple decision to either buy or sell and then click the mouse to execute the trade. If we made the right decision, a moment or two later, we could find ourselves in a winning trade that far exceeds anything we could have imagined before we clicked the mouse.

What could be easier or simpler for that matter? To win, we don't need any physical skills to speak of. The amount of energy that gets expended to move and click the mouse is negligible. And as far as trading expertise is concerned, we don't need any particular market knowledge or even a good reason to justify the decision about whether to buy or sell. All we have to do is just – pick - point and click.

Furthermore, it isn't even necessary to experience a real winning trade to become absolutely thrilled about the possibilities. In other words, that first winning trade doesn't have to be in an actual trading account. It can be in a simulated account or we can just be watching the market move and imagine ourselves buying low and selling high, or selling high or buying low to come to the realization that trading surely has to be one of the easiest and also one of the fastest ways to make money there is. This is especially true, when you apply what I call the multiplier effect.

For example, let’s say a typical person, we'll name him Greg, experienced his very first winning trade when he bought 100 shares of WXYZ Corporation for $10.00 a share. A few minutes after his order was filled, the stock started to rally in his favor. By the end of the day WXYZ was trading at $12.00 a share. Now he has a $200.00 profit. Under normal circumstances, two hundred dollars may not be a lot of money to Greg, and wouldn't be considered significant, except for what it represents. He made an incredible 20% return on his investment in just a few hours. Twenty percent is really huge from a financial perspective; however, it has even more impact from a psychological perspective.

As Greg starts to consider the possibilities of getting a twenty percent return, or more, in less than a day, he will quite naturally start to imagine several "what if" scenarios. What if he bought a thousand, or better yet, five thousand shares? He will inevitably think that all he had to do to increase his profits from two hundred to one thousand dollars is just put another zero in the "number of shares column" of his trading platform.

Certainly adding a zero and clicking the mouse is a profoundly simple task in relationship to the dollar value and speed at which he can get paid for doing it. Bottom line, whether it's from a real or imagined experience, it's almost impossible not to conclude that since winning is so easy, making money must also be easy.

If Winning is Easy, Then Where's the Problem?

Winning is simple and easy and we produce profits from winning, so how could trading be the hardest easy money we will ever make? In other words, what's the hard part of all this? If it's genuinely simple and easy to win, then what could possibly make trading difficult?

First of all, to answer this question we have to make a distinction between "winning" and "trading." We have already established that winning requires little or no effort physical effort or any particular market knowledge. Just a simple decision, at any given moment, to either buy or sell, and the click of mouse is all that is necessary to find ourselves in a winning trade. However, if we define "trading" as the process of achieving a consistent, reliable income over-time, then what you're going to find is; winning or more specifically the ability to identify money making opportunities on a consistent basis, is only one component part of the over-all process of what it takes to make a living as a trader.

Trading with the objective of achieving consistent, reliable results over-time, is a very complex, multi-step process, requiring the mastery of several unusual, as well as, contradictory skill-sets to be successful at it.

THE GAP BETWEEN THE ABILITY TO WIN AND THE ABILITY TO MAKE A LIVING

The implications of what I am saying here is; there's a huge difference between the skills that it takes to win and the skills we have to acquire to successfully implement an organized, systematic trading approach that produces a consistent income. Because unlike the ease and simplicity of winning, the sheer complexity of what I am going to call "the process of consistency" is enough to make it difficult to master.

It’s not difficult enough, however, to qualify for why trading is the hardest easy money you'll ever make. Unfortunately, other factors come into play that also have the potential to make producing a consistent income exponentially more difficult than it has to be or what it would otherwise be all on its own.

To help you understand my point, I would like you to take a moment and ask yourself, why am I going through all of the trouble to point out the differences between how easy it is to win and make money and how complex and potentially difficult it can be to achieve consistent results. If the gap between the skills it takes to win and the skills it takes to make a living is as wide as I am implying it is, then wouldn't it be obvious or self-evident to some degree?

This gap is neither obvious nor self-evident. And the reasons have to do with the kind of assumptions we usually make about how this business works, and what we have to do to be successful at it once we discover how easy it is to win. This is where we "unknowingly" start laying the foundation for causing trading to be the hardest easy money we will ever make; as well as, putting us squarely on the path of frustration and ultimate failure. Because as you'll see in a moment, we have a tendency to adopt certain assumptions about how we should proceed that will render the skills we need to make a reliable income as either unnecessary, irrelevant, or even undetectable, as if they didn't exist.

We won't know we've chosen a developmental path that excludes these other skills because the assumptions I am referring too are completely logical, reasonable and consistent with our experiences. To make matters even more perplexing, these assumptions stem from a premise that represents a true and accurate characteristic about the nature of trading - that winning is, in fact, easy.

What we have is a situation where we make assumptions based on an underlying premise that is true. But the assumptions themselves, although completely logical and reasonable, are not accurate; because they leave out major components of the process of consistency. As a result, if we're not taught otherwise at the very outset of our career, it usually takes us several years, along with some very frustrating and painful trading experiences before we even start coming to the realization there's something missing in our approach.

How We "Unknowingly" End Up on the Path of Frustration and Ultimate Failure

Let's look at some examples of the typical reasoning process the beginning trader will go through to determine how they need to proceed once they've discovered the world of trading:

- *This is so easy, what's going to hold me back when I actually know what I'm doing.*

- *If I can win and make money knowing almost nothing about the markets or how to trade, then all I have to do to assure myself of making a consistent income is learn more about how to win.*
- *If it's this easy to win, then why shouldn't it also be easy to make a consistent income. It would appear that all I have to do is find some method or technique that consistently identifies profitable trading opportunities and I'll be on the road to fulfilling my grandest dreams of financial success.*
- *If I learn how to win, I will know how to trade.*
- *The more I know about how to win the less likely I will ever have to lose.*

What I want you to notice about all of the above statements is they represent a reasoning process that makes "winning" and therefore "learning how to win" the key to our success. Certainly, there are any number of other word combinations someone could use to convey the same ideas. However, regardless of how the words get strung together, the underlying assumption is virtually always the same; that our success as a trader is a function of knowing how to win.

How are We Going to Know How to Win?

We are going to know how to win by learning how to properly analyze or read the market. I am defining market analysis as any combination of tools and methods that organize market information into something we can use to determine the most ideal price and or time to enter into (and exit) a trade. In other words, some form of market analysis that will tell us:

- *what to pick (the stock, futures, option or currency trade that has the highest probability for success);*
- *where to click (the buy or sell button); and*

- *when to click (most ideal price or time to get in or out).*

The tools and methods I am referring to fall into three broad categories:

1. *Technical Analysis* - predicting price movement with geometric chart patterns (i.e. trends, retracements, congestion, support/resistance, candlesticks etc.) or using various mathematical formulas applied to price and volume data to identify behavior patterns (i.e. moving averages, Stochastics, RSI, MACD, volume ratio etc.).

2. ***Fundamental Analysis*** - using supply, demand and valuation models and formulas to predict price behavior.

3. *The News* - any trading strategy based on predicting the markets' reaction to economic reports or any other current events reported by the media.

Believing that "winning is the key to our success" and therefore assuming that "learning how to win with good market analysis will assure us of that success," on the surface make absolute, perfect sense. In fact, all of the assumptions stated above seem so self-evident, you may be thinking it's a bit odd that I'm even be pointing any of this out in the first place. But, as you may also be anticipating, I wouldn't be doing it, unless there was something about these assumptions that has the potential to cause us some real difficulty.

Here's the problem, and it's a most perplexing one. If we're defining success as the ability to produce a consistent, reliable income from our trading, then learning how to win, *is not the key component* in the process of achieving that success. In fact, learning how to win (although essential), plays a relatively small part (role) compared to the other skills we have to learn to be consistent.

How is it possible that learning and therefore knowing how to win could **"NOT"** be the key to our success? Unfortunately, the answer will probably seem even more perplexing than the question itself. However, before I explain why, I want to breakdown the logic sequence to make sure you know exactly what part I am referring too as problematic.

Is the premise that "winning is a function of market analysis" true? Absolutely! The better we are at using the tools of market analysis, the more we will be able to recognize profitable trading opportunities. What about the premise that "to be consistent we need winning trades?" Obviously this is also has to be true because we can't produce a consistently raising equity curve without winning trades.

Since we know that winning can be a function of analysis and we need winning trades to be consistent, wouldn't it then be completely logical to conclude that the better our analysis is, the more consistent our results will be? Logical - yes, but it's not completely true.

The problem with this conclusion is that it is only valid to the extent we have developed as a complete trader. Meaning, for those traders who don't understand how this business really works or haven't learned all of the skills that are required to be successful, eventually they will notice there's no positive correlation between how good or even great their analysis is and their bottom-line results over-time. In other words, we can have winning trades, even incredible winning streaks, without ever experiencing anything close to consistent results.

What I intend to establish is, even though market analysis identifies winning trades, it **"*will not by itself*"** assure us of producing a consistently raising equity curve; it's only in combination with all of the other skills that make-up the process of consistency where our bottom line results will become a direct reflection of the quality of our analysis.

So if you've adopted the operating principle that market analysis is the key to your success, then you are headed down the path of frustration. At best you'll aspire to be a boom and bust trader and worst case, like so many others, you’ll leave the business completely exasperated wondering what went wrong.

Chapter Three

Analysis is not the Key to Achieving Consistent Results

Generally speaking, when we use a process of analysis, it's to understand the properties, traits and characteristics of whatever it is we are examining. Or to understand the underlying dynamics that are causing a particular circumstance or situation to be the way it is.

The analysis we do, will, in turn, lead us to conclusions, and, help us devise strategies to accomplish our objectives. Finally, once we make a decision about how to proceed, we will naturally expect that the results we get will be consistent with what we've learned. Especially, if we believe that we followed the correct procedures and took everything we were supposed to into consideration. Bottom line, doing analysis implies that once we've completed the process, we can presume to know something and therefore expect whatever decisions we've made to be correct.

Using some form of analysis on the markets as traders works almost the same way. However, there is one very important and profound difference that can make it virtually impossible to produce consistent results, if we're not aware of it. When we examine the markets, we can take all of the normal analytical steps; such as, dissecting price charts, calculating mathematically based technical indicators, using fundamentally based supply/demand and valuation models or formulating various trading strategies on the news or anything else for that matter.

Then, as a result of what we've discovered, we can come to a conclusion and make a decision about whether to put on a trade as either a buyer or seller. It’s when we get to the final step of the process, where we assume we're going to get a result that is consistent with what we expect that analysis for trading radically departs from what we would otherwise take for granted about how the process works.

For example, if we apply our normal expectations of analysis, then it would be completely logical to assume that if we do our analysis and build a good enough case to convince ourselves that a trade is going to work, then we're naturally going to expect to be right. In other words, we're not going to get into to a trade that we don’t believe is going to be a winner. This is typical of the way the average or uninformed trader thinks going into a trade. He's not going to get into a trade unless he's convinced himself the trade is going to work.

This is definitely ***not*** the way a professional trader who has developed the ability to produce consistent results would think. As strange as this may sound to those of you who may be hearing this for the first time, a professional trader does not go into the next trade convinced that he's right or go through the mental gymnastics necessary to convince himself as a justification for making the trade.

Quite the contrary, after doing his analysis, instead of expecting to be right, the professional just expects there's a "good chance" that he'll be right. What he assumes is that his analysis has put the ***odds*** of success in his favor and nothing more. He doesn't allow himself to think, assume or believe that he knows what is going to happen next, because at some point in his career he learned, usually quite painfully, that regardless of how good a trading situation looks or how much time and effort he put into his analysis - there's

nothing about the markets' behavior that is ***ever certain***, because ***anything can happen*** in any moment. Convinced that "anything can happen," he realized that subscribing to any thinking paradigm that caused him to assume or believe that he "knows" what's going to happen next or that his analysis is "assuring" him of a particular outcome on any given individual trade, is the most dangerous and potentially damaging mistake he can make.

Why is Thinking, Assuming, or Believing We Know, Such a Dangerous Mistake?

Why is it such a dangerous mistake to think, assume or believe that our analysis is telling us what's going to next? The reasons fall into three broad categories.

First ***:*** *Going through the process of convincing ourselves that we "know," makes it very difficult, if not nearly impossible to recognize or acknowledge we're in a trade that isn't working - without having to lose a lot of money first.*

Remember the wise old trading adage that I quoted in the first chapter "*to be a successful trader we have to be able to cut your losses short and let your profits run*." Well, how are we going to cut our losses short, if we only put on a trade "after" we've convinced ourselves we're right? The whole point of going through the process of building a case to be right is to "make sure" that we win.

The problem is if we go into a trade, thinking, assuming or believing our analysis is assuring us of a winner, what we've done is eliminate from our thought process the possibility of losing. If we've eliminated the possibility of losing, then what would we use as a resource to tell us that we're in a trade that isn't working, a trade that is losing its potential to be a winner or a trade that never had any potential to be a winner from the moment we got into it. In other words, when we're expecting one thing, and the market is giving us something else, how are we going to know we're not getting what we expected? We have to genuinely believe that's it's possible for a trade not to work to be able to recognize we're in a trade that isn't working.

In fact, the most common error the uninformed trader makes is not defining the potential cost of a trade before it he gets into it. What do I mean by cost? It's the dollar value of the distance between our entry point and how far the price has to move against our position to tell us the market is not responding in a way that confirms our definition of a winning trade. For the typical uninformed trader, the only resource he has to get himself out of a losing trade is pain. Meaning, when the pain of losing one more dollar is greater than the pain of admitting that he's wrong, is when he will finally be able to recognize and hopefully (depending on how stubborn he is) fully acknowledge that the trade isn't working out as he expected. By then the loss can be catastrophic or at the very least, a great deal larger than it needed to be, that is, if he knew how to think like a professional.

The professional will always, without exception, determine in advance of getting into a trade precisely where the market "shouldn't" be for the trade to still be defined as a potential winner. To properly calculate the cost we have to find the optimum point where the potential for success is so diminished in relationship to cost of finding out, that from a money management perspective, it isn't worth staying in any longer, even if it means taking a loss.

Like the professional, what you're going to learn is, if you can't recognize when you're in a losing trade, it won't make any difference how good your analysis is, because you'll always be susceptible to a catastrophic type of loss that wrecks your equity curve. For instance, your analysis could be good enough to give you ten winning trades in a row. But if the next trade you get into isn't working and you can't recognize that it isn't working, then you have the potential to give all of the profits back to the market from the previous ten trades, plus more. If that happens, your overall win/loss ratio would be ten wins to one loss, certainly an indication of excellent analysis. But your bottom-line results would be little or no net profits, or worse, you're in the hole, having lost more money on one trade than you made on ten.

Losing trades are always unintended. But if anything can happen, it implies there's no perfect analytical method that can accurately factor in all the possible ways the market can impact the direction of prices in any given moment. In other words, there's nothing we can do in advance to prevent or avoid finding ourselves in a losing trade. However, what we can do is always be prepared to find ourselves in a trade that isn't working. And building a case to convince ourselves beforehand the trade we are considering is a winner and then rationalizing that we wouldn't be making the trade in the first place if we had reason we to think otherwise, is not exactly the appropriate preparation.

Second : *Convincing ourselves or giving in to a feeling that we "know" also*
makes it very difficult to recognize the most appropriate place or time to take profits
in a winning trade.

Winning trades don't last forever. There are a number of underlying factors that will virtually guarantee that prices will not move in one direction indefinitely. To maximize our profit potential in a winning trade, we have to be able to manage a delicate balance between staying in the trade long enough for the market to hit our profit objective or go beyond that objective so that we can extract as much money as possible; and, at the same time, get out of the trade soon enough to minimize the amount of unrealized profits we give back to the market, when a trade doesn't reach our objective or the price retraces against our position to a point that indicates it’s unlikely to move any further in our favor.

Unlike the ease at which we can just find ourselves in a winning trade, the ability to "let our profits run" without giving too much back to the market in the process of doing so, is a very advanced trading skill. Without the proper guidance, it usually takes people years to develop and refine. At its most sophisticated level, it requires making these never ending assessments of how much of our unrealized profits we are willing to risk to find out if the market will reach our profit objective or go any further in our direction.

There are a number of money management and technical strategies available to help us with all of these decisions. However, to effectively utilize these techniques requires a fairly high degree of objectivity. Meaning, in a winning trade, our money management and technical strategies could clearly indicate that it’s time to book our profits and exit the trade. Actually doing it, however, is not that simple or easy. Why?

First, our analysis or whatever means we used to get into the trade is being validated by the market. Second, we're getting exactly what we wanted or expected. And third, we are winning and making money. All of which can be the source of some very powerful and intensely pleasurable emotions. All of these intensely positive feelings can put us in a state of mind that will make it very difficult to make an objective assessment of the status of a winning trade.

For instance, under normal circumstances when we're feeling really good, we naturally want whatever experience we're in to continue. Well, it won't be any different when we're in a winning trade. Except that with trading our good feelings are going to be in direct conflict with our profit taking strategies.

When we get an indication to close out a winning trade, it means we have to be willing to end an experience that is giving us a great deal of pleasure. We will also have to face the feelings of regret we'll likely experience if the market continues to move in our direction after we get out of the trade.

It isn’t too hard to see that winning can produce a distinctly un-objective state of mind, making it very easy to talk ourselves out following the signals of our exit strategies. Or too not give serious consideration any information that would indicate the move in our favor is coming to an end.

However, what isn't so obvious is how winning trades can also lull or seduce us into sense of "security" or "general state of well-being," where it feels like we don't have to do anything because "we just know" that nothing can go wrong. What I'm referring to is a euphoric state of mind that causes us to believe that the winning trade we are in will last indefinitely. It goes without saying, that euphoria is certainly a wonderful state of mind to be in. But at the same time, it can also have a real negative impact on our ability to take profits on a timely basis.

So without the proper skills, namely the ability to think like a pro, we're going to be susceptible to feelings that, at a rational level of thinking, get translated into assumptions or beliefs that say "we know" what the market is going to do. However, more often than not, what we are thinking, assuming or believing we know about the market, in the moment, will be in direct conflict with what our exit strategy says we need to do.

Instead of booking our profits based on a planned, organized and systematic approach so that we can assure ourselves of producing a steady income, we'll be getting out of our winning trades haphazardly. Sometimes with a lot less profit than what the market made available, or worse, we let a winning trade, especially one that accumulated substantial, but unrealized profits, turn into a trade that we end up closing out for a loss. This is not a very pleasant experience, but at the same time, one that is very difficult to avoid when we don't know what we're doing, while simultaneously thinking that we do.

Third : *Allowing ourselves to think, assume, or believe that we know what's*
going to happen next, also makes it extremely difficult, if not nearly

impossible to

utilize a technical trading system without making errors.

There are a plethora of very good, highly developed technical trading systems available to the general public that can produce consistent bottom line results. However, to experience the full potential these trading systems have to offer, we have to be able to execute them as they were designed. Meaning, we have to be able to follow the rules, stick to the plan, without making trading errors.

HERE ARE SOME EXAMPLES OF TYPICAL TRADING ERRORS

- *We could get a signal from our technical trading system to enter a trade, but instead of immediately putting our order into the market, we hesitate, waiting for some assurance the trade is going to work. As a result, we end up getting into the trade at a worse price and increased risk (potential cost) then the system called for.*

- *Jumping the gun. We end up in a losing trade we shouldn't be in, because we anticipated a signal that actually never materialized.*

- *We get a signal from our system and decide for whatever reason (usually because we're not completely convinced it's going to work) not to take the trade at all and it turns out to be a winner.*

- *We get a signal from our system, put the trade on, but not enter a stop loss in the market, even though the system clearly calls for one. The market moves against our position and we find* *ourselves in a situation where we're losing a lot more money than we would have if we had used a stop loss.*

- *We get a signal from our system, put the trade on, actually enter a stop loss in the market, but just before it looks like the stop is going to get hit, we cancel it and again find ourselves in a situation where we're losing far more than what we would have otherwise lost if we kept the stop in the market.*

- *We get a signal from our system, put the trade on, enter a stop loss in the market but keep moving the stop further away from our entry point as the market gets closer and closer to hitting it. This experience is the trader's version of dying the slow death of a thousand cuts as they say in China.*

- *We can get a signal, put the trade on, enter a stop loss, but because "we're sure" the market is going to hit it anyway, we get out of the trade ahead of time hoping to save some money. But as it turns out, our stop would not have been hit and the trade turns into a winner that we're not benefiting from.*

All of these errors and many more like them, will stem from a lack of objectivity caused by our doubts and fears, as well as, the inevitable conflicts that arise when our opinions about what the market is going to do differ from what our trading method says we should be doing.

If you don't know this already, what you are about to learn is that we don't need any opinions or judgments about what the market is going to do to follow the rules of a technical trading system and properly execute the signals. Quite the contrary, our opinions and judgments will only get in the way by causing us to make trading errors, when what we think is going to happen doesn't agree with the system says we should be doing. Our doubts and fears won't exactly provide us with any assistance either. Just because we know we're afraid, it doesn't mean that we also "know" what the market is going to do next, although our fears will certainly make seem that way.

Obviously, trading errors can have a very negative impact on the potential results of a trading system. At best, trading errors cause those results to be so erratic, they become untrustworthy. However, there's another, far more perilous dimension to trading errors that isn't as obvious. The effects can be so catastrophic that it completely wipes out our trading account. The kind of error I'm talking about is one that results in a psychological phenomenon commonly referred to in the industry as "mind freeze."

I would define mind freeze as state of mind in which we are conscious or aware of what's going on, but paralyzed for some indeterminate period of time, unable to respond to the situation we find ourselves in. It occurs when the difference between what we are actually experiencing and what we expected to experience is so vast and sudden that our minds can't process the gap and simply freeze up.

How could we get ourselves in a situation where the gap between what we expect and what we experience is so huge that our minds literally freeze up? Unfortunately when we're trading it's extremely easy.

Trading has the unique characteristic of providing us the opportunity to win regardless of the reason, rational or timing we use to get into a trade; including what we decide to do or not do while we're still in it. Remember, all it takes to find ourselves in a winning trade is to pick - point and click in any given moment. Therefore it isn't necessary to precisely follow the rules of any particular trading strategy or plan to win. Nor do we have to adhere to any basic principles of consistency.

Go back for a moment and review the errors listed above and consider that every action or inaction could have just as easily resulted in a positive outcome. We can hesitate and end up with a better price. Jump the gun, and end up in a trade we shouldn't be in, that turns out to be a winner. Get a signal from our system, decide not to take the trade and it turns out we saved ourselves from what would have been a losing trade. We can pull a stop loss out of the market just before it would have been hit and instead of taking a loss the market ends up reversing in our favor. So not only did we save ourselves from a loss we also made money. The point is, we can make every mistake possible executing a trading system, as well as, violate every principle of consistency and still win.

Now, at first glance you may be inclined to think that winning without having to follow any specific rules or procedures is a good thing. And I would agree, **IF** you don't care about producing consistent results and you don't plan on staying in the business for very long.

What I'm about to say is so important that I want you to imagine that I'm shouting the words loud enough to hurt your ears. If you want a consistent income from your trading, ***how you win matters***. I cannot stress enough the significance of this statement on your long term development to become a successful trader. Why would this matter so much? When we violate certain basic principles of consistency, meaning when we make the kind trading errors outlined above and win anyway, it can cause us to form some very dangerous assumptions about the way this business works. These assumptions can leave us completely unprepared to anticipate or respond to an adverse market situation making us vulnerable to mind freeze and losing our entire trading account on one trade.

For example, let’s say that in the process of doing our market analysis we take special care to be very meticulous in making sure we're following the correct procedures and taking into account all the relevant criteria. As a result, we become so thoroughly convinced the trade we’re considering is going to win, we don't give any thought to the potential cost of making the trade, as I described above. We could “reasonably” conclude there wouldn't be much point to calculating the risk or using a stop if we already believe we're going to win.

Besides, once we start giving serious consideration to the risk, we might end up talking ourselves out of making the trade. If we talk ourselves out of a trade that turns out to be a winner, the emotional pain we'll likely experience can be as intense as putting on a trade that turns out to be a loser. So, to avoid the pain of missing out, as well as, make sure we are doing the right thing, we simply tell ourselves that "we wouldn't be making this trade in the first place if we had reason to believe it wasn't going to work.” Once the this last statement is accepted as valid, we put the trade on, convinced it’s going to win and excited about all of the money we anticipate flowing into our account.

Now, let's say that's exactly what happens. The trade turns out to be a winner and the money flows into our account just like we imagined it would. Did we make a trading error by not calculating the potential cost or by not putting a stop loss in the market? It certainly won't seem that way considering an error is synonymous with making a mistake and mistakes usually result in a negative or undesired outcome. Winning implies that whatever process we used to win was correct.

We did our analysis the way we were supposed to. We came to a conclusion, made a decision and acted on our decision. We got an outcome that was consistent with our analysis. In other words, we won, made money and we're feeling great. The results speak for themselves, so why should ***"how we won"*** make any difference, or be so important?

Because in this particular case, we won in a way that could easily cause us to form some very dangerous misconceptions about how analysis works and what it can do.

For example, we could quite logically conclude that:

- *analyzing until we've convinced we're right is a valid process for achieving consistent success;*
- *the right kind of analysis can "assure" us of a winning trade; and*

- *completing the process of convincing ourselves we're right, will, for all intents and purposes, eliminate the risk of losing. Thereby making it unnecessary to calculate the potential cost or use a stop loss.*

When our analysis predicts that the price is going to go up and that's exactly what it does from the moment we get into a trade, it's almost impossible not to conclude that analysis or some sort of analytical process can assure us of a specific outcome. As well as, make it appear as if the risk of losing never existed. However, in trading, appearances can be very deceiving. Because as logical as the above conclusions seem to be, the moment we've adopted them as primary operating principles, we have unknowingly set ourselves up to experience trading's worst case scenario - mind freeze.

For example, let's say we get into a trade after thoroughly convincing ourselves we're right, but the market doesn't respond in a way that conforms with our analysis. So we find ourselves in a losing trade. If we're not losing very much, it isn't too difficult for most people to find a way to rationalize that they're not actually in a losing trade. As long as, the gap between the current price and their breakeven point isn't too wide. But if that gap gets wide enough, there is always a psychological threshold beyond which we won't be able to come up with a line of reasoning that can explain what is happening or take the pain away.

This is especially true if that threshold is crossed by a sudden or violent move against our position. The shock of finding ourselves in a situation where the market is behaving in a way that is completely outside of anything we expected or believed possible can cause us to become temporarily paralyzed like a deer staring into the headlights of a car at night.

The duration of the paralysis varies by individual. But a good rule of thumb is, when the loss gets so large that the additional shock of watching the equity in our trading account disappear, triggers an innate sense of selfpreservation that causes us to snap back to some level of normal functioning.

Believing that any form of analysis can assure us of a particular outcome and make the risk of losing go away, (as if it never existed), is an illusion. It is what I call "the illusion of analysis" that stems from not understanding the basic underlying dynamics of price movement. Because when we do understand how prices move, we will realize that even when our analysis gets us into a trade that produced, what we would consider to be an absolutely perfect outcome, it still didn't eliminate the actual risk of losing. The risk was **"*always*"** present, it **"*never*"** disappeared, it only **"*seemed*"** to.

Making any assumptions to the contrary, will not prevent us from winning, but it will definitely cause us to make some dangerous trading errors that we won't know are errors. In other words, we can win with an inherently flawed process. And because we won we won’t have the slightest idea that we are setting us up for a disastrous experience at some point down the road.

One of the biggest distinctions between the way a professional trader thinks and everyone else is the professional ***knows*** the risk never goes away, regardless of how it may appear. As a result, they're not susceptible to a mind freeze type of experience. Whereas, everyone else, to one degree or another is operating out of the illusion they ***know*** what's going to happen, making it appear as if the risk disappeared when they're right. However, when the market doesn't cooperate, what appears to be so, can extract a very heavy price, both financially and psychologically.

For those of you who haven't experienced trading’s worst-case scenario, it is far more common than what you might imagine it to be. In fact, it’s probably the single biggest reason that people stop trading or leave the business altogether. Fortunately, however, mind-freeze is a completely avoidable phenomenon. All it takes to prevent it, and dispel the many misconceptions about analysis that cause us to make dangerous trading errors, is an in-depth understanding of what makes prices go up and down.

Because once we genuinely understand price movement, the inherent limitations of any analytical method will become self-evident and the idea that analysis can eliminate the risk will seem absurd.

Chapter Four

The Mechanics of Price Movement ~ It's All About Order Flow

What makes the price of a stock - or any other exchange traded futures or option contract - move up (tic up) to the next highest price level or move down (tic down) to the next lowest price level? The answer: there has to be an imbalance between the number of buy and the number sell orders that have to be executed at the current price. Meaning when there's more buy orders (buying volume) than sell orders (selling volume) coming into the market, the price will tic upward. Conversely, when there's more sell orders than buy orders coming into the market, the price will tic downward.

It's that simple. But like most everything else about trading, the simplicity on the surface disguises a number of implications that have a profound effect on how we develop, if we don't understand what's really going on beneath the surface. Therefore, I cannot stress enough how important it is that you completely and thoroughly understand the underlying dynamics of how prices move as a function of order-flow.

Understanding the dynamics of order flow will cause you to the realize that regardless of how market analysis may make it appear, if you're objective for trading is to profit from price movement, ***there is absolutely nothing you can (ever) do that will take the risk of losing away. Ever! Period!***

To whatever degree you don't believe the above statement, is the same degree to which you have the potential to get caught in the illusion that analysis can somehow eliminate the risk. Once caught in the illusion, besides experiencing the negative effects of trading errors (that you may not know are errors), you'll find it nearly impossible to see the need to learn the kind of mental skills that are necessary to assure yourself of producing consistent results; at least not without experiencing a lot of pain first.

> *Nearly every core assumption we need to perceive the market from the perspective of a professional trader, will stem from understanding how prices move as a function of the Buy/Sell order flow.*

So I'll start the process of bringing you up to speed on the relationship between price movement and order flow dynamics with a real life example.

Several years ago while I was working in the capacity of a trading coach, someone came to me seeking my assistance. He explained that he had developed excellent analytical skills, but had several failed attempts at trading his own account, as well as, the accounts of many of former friends and family. After assessing his situation, I suggested that he stop trying to be a trader and get a job as a technical analyst. It was definitely something he was good at. And I felt he could earn a steady income doing something legitimate while he worked though some of the issues that were preventing from being a successful trader. He was really desperate and genuinely wanted to turn his life around, so he took my advice and got a job as a technical analyst with a major brokerage firm in Chicago.

The person that owned the brokerage firm he went to work for spent most of his life as a very successful floor trader in the soybean pit at the old Chicago Board of Trade (currently part of the CME Group). Since retiring from the floor, he found trading from a computer screen in an office very different than what we was used to as a floor trader.

He knew very little about trading from a screen or how to use the technical indicators that most screen based traders rely on, so he asked his firms newly hired technical analyst to teach him how identify buy and sell opportunities using technical indicators. This was something the analyst was more than happy to do, especially since the retired soybean trader had somewhat of a legendary reputation in the Chicago trading community.

I need to point something out here before I go any further with this example. The retired floor trader and the analyst lived in two completely different worlds, even though both would call what they did trading. The main distinction between the two was the retired soybean trader, having spent his whole trading career on floor of the exchange, had an intimate knowledge of how an imbalance in order flow makes prices move. Whereas the analyst, who had never been on the floor of an exchange, didn't have the slightest idea of how prices move. But, at the same time, assumed he did, because the mathematical equations he used to predict what the market would do were often very accurate. And when they weren't, he always had a credible sounding excuse (a logical exception) as to why.

So one way or the other, the analyst always sounded like he knew what was happening. On the other hand, the retired soybean trader knew the analyst didn't know what was going on. But was also probably mystified as to how the lines on the charts and mathematical equations could, at times, be so accurate in predicting how other traders would behave.

One morning as they were watching the soybean market, the analyst announced with a strong sense of assuredness that if the market traded up to 8.20 a bushel, prices would reverse and go lower because his analysis had projected that 8.20 would be the high price of the day. And if the market traded down to 7.85 a bushel, prices would reverse and go higher because 7.85 would be the low price of the day. At the time he made his announcement the beans were trading around 8.12 a bushel.

As the morning progressed the beans were slowly drifting lower. When price got to around 7.87 a bushel, the retired floor trader turned the analyst and said, "This is where the market is supposed to stop -right?" The analyst responded - "yes." Then the retired floor trader said, "And this is also supposed to be the low of the day - right?"

The analyst responded - "absolutely!" The retired floor trader hesitated for a moment, looked the analyst straight in the eyes and said "that's bullshit, watch this." He turned away to pick up a phone that had a direct line to the order desk in the soybean pit. When the order taker on the other end answered, the retired floor trader said "sell two million beans (bushels) at the market."

For those of you who are not familiar with soybeans futures, one contract represents 5,000 bushels of soybeans. The value of a one penny move in the price of soybeans is $50.00 per contract. So if you "bought" one contract and the price went up a penny you would have a $50.00 profit. Or if you "sold" one contract and the price went down a penny, you would also have a $50.00 profit. Conversely, if you bought or sold and the market went against you by one penny you would have a $50.00 loss.

Here's What Happened

Within a couple minutes of the retired floor trader calling the order desk to sell two million bushels of soybeans (400 contracts) at the market, the price of soybeans dropped 10 cents ($500.00 per contract) down to $7.76 a bushel. Which of course was well below what the analyst had projected as the low price of the day.

After watching the price drop in increments of as much as a penny a bushel (four times the smallest incremental price change of a soybean contract which is one-fourth of a penny), the retired floor trader turned back to the analyst, (who now had a look of horror on his face) and said, "if I can do that, anyone can." Of course, what the retired floor trader was implying with his statement "if I can do that, anyone can," is that he caused the price of soybeans to drop 10 cents a bushel within a couple of minutes.

Is this possible? Well the analyst sure didn't think so until that moment. I've found that most people or traders who haven't had a direct exposure to an actual physical exchange, or worked for a relatively large trading operation, have a very difficult time believing that an individual trader can have a significant impact on price movement. In other words, they are usually operating out of an erroneous belief that the markets are just too big for one trader or a group of traders acting in concert to willfully cause the price to move in one direction or the other.

It is certainly true that most of the exchange traded markets are so big that it would take an extraordinary amount of volume to create enough of an imbalance to move prices in one direction over a sustained period of time.

But over relatively short distances for relatively short periods of time, there a multitude of trading operations that can place orders large enough to have a significant impact on the direction of prices. And there are moments when even a relatively small order can cause prices to move, if at the time the order hits the exchange there is a distinct lack or traders who are willing to take the other side of the trade.

Since I wasn't in the soybean pit when the retired floor trader called in his order to sell 400 contacts at the market, there is no way I can know for sure exactly what happened. However, I can give you a likely order flow scenario that would certainly account for why the price to dropped 10 cents ($500.00 per contract) in such a short period of time.

However, before I can describe what probably happened, there are some things you're going to have to be familiar with first:

- *the difference in trading objectives between hedgers and speculators;*
- *understand what is means to be long and short;*
- *what it means to be hedged; and*
- *understand the anatomy of a trade.*

HEDGERS AND SPECULATORS

Hedgers - Buy and sell orders that originate from a multitude of commercial, industrial, and institutional sources, that need to be long or short an exchange traded instrument in order to reduce or eliminate their exposure to financial loss due to fluctuating prices. Hedgers place buy and sell orders as a way to either protect the value of their assets or to stabilize their profit margins. In the most general sense, any participant using the markets to hedge, doesn't want and is therefore trying to eliminate the risk associated with price movement.

Speculators - on the other hand, participate in the markets for the exact opposite reason as a hedger. Speculators place buy and sell orders because they are attempting to profit from the opportunities created by fluctuating prices. In other words, they willingly assume the risk of taking a long or short position in the market for the opportunity to make a profit if prices move in the direction of their position.

Even though individual speculators may have vastly divergent ideas about how and when to get long or short, they are all trying to do the same thing. Buy something at what they believe to be a low price and sell it back at a higher price at some point in the future. Or sell something at what they believe to be a high price and buy it back at a lower price at some point in the future. For a speculator it all boils down to buy low and sell high or sell high and buy low, no matter what the speculator trades there is no other way to make money other than for prices to move in his favor.

What Does it Mean to be Long

To be long the market means that we are either in physical possession of a tangible asset, or in control of an asset in a way that exposes us to the possibility of that asset either increasing in value, if the market price moves up, or the risk of the asset losing its value, if the market price moves lower.

I'll give you some examples of ways we can either make ourselves or find ourselves "long the market."

- *As a speculator, we can make ourselves "long the market" by entering into a trade on the BUY SIDE of a stock, futures, options, or currency transaction. The moment the transaction is complete, we would be considered "long the market" because we have bought and taken possession of a stock, or gained control of an asset like treasury bonds, gold, wheat, cattle or Euro's (to name a few), when we entered into a trade on the buy side of a futures or options contract. Being long gives us the opportunity to make money if the price of whatever we bought goes up or exposed to the risk of losing money if the price goes down.*

- *We can find ourselves "long the market" as a natural consequence of our experiences. For example, let's say you received (a relative gave us) 100 one- ounce gold coins as a college graduation gift. Having the coins in your possession as an asset would make you "long the cash (spot) gold market." As a result, the value of the coins would be changing based on the price fluctuations determined by whatever forces are affecting the gold market in any given moment.*

- *We can be "long the market" as a natural consequence of many commercial, industrial or institutional activities. For example, let's say you wanted to be a cattle rancher, a soybean farmer, decided to mine for gold, drill for oil or run a hedge fund. Each of these businesses, and many others like them, are examples of enterprises that accumulate or grow inventories of a physical or financial asset as a natural consequence of their operations.*

In other words, the very nature of the operations themselves would automatically make them "long" whatever "cash or physical market" corresponds with their inventory. And having a "long position" means the value of their inventory, as well as, the financial well-being or their entire business would be exposed to the possibility of loss from the constant fluctuation of prices.

What Does it Mean to be Short

Unlike the concept of being long, most people find the concept of being short very abstract and somewhat confusing. When we're "long" it means we are either in possession or control of whatever it is we are "long." On the other hand, being "short" is the exact opposite. Instead of having something, it means we "don't have" possession or control of something we're going to need, and therefore have to buy at some point in the future.

The following are some examples illustrating what it means to be "short" the market:

- *Let's say I'm planning on taking a road trip and the gas gauge in my car is showing that my gas tank is on empty. Since I'm out of the gas that I need to take my trip, I would be considered "short" the retail gas market. I'm "short" because the moment that my situation or circumstance dictated that I had to go to the market to buy or control something that I didn't have; I simultaneously became exposed to the economic risk of price fluctuation. I will* *continue be "short" the market until I buy the gas I need or find a way to lock in the price that I'll have to pay before I actually take possession of the gas.*

- *We can cause ourselves to be "short" the market, when we act in the capacity of a speculator by entering into a trade on the SELL SIDE of a futures or options contract. This is where getting "short" can be confusing. Because when we take the sell side of a futures or options trade, as a speculator, we are selling something that we don't actually have.*

The reason we would consider doing this is to take advantage of a situation where we believe that prices are headed lower. In other words, we are speculating that we can sell something at a high price and then at some point in the future buy it back at a price lower than the price we sold at and the difference will be our profit. Now you might be asking yourself, how do we sell something we don't have and furthermore, why would we have to buy it back if we didn't own it or have it in the first place?

Futures and options contracts are designed to let us sell something we don't own, control or have possession of at the time we enter into a trade. For example, if I decided the price of gold is going down and wanted to speculate on that possibility, I can simply go into my trading platform and click the appropriate button to sell a 100-ounce gold futures contract. When I get a confirmation the trade has been executed, I will be "short" one hundred ounces of gold.

I'm considered short in this situation because, based on the terms of the futures contract, when I took the sell side of the trade, I simultaneously obligated myself to deliver to the buyer on the other side of the trade, 100 ounces of gold, that is, if I don't enter a buy order to cover (exit) my short position before the contract expires.

If I exit the trade before the contract expires the only consequence to being short will be the profits or losses I accrue based on how the price of gold moves. If the price drops, money will flow into my brokerage account through the exchange clearing corporation, from the brokerage account of the person or organization on the other side of my trade. Conversely, if the price goes higher, money will flow out of my brokerage account, into the brokerage account of the person or organization on the other side of the trade. Otherwise, if, for whatever reason, I do happen to stay in the trade until the contract expires, I will be obligated to fulfill the terms of that contract. Meaning, in this case, I will have to go to the cash gold market, buy 100 ounces of gold and then deliver the gold to whoever the buyer was on the other side of the trade. The same conditions would apply if I took the sell side of any futures or options trade that I held until contract expiration.

> *We can find ourselves "naturally short" the market by engaging in any business enterprise that consumes materials, commodities or products in the process of manufacturing something, providing a service or is involved in import or export transactions that have to be settled in a foreign currency*

Finished food manufacturers are naturally "short" the grain and meat markets, because they have a perpetual need for wheat, corn, soybeans, sugar, cattle, and hogs etc. Transportation providers, like trucking companies, railroad companies, or airlines have a perpetual need for gas and oil making them naturally "short" the gas and oil markets. Durable goods manufacturers are naturally "short" the metal markets, because they have a perpetual need for copper, aluminum, steel, gold and silver. I think it is fairly self-evident how food processors, transportation companies and durable goods manufacturers find themselves "short" their respective markets.

I'm not going to elaborate any further just yet. However, businesses that find themselves "short" the market as a result of their import/export transactions is a bit abstract, so I'll give you an example.

For instance, suppose you own a chain of appliance stores that import high definition televisions from Sony Corporation in Japan. And let’s say that Sony decides to run a sales special for their distributers, where if you order 5,000 TVs, they will give you 180 days same-as-cash terms to pay for them. In other words, you get to take delivery, offer them for sale in your stores, and not have to pay Sony until six months after you receive them. The only stipulation is that Sony requires that instead of paying for the TVs in dollars, you have to pay for them in their home currency - the Japanese yen.

Basically, Sony is giving you free credit for 180 days. But there is a possible downside to the deal. You will be assuming all of the risk associated with converting your dollars to their yen, when it comes time to pay. More so, that risk will begin immediately upon your acceptance of the deal. Because the moment you say yes, you will automatically find yourself "short" the Japanese yen market. Why? Remember the definition of being "short" is when we do not have possession or control of something we're going to need, and therefore have to buy, at some point in the future.

One hundred and eighty days after you take delivery of the TVs, you're going to have to pay Sony for the value of the inventory not in dollars, which is something you have, but rather in yen, which is something you don't have. Actually purchasing the yen won't be a problem, because your bank can easily make the conversion for you. The problem is, you won't know what the exchange rate will be when it comes time to send Sony what you owe them. In other words, you won't know how many dollars it’s going to cost you to buy the amount of yen you need.

If, at the time you make the conversion, the value of the yen has gone down in relationship to the dollar, it will take fewer dollars to buy the amount of yen you need. This would certainly be a good development because your over-all cost of sales will go down and therefore your profit margin on the TVs will go up. On the other hand, if the value of the yen increases in relationship to the dollar, it will take more dollars to buy the amount of yen you'll need, increasing your over-all cost of sales, causing a corresponding decrease in your profits. Worst case scenario would be dramatic upside increase in the value of the yen. If that happens you could lose all of your profits or possibly lose money on the deal altogether.

As I said above, you become "short" the Yen the moment you say yes to Sony. Now, when it’s all said and done, you could end up making more money on the deal if you stay "short" and the exchange rate moves in your favor. Or you could end up losing money if the exchange rate goes against you. Either way, until you buy the amount of Yen you need through your bank, or "hedge" your position in the futures or Forex market (by taking the buy side of the equivalent number of Yen futures contracts), you are speculating. Or to put it more realistic terms, you will be gambling.

What Does it Mean to be Hedged

Most businesses would find it very difficult to stay financially viable if they didn't have a mechanism to off-set the uncertainty caused by the constant price fluctuations in the markets they use to sell their products, or in the markets they use to buy the materials they need to produce their products. Basically, hedging is a way to:

- *stabilize the value of something we currently own;*
- *lock in a selling price of something we intend to grow or accumulate and eventually take to market; and*
- *lock in the price of something we have to buy or intend to buy, but not ready to take delivery of. If done correctly, hedging can, at a minimum, reduce the financial uncertainty of price fluctuations or, at best, eliminate the risk altogether.*

Here's a simple non-commercial example to illustrate the value of hedging:

- *Let's go back to the illustration where (a relative gave) you received 100 one-ounce gold coins as a graduation gift. You've had the coins in your possession for years and watched their value bounce up and down along with the price of gold. When you were given the coins, gold was trading in the neighborhood of $250.00 an ounce. Now gold is trading at or near $1,200.00 an ounce. And for whatever reason, you don't think gold has much or any further up-side potential.*

In other words, you believe gold is at a major top and therefore think it would be a good time to sell the coins. The problem is you don't want to sell the coins because along with their monetary value they also have sentimental, as well as, difficult to replace, numismatic value. So how do you lock in or stabilize the value of the coins without actually having to sell them.

Fortunately, this is a dilemma that is easily resolved by hedging your position.

To protect yourself against the possibility that the value of your coins could decrease and at the same time keep possession of them, all you would have to do is go into your trading platform and sell 1 one-hundred ounce gold futures contract. Your position would then be "long" 100 ounces of gold in the cash market and "short" 100 ounces in the futures market.

If you're right and the price of gold decreases, the profits you accumulate in your futures account will off-set the decrease in the value of your coins. On the other hand, if the price of gold goes up, the value of your coins would continue to go up, but you would be losing money in your futures account. And although, the losses in your futures account would be offset by the increase in the value of the coins, this scenario could create some cash flow problems, if don't have enough liquid assets to pay for the losses.

There are other ways of hedging the value of the coins, like buying a put option on a gold futures contract. But the details of how it would work and the pro and cons of doing so go beyond the scope of what I am trying to accomplish at the moment, so I'm not going to get into it.

The same hedging strategy could apply to a stock portfolio. Let's say that over the years, you've accumulated a substantial portfolio of high quality stocks. They have consistency paid good dividends and you don't see any particular reason why the dividends would stop. However, you do believe that the stock market in general is headed for a substantial downside correction.

You want to protect the value of your portfolio without having to sell the stock. In fact, you may be required to protect its value if you've used the stock as collateral on money you may have borrowed from your bank. Again the solution is relatively simple:

- *you can take a short position in each individual stock by selling stock futures;*
- *you can buy "put" options on each individual stock; or*
- *you can take a short position in any number of financial instruments that track the market in general like the Dow and S&P futures or puts on the futures, etc.*

Again, if you're right and the market goes down, the profits you accumulate from the hedge will off-set the loss in the value of your stocks.

Commercial, industrial and institutional forms of hedging are not as simple. Quite the contrary, they are usually very complex operations, requiring a high degree of financial sophistication. So I have no intention of getting into the various complexities of how they work. But I do want to give you a couple of "very over simplified" examples to illustrate, at least conceptually, what an essential component hedging plays in maintaining the financial well-being of a substantial portion of our economy.

Understanding the over-all economic necessity of hedging will, in turn, help you understand price movement. Considering that under normal circumstances commercial, industrial, and institutional hedging operations usually account for the highest percentage of the buy\sell order flow in any given market and therefore has the most potential to impact which direction prices go.

For the first example ~ imagine you have a farming operation that grows corn. Its spring time and you're just starting to plant this year's crop. Based on the amount of land you have available, you are looking for a yield of approximately 200,000 bushels. You estimate your cost of production to be $3.00 a bushel. So it's going to cost you approximately $600,000 to bring the crop to harvest.

You notice that December corn futures are trading at $4.50 a bushel. If you sell your crop now in the futures market you can guarantee yourself a $1.50 a bushel profit. Of course, when you harvest your crop in the fall, corn could be trading at a higher price. But then again, it could also be trading at a much lower price. Since you really don't know where the price of corn will be in the fall, you decide to manage the price fluctuation risk and put on a hedge by selling 40 December corn futures contacts @ $4.50 a bushel (as with soybeans, 1 corn contract = 5,000 bushels, so 40 contacts times 5,000 bushels = 200,000 bushels).

It's now six months later, you've harvested your crop and ready to deliver it. There are two ways you can handle the transaction. Since you've already sold the crop in the futures market, you could let your futures contracts expire and deliver the corn through the exchange to whoever the buyer was on the buy side of the trade. But this is rarely ever done, simply because it's more convenient to sell and deliver the corn to your local grain elevator.

Selling to the grain elevator would make the transaction look something like the following.

First, let's say the price of corn in the last six months has dropped to \$3.50 a bushel. The grain elevator pays you \$3.50; multiplied times 200,000 bushels gives you gross sales of \$700,000. At the same time you are going have to "lift your hedge" in your futures account. Meaning you are going to buy back your short position by taking the buy side of 40 December corn contracts.

You originally sold the corn futures contacts @ \$4.50 a bushel, now you buy those contracts back at \$3.50 a bushel, giving you a profit of \$1.00 a bushel or \$200,000 (5,000 bushels per contract times 40 contracts equals 200,000 bushels times \$1.00 a bushel). You now have a gross profit of \$900,000 (\$700,000 from the grain elevator plus \$200,000 from the futures), minus your cost of production of \$600,000 (\$3.00 per bushel times 200,000 bushels), gives you a net profit of \$300,000.

On the other hand, if the price of corn went up to \$5.50 a bushel instead of down to \$3.50, you would still have a \$300,000 profit. The difference would be the effects your loss in the futures may have on your cash flow.

As above, the grain elevator would pay you the spot price, which in this case is \$5.50 a bushel. Now you have gross sales of \$1,100,000 (\$5.50 times 200,000 bushels). When you lift your hedge in your futures account you will have a loss of \$200,000 (200,000 bushels times \$1.00 a bushel). With \$1,100,000 of gross sales, minus the loss of \$200,000 from the futures trade, minus the cost of production of \$600,000 you still have a net profit of \$300,000.

A QUICKREVIEW

You are "naturally long" the corn market because its spring and you intend to plant approximately two hundred thousand bushels of corn. Note, that the moment you decide to plant, you become "long" the market because the value of your "intended crop" is subject to the constant price fluctuations of the value of corn. At the time of your decision, corn is trading at a price that would give you $1.50 a bushel profit. You decide that $1.50 a bushel profit is satisfactory.

So to protect yourself against the possibility of the price of corn dropping between the time you plant and when you harvest, you sell your crop using futures contracts. Your crop grows. You harvest it, and you now have the option of either fulfilling the terms of your futures contracts or selling your corn in the "cash" market. You decide to sell your crop in the cash market and simultaneously buy back your short position in the futures market.

I will illustrate a situation where we want to lock in the price of something we have to buy but not ready to take delivery of. Let's say you own a company that manufactures large electrical generators. The kind that cities, corporations, or even countries would buy to produce electricity.

One day, your top account manager announces that his team just closed a sale. They won a contract to manufacturer $50 million dollars' worth of generators. The terms of the agreement specify that the customer will give you a $10 million dollar deposit and the balance to be paid in 18 months when the generators are to be installed and certified in working order.

Factored into the sales price is a $5 million dollar profit. Of the $45 million dollars left to produce the generators, you're going to need approximately $25 million dollars in copper. The $25 million dollars in copper was calculated based on the average cost of the copper currently on hand in your inventory; times the number of pounds it will take to build the number of generators you have to deliver.

However, at the moment, your plant is operating at or near 100% of its production capacity and all of the copper you currently have on hand has already been allocated to other orders. Meaning the moment the customer signed the purchase order, you simultaneously became short $25 million dollars' worth of copper, let's say at or near the market price.

Now, to assure yourself of producing a $5 million dollar profit on this job, you could immediately buy and take delivery of the amount of copper you need, thus locking in your production costs. But since you have 18 months to fulfill the contract and it’s only going to take a year or so to build and install the generators, you don't actually have to take physical delivery of the copper now. Besides you don't want to tie up $25 million dollars in capital to buy something you're not going to start using for at least six months.

The solution ~ buy copper futures. With futures you can control the amount of copper you will need for a small fraction of what it would take to actually buy the copper in the physical market. When the time comes for you to start using copper in the production process, you can buy the copper through your normal suppliers and simultaneously lift your hedge in the futures market by selling your futures contracts.

In the meantime, if the price of copper goes up the additional costs will be offset by the profits you accrue from your futures contracts. If the price goes down the losses from your futures contracts will be offset by the decreased price you pay when you buy the copper you need from your supplier.

CHAPTER FIVE

THE ANATOMY OF A TRADE

This may sound ridiculously simple, but for a trade to be consummated there has to be a buyer for every seller and a seller for every buyer. No order gets filled unless there is another trader willing to take the opposite side of the transaction. This fundamental characteristic of a trade is so self-evident that most people take it for granted in a way that causes them ***"not"*** to realize it's the primary driving force behind all price movement. To understand what I mean, just take a moment and think about what would happen if there wasn't a buyer available to take the opposite side of a trade a seller wanted to make. Or if there wasn't a seller available to take the other side of a trade a buyer wanted to make.

But don't think about it in terms of the actual number of people who want to buy or who want to sell, but rather, in terms of the actual number of shares or contacts that are "available to be bought" in relationship to the number that "want to be sold" or the number of shares or contracts that are "available to be sold" in relationship to the number that "want to be bought." In other words, what happens when there aren't enough sell orders to take the opposite side of the buy orders that have to be filled or there aren't enough buy orders to take the opposite side of the sell orders that have to be filled?

The answer - *prices will move in the direction of the side that has the most number of orders.*

What we have at work here is the basic economic law of supply and demand. Since it always takes two sides to make a trade, excess demand in relationship to a shortage of supply will naturally move prices in the direction of whatever there is most of. So at any given price level, if there's a shortage of sell orders to take the opposite side of the buy orders, we can say that the buyers demand for sell orders exceeds the available supply, which will cause the price to move upward until the supply equals the demand. Conversely, if there's a shortage of buy orders to take the opposite side of the sell orders that have to be filled, we can say that the sellers demand for buy orders exceeds the available supply; which, in turn, will cause the price to move downward until the supply equals the demand.

Volume is the energy that moves prices.

The greater the imbalance between the volume of buy orders in relationship to the volume of sell orders, the further the price will move in the direction of the greatest volume. Bottom line, the price of any exchange-traded product will move up, down, or stagnate in a way that perfectly reflects the relative degree of balance or imbalance between the number of buy and sell orders flowing into the exchange at any given moment.

For example, let's say we're watching a hypothetical XYZ futures contract and see the current price posted as 70 one tic up from the previous price of 69. For an exchange to post the last price at 70 means a buy order and a sell order were actually matched up at that price. In other words, there was a completed transaction where the trader on the buy side got long at 70 and a trader on the sell side got short at 70. Now to see the price move up to 71, a couple of conditions have to be met first. One, there has to be an excess of buy orders in relationship to the number sell orders available to take the other side of the trade. Two, "all of the sell orders" that were available to be filled at 70, have to already be matched up with buy orders. Note: "all of the sell orders" include all of the resting "limit" orders, market orders or any other executable offers.

At the point when the pool of sell orders has been completely depleted, electronic exchanges will match up the excess (executable) buy orders (the ones that could have been filled at 70 if there had been enough sell orders to do so), with any available sell orders at the next highest price, which in this case is 71. Notice that the software that governs how electronic exchanges operate will move the price up to the next highest level to satisfy the buyers demand for sell orders.

The exchange can't consummate a trade, if at any particular price there aren't enough orders to take the opposite side. There may not be enough orders because the supply simply ran out, or there wasn't any supply to begin with - meaning there were no traders, who for whatever reason, willing to take one of the side of an available trade at that price. In either case the exchange software is designed to move the price to a level that will get the excess orders filled, a price where trades can actually be consummated. Now, to see the price move up another tic up to 72, the same conditions as I just described would have to exist. The price will continue to move up as long as there aren't enough sell orders to satisfy the demand generated by traders who want to be long.

What Order Flow Conditions Have to Exist for the Price to Stop Going any Higher?

At least one of three things has to happen to cause the price to stop ticking up.

- *The buy order flow remains relatively constant but the sell order flow increases to the point where there's a balance between the buy volume flowing into the exchange and the sell volume flowing into the exchange. When there's a balance in the buy/sell order flow the exchange no longer has to go to the next highest price to find a sell order. (Or the next lowest price to find a buy order if we were looking at an example that was demonstrating how prices move lower.) The buy and sell orders simply get matched up at the current price. Prices will remain in a stagnant, unmoving state as long as there's an even amount of buy orders to get matched up with the sell orders.*

- *The buy order volume becomes less than the sell order volume or stops altogether. As the price of something gets higher and higher it becomes less and less attractive for many of the traders who want to be long, because they have to buy at exceedingly* *higher prices to do so. This is especially true for speculators whose primary objective is to enter trades on the long side at a low price. The higher prices could also compel a large number of traders who are long at lower prices to enter sell orders to liquidate their long positions and book their profits. As they do so it has the effect of depleting the pool of buy orders and increasing the number of sell orders. The price will stop moving up as long as the exchange doesn't have to go to the next highest price to fill a buy order.*

- *There's a substantial increase sell order volume. Buy order volume can remain relatively constant or even be increasing, but if the exchange is suddenly over-whelmed with a flood of sell orders that is larger than the number of buy orders available at that moment, prices will not only stop dead in their tracks, they'll reverse and start heading lower. To continue moving lower at least one of the three conditions I just described above would have to exist, except in reverse. The imbalance in the buy/sell order flow would have to be in favor of the sell orders; thereby causing the exchange to seek buy orders at lower and lower prices to fill the excess demand of the sell orders.*

- *As the price gets lower, it will have the effect of attracting buy orders into the market from traders who believe the price can't or won't go any lower. There will also be some percentage traders who are short at higher prices that will enter buy orders to liquidate their positions so they can take their profits. The net effect is a shift in the ratio between the buy and sell orders to a* *point where prices stop going lower, if there's a balance, if not the price will start moving up if there's an imbalance in favor of the buy orders.*

THE DIFFERENCE BETWEEN AN ELECTRONIC AND PHYSICAL EXCHANGE

In principle, the dynamics of how prices move, work the same way for a physical, open outcry exchange, with one very major difference. Instead of a computer matching up buy and sell orders at the next highest price or the next lowest price, when there's an imbalance in the flow, at an open outcry exchange the traders have to do it themselves. In other words, price movement is a direct reflection of the willingness of traders to either bid a price up ("buy high" relative to the last posted price) or offer the price lower ("sell low" relative to the last posted price).

There are a lot of different types of traders who operate on the floor of an exchange. However, for what I'm trying to accomplish at the moment, it isn't necessary for me to go into a detailed explanation of how all of these traders conduct their business.

All you really have to understand is people who trade at a typical open outcry exchange would fall into two very broad categories.

Floor brokers - these are people who are hired by and therefore responsible for executing the buy and sell orders for:

- *the off the floor retail, commercial, and hedging customers of a brokerage firm;*
- *professional, commercial, hedge and institutional fund managers that have their own floor operations; and*
- *professional off-the-floor traders who want direct access to the floor of the exchange.*

Locals - these are people that have either bought or leased a seat on the exchange and for the most part trade for their own account. Typically traders who would consider themselves "locals" are short term scalpers of the order flow.

Basically a trader who scalps order flow is someone who is trying to buy at least one tic lower or sell at least one tic higher than the last posted price. The effect of traders trying to scalp creates a minimum of a two tic spread between the bid and the offer. (*Note: the spread between the bid and offer is only limited by what traders are willing to do.)* Normally, the less liquid a market is, the greater the spread between the bid and the offer. When a trader is bidding, he is broadcasting to the rest of the market his willingness or desire to be a buyer. Conversely, if a trader is offering, he is broadcasting his willingness or desire to be a seller. In an open outcry market, traders will demonstrate this willingness by screaming and yelling to draw attention to themselves, while simultaneously using hand signals that indicate if they are buyers or sellers, as well as, the price and size of the trade they want to make.

For example, if the last posted price of something is 10, then a scalper would either be bidding (trying to buy) at 9 or offering (trying to sell) at 11. If he can buy at 9 and immediately sell it back at 10 or 11, he just made one or two tic profit. Or conversely, if he can sell at 11 and immediately buy it back at 10 or 9, again he will have made a one or two tic profit. When I say immediately, I'm not exaggerating. A good scalper is usually in and out of the trade in a few seconds.

Now, at first glance a one or two tic profit may not seem like much, but the money can pile up quickly if you're scalping size. For example, a one-tic profit on twenty Treasury bond contracts is $625.00. Do just five, twenty contract size, one-tic trades a day and you're making a million dollars a year.

To illustrate the mechanics of how prices move at an open outcry exchange, I'll go back and finish the soybean example I started at the beginning of the previous chapter.

If you will recall, the retired floor trader placed an order to sell 400 soybean contracts "at the market." And the price of soybeans immediately (within a couple of minutes) dropped ten cents. Based on the remark the retired floor broker made to the shocked analyst, "if I can do that anyone can," he obviously expected his order to drive the price of soybeans lower. What did he know about how prices move that the analyst didn't?

First: When he called his order down to the floor, the price of soybeans had already been slowly drifting lower, indicating a slight imbalance in the order flow dynamics in favor of the sellers. So he knew that hitting the market with an additional 400 contracts to sell would add more energy to the seller's side of the imbalance. And if everything else remained relatively constant, at the very least, his 400 hundred contracts would result in further downward pressure on the price. But, there was also something else he knew; that the locals (the floor traders who typically scalp) would most likely be the first to respond to his order. And since he used to be a local himself, he would be intimately familiar with how they think and as a result, how they would likely behave. So if the locals acted characteristically, and he obviously must have assumed they would, then he knew that his order would unleash a downward force on prices equivalent to several 400 contract sell orders.

HERE'S WHY.

Scalpers are speculators and speculators need price movement to make money. There are two circumstances that have the most potential to create a big enough imbalance in the buy/sell order flow ratio, that will cause prices to make a significant move in one direction over the other.

One is a news event that compels an overwhelming number of traders to all want to do the same thing. And the other is a large, high volume order coming into the market, most notably an "at the market order."

Scalpers love anything that has the potential to drive prices in one direction. But they're especially fond of a large-high volume market order because they give any floor trader, not just scalpers, the opportunity to make some fast, easy, and very low risk money, if they're quick enough to respond.

Here's what I mean. One of the advantages of trading on the floor of an exchange is that you can pick and choose what orders you take the opposite side of. In other words, a floor trader can choose who he trades with, with one exception; if he is actively bidding or offering and another trader chooses to "hit" (take the opposite side of) his bid or offer.

So, if a floor trader wants to be short, for example, he could make eye contact with another floor trader who is actively bidding (wants to be long), and then using his hands, signal to the other floor trader that he just hit his bid. Or he could take the opposite side of a buy or sell order that is originating from off the floor. If he decides to take the opposite side of an order originating from off the floor, he may not know the identity of the trader or organization the order is coming from, but he certainly has to know the identity of the broker who is executing the order on behalf of that trader or organization.

Since scalpers are in a position to choose what orders they take the opposite side of, as well as, see and hear from hand signals and screaming, the buy/sell order flow as its coming into the market, they soon learn how easy it is to make money exploiting large-high volume orders that have to be filled. Especially if they think those orders have the potential to cause some price movement.

When an accomplished scalper sees or hears that a large order is hitting the floor of the exchange, he will immediately have a sense of whether or not there's enough inventory available to complete that order at the current price.

Meaning, will there be enough bids or offers available to take the opposite side of the order to fill it completely. Because if he thinks there won't be enough inventory, then he knows that whoever is responsible for getting that order filled is going to have to move the price to do it.

What we have here is the same principle of price movement at work as I described above with an electronic exchange. Except, instead of a computer matching orders and moving the price to fill the excess demand, individual traders have to do it themselves. For instance, in our example, the retired floor trader sent a 400 contract "sell at the market" order to the floor of the soybean pit. A "market order" specifically does not give the floor broker executing the order any discretion to try and get the best price he can for all 400 contracts. A "market order" says to the floor broker, get this trade executed at whatever price you have to pay.

What happens if the floor broker responsible for filling that order can't get a total of 400 buy orders to complete the trade at the current price? In other words, what if there aren't enough bids (including resting buy orders) available to take the opposite side of his sell order at the price soybeans are trading at when he gets it? He will have no choice but to hit any available bids at the next lowest price level. If he hits every available bid at this next lowest price and still can't (doesn't) get the entire order filled, then, again he will have no choice but to go down another price level, and keep on going lower, until he finds the number of bids he needs to complete the order.

As a side note to those readers who are really new to this business, if you’re wondering why the floor broker immediately went to the next lowest price level to hit bids, it’s because there wouldn't be any bids at the next highest level. To understand what I'm getting at to have to apply the most basic of all trading principles, namely that everyone wants to buy low and sell high or sell high and buy low. It’s the only way anyone can make money from price movement.

You can think of it like this, if a floor broker runs out of buy orders to take the opposite side of his trade at a particular price (let's say at 10), it means there aren't any more traders at the exchange or in the world for that matter, who, in that moment, believe that 10 is a low enough price for them to buy at. If the primary objective for trading is to buy low and sell high and there isn't anyone who is willing to buy at 10, there certainly won't be anyone available to buy at 11.

The moment the broker runs out of buy orders to hit at 10, "the market" for buy orders will automatically shift to 9 or lower. Unless a moment later an excess supply of buy orders enter the market creating a shortage of sell orders available to take the opposite side of those buy orders. Large orders like the "sell at the market" order the retired floor trader called down to the soybean pit, can act like a freight train barreling down the tracks, if there aren't enough buyers to take the opposite side. Unless the order runs into any resistance, meaning other traders willing to be buyers, the order will create instant downward pressure on the price.

Scalpers can add to that downward pressure by simply "NOT" making themselves available to take the buy side of the trade. If any of them were actively bidding when the 400 contract sell "at the market" order hit the floor, they can instantly withdraw their bid by simply putting their hands down; which is exactly what they'll do. As a rule, scalpers almost never take the opposite side of any large-high volume order. If a large order is the equivalent of a freight train barreling down the tracks, then taking the opposite side of that order is the equivalent of standing front of that train waiting to get run over. Meaning take the other side and the odds of finding yourself in a losing trade are extremely high.

On the other hand, if the scalper can hop on the train before it gains too much momentum, the likelihood of finding himself in winning trade is extremely high. How does the scalper "hitch a free ride on the profit train" as I like to refer to it? By being one of the first to realize there's a large sell order in the market that has to be filled. And quick enough to turn that realization into a short position before the rest of scalpers find out about it and start trying to get short themselves.

By actively or aggressively selling (attempting to take a short position), the scalpers will be competing with the floor broker for whatever buy orders are available. Every bid the scalpers manage to hit before the floor broker does, takes away buy orders he could have used to fill the 400 contract sell order. The more buy order inventory the scalpers can take away from the floor broker, the more they are assuring themselves that the broker will be forced to move the price of soybeans to lower levels to find the bids he needs to completely fill his order.

So for those scalpers who managed to get short early, at higher prices, the lower the floor broker has to move the price, the more profits they accumulate. The scalpers are getting a free ride because the floor broker is doing all the work. The floor broker is forcing the price lower because he is obligated to fill his customers order.

In this particular instance the floor broker had to move the price of soybeans ten cents a bushel to get the 400 buy contracts he needed to take the other side of the trade. Or to put it another way, since the soybean contract trades in one quarter cent increments, the broker had to move the price forty price levels lower from where the price was when he actually got the order in his hands.

But the free ride for the scalpers isn't quite over yet. To book their profits the scalpers at some point will have to exit their short position. To do that they have to be buyers and to be buyers they will have to find another trader who will take the sell side of their trade. And whose sell order do think they will use take their profits? You guessed it, as the scalpers decide to book their profits, if the floor broker still isn't finished filling the original 400 contract sell order, the scalpers will simply take the buy side to exit their short position at a much lower price than where it all started.

When it was all said and done, the retired floor trader ended up with a range of fills on his sell order from a high of $7.86 all the way down to $7.76 a bushel. His average price for all 400 contracts was around $7.78 a bushel. The market continued to trade lower for the rest of the day and closed at $7.72 and a half. Considering that the only apparent reason the retired floor trader had for making the trade was to prove a point to the analyst, he still ended up $110,000.00 profit by the close of trading that day - ($7.78 average price minus $7.72 and a half closing price equals 5.5 cents per contract in profits x $50.00 per penny per contract equals $275.00 x 400 contracts equals $110,000.00).

Now, before we go any further, there are a few more components to this example that I want you to be aware of. First, the kind of traders who hit the market with large orders are usually, by rule, very sophisticated. They along with the many organizations that use the markets as hedging mechanisms know what they're doing. As a result, they will rarely ever use an "at the market" order to get in or out of a trade.

Quite the contrary, they will go to great lengths to disguise the fact that they attempting to get in or out of a large position. The most common way of disguising their intentions is to give the executing broker discretion as to how he fills the order. In other words, they leave it up to the broker to get the order filled in a way that has the least amount of adverse impact on the price. The broker would have to use his best judgment to determine when to bid or offer or step out and hit available bids or offers so that he’s creating as little of an imbalance in the buy/sell order flow ratio as possible.

When the executing broker starts filling the order, he will need to be as subtle as possible, so other floor traders don't suspect he has a large order that has to be filled. This is why the retired floor trader was so confident the scalpers in the soybean pit would stop bidding and instantly turn sellers the moment his "at the market" sell order hit the floor. He knew the scalpers would assume that any professional (large order) trader who didn't care about using any discretion to fill their large order is acting out of some degree of desperation.

By seeing a 400 contact "at the market" order hit the floor, the typical scalper would immediately ask himself, why would an off the floor trader who is experienced enough to trade size be so impatient to get into a short position or out of a long position that it didn't matter what price his order was filled at. The most likely answer would be, that the off the floor trader has access to some important information about soybeans that will undoubtedly have a negative impact on the price. The last thing any trader wants is to be on the wrong side of a news event that creates a one-way flow in prices. Or to miss out on the opportunity to make some easy money that a one way flow creates.

As a side note *Some of you may be wondering how all of the price changes in an open outcry pit get on your computer screen. There are exchange employees stationed throughout the trading floor whose job it is to report all of the trading activity in the form of price changes. Every time these employees see two traders consummate a trade at a higher or lower price than the last reported price, the change is recorded and immediately sent to the member clearing firms, brokerage firms, news agencies or*

Chapter Six

The Various Sources of a Buy/Sell Order Flow Imbalance

As a speculator your objective is to find a way to profit from price movement. When you consider how prices move within the context of buy/sell order flow dynamics, there are a number of psychological implications that have a profound effect on how we need to think to be able take maximum advantage of that flow.

To understand these implications, we are now going to:

- *look at the multitude of sources from which buy and sell orders originate,*
- *look at the various combinations of buys and sells that are impacting the "order flow ratio" in any given moment, and*
- *dissect order flow dynamics in a way that help you come to a full realization as to why "anything can happen," and why "the risk of losing never goes away," regardless of how, at times, it may appear to the contrary.*

Most Common Sources of Speculative Buy & Sell Orders

The following is a list of the various types of speculators who enter into long or short positions with an objective of making a profit from price movement.

- *Non-professional retail traders who make their own trading decisions, including those who follow the signals of an advisory service or online guided chat room.*
- *Individual professional traders who speculate for their own account, including on and off the exchange floor scalpers and arbitrage traders.*
- *Professional money managers who offer the services of trading other people's money through the various types of managed funds, including the so called "hedge funds." I am referring to "hedge funds" in this way because managed hedge funds are primarily speculative. Although at times they will hedge their own speculative net long or short positions. Originally, when "hedge funds" came into existence they were for all intents and purposes speculative managed accounts, but were called "hedge funds" to circumvent SEC and CFTC regulations.*
- *Various independent trading firms and operations that have designed and enter buy and sell orders through automated trading programs, including "automated high frequency trading programs."*
- *Professional traders who are employed to speculate on behalf commercial banks, investment banks, brokerage firms, and the multitude of managed funds (hedge, pension, mutual, etc.) that*

will take a net long or short position in the various stock, futures and Forex markets.

Keep in mind as you read the list that each of these sources of speculative order flow will have their own reasons, and rational for believing, in any given moment, that the price is low and therefore time to enter their buy orders, or that the price is high and therefore time to enter their sell orders.

MOST COMMONSOURCESOF HEDGING BUY & SELL ORDERS

In Chapter 5, I gave you some examples of how the assets and inventories on hand, as well as, projected future assets, inventories, manufacturing processes, and contractual obligations of any economic enterprise can cause them to be what I referred to as "naturally long or naturally short."

To protect the value of these assets, as well as, stabilize their profit margins, many of these enterprises will hedge their exposure to rising or falling prices by taking an opposite long or short position in the various stock, futures or Forex markets.

The following is a list of the type of companies, business, manufacturing operations and financial institutions that will enter buy and sell orders using stock, futures or Forex exchange traded instruments or products to hedge the price risk created by their naturally long or short positions.

- *Investment banks, commercial banks, brokerage firms, mutual funds, mutual funds, pension funds, insurance companies, commercial trading operations, professional portfolio managers;*
- *Oil companies, natural gas companies, utility companies, airlines, railroads, trucking companies, mining companies,*

manufacturing companies that use copper, aluminum, platinum, gold and silver etc.;

- *Farming operations that grow wheat, corn, soybeans, sugar, rice, coffee, cocoa, etc.;*
- *Grain elevators;*
- *Companies that process wheat, corn, soybeans, sugar, rice, cocoa, etc., into finished products;*
- *Livestock producers and the companies that process the meat;*
- *Housing contractors, lumber yards.*

Again, as you read the above list, I want you to keep a few points in mind.

First, the size of many of the buy and sell orders coming into the exchanges from hedgers can be huge. So large that the typical non-professional trader can't imagine how it's possible that anyone could take the amount of risk associated with putting on a position large enough to actually have a significant impact on the buy/sell order flow ratio. The problem with this thinking is, it doesn't take into account that when a true hedger enters into a long or short position in the stock, futures or Forex markets, they aren't doing so to speculate on price movement.

The hedger's purpose for getting into a trade is to reduce or eliminate the risk they were already exposed to by the nature of their operations. Once the hedge is in place, and if it's done it properly, it won't matter what direction the price moves or how far. So, the size of hedgers buy and sell orders is only limited by the breadth and scope of his economic operations. The risk for the hedger is getting a trade on without creating price movement against their position while they're doing it.

Second, hedging decisions are often made completely outside the context of the fundamental and technical analytical criteria that speculators use to predict what direction the price will move. I'm not implying that hedgers don't or won't take the technicals or the fundamentals into consideration when they're deciding the best time and price to put on a hedge. It's just that their unique inventory situation (both current and projected), or their contractual obligations to deliver or take delivery of something may require them to enter a potential price moving order at a time and a price that from a technical or fundamental perspective don't make any sense.

What we have is a situation where at any given moment, a huge buy or sell order can be hit the exchange, one large enough to have a major impact on the direction of the price, where the rationale behind the order had absolutely nothing to do with the fundamental criteria or the technical patterns the typical speculator uses to determine which way the price of something is going to move.

COMBINATIONSOF BUY/SELL ORDER-FLOW VOLUME

- *In any given moment, there could be "any" number of speculators who, for whatever reason, believe that the price is going higher and intend to initiate a long position. As a result, they will be impacting the buy/sell order flow ratio with an unknown number of buy orders that need to be filled.*
- *In any given moment, there could be "any" number of speculators who are already in a long position at a lower price and for whatever reason, intend to take their profits. They will be impacting the buy/sell order flow ratio with an unknown number of sell orders that need to be filled.*
- *In any given moment, there could be "any" number of speculators who are already in a long position at a lower price and for whatever reason, intend to cut their losses. They will be impacting the buy/sell order flow ratio with an unknown number of sell orders that have to be filled.*

- *In any given moment, there could be "any" number of speculators who, for whatever reason, believe that the price is going lower, and intend to initiate a short position. They will be impacting the buy/sell order flow ratio with an unknown number of sell orders that need to be filled.*
- *In any given moment, there could be "any" number of speculators who are already in a short position at a higher price and for whatever reason, intend to take their profits. They will be impacting the buy/sell order flow ratio with an unknown number of buy orders that need to be filled.*
- *In any given moment, there could be "any" number of speculators who are already in a short position at a lower price and for whatever reason, intend to cut their losses. They will be impacting the buy/sell order flow ratio with an unknown number of buy orders that need to be filled.*
- *In any given moment, there may be a hedger or a number of hedgers who need to reduce or eliminate the risk of a naturally long position. As a result, they intend to initiate a short position in the applicable stock, futures or Forex market, impacting the buy/sell order flow ratio with an unknown number of sell orders that need to be filled.*
- *In any given moment, there may be a hedger or a number of hedgers who need to reduce or eliminate the risk of a naturally short position. As a result, they intend to initiate a long position in the applicable stock, futures or Forex market, impacting the buy/sell order flow ratio with an unknown number of buy orders that need to be filled.*

- *In any given moment, there could be a hedger or a number of hedgers who need to "lift" their hedge of a naturally long position. As a result, they intend to liquidate their position, impacting the buy/sell order flow ratio with an unknown number of buy orders that have to be filled.*
- *In any given moment, there could be a hedger or a number of hedgers who need to "lift" their hedge of a naturally short position. As a result, they intend to liquidate their position, impacting the buy/sell order flow ratio with an unknown number of sell orders that have to be filled.*

DISSECTING BUY/SELL ORDER FLOW DYNAMICS

If we look at price movement as a function of an imbalance in order flow, then, as speculators, the only way we can make money is if the orders flowing into the market are imbalanced in our favor, after we put on position.

There are only two ways we're going to find the order flow going in our favor after we put on a trade. One way is to actively create an imbalance in our favor; the other is to passively rely on other traders do it for us.
How realistic is it to actively cause enough of an order flow imbalance so that prices actually move in ones favor? If you have the financial and psychological resources to trade with size, it’s a lot easier than you would probably imagine. In fact, speculators who would fall into the large or mega large category, under certain circumstances, are more than capable of moving most any individual stock, futures or options contracts in a direction that benefits them, and they do it quite frequently.

Let's go back to the soybean trade I illustrated in the last chapter. It certainly wasn't the intent of floor broker responsible for filling the 400 contract order to move the price of soybeans ten cents. He was forced to move the price lower because he was obligated to fill his order. He had to offer soybeans at lower prices to attract someone to take the other side of the trade.

Now if a floor broker can move the price because the circumstances required him to, would it be reasonable to think that other traders can also move the price because it suits their purposes? The actual mechanics behind the way prices move in the stock, futures or Forex markets is really quite simple and not much different than if you were participating in a car, fine arts or antique auction, only in reverse.

At a public auction if two or more people want to buy the same item they will bid the price up to drive other participants out of the market. As the price gets higher, people will drop out of the bidding because they're not willing to pay any more than their last bid. The price will continue to move up as long as there is more than one bidder willing to pay a higher price. And the price will stop moving when there is only one bidder left. In other words, as long as, there is more than one participant the price will move.

The difference with the stock, futures or Forex markets, it is a lack of participation by one side or the other that causes the price to move. Remember each trade requires two participants a buyer and seller. In the markets the price moves (gets bid up or offered lower) to find buy and sell orders to take the other side of the trade.

For example, if, for whatever reason, traders are displaying an unwillingness to buy in sufficient numbers to equalize the flow, then those traders who want to sell will have to offer the price lower as an incentive to attract other traders into the market as buyers. And conversely, if there's a lack of sellers, then the traders who want to buy will have to bid the price up as an incentive to attract other traders to take the sell side of their trade. When there are enough orders for each side, they get matched up at the current price resulting in no movement.

So, if you wanted to purposefully move the price of something that was currently trading at 10 up to 11, for example, all you would have to do is trade with enough size to take out all of the offers at 10 and then start hitting any offers available at 11. If there aren't any offers at 11, meaning in that moment, there wasn't one trader in the world willing to sell at 11, you could bid the price directly up to 12. By bidding the price up from 10 to 11 you would be making all of the trades you made at 10 winners and correspondingly make all of the traders who took the other side of your trades at 10, losers.

To keep the price moving in your favor, all you would have to do is repeat the process over and over again. How far you move the price in your direction would only be limited by:

- *your tolerance for the risk; and*
- *your financial resources in relationship to the number of opposing orders you encounter in any given moment.*

PRICES TYPICALLY TAKE THE PATH OF LEAST RESISTANCE

For a large speculator who wants to move the price, the most ideal circumstances are thinly traded markets or very liquid markets that are having an uncharacteristically low volume day.

Because the fewer the number of opposing orders that he encounters the easier and less expensive it will be to move the price. As a side note, a hedger who's objective is to eliminate his risk, would want there to be opposing orders so that he could get his buys or sells filled at the best price possible.

I have personally worked, in the capacity of a trading coach, with several on and off the floor speculators who routinely put on futures positions in the thousands of contracts at a time. Most of them rarely, if ever, put these large positions on as part of a long term strategy. But rather, when they sensed that a large order could create enough of an imbalance in the order flow that it would trigger a short term buying or selling panic among the unsophisticated and less experienced traders in the market.

Seasoned traders will often refer to their inexperienced and unsophisticated counter parts, as "weak longs" and "weak shorts." Large speculators understand that less experienced and unsophisticated traders typically operate out of a "herd" type of mentality; making it possible, under the right conditions, to stampede "the herd" in or out of a position, in a way that benefits the large speculator at, of course, the direct expense of "the herd."

For example, let’s say a large speculator decides that a particular market is poised to trend up or it could already be trending up and he wants to get into a long position at a lower price. What he'll do is wait for the right market conditions (note: the right market conditions is too big of a topic to get into right now), where he believes that a huge sell order will create enough downward pressure on the price so that it causes the "weak longs" who bought at the current price or higher to panic and start selling to get out of their long positions. If he enters a large enough sell order to start a stampede of “weak longs,” trying to get out, the additional sell orders flowing into the market from the “weak longs” will give the large speculator the sell order inventory he needs to take profits on the original sell order he used to trigger the stampede, as well as, accumulate a long position at a lower price.

How much would a strategy like this cost. Well if doesn't work; the cost in losses could be considerable. Otherwise, in terms of margin requirements not that much. The margin on the 400 contracts for the soybean trade from the example above would have been about $300,000 at the time. That may sound like a lot to those of you who are relatively new to the business.

But if you're managing a billion-dollar speculative account (which is not that large by today’s standards), $300,000 in margin is less than three one-hundreds of one percent of your account. In other words, all it took, in that instance, to move the soybean market 10 cents was $300,000 in margin. By the way, the margin would have much less if the orders were coming from a bona-fide hedger.

So far we have learned about two categories of traders that have the ability to move prices. There are bona fide hedgers whose trades can have a very significant impact on the buy/sell order flow ratio, if there aren't enough opposite orders in the market to absorb theirs. But since the primary objective of the hedger is to eliminate the economic risk of doing business, they generally don't use the stock, futures or Forex markets to purposefully move the price or speculate for that matter.

Quite the contrary, under normal circumstances hedgers will go to great lengths to disguise the size of their orders to insure they are filled at the best possible price. Meaning, they don't want their buy orders to cause the price to be bid up or their sell orders to cause the price to be offered lower. Once they are properly hedged they don't care which way prices move. I have a personal example that will illustrate some of things that hedgers to make sure their orders get filled at the best possible price.

In 1982 I was working for Merrill Lynch Commodities as a retail broker at their Chicago Board of Trade office. Compared to today, in terms of sophistication, the trading industry was in its infancy. No personal computers, electronic trading platforms or slick financial news stations. However, Chicago did have a local news station that reported financial news during trading hours.

Our office had a TV mounted to the wall, where, we as brokers could watch or listen to the station throughout the day. We also had what is called a squawk box. The squawk box was a conference call speaker for a telephone attached to an open phone line that was connected to the various trading pits at the Chicago Board of Trade, the Chicago Mercantile Exchange and the COMEX in New York.

Merrill Lynch employees on the exchange floors would rotate throughout the day to each of the pits (financials, grains, metals, meats and currencies), pick up the phone and tell the Merrill Lynch brokers throughout the system to the best of their ability what was going on in the various pits.

Since specific floor brokers always executed trades for certain large off the floor traders and commercial hedging operations, the roving employees could tell us who (in all likelihood) was entering large buy and sell orders in any given moment.

One morning, while sitting at my desk I happened to be watching the local financial channel and a vice president for a company called Heinhold Commodities, at the time one of the largest hog producers in the world, was being interviewed by the station. This vice president was making a very strong case for why buying hog futures was a particularly good investment at that time. He had all kinds of reasons why the price of hogs should be going up.

As I'm listening to this, I noticed that the phones lines started to light up. Local, at home, commodity traders in the Chicago area were obviously watching the same program because almost all of the brokers in our office were being inundated with buy orders for hog futures. All of the activity created quite a commotion in contrast to the relative quite that existed before hand.

While the brokers where time stamping their customers buy orders and calling them down to the floor of the exchange, one of the roving Merrill Lynch employees happened to step in the hog pit to report over the squawk box what was going on. He noticed a lot of retail buy orders flowing into the market. Not just from Merrill Lynch customers but also the other major brokerage houses at the time.

Naturally, the price of hogs immediately started to climb higher, and then very matter-of-factly, the roving Merrill Lynch employee announced that Heinhold was a major seller. Meaning that, Heinhold waited for the retail traders to drive the price up and then started selling into their buy orders. Basically Heinhold sent one of their vice presidents on TV to encourage traders to buy hog futures because they had a very large hedging position they wanted to get on and needed buy order inventory at the exchange to take the other side of their sell orders.

Remember large orders can move the price, so it is almost never in the best interests of a hedger who is about to place a large order to reveal or tell the truth about what they intend to do. In other words, traders who put on large positions are notorious liars about their intentions, unless the truth will benefit them in some way.

> ***A note of interest***: *Since in all likelihood the roving Merrill Lynch employee would not have had an opportunity to be watching TV, he wouldn't have had any advance knowledge of the vice*

The second category are the large speculators. Without going into much detail, I explained that under certain types of market conditions, they will use large orders to execute trading strategies that attempt to drive weaker, less sophisticated traders into a position so that they will have enough opposite orders to take their profits. Or out of a position, so that they can take the place of the weaker trader at a more attractive price.

Now, before we get into the next category, there are a couple of points I want to remind you of. Hedgers who are actually hedging are not trying to win, because they aren't speculating, so it doesn't matter to them if the price moves or which direction it goes when it does. On the other hand, speculators are always trading to win and therefore need the price to move to do it. As a result, large, sophisticated speculators will often engineer their own winning trades by taking an active role to deliberately cause the price to move in a direction that benefits them.

The last category we're going to look at, which basically includes the rest of the market, is the speculator who doesn't have the financial or psychological resources to move the price in his favor. In all likelihood, if you're reading this book, you're going to be in the category of traders who are ***entirely dependent on the actions of other traders for you to make money***. If that's the case, you're not going to find yourself in winning trade unless someone or a number of traders come into the market with enough volume to create an imbalance in the buy/sell order flow ratio in your favor.

Taking into consideration three basic conditions that govern your circumstances:

- *the only reason you're trading is to win;*
- *you need price movement to find yourself in a winning trade; and*
- *you don't have the resources to take an active role to impact the order flow in your favor; I would like you to contemplate the following question. After you decide to put on a trade,* ***where is the order flow imbalance going to come from to make your trade a winner****?*

At the beginning of the chapter I listed a variety of both hedging and speculative sources of order flow. Out of all of the possible buys and sells that can flow into the market from the vast variety of participants, who's going to make your trade a winner and furthermore why are they going to do it? Conversely, what's going to stop any one or more of these same participants from putting on a trade in the opposite direction of yours, causing an imbalance in the flow against your position.

Hopefully, you didn't have to think about this very long before it occurred to you that without some extraordinary psychic abilities, there's no way any of us could know in advance where the next order is coming from, how large it’s going to be, whether it's a buy or a sell or what effect it will have to the buy/sell order flow ratio. Even traders who are entering large orders with the intent of moving the price don't know if they will be able to accomplish their objective. Simply because they have no way of knowing the number of opposing orders that may hit the market in the next moment or beyond. For example, there could be a large hedger who's been waiting for a substantial buy or sell order they can use to take the opposite side of a hedge they need to put on. The hedgers order could end up absorbing the speculators order, causing the price to stagnate. This would be exactly what the hedger would want because their order would be filled without the price moving against them.

However, this wouldn’t be a good situation for the speculator, because now he's in a large position where the price didn't move in his favor. He has no profits. And to exit the position he will have to hit the market with another large order in the opposite direction of his entry. If there aren't enough opposing bids or offers to take the other side of his trade, he'll have to move the price against his position to find them. In other words, he will cause his own losses trying to get out of his position.

The point I am making here is, if a speculator is capable of hitting the market with a large enough order to actually move the price doesn’t know what will happen, what are the implications for the rest of us who are using various forms of fundamental and technical analysis to predict what will happen. In other words, what is about the way fundamental and technical analytical methods work that will enable us to accurately predict the direction of the price, when we don’t have a connection to the actual mechanism that determines what direction the prices moves – the buy/sell order flow.

Chapter Seven

Understanding Technical Analysis from a Buy/Sell Order Flow Perspective

From an order flow perspective the underlying force that drives all price movement is an imbalance in the buy/sell order flow ratio. As the buy and sell orders flowing into the exchange are matched up to create a consummated trade, unless there's even number of buys to sells, that matching process will result in an up tic in the price or a down tic in the price. In any given moment, if more buy orders are flowing into the exchange than sell orders the price will tic up, if more sell orders are flowing into the exchange than buy orders the price will tic down. Every buy and sell order plays a part in which way the price moves, but large orders have the greatest potential to create an imbalance in the order flow ratio and therefore have the most potential to move the price.

The raw buy/sell order flow can best be described as pure chaos. If you've ever been on the floor of an exchange, especially when it is busy, then you know exactly what I'm talking about. Its chaotic because the buy and sell orders that enter the flow reflect all of the competing and conflicting intentions, beliefs and objectives of all the traders from around the world who are using a buy or a sell order to either eliminate the risk associated with price movement as a hedger, to make money by speculating on the direction of the price, or to make money by deliberately attempting to create an imbalance in the order flow ratio to move the price in a particular direction or stop the price from moving in a particular direction.

In the process of matching up the various size buy and sell orders, a transformation can take place that I think is nothing short of a phenomenon.

Pure chaos can turn into symmetrical patterns that have predictable characteristics. As buy and sell orders become consummated trades and the trades, in turn, distilled into up and down tics in the price, if we plot those price changes on a graph we will find they coalesce into various types of patterns. The patterns represent the actions taken by each individual trader in a distilled, collective or aggregate format. These patterns are quantifiable, measurable and can be, at times, as symmetrical in their design as a snowflake.

Symmetry implies an underlying uniformity of behavior. And anything that is uniform in its behavior also implies that behavior may repeat itself, making it predictable. Why, because the collective behavior patterns created by the activity of several individual traders interacting with one another, day after day, week after week or month after month, can be just as reliable in their predictability as the behavior patterns typically displayed by an individual person. As individuals, all of us have the tendency to act the same way under the same or similar circumstances and situations. Technical analysis applies the same principle to groups of traders. Representing the price changes created by groups of traders over time on a chart, can have the effect of organizing the chaos of the flow in a way that allow us to identify any behavior patterns that may be imbedded within the chaos of that flow; patterns that would otherwise be invisible and therefore unperceivable.

To my knowledge it was the Japanese, well over a hundred years ago, who first noticed that groups of people interacting with one another, buying and selling, can display collective behavior patterns that repeat themselves over and over again. They discovered that if you organize that buying and selling activity into what are now commonly referred to as Japanese candle stick charts, it was possible to make some very accurate predictions about what direction the price will move after a pattern appears.

Modern day technical analysis also uses visual patterns displayed on price charts like the candlesticks developed by the Japanese, but it has also evolved to use mathematical equations to find patterns imbedded in the buy/sell order flow, as well. Once you find a pattern that consistently repeats itself, the presumption is, after the pattern shows up, traders will behave in a way that's consistent with the way they behaved after the pattern developed in the past.

PRICE BARS

The most fundamental component of a technical chart pattern is a price bar. A price bar is a vertical line that represents the range of prices of something traded at during a specified period of time. The price bar is plotted on a chart where the vertical axis is divided into incremental price changes from low to high and the horizontal axis is divided into time periods that correspond with the amount of time each individual bar represents.

A single bar can represent any time period that suites your purposes, from one minute on up to a year or more. For example, on a five minute bar chart, each vertical line would represent five minutes of price action. Meaning, in that five minute period the buy/sell order flow produced a range of prices at which trades were made.

The top of the bar would represent the extreme high price where one or more buy and sell orders were matched up to consummate a trade. And the bottom of the bar would represent the extreme low price where one or more buy and sell orders were matched up to consummate a trade, in that five minute period.

After five minutes of plotting the price action, the bar is closed and a new bar is started. So a market that's open for six hours would produce 72 five minute bars. If you were looking at a daily bar chart for a market that's open for six hours, all of the trades that were made for the whole day would be represented by a single vertical line.

As the bars are plotted in sequence, behavior patterns will begin to emerge based on the relationship between two or more bars in a series. For example, if you were to see a series of bars where the high price on each bar was higher than the previous bar and the low price on each bar was higher than the previous bar, in technical analysis terms, this would be considered an up trending market. Conversely, a down trending market is one where you can clearly see a series of bars where the high price achieved is lower than the previous bar and the low price is lower than the previous bar.

What would cause a market to behave in a way that it displayed a series of price bars where each bars high price was higher than the previous bar and the low price was higher than the low of the previous bar?

The simple answer is there’s enough of an order flow imbalance in favor of the buyers to drive the price higher in each subsequent time period and not enough sell orders to cause the price to go any lower than the low of the previous price bar. Now, if you want to know the reasons why more buy orders are flowing into the exchange than sell orders, that question isn’t so easy to answer, if it can be answered at all. There could be a multitude of different hedging or speculative reasons that traders used to justify why they entered the buy orders that caused the price to go up. Some percentage of the traders participating could have been motivated by the same reasons or rational for entering their buy orders, but the only way we could know for sure is to ask them; not a likely possibility, since people from all over the world are trading in each of the markets. From a psychological perspective, this issue of the reasons why traders enter their buy and sell orders is a big topic with some profound implications on how we need to think to be successful. This is something I will cover in greater depth further on.

There are a number of ways to trade a trending market. From my experience, however, one of the most effective is buy dips in an up-trending market and sell rallies in a down trending market. Many of you I'm sure have heard the sayings "the trend is your friend" and "go with the flow." What they mean is you normally wouldn't fight with your friends, so don't fight the trend. And if you can't cause the flow to move in your favor, then wouldn't make sense to just "go with the flow." Buying dips in an up-trending market and selling rallies in a down-trending market is the practical implementation of operating out of the principles of “the trend is your friend” and “go with the flow.”

However, like most everything else about trading, buying dips and selling rallies sounds simple enough, but it’s not; especially if you intend to develop a trading plan with specific entry and exit rules. Developing a trading plan with specific entry and exit rules will require a comprehensive understanding of how to draw trend lines, how to define and recognize trend symmetry, understanding the relationship between trends and retracements in different time periods, and how to recognize the difference between a normal retracement (dip or rally) and a retracement that violates the symmetry of the trend in the time frame you’re trading in.

There are already a number of books available on the characteristics and nature of trending markets, as well as, other widely used chart patterns. So I don’t have any intent on covering these topics here.

Rather, my purpose is to help you recognize that in spite of how accurate technical chart patterns can be at predicting the direction of the price, they all have inherent limitations. When you recognize, understand and compensate for these limitations, you won’t be susceptible to operating out of the “illusion of analysis.” In other words, you won’t have any potential to ever think that a buy or sell signal from a technical chart pattern or indicator is so good or reliable, that the risk of a trade not working, no longer exits.

When I started trading, there were very few mathematically-based technical tools available. We had moving averages, RSI, MACD, Stochastics and a few others. Now of course there are hundreds, if not thousands of mathematically based technical indicators that will help us get into winning trades and out with good profits.

The most fundamental of all mathematically-based technical methods is a moving average. A moving average is usually a line plotted on a price chart right along with the price bars that are being used to calculate the average. For example, if I wanted to see a 16 period moving average of five minute price bars, I would take the high price, the low price, the open price and close price of the last 16 bars and add them all together and then divide the sum total by 64.

You divide by 64 because that's the number data points you are averaging (16 highs, 16 lows, 16 opens and 16 closes). Once you have your average price, you then plot it as a dot on the chart where your next five minute bar will be forming. To get the next dot (average price) you wait for the current bar to close, add the high, low, open and close price of that bar together, then add that total to the total of the previous 16 bars after you subtract the oldest bar in the series from the total. Now divide the new sum by 64 and plot the new average price on your chart. The last thing you have to do is draw a line connecting the dots. What you will end up with is a continuous line that will give you a graphic representation between the average price over the last 16 five minute bars and what the current bar is doing in relationship to the average.

As with all chart patterns there are a number of different ways to trade a moving average. One of the most common is to plot two averages, a long and a short and wait for them to cross after the market has been in a trend for a predetermined number of bars. The size of the averages you decide on will be a function of what gives you the best results. On intraday charts I like to use a 16 and a 7 period moving average.

If you not already familiar with moving averages, what you will find is, in a market where the bars are making consistently higher highs and higher lows, the lines that represent both the 16 and 7 period averages will be trailing the price action, below the bars. So if the next bar continues the up trending pattern it should be well above the 16-period line and less above the 7-period line. The further the bar is above the lines the stronger the trend. If and when the trend starts to lose momentum the bars will start to `get closer to the moving average lines.

If the market loses enough up-side momentum, the line representing the shorter 7 period average will cross the line that represents the longer 16 period average to the downside. When that happens, it can be viewed as a confirmation that the up-trend has run out of steam and therefore time to enter a sell order.

If the bars have been trending down, everything is exactly the opposite. When the line representing shorter period average crosses the line representing longer period average to the upside it can be viewed as a confirmation that the down trend has run out of steam and therefore time to enter a buy order. If you get the right combination between the lengths of the averages and the timeframe of the bars, you would be amazed how accurate something like a simple crossing moving average can be in predicting swing tops and bottoms.

DefiningTechnicalAnalysis

Technical analysis is a methodology that applies geometrical relationships and mathematical equations to price data to find repeatable behavior patterns imbedded in the chaos of the buy/sell order flow. Technical methods will cause the patterns to emerge and become clearly visible, giving us the ability to measure the frequency of their repetitiveness, as well as the potential for producing profits. To measure their potential to produce profits, what we are looking for is a positive statistical relationship between the occurrence of the pattern and how traders typically behaved (the effect their orders had on the buy/sell order flow ratio) after the pattern developed.

If, over a series of occurrences we find that traders exhibit a response that causes the price to move in one direction more than the other a high percentage of the time, what we will have discovered is a statistical, as well as a historical, winning edge. This definition may sound simple enough, but from a psychological perspective the probabilistic nature of technical predictions present us with some challenges that most people find very difficult to over-come.

Chapter Eight

The Inherent Limitations of Technical Analysis

Chances are you wouldn't be reading this book, if you haven't already been exposed, in one way or another, to how incredibly accurate some technical chart patterns and mathematical indicators can be at predicting the direction of the price. So accurate, in fact, that it wouldn't be unusual to get a signal to enter a trade and find that you bought the absolute low tic of what turned out to be an up-trending market, or that you sold the high tic of what turned out to be a down-trending market. The patterns are real, they show up over and over again in every time frame and with the sophistication of today's electronic trading platforms, technical patterns and indicators have the potential to turn a personal computer into a perpetual money making machine.

At the same time however, there are some very perplexing psychological characteristics associated with the nature of technical chart patterns and indicators that you're going to have to become aware of and compensate for, that is if you plan on taking maximum advantage of the potential they offer to make money.

ONE:

The geometrical price patterns and mathematical equations that constitute technical analytical methods are ***NOT*** *giving us favorable odds of success on a "prediction-by-individual prediction" basis. What we are getting is favorable odds of success over a "series of predictions," where the outcome to each individual prediction is unknown and the odds of success for each individual prediction cannot be determined.*

When we find ourselves in a winning trade as a result of acting on a prediction from a technical pattern or indicator, the experience can give us the distinct impression that technical predictions are designed to tell us what other traders are going to do next, on a trade-by-individual trade basis.

Regardless of how it appears, this is absolutely not the case.

Technical patterns and indicators are only telling us there's a possibility the price will move in the direction predicted by the pattern or indicator.

Possibility means exactly what it implies. The pattern is saying it is possible that some undeterminable number of traders (it could be one trader or several) will come into the market with enough order flow volume to cause the price to move in the direction predicted by the pattern or indicator. However, it is also possible there won't be enough traders or orders coming from those traders to cause the price to move in a direction that is consistent with the prediction. As well as being possible that one trader or some undeterminable number of traders come into the market with enough order flow volume to cause the price to move in the opposite direction predicted by the pattern or indicator.

In other words, just because a pattern appears and is identified, it doesn't mean that ***anything still isn't possible.*** What it does mean is, based on the impact traders had on the direction of the price the last several times the geometrical price or mathematical pattern developed, there's a positive statistical relationship between the pattern and the outcome, indicating that some indeterminable number of traders, for whatever reason (hedging, speculative, etc.), will come into the market with enough order flow volume to fulfill the prediction of the pattern. Keep in mind that the statistical relationship between the pattern and the outcome to the pattern is based on a series of predictions. A series or sample size of predictions that is large enough to determine if the positive statistical relationship is reliable. So when a pattern appears, what we're getting is just the possibility that any given individual prediction within the series could, ***but not necessarily*** result in a favorable outcome and that over a series of predictions we'll get more favorable outcomes than not.

I'll give you a non-trading illustration to make this easier to understand. If you had an evenly weighted coin and flipped it a thousand times, a clear, unmistakable pattern would emerge. There would be a relatively even distribution between heads and tails. If you did another one thousand flip series the same pattern would emerge. Each thousand flip series would produce a consistent result, a relatively even number of heads and tails.

The even distribution between heads and tails over a large sample size of flips is a statistically reliable pattern. If someone gave me the opportunity to place a bet on whether or not the distribution between heads and tails will be within a few percentage points of one another over a thousand flip series, I would bet that it would and more than likely win the bet every time. On the other hand, betting on the outcome of each individual flip of the coin within a thousand flip series is another matter entirely.

So, if someone said, correctly predict the sequence between heads and tails for each individual flip, I wouldn't even attempt to do it, much less to actually bet on whether I would be correct. I wouldn't do it because even through there's a reliable 50/50 distribution pattern over a large series of flips, the sequence of heads and tails on a flip-by-flip basis is totally random. Random meaning, any possible combination of heads and tails could appear, including streaks where heads comes up several times in a row or tails several times in a row, making it extremely difficult to accurately predict, even though the probability of seeing a head or a tail on each individual flip is 50/50. With one major exception that I'll get into in a moment, technical patterns have a similar dynamic at work.

Technical methods will find behavior patterns imbedded in the buy/sell order flow that repeat themselves with statistical reliability. For example, we could find a technical pattern that produces a prediction about the direction of the price that's correct 70% of the time and incorrect 30% of the time over a large series or sample size of predictions. However, as with the coin flipping illustration above, within any given series of occurrences of the pattern, there's a random distribution between the predictions that are correct and those that are not. Meaning, regardless of the fact that we are using a bona-fide analytical method to tell us what to do and when to do it, there's literally no way to know which individual predictions within the series are going to be correct. Here's why.

The geometric and mathematical patterns created by price movement, are a highly distilled, aggregate representation of all of the underlying reasons that cause traders to enter a buy and a sell order. Whereas the outcome to each individual prediction produced by the patterns are created by the impact that each individual buy or sell order has on the relative degree of balance or imbalance in buy/sell order flow ratio after the pattern has developed. In other words, the combined, aggregate behavior of all of the traders who participated in the creation of the pattern, produce the prediction, whereas the outcome to each individual prediction is the result of the size of the individual buy and sell orders that any given trader submits to the exchange after the prediction is produced.

In short, it's the aggregate behavior of traders that produce the predictions.

It's the ***non-aggregate/individual*** behavior of traders that produce the outcomes to the predictions.

The outcomes to the predictions are random in relationship to one another, because, all it takes is one trader deciding to put on a position large enough to initiate a chain reaction wave of buying or selling to cause a prediction to be either correct or fail. And that one trader's justification for entering their buy or sell order need not have any relationship with the technical pattern that produced the prediction. Geometric relationships and mathematical equations simply can't take into account the objectives and intentions of all the individual traders (especially those that have the potential to submit a high volume order), on a prediction-by individual-prediction basis.

The patterns are predicting what traders will do on a percentage basis over a series of occurrences of the pattern.

Understanding random outcomes over a series of events is something we're all familiar with from gambling. But it takes more than a familiarity to compensate for the way our minds are naturally wired to process information. Our minds don't naturally process probable outcomes over a series of events in a way that actually reflects the reality of the situation. For example, if we've had two or three winning or losing trades in a row, it certainly won't seem or feel as if we don't know what the outcome of the next trade in the series will be. If we've been on a winning streak it will feel like the next trade is a sure thing. If we've been on a losing streak, it will feel like the next trade will absolutely be a loser.

Our minds are hard wired to associate the present moment with our memories of similar or seemingly identical experiences from our past. Combine that hard wiring with a typical belief that the purpose of analysis is to tell us what the outcome of the next trade will be and we're going to find it extremely challenging to execute the buy and sell signals from a technical method without making several fear based trading errors.

The experience of winning two or three trades in a row from the same technical method will naturally cause us to assume, without question, that the next buy or sell signal we get, will produce the same outcome. Why would we question the veracity of the signal, if our analysis has been doing its job by giving us a series of winning trades? However, the instant we're convinced we're going to win, what happens to the risk of losing? It just disappears, in our mind that is, because it certainly doesn't go away from an order flow perspective - ***ever***!

The same identical mental process will be at work if we've had two or three losing trades in a row from the same technical indicator. After losing two or three trades in a row, the next signal to enter a trade will feel like it has no chance of being successful. Our minds will automatically associate the disappointment or sense of betrayal from the last two or three experiences with the present moment situation. We'll be convinced the trade is going to be a loser and as a result, probably not take it.

The probabilistic reality of the situation is not at all like the way our minds make it seem to be. In the coin flipping example above, I pointed out there was no relationship or connection between the out-come of one flip to the next in a sequence of flips. It doesn't matter how many heads or tails you get in a row, the next toss is always a unique event that has nothing to do with the outcome of the last flip. The outcome of each individual signal from a technical pattern or indicator is also a unique event that may not have the slightest connection with the outcome of the previous signal; even though the signals are being produced from identical price patterns or mathematical equations.

For there to be any connection from one signal to the next, at least some percentage of the same traders whose orders produced the outcome the last time the pattern appeared, would have to be available to participate the next time the pattern or indicator gives a signal to buy or sell. We'll never know how many of those same traders intend to participate, or what they'll choose to do. The good news is, it isn't necessary to know to win. In fact, it isn't necessary for any of the traders whose orders caused a favorable outcome the last time the pattern or indicator gave a signal, to participate the next time, for that signal to turn into a winning trade. (*A good place to do a video story on the floor traders who were responsible for providing support and went to lunch.)*

As screen-based technical traders, the reality of our situation is, we'll never know, nor is there any way to find out, which particular signals in a series of trades are going to be the winners and which ones are going to be the losers. We could have several winners in a row followed by several losers in a row but, in the end, over a series of trades still see a 70/30 win loss ratio I referred to above. Bottom line, because of the chaos of the buy/sell order flow, every single individual prediction from a technical indicator is a unique event that has an uncertain and probable outcome. And when I say probable outcome, don't take that to mean, if your method has an over-all 70/30 win/loss ratio over a series of trades that there's a 70% chance that any given individual trade in the series is going to be a winner. This is absolutely not the case; which brings us to our second point.

TWO:

Technical patterns have the unique characteristic of giving odds of success over a series of trades, but at the same time, it's not possible to determine the odds of success of any particular individual trade within the series.

Unlike the coin flipping example above, where we know there's always a 50/50 possibility of seeing heads or tails on any given individual flip, the moment to moment chaos of the order flow make it impossible to calculate the actual or true odds of any individual prediction from a geometric or mathematical pattern as being correct. In other words, we'll never be able to find out what the actual odds of success are for any individual trade within a series of trades.

Remember, if we don't have the resources to impact the order flow in our favor, then we have to rely on other traders to do it for us after we put on our position. In any given market moment, buy and sell orders can come from any source, for any reason, and be any size, so exactly how does one go about calculating the odds on what other traders are going to do. Or more specifically, calculate the odds on whether or not other traders are going to submit enough orders in the direction of our trade to make it a winner.

Depending on our level of experience, we could certainly come up with a reasonable guess, if we had access to inside information or if we were trading on the floor of an exchange. For instance, if my technical method happened to give me a buy signal in the DOW Futures right after I got off the phone with a mega huge hedge fund manager who told me he was about to unload (sell) a major portion of his DOW stock inventory, I would reasonably assume the odds of my buy signal being successful were quite low, if not non-existent.

It would seem like a good guess at the odds, but it could also be completely wrong. I might know there's a huge sell order that's about to hit the order flow, but there's no way for me to know if there are any large traders who may intend to be buyers of Dow Futures or individual Dow stocks. If that's the case, there could be more than enough buy order inventory available to absorb the hedge fund managers sell order with enough left over to cause an imbalance in favor of the buyers. My guess at attempting to figure the odds, really didn't help because it would have kept me out of a winning trade, that on the surface (even with the inside information) looked like a certain loser.

We can't calculate the odds of success of any particular individual prediction simply because we don't have advance access to any information that would tell us the type and size of the orders other traders intend to submit to the exchange. Based on the size and type of the orders that are, let's say "intended" to flow into the exchange after we get into a trade, the odds of any individual prediction within the series of predictions being correct, could be anywhere within a range of zero to ninety nine percent; not 50/50 as many traders mistakenly think.

Many traders, especially those who are inexperienced, mistakenly assume that since the price has only two possibilities for movement, either up or down, that the odds of winning any given individual trade are basically the same as a coin toss, 50/50. A coin toss has 50/50 probability of seeing a heads or a tails because the coin is "evenly" weighted. Whereas prices move as a result of an “uneven” amount of buy and sell orders flowing into the exchange.

So, although the price can only go up and down, if you just entered a small buy order and a few minutes later a hedge fund manager enters an extremely large sell order, the odds of you experiencing a winning trade could be close to zero.

In other words, the fact that the price can only move up or down has absolutely (no bearing on what the odds of success are for) nothing to do with the odds of success of any individual prediction. The odds that the price will move either up or down are a function of the size of the orders that are about to hit the flow. Since we don’t have any idea who’s about to submit their buy or sell order, or how big those order are going to be, the odds of success for any individual prediction (within series of predictions), is always an unknown variable that has no relationship to the odds of success that can be calculated and applied to an aggregate number of predictions within a series.

THREE:

Geometrical price patterns and mathematical equations aren’t telling us the reasons why we are winning or losing.

.

If not having advance access to information that would tell us the type and size of the orders traders are intending to submit to the exchange prevents us from calculating the odds of success of any individual prediction, then by the same token, we also don’t have any way of knowing the reasons why traders are going to submit those orders. In other words, geometrical price patterns and mathematical equations can’t factor into their predictions the actual reasons why the buy/sell order flow may become imbalanced in favor of a technical prediction, if in fact, that’s what happens.

For example, let’s say you were trading soybean futures the same day the retired floor trader from the previous Chapters decided to sell 400 soybean futures at the market, and just before his order hit the floor of the exchange, you got a sell signal from a two period 7/16 crossing moving average like the one I described in the last Chapter. So you put an order in the market to sell two 5,000 bushel contracts, get filled and about fifteen minutes later find yourself in a winning trade where the market has gone over ten cents ($1,000.00) in your favor.

The order flow imbalance causing the price to move in your favor, happened because the retired floor brokers sell order initiated a chain reaction wave of selling in the soybean pit. Your crossing 7/16 period moving average, giving you a sell signal a few minutes before his sell order hit the exchange was basically a coincidence. *Meaning there was no relationship between the analytical criteria that justified your decision to enter a sell order in the market and the reasons why other traders decided to sell with enough volume to cause you to end up in a winning trade.*

When the two lines representing the moving averages crossed to the downside, the mathematical formula was saying, based on the results of a series of occurrences of this mathematical pattern from the past, if you put in a sell order in the market right now, the odds **“*may*”** be in your favor that the price will move lower. However, from an order flow perspective the pattern is not indicating "how" the price is going to move in your favor or for what reason. The math formulas and the lines we draw on price charts to identify geometrical patterns, can't tell us **“*who’s*”** going to participate in the order flow, **“*how*”** the price is actually going to move in our favor, if in fact it does, or the underlying **“*reasons why*”** other traders decide to put on or take off the trades that impact the direction of the price.

The buy and sell orders from other traders don’t flow into the exchange with attachments explaining the reasons why they are being submitted. If the reasons traders are using to justify getting into or out of a trade accompanied their orders, the exchange could, in turn, broadcast those reasons to the rest of the market. Since that doesn’t happen, the underlying reasons motivating each buy and sell order stays in the mind of each individual trader, making those reasons ***"invisible"*** to the rest of the market; unless, of course, they decide to share them with somebody.

The only way we could know for sure why we were winning or losing (meaning, the reason why more buy orders are flowing to the exchange than sell orders or vice versa), would be to ask each individual trader why they're placing them. If, for example, you initiated a long position that turned into a winning trade and wanted to verify that your reason for buying correlated with the reason why the price moved in your favor, then you would have to identify and poll all of the traders who entered the buy orders that contributed to the order flow imbalance in your favor.

To identify these traders, the exchange would have to be willing to give you the order flow consistency for the time period involved, as well as, reveal who placed each order. To my knowledge the exchanges do not provide this kind of information to the general public, or anybody for that matter. But, let’s say for argument’s sake, the exchange did give you the information you needed to contact and then ask the other traders why they entered an order that helped your trade win. What you would find is, anyone using a valued or expensive proprietary trading methodology probably wouldn't talk to you. And for those traders who would be willing to talk, there's no way we could be sure that whatever they decided to tell you would be the truth.

However, regardless of whether or not they talk to you or tell you the truth, the sources contributing to the buy/sell order flow ratio are so diverse, and the reasons motivating these sources to enter an order so different, that even if there was a practical way to find out why other traders were either buying or selling, the possibility of there being a correlation between the reasons being used by the typical screen based technical trader and the rest of the market, is extremely remote. Even in a situation where we find ourselves in a winning trade because of a predominance of orders coming from other traders who are using the exact same technical methodology as ourselves, at the same moment, we still wouldn’t have any way of knowing that was the reason why we were winning.

Why do you think people paid hundreds of thousands of dollars to buy a seat to trade on the floor of physical exchange before electronic trading platforms came into existence? So they would have direct access to the order flow and order flow information. Having direct access to the order flow gave them the best and most efficient trade execution, as well as, personal access to order flow information; not just the distilled version represented as the up or down tics in the price that we see on our computer screen. Direct access to order flow information enabled them see and hear the size of orders flowing the market, along with where they are coming from.

In most cases, they knew the trader or trading organization on the other side of their trades and in some cases, they could clearly see if there's a direct connection between the reasons why they got into a trade and the reasons why the order flow either did or did not move in their favor.

As screen-based technical traders, the only way we'll ever know for sure the reasons why the price moved in our favor, is to trade with enough volume to move the price ourselves. Although a distinct minority in relationship to all of the people in the world who trade, there are a number of traders who know exactly why the price is moving in their favor and it’s certainly possible for you to develop into one. All you have to do is get to the point where you can trade with enough volume to take out all of the offers above the last price, and then deliberately bid the market up to the next highest price level, or take out all of the bids below the last price and then deliberately offer the market lower to the next lowest price level.

Traders who can intentionally bid the price up or offer it lower, know exactly why the price is moving in their favor, why they're winning, and why anyone who took the other side of their orders are losing, because they're the ones who are making it happen.

Otherwise, if we can't trade with enough volume to cause an order flow imbalance in our favor, there are four primary buy/sell order flow scenario’s that will determine the outcome of our trades in relationship to whatever analysis, logic or reasoning we use to get into those trades.

1) *Our analysis is correct and we win.*

    1. In this first scenario, our analysis is correct when the analytical criteria we use as a premise to predict the direction of the price is essentially the same as the reasons why other traders became motivated to enter whatever number of orders it took to cause the price to move in the same direction of our prediction. In other words, our prediction turned out to be right, because the buy/sell order flow ratio was dominated by orders being entered for reasons that corresponded with the reasons why we made the prediction in the first place.

2) *Our analysis is incorrect but we win anyway.*

    1. In this second scenario the price moved in our favor as a result of what I like to refer to as a "***planned coincidence***" or a "***planned synchronicity***" with the order flow. The wins are "***planned***" because the purpose of doing analysis is to identify collective behavior patterns that predict the impact that traders will have on the direction of the price after the pattern completes itself. On the other hand, winning trades can also a "***coincidence***" or a "***synchronicity***" with the order flow, because the orders that are causing an imbalance in the buy/sell order flow ratio in our favor,

may not have any correlation, whatsoever, with the criteria that defines the geometrical price or mathematical patterns we used to predict what other traders would do.

In other words, our winning trades are the result of a **"*planned synchronicity*"** with the order flow to the extent that the orders causing the price to move in our favor are being submitted for reasons that **"*are not the same*"** as the analytical criteria we used to make our prediction about what direction the price will move.

2. The uncorrelated orders that caused the buy/sell order flow ratio to become imbalanced in our favor could have been submitted for non-speculative reasons that were contractual or hedging in nature or the orders could have come from other speculators who came to the same conclusion as our analysis about the direction of the price, but for completely different technical, fundamental or news driven reasons. Understand that to find ourselves in a winning trade, none of the orders that caused the price to move in our favor need to be submitted for reasons that correspond with the analytical criteria we used to make our prediction.

3) *Our analysis is incorrect and we lose.*

1. In this third scenario, we find ourselves in a losing trade because our analysis simply produced an inaccurate prediction about the direction of the price. For a predominance of orders to flow into the exchange in the opposite direction of our prediction, it would have to be the result of other speculators who's analysis, logic or reasoning caused them to come to a different conclusion about what direction the price was going to move or the result of other traders who placed orders against our prediction for non-speculative, hedging or contractual reasons. We could probably call this scenario a "reverse synchronicity" with the order flow.

4) *Our analysis is correct, but we lose anyway.*

1. In this scenario, our analysis accurately reflected the reasons why a predominance of other traders would likely be motivated to enter the same kind of order for the same reasons. Our assessment of the situation could be almost perfect. Let’s say something less than but approaching one hundred percent correct, but we still find ourselves in a losing trade.

2. What happens in this scenario is, a significant majority of traders all behaved in the same way for reasons that were consistent with our analysis, but our analysis

didn't or couldn't take into account a small minority of very large traders who, for whatever reason, didn't agree with the majority or had other ideas about how to take advantage of the situation. As long as, the relatively few large traders are willing to trade with enough volume to exceed what it takes to absorb all of the orders from the majority, they can not only stop the price from moving in the direction of the majority, they can also tip the order flow ratio in their favor.

3. From a consensus perspective, we can say that our analysis was right, because a very high percentage of other traders agreed with us. But from a buy/sell order flow perspective, it didn't matter that we were right because we still ended up on the wrong side of the order flow ratio and lost. Always keep in mind that price movement is a function of order flow volume, not the actual number of traders who are entering those orders. So it only takes one large trader anywhere in the world to negate the positive outcome of any assessment we or any number of other traders may have about why the price should move in a particular direction.

FOUR:

An accurate prediction about the direction of the price that results in a winning trade, doesn't verify the accuracy of the analytical reasons we used *as a premise for making that prediction and deciding to get into that trade.*

To win, we need a predominance of the same kind of orders to flow into the exchange after we get into a position. Every buy and sell order that hits the exchange, regardless of its size, whether the order is to initiate a trade or exit one, adds to the mix that creates an imbalance in the buy/sell ratio that, in turn, causes the price to move either for or against our position. Every order counts.

Now, imagine yourself in a trade where the predominance of orders flowing into the exchange are in your favor, making you a winner. Taking into consideration all of the entities that have hedging and contractual reasons to enter both buy and sell orders, and all the technical, fundamental and news reasons that speculators can use as a justification to enter a buy or sell order, how likely is it that "all" of the orders that are causing the buy/sell order flow ratio to become imbalanced your favor, are being entered for the same reason you put on your trade? In other words, what's the possibility there's a one hundred percent correlation between yourself and the other traders who are entering orders in the same direction of your position? The possibility is virtually non-existent.

If the possibility for a one hundred percent correlation is genuinely non-existent, it means that when we win, we will always be winning with reasons that are, to one degree or another wrong, as in, uncorrelated with the reasons why the price moved in our favor. The correlation could be high, low, something in-between or nothing at all. Winning only requires that our analysis give us the right prediction. But that right prediction can come from analysis or a reasoning process that has a zero correlation with the reasons other traders are using as a motivation to enter the orders that cause the price to move in our favor. In other words, our analysis will never be one hundred percent right, but it’s theoretically possible for our analysis to be completely wrong (100% uncorrelated) every time we get into a trade, and we can still win.

If we don't have access to any verifiable information that would tell us the percentage of order flow volume that was submitted by traders who agreed with the reasons we used to predict why the price would go up or down, in relationship to the percentage of order flow volume that came from traders who entered orders in the same direction that our analysis predicted, but did so for reasons that didn't have any correlation with ours, then we don't have any way of knowing the extent to which we're winning because our analysis was correct, or the extent to which our analysis was incorrect, but winning anyway, as a result of coincidental synchronicity with the order flow.

The same condition applies when we find ourselves in a losing trade. Without access to the appropriate information, we can't determine if we lost because the reasons we used as a premise for getting into a trade were actually incorrect, or we lost because of the contrary intentions of one or a few large traders, even though our analysis predicting what other traders would do was essentially right.

Now, if it's possible to win with both correct (correlated) and incorrect (uncorrelated) analysis, and it's also possible to lose with both correct and incorrect analysis, and at the same time, not have access to any information that can tell us what the case may be, then our winning trades can **"*only prove*"** the accuracy of our predictions and **"*not*"** the accuracy of the analysis or reasons we used as a premise to make those predictions. Bottom-line, without a way to prove the percentage of correlation between our analytical reasons for making a prediction and the reasons why the price moved in our favor when we win, then ***"a winning trade doesn't tell us anything about the reasons why we are winning."***

Some of you who already have experience trading technical patterns, will undoubtedly want to take exception to the above statement, claiming that the pattern itself will tell you the reasons why you are winning when the price fulfills the prediction produced by the pattern. What I'm saying is, it only seems that way when you don't look at it from the perspective of order flow dynamics. It would certainly be true to say that a pattern appeared, because there will be indisputable proof of its existence. And it would also be true to say that the price moved in the direction predicted by the pattern, because, again, we would have indisputable proof that it did. Beyond that, however, we don't know what the truth is, because there aren't any indisputable facts available to indicate the reasons why the pattern came into existence or the reasons why other traders caused the prediction from the pattern to be correct.

For example, let's say you're looking at a price chart and notice a very common technical pattern defined as support. The price is currently trading above the support point, but trending lower. You decide that if the price continues to move lower to the designated support point, you'll enter a buy order to establish a long position; reasoning, if the market behaves in a way that's consistent with the definition of technical support, the price should stop moving lower, reverse its direction and start trending upward. Now, let's say that's exactly what happens. You put your buy order in the market, it gets filled and the price reverses direction and starts to rally higher in your favor.

As a result, you may feel compelled to argue that you're in a winning trade because the market behaved exactly the way the pattern told you to expect that it would; so, how could you not know the reason why you're winning?

My answer would be, you don't know because a technical pattern by itself doesn't explain why the price is moving in a particular direction, you need additional information. The actual or real reasons why the price is moving only exist at the order flow level. So the only way to confirm if the support pattern explains why the price reversed its direction, is to find out: a.) who was buying at the support price, b.) the reason why they decided to do so and c.) the size of their orders. Once you have all of the relevant information you can then determine what percentage of the buy orders came from traders who were buying the support pattern, like yourself, in relationship to the percentage of buy orders that came from traders whose reasons for entering their orders didn't have any connection with the support pattern. If you find that the highest percentage of buy orders came from traders who bought because of the support pattern, then you can truthfully say that the pattern explains why the price moved in your favor, and therefore you know the reason why you won.

Otherwise, without the additional order flow information, the only thing you know with one hundred percent certainty about the accuracy of the pattern is that it correctly predicted what other traders would do. What you can't say with any degree of certainty, whatsoever, is that the pattern accurately represented the reasons why other traders did it; meaning why other traders entered the orders that caused the price to move in the direction of the prediction. You can't say you know the reasons why, because those reasons are "*invisible"* and for all intents and purposes, *"unavailable."* In other words, without access to the appropriate order flow information, we'll never know the actual reasons why the prediction produced by the pattern turned out to be correct; which is the same as saying:

"We will never know the actual reasons why we ended up in a winning trade."

On the surface, it may seem as if I am making relatively abstract or unnecessary distinction here. Some of you may be thinking, "as long as, I get a prediction from my analysis, that results in a winning trade, why is it of any consequence that I can't ever determine if the analytical premise or reasons I used for getting into that trade had any correlation with the reasons behind the orders that caused the price to move in my favor.
In other words, if my analysis gives me a winner, why should I care if I'll never know the true or actual reasons why the trade became a winner?"

My response would be, you shouldn't care. In fact, your ability to produce over-all consistent results will depend on you believing that you don't know the actual reasons why you win, not caring that you don't know and not caring that you can't ever find out. None of this information is necessary to produce consistent results.

On the other hand, for those you who do care about knowing, care about finding out, or have the tendency to assume your analysis is right when you win (right in the sense that you believe your analytical reasons for getting into the trade are the same reasons why other traders caused the price to move in your favor), you will more than likely be operating out of a perspective that I have referred to earlier in the book as the “illusion of analysis. If this is the case, what’s of consequence is, you’ll find it virtually impossible to produce consistent results. Operating out of the illusion of analysis is the primary force behind most of the trading errors that keep us in a perpetual boom and bust cycle, our susceptibly to catastrophic type losses and why so many traders become afflicted with analysis paralysis.

Chapter Nine

Understanding the Illusion of Analysis

I'm defining an illusion as believing something is true that doesn't have any basis is fact other than in our imagination. The "illusion of analysis" stems from the belief that with the right analysis we can accurately predict the impact that other traders buy and sell orders are going to have on the direction of the price to the extent that we actually eliminate the risk of losing and assure ourselves of a winning trade. In the other words, when we're operating out of the "illusion of analysis" it seems as if we can take the gambling component out of speculating on price movement. Nothing could be further from the truth, and we pay a very high price for believing it.

The "illusion of analysis" is one of the primary psychological forces behind the trading errors that can keep us in a perpetual cycle of boom and busting, make us susceptible to catastrophic type losses and why we become afflicted with analysis paralysis. Operating out of the "illusion of analysis" is by far the most dysfunction and potentially dangerous thing we can do as traders.

> ***It is absolutely one hundred percent impossible for any rationally based analytical prediction to eliminate the risk of losing and assure ourselves of a winning trade.***

So what I'm going to do in this Chapter is explain, how the "illusion of analysis" works, and why it's so easy, as well as, emotionally compelling to get trapped in a trading perspective where, instead of being assured of a winning trades, the only experience we'll absolutely be assured of is erratic results and a lot of frustration.

As traders speculating on the direction of the price, the risk of losing and being wrong is a function of the number and size of the buy and the sell orders other traders ***"intend"*** to enter in the opposite direction of our position after we get into a trade. There isn't a chart pattern, mathematical equation or analytical premise in existence that can factor into its prediction the following order flow variables that determine whether we end up in a winning or losing trade.

- *How many traders in the world are getting ready to send an order to the exchange,*
- *who these traders are,*
- *whether they're intending to submit a buy or sell order,*
- *the size of the buy or sell order they intend to submit,*
- *the reasons why they've decided to put on or take off a trade*
- *and the degree to which all of the buy and sell orders destined to hit the exchange will affect the direction of the price.*

It's impossible to eliminate the risk of losing or assure ourselves of a winning trade, simply because rationally based analytical methods can't foretell the intents of all of the traders around the world who have the potential to adversely impact the direction of the price after we make our prediction and get into a trade.

What isn't impossible, however, is to acquire and operate out of a set of erroneous assumptions and dysfunctional beliefs that will make is "seem like" having the right analysis can get us into trades that are sure winners and therefore risk free. In the world of speculative trading, there isn't anything we can do that has the potential to cause more damage to ourselves than to believe we're in a risk free or reduced risk situation, when the reality is the exact opposite.

Now, if you're thinking everyone knows it's possible to lose, and it would be absurd to assume otherwise. My response would be, we can certainly be aware of the fact that that we can lose, but not everyone believes that the risk of losing is a distinct possibility with every single trade they get into – with absolutely no exceptions whatsoever. Most traders believe there are, in fact, exceptions. As well as, believe their analysis can identify those exceptions and the trades they decide to get into are the ones their analysis is telling them are going to win or not going to lose.

There's a very simple way to know whether you do or do not believe it's possible to trade without the risk of losing. A trader who believes that the risk of losing always exists would never contemplate getting into a trade without first predefining the risk. And they're never surprised when they find themselves in a trade that isn't working. Remember we're defining "the risk" as the dollar value of how far the price has to move against our position to tell us the trade is no longer an opportunity, as defined by criteria of our edge. So the idea of not predefining the risk wouldn't even cross the mind of a trader who believes the risk always exists; nor would the idea of pulling a stop or continually moving a stop further away from their entry point to avoid taking a loss.

Whereas, someone who does believe it's possible to trade without the risk of losing will resist the idea of determining in advance of getting into the trade what the market has to do to tell him the trade isn't working. When they do manage to define the risk and put a stop in the market, they're just going through the motions, because they really don't believe the stop will ever get hit. And if the price does get close to their stop, they will either move it further away or pull it altogether. Pulling and moving stops is behavior that is consistent with someone who believes that analysis makes it possible to take the gambling component out of speculating on price movement.

Remember to produce consistent results, the idea is to cut our losses short and let our profits run. If we operate out of the belief that our analysis can make the risk of losing go away, we'll be getting into our trades assuming our analysis is right or we're right. Once we've assumed our analysis is right, the only mechanism we'll have to cut our losses is increasing levels of pain. Pain is not exactly an efficient method for cutting our losses short, since it's something we naturally try to avoid. And in the process of trying to avoid the pain, we will also be avoiding cutting our losses.

In a moment I am going to assume to role of the typical, uninformed (or) novice trader to demonstrate how we get trapped into a perspective that makes it appear as if our analysis is doing something that in reality can't be done – make the risk of losing go away and assure us of a winning trade. However, before I do, there are a few points you need to be very clear about and keep in mind.

FIRST:

The force that initiates all price movement are the reasons traders use to justify their decision to enter into or exit a trade. These reasons usually take the form of technical, fundamental or news criteria, but they can also be a reason that is the result of any idea that pops into ones conscious awareness. Each reason, regardless of how simple or complex, whether they are hedging, contractual or speculative in nature all get distilled into either a buy or a sell order.

The buy or sell order is then sent to an exchange where the reasons get distilled again when the order is transformed into a trade by matching it with an opposite buy and sell order that's been entered by another trader somewhere in the world. Depending on the ratio between the number and size of the buys and the sells, in any given moment, the matching process will then create either an up tic or a down tic in the price. So what we're really seeing when we watch the price move is what I like to refer to as ***"reasons in motion,"*** or rather ***"invisible reasons in motion,"*** because the specific reasons that are making it all happen are not obtainable in any verifiable way; making them, for all intents a purposes, **"unknowable"** to the general trading public.

SECOND:

There are two completely separate and distinct ways in which our analysis can be right. First, our analysis can be right about **"*what's*"** going to happen. Meaning, it produces a correct prediction about the direction of the price. Second, our analysis can be right about the reasons **"*why*"** it's going to happen. Meaning, the analytical premise or reasons we use to make a prediction are highly correlated with the reasons why other traders will decide to enter the orders that cause the price to move in the direction predicted by our analysis.

THIRD:

To find ourselves in a winning trade, the predictions produced by our analysis **"*always*"** have to be right. On the other hand, to get the right prediction about the direction of the price, our analysis **"*never*"** has to be right. In other words, it's possible that all of our winning predictions can be the result of a "planned or coincidental synchronicity" with the order flow, where our analysis has no correlation, whatsoever with the reasons why traders entered the orders that caused the price to move in our favor.

FOURTH:

Winning only verifies that our analysis was right about **"*what*"** would happen. Winning doesn't in any way verify that our analysis was right about the reasons **"*why*"** it would happen. To know if the our analysis was right about why the price moved in our favor we would need to find out who placed orders after we got into our trade, whether they were buys or sells, the size of the orders and most importantly the reasons why they did it. We don't have access to any of this information.

FIFTH:

If it's possible to get a winning prediction from analysis that doesn't have any correlation with the reasons why the price moved in our favor and, at the same time we don't have access to any information that can verify the degree to which our analysis may be right (correlated), if at all, then the reality of our situation is, ***we don't know the truth about why we're winning when we experience a winning trade.***

HOW ONE SIMPLE ASSUMPTION CAN RUIN A TRADING CAREER – BEFORE IT EVER REALLY GETS STARTED

Let's say that I'm a typical, uninformed trader just starting out, using what I believe to be a bona fide analytical method to do my analysis. I come up with a prediction about the direction of the price, which prompts me put an order in the market that turns into a winning trade. As a result of winning, what I know for an absolute fact is that my analysis was right about "what" would happen; because the only proof I need to substantiate that it was right, is the price moved in the direction my analysis predicted that it would.

On the other hand, I don't have any proof, whatsoever, to substantiate if my analysis was also right about the reasons "why" the price moved in the direction predicted. The price could have moved in the direction predicted by my analysis because of orders coming from any number of diverse sources, motivated by any number of diverse reasons that may or may not have any correlation with the reasons why I got into the trade. Without access to those sources or their reasons, I don't have any way of proving "why" I won. It could have been because my analysis was actually right (highly correlated), or I could have used analytical reasons that were one hundred percent wrong (completely uncorrelated), but I won anyway because I experienced a coincidental synchronicity with the order flow.

In either case:

I can get the right prediction and win just as easily with the wrong analysis - as I can with the right analysis - and <u>never know the difference</u>.

Not knowing there's a difference is the point where I start getting myself into trouble. If I don't understand enough about the nature of price movement within the context of order flow dynamics to know that a winning trade isn't giving me any information, whatsoever, about the accuracy of the reasons I used to make a prediction, then I'm going to take it completely for granted and assume that since my analysis was right about what I should expect from the market, that the reasons why I made the prediction must also be right about the reasons why the market would behave the way that it did. In other words, since the prediction was right, the reasons I used to make the prediction must also be right. This would be a perfectly logical assumption, considering I engaged in what I believed to be a bona fide analytical process, using a bona fide analytical technique that gave me specific reasons about why I should expect the market to behave in a particular way.

It's certainly possible that my analysis was right about the reasons why the price would move in my favor, however, assuming that it was right, is not based on any (provable) facts. The analytical reasons (chart patterns, mathematical equations, etc.) I used to justify making a prediction about the direction of the price cannot be considered facts, because those reasons are all based on information that's a distilled representation of the actual forces that cause the price to move. Those forces are invisible, (other traders' reasons) and I don't have any way to make them into a tangible, verifiable fact. As a typical screen based trader, there are only two verifiable facts available to me that would explain why the price moved up or down. One, the reason why the price went up, is because more buy order volume flowed into the exchange than sell order volume. Two, the reason why the price went down is because more sell order volume flowed into the exchange than buy order volume. That's it. Everything else I read or hear, is going to be an opinion, conjecture, an extrapolation or simply a guess that's usually being explained within the context of a lot analytical jargon to make it sound like whatever is being said is the true reality of the situation.

For many of you, this may be difficult to hear because it implies that the financial industry experts you're exposed to don't know any more about the actual reasons why the price moved or is moving than you do. The implication is correct! Unless someone has access to inside order flow information, they're willing to share, or they're moving the price themselves, everyone else, regardless of how articulate, eloquent or sure of themselves they sound, don't know the true underlying reasons why the price is moving.

When they speak, what you're hearing is something they're "making up" based on their experience or a hidden agenda they're promoting. Their "made up" reasons may, in fact, be correct, it's just that ***"they don't know as a fact,"*** if what they're saying is actually true or correct.

When I worked for Merrill Lynch Commodities as a retail broker in the early 1980's, we used to "make up" what I called the "reason of the day." Our brokerage customers naturally wanted to know why the price was trading up or why it was trading down on any given day. They didn't want to hear an explanation like; frankly we really don't know why, other than to say there are more buy orders flowing into the exchange than sell orders or vice versa. So what we would do to satisfy our customer's "need to know" is go to the Reuters or Merrill Lynch News Wire and pick an event from the night before or that morning and then "make up" a reason within the context of the news that sounded like a logical explanation of why the price was moving up or down. The truth is, in most all cases, we didn't have the slightest idea what reasons traders were using to justify entering their buy and sell orders, except for the Merrill Lynch customers we were personally working with. To my knowledge, there was never an instance where one of our customers ever challenged the veracity of our "made up" reasons.

If you're having a problem accepting what I just said, it's very easy for you to prove to yourself what I am asserting here is true. Whenever you encounter anyone claiming to know the reasons why the price is moving or know the reasons why their prediction about the direction of the price was correct, simply ask them to prove it. Ask them to provide you with some sort of verifiable information that would prove how they know the actual reasons why there's more buy volume flowing into the exchange than sell volume or vice versa. I guarantee you'll get nothing, because there's nothing available in the way of verifiable facts for them to give you.

Nobody has access to the consistency of all the reasons that motivated other traders to enter the orders that caused the buy/sell order flow ratio become imbalanced in one direction or the other.

As a new trader, it would be extremely unlikely that I would have been exposed to any information about the nature of trading, from an order flow perspective, informing me that my winning trade doesn't validate the accuracy of the analysis I used to get into that trade. That the real reasons why the price moved in my favor are unavailable and therefore unknowable to me, and most importantly, those reasons may not of had any relationship, whatsoever, with the reasons why my analysis told me to get into the trade. As a result of not having the benefit of this insight, as I reflect on the winning trade I just got out of, I'm going to end up thinking myself into (unknowingly create) the most dangerous and dysfunctional trading perspective I could operate of – believing that my analysis can definitively tell me what's going to happen next, making it seem like it's possible to avoid a losing trade and assure myself of a winning trade.

The reality of my situation is, in spite of the fact that I used a bona fide analytical method – that, as it turned out, accurately predicted "**what**" would happen, I know virtually nothing about the reasons "**why**" it happened. However, as long as, I'm operating out of the erroneous assumption that a winning prediction verifies the accuracy of the analytical reasons used to make that prediction, I can easily build a case that my analysis actually caused the risk of losing to go away.

Here's what I mean, as I look back at my winning experience in hindsight, I am going to think, the market behaved in a way that was consistent with what my analysis told me to expect, and did so for, what I'm assuming to be, the same reasons why my analysis told me to expect it to. In other words, I'm thinking my analysis was right about what would happen, because it was right about the reasons why it would happen. And although I wasn't aware of it at the time, when I finish my analysis, it's going to occur to me that I actually knew in advance what the market was going to do and why it was going to do it before I actually got into the trade. And if I knew what was going to happen before I actually got into the trade, then I'm going to conclude that my analysis assured me of winning before I even sent my order to the market. As a result, what I'm going to take away from this experience is, with the "right analytical reasons" I can ***"definitively know"*** what the market is going to do before it does it. And if I can ***"definitively know"*** what the market is going to do before it does it, then losing will not exist as a possibility.

The problem with this logic is that it's based on an assumption that isn't true. For something to be true there should be some indisputable facts available to prove that it's true. It's certainly ***"possible"*** that my analysis was right about the reasons why the market behaved in manner that was consistent with what it predicted, However, what isn't possible and therefore ***"not true,"*** is that ***"I know"*** my analysis was right about the reasons why the market behaved the way it did. I don't have any facts, whatsoever, to verify if my reasons for making the prediction were an accurate representation of why the price moved in my favor.

It only seemed, as if, I knew (as a definitive fact), the reasons why I was going to win, because I assumed my analysis was right. And I assumed my analysis was right because the prediction it produced turned out to be right.

But, as we've already learned, a correct prediction doesn't verify the accuracy of the analysis we used to make that prediction. The degree to which my analysis may have been accurate, if at all, cannot be determined. The truth is, regardless of how it seemed to me as I was reflecting on what happened, I had no way of knowing if my analysis was right. As a result, thinking that "I knew" the reasons why I was going to win before I got into the trade, also can't be right. And if I had no way of proving the reasons why I was going to win before I got into the trade, then my analysis wasn't assuring me of anything. So, even though the prediction turned out to be correct, my analysis did not, in any way make the risk of losing disappear, as if it never existed.

As a beginning trader I haven't learned yet, that regardless of how it may appear otherwise, no form of market analysis can eliminate the risk posed by what other traders intend to do after I get into a trade. There's just no way to determine at a rational level of analysis the number of traders who are planning to enter orders in the opposite direction of my prediction, the size of those orders and the effect they will have on the direction of the price.

> *Whether or not I'm going to win or lose on any given individual trade is always an unknown, as well as, an unknowable variable.*

So, at this point in my development, I don't know that the possibility of losing always exists, and that it never goes away, ever, no exceptions; making anything I choose to believe to the contrary an illusion; meaning something I think is true only because I believe it's true, not because that belief is based on any verifiable facts or founded in reality. Without this clear understanding of the relationship between market analysis and the "***always unknown and unknowable risk"*** inherent within the chaos of the buy/sell order flow, the instant it occurs to me that my analysis made it possible for me ***"to know,"*** as in definitive fact, what the market is going to do before I get into a trade, what's going to stop me from formulating a belief that I can speculate on price movement without having to lose. Nothing!

As a matter of fact, I wouldn't want to be stopped from believing it. Concluding that it's possible ***"to know"*** what's going to happen, so that I don't have to lose and thereby assure myself of winning, is an extremely powerful and seductive idea. An idea I will be absolutely thrilled and elated to buy into and adopt as a core belief (operating principle) about how to be successful as a trader.

It doesn't make any difference how I end up acquiring it, the instant I decide to believe that my success is a function of using analysis to know what's going to happen, so that I can assure myself of winning and not losing, I have unknowingly put myself on the path ultimate failure. If you've ever wondered why it's seems so mysteriously difficult to be successful in this business, then take a moment and think about the implications of what I just said. I'm saying that ultimately, ***I'm going to fail at trading for the exact same reasons why I've convinced myself that I'm going to be successful.*** It will only be matter of time, (which in many cases could take years), money and pain tolerance before I give up trying to make a living as a trader and leave the business entirely, or find a way to utilize what I've learned in another capacity; like becoming a professional analyst or system developer.

Chapter Ten

Why it's so Dysfunctional to use Analysis to Assure ourselves of Winning and Avoiding Losing

It's dysfunctional to use market analysis for the express purpose of trying to assure ourselves of a winning trade or avoid a losing trade, because when we're using various forms of analysis to predict the impact on the direction of the price the order other traders intent to submit to the exchange, there's absolutely nothing our analysis can assure us of.

As a result, we will be attempting to do something that isn't possible. But at the same time, it can seem as if our analysis can give us a sure winner and eliminate the risk of losing when we convenience ourselves before we get into a trade that our analysis is right about the reasons why the price is going to move in favor. Then if we win, it will seem like the market validated that we knew the reasons why our prediction was right. But the reality is, we'll ***"never know"*** if that's the case, because the reasons why other traders submitted the orders that caused the price to move in our favor are only known to them. In other words, believing that the price moved in our favor for the same reasons why we predicted that it would, is something we are "imagining" or "making up," because there's absolutely no way to prove or verify if it's the truth.

Operating out of the belief that we won because we had the right reasons (even though we have no way of knowing if it's true), creates the appearance that once we've completed our analysis and convinced ourselves that we have the right reasons for making a prediction that ***"we know"*** what the market is going to do after we get into the trade.

And the instant we've decided that ***"we know,"*** what's going to happen, the risk of losing disappears and we become susceptible to all of the trading behavior errors that will prevent us from taking maximum advantage of the profit potential built into our trading methodology or edge.

The only thing we know or can know for sure is that it's possible other traders will behave in a way that's consistent with what our analysis predicted. And if it's only possible they will behave as predicted, then it's certainly possible that they won't behave as predicted and no form of market analysis can tell us in advance when that's going to happen. Bottom line, the risk of losing is always present, because to lose, it only takes one trader somewhere in the world who intends, for whatever reason, to enter an order large enough to start a chain reaction wave of buying or selling against our position. *That one trader's intentions didn't disappear just* *because we're choosing to believe that we have the right reasons for making a prediction and getting into a trade.*

The false sense of security that analysis can engender is an illusion, because it has no basis in truth outside of our own mind. The risk seems to go away because we believe that it's gone, not because it's actually true that it's gone. What's true is buy and sell orders can hit the exchange at any moment, from any source, for any reason imaginable, and be virtually any size. As a result, whatever we believe ***"we know"*** about what other traders are going to do, and why they're going to do it, is something we have to be ***"making up"*** in our own mind, because we don't have access to any information that would enable us to prove that what we think we know is actually true.

Just in case there's any confusion on your part, I want you to be clear that I'm ***"not saying"*** it's an illusion to believe it's possible our analysis is right about the reasons why other traders moved the price in our favor when we win. The illusion results from believing ***"we know"*** that our analysis is or was right about the reasons why other traders moved the price in our favor when we win. On the surface, it may seem like a subtle distinction, but the difference between ***"knowing"*** (which is definitive) and ***"possibly"*** (which is maybe), is night and day as it applies to how we perceive the risk and what we do or don't about it. When you look at that difference within the context of what it means to produce consistent results, almost every behavior defined as a trading error will stem from operating out of the "illusion of analysis."

WHAT ARE THE NEGATIVE CONSEQUENCES OF OPERATING OUT OF AN "I ANALYZE TO BE RIGHT" PERSPECTIVE?

Meaning, we believe we know we're going to win because we're choosing to believe our analysis is right about the reasons why our prediction is correct. Considering all of the errors we're susceptible to making, the only thing an analytical "I know" approach to trading will assure us of is that we won't experience consistent results, regardless of how accurate our analysis turns out to be.

ONE: *We're susceptible to catastrophic draw downs in our equity.*

In almost every instance where we experience an inordinately large or catastrophic drawdown in our equity, it will be the result of operating out of a belief that we know our analysis is right and therefore know what's going to happen. The exception would be the rare situation where we get caught on the wrong side of a one way market that traded through our stop and genuinely did not provide us with an opportunity to get out of the trade. Otherwise, if we had an opportunity to enter an executable order to get out, it was our mind-set about being right that caused the drawdown, not the market.

If we believe our analysis is right about what the market is going to do, we've excluded the very real and always present possibility there may any number of traders, out there, who have different ideas about what direction the price is going to move and intend to back those ideas up with orders in the opposite direction of what we believe we "know." When we trade from an "I analyze to be right" perspective, if the price does move against us, at the very least we'll be surprised, but not necessarily surprised enough to be willing to acknowledge we're in a losing trade. On the contrary, even though in reality the price is moving against our position - in our minds, we're still in a winning trade that just hasn't manifested itself yet. There will be times when the market will come back in our direction, but if it doesn't, then increasing levels of pain is the only resource we'll have to get us out.

If the price continues to move against us, it's our degree of stubbornness in relationship to our pain tolerance that will determine how catastrophic the loss becomes. In other words, when losing one more dollar becomes more painful than admitting that we're wrong is the point at which we'll be able to recognize that we're actually in a losing trade.

As long as, we're susceptible to, what I call a "***psychologically induced catastrophic drawdown"*** in our equity, there's no way we can produce a reliable results or a consistent income.

> *I believe that I don't know any more about what's going to happen after I do*
> *my analysis than I did before I did my analysis.*

As an informed trader, I'm no longer susceptible to a psychologically induced catastrophic drawdown, because I operate out of beliefs that are in complete harmony with the way my technical indicators and reasons for getting into trades are giving me opportunities to be successful. I've learned that my analysis is only giving me a statistical winning edge over a series or reasonably large sample size of predictions, where it's possible to determine the potential win/loss ratio for whatever sample size I choose, but the odds of winning on any given individual trade within that sample size is always an unknown factor that cannot be determined. As a result, I operate out of a resolute belief that "I don't know" if any given individual prediction produced by my analysis will result in a winning trade. I believe that I don't know, because it's the truth. And because I believe it's the truth, I'm not going to be thinking or doing anything to convenience myself that I do or that I can know. In other words, *even though my analysis is telling me what to do, when to do it and why, I still believe that I don't know what's going to happen after I get into a trade.*

My belief that "I don't know" has the effect of neutralizing my expectations, so that I'm never surprised by what the market does or doesn't do (regardless of what my analysis predicted). I'm expecting the market to do something, but I don't know what or why. Since I'm not going to be surprised by anything ,when the market does behave in a manner that's inconsistent with the criteria that defines my edge, I won't need increasing levels of pain as a resource to recognize I'm in a trade that isn't working. If I can recognize I'm in a trade that isn't working without pain there's nothing to avoid. So I'm not going to be susceptible to psychologically induced catastrophic drawdowns. On the contrary, I'll simply objectively acknowledge that price movement is not conforming to my definition of an edge, get out of the trade and be ready to execute the next signal.

TWO: *When we operate out of the illusion of analysis, then we won't know when we are making a typical risk avoidance trading error.*

For something that we do or not do to be defined as a trading error depends on what we are trying to accomplish in relationship to the perspective we're operating out of. In other words, a behavior defined as a trading error from one perspective, may not be considered an error from another perspective, but rather the normal mode of operating.

Basically, there are two primary, but polar opposite perspectives we can operate out of with respect to how we use market analysis. One is using analysis for the purpose of convincing ourselves that we have the right reasons for making a prediction about the direction of the price, so that we can at least imagine we're sure about what's going to happen after we get into a trade. The other, is approaching trading from a probabilistic perspective, where instead of using analysis to build a case to convince ourselves that we're right and therefore know what is going to happen, we use it as a tool to put the odds of winning in our favor over a series of trades, and resolutely believe that regardless of what our analysis predicted and why, we don't know what's going to happen after we get into any given individual trade.

At the core of a probabilistic perspective is a belief that all predictions that result from any analytical method are nothing more than a guess, or what I like to refer to as an ***"edge-u-cated guess, "*** or an***" un-informed analytical guess."*** The predictions and the underlying reasons for making those predictions are educated in the sense they're the result of a bona fide analytical method, technique or process. But at the same time, the predictions are also ***"un-informed"*** because there isn't any type of market analysis that can factor into its prediction the adverse intentions of every other trader in the world who has the potential to enter an order that could cause the price to move in the opposite direction of our prediction.

If there isn't any form of analysis that has the capability to tell us ***"for sure"*** what other traders are going to do or not do after we get into a trade, then by definition our analysis can't be anything more than a guess - a guess with a statistical winning edge.

For example, if someone asked you predict the outcome of flipping an evenly weighed coin, you agreed, called heads and it turns out you were right, would you think that you knew the reasons why you were right. No, because you know you don't have a functional awareness of the underlying dynamics of the way the coin was flipped to cause it to land heads up.

Now let's say someone asked you to call the flip of a coin that you, alone, had thoroughly analyzed and found that it was unevenly weighed on the tails side so that over a series of flips it had the tendency to land heads up roughly seventy percent of the time. Now because you've analyzed the coin and found the tendency for it to land heads up seventy percent of the time, are you going to call the next flip believing you've eliminated the risk of being wrong.

Unlikely, because you still don't know the underlying dynamics of how the coin is going to be flipped. So although, you know the odds of being right are in your favor if you call heads, you also know the possibility of the coin landing tails up did not disappear just because your analysis found a characteristic in the coin that gives you a winning edge. In other words, you know you can still be wrong and that *your edge assures you of absolutely nothing with respect to the outcome of each individual flip.*

As someone who has learned to approach trading from a probabilistic perspective, I believe that any analysis I use to speculate on the direction of the price, like the coin flip example above, is going to result in a prediction that's essentially a ***"guess."*** A guess that's designed to give me favorable odds of success over a series of predictions, but otherwise assures me of absolutely nothing with respect to each individual prediction within the series. You may want to go back and review the material in Chapter Nine explaining why it's not possible to determine the odds of success for any given individual prediction, if you're having problem with the idea that our analysis assures of us nothing.

Now if my objective is to extract the maximum profit potential available from the favorable odds my analysis is giving me over a series of trades, then I have to be able to limit my losses when I find myself in trade where the market isn't behaving in a way that my analysis predicted it would. To systematically cut my losses, first and foremost I have to believe that the risk of losing always exits. Second, I have to determine how far I have to let the price move against my entry point to tell me that other traders (based on the orders they're submitting) are not choosing to confirm my definition of an edge. And third, I have to put stop loss orders in the market, and leave them there to get hit, if need be.

Since I'm operating out of a belief that my analysis isn't giving me anything more than a statistically viable guess about what other traders are going to do after I get into a trade (meaning, maybe their behavior will conform to my definition of an edge and maybe it won't), then ***"deciding not"*** to adhere to the risk management principles of always determining the dollar value of the risk, placing stops in the market and leaving them there to get hit if need be, would be considered trading errors.

The kind of errors that could put me in a position to experience a psychologically induced catastrophic loss, or at the very least, an erratic, boom and bust equity curve.

On the other hand, if I'm a trader who's operating out of a belief that the purpose of analysis is to make sure that my predictions are right for each individual trade I decide to get into, then managing the risk of losing by putting stops in the market will ***"not"*** seem like a trading error to me, but rather, a contradiction. It's not going to make any sense to manage the risk of losing with stops when I believe the purpose of doing analysis is to determine what's going to happen. As far as I'm concerned, the risk of losing is already being properly managed by the results of my analysis. Meaning, I don't consider my analysis to be complete until I'm thoroughly convinced I have factored into my prediction all of the reasons why it should be right and in the process factor out the possibility of being wrong and losing. Otherwise, if I suspected losing was still a possibility, I wouldn't have concluded that I have the right reasons for making a prediction and would keep on analyzing (gathering information and building a case) until I was confident that I did. As a result, when I come to a final conclusion, it means that the price moving against me and losing is ***"not supposed to happen."***

For those of you who have been in the business awhile, I'm sure you can relate to the consternation it can cause someone who doesn't operate out of a probabilistic perspective, when he reads or hears from the financial industry experts advising him that not determining the risk of losing and putting a stop in the market is one of the biggest mistakes he can make as a trader. On the one hand, he may feel compelled to consider the validity of the advice because it will be coming from what he may recognize to be an authoritative source. On the other hand, he's not going to understand why he needs to determine the risk and put a stop in the market if his analysis is telling him that he's not supposed to lose.

If he does decide to try and follow the advice of the experts in spite of the contradiction, he will undoubtedly have some very painful experiences that will leave him bewildered and confused as to why it can be such a big mistake if he doesn't assess the risk or use a stop. For instance, in the process of deciding where he should place a stop, he could inadvertently expose himself to information that causes him to doubt the veracity of his analysis. In other words, he has already convinced himself the trade is going to be a winner, otherwise he wouldn't have decided to put in on in the first place, but in the process of determining where to place a stop, he inadvertently exposes himself to information that conflicts with his prediction.

As a result, he starts second guessing his original analysis, and ends up talking himself out of taking the trade. If the trade turns out to be a winner, he will undoubtedly experience a great deal of emotional pain. For many traders the sense of despair they experience from a genuine missed opportunity is greater than the pain they experience from taking a trade that turns out to be a loser.

In another example, let's say he decides to take the advice from the experts, and manages to choose a place to put his stop without exposing himself to information that could cause him to second guess his analysis. This would most likely be the case where his stop placement was based on an arbitrary percentage of his equity. So in this second scenario he doesn't talk himself out of getting into the trade, but unfortunately from an emotional perspective his result is going to be just as painful as in the first scenario. He puts his trade on, including a stop, the price moves against his position, hits his stop and takes him out of the trade for a loss. Shortly thereafter the price reverses its direction and moves all the back to his original entry price and beyond.

He was stopped out of a trade that ultimately would have been a very profitable winner. His analysis correctly predicted the direction of the price, but he didn't get to experience the benefits, because he was trying to do what he thought was the right thing by adhering to the advice of the experts.

After experiencing the intense despair that he undoubtedly felt by getting stopped out of what would have been a nice winning trade, whether or not he puts a stop in the market the next time he's ready to get into a trade will depend on how much credence he gives the advice of the experts in relationship to how much confidence he has that his analysis is right. If he's really convinced that his analysis is right, he'll dismiss the expert's advice, not assess the risk or put a stop in the market. On the other hand, if he really puts a lot of weight in what the experts have to say and, at the same time, the level of confidence he has in his analysis isn't enough to completely out-weigh the conflict created by the expert's advice, he'll probably go ahead and put a stop in the market. However, after what happened in the last scenario, it's very unlikely he'll leave it there if it looks like the market is going to stop him out.

And let's say that's exactly what happens. The price moves to where his stop is, but he manages to get it cancelled before it gets hit. So he's still in a trade that he otherwise would have been stopped out of for a loss. However, once he pulled his stop, no matter what direction the price moves, he has set himself up to experience pain.

For instance, if the price keeps moving in a direction that's against his position, he'll be in a state of anguish wishing he had left his stop in the market; how far he has to let the price move against him before he gives up his hope that it will come back in his favor will be a function of a number of psychological factors unique to him as an individual.

On the other hand, if the price reverses and moves back in his favor he will be elated, especially if it moves far enough to generate a profit. However, by pulling his stop, he may have won on that particular individual trade, but he also positively reinforced a behavior that will set him up for a "mind-freeze" experience or catastrophic type loss on some future trade. Pulling his stop left him vulnerable to the unknowable and unforeseeable intentions of all the traders in the world who have the potential to enter an order in the opposite direction of his position. Just because he got away with pulling his stop this time, doesn't mean he's going to get away with it the next time.

And there will be a next time, because there's nothing that's going to stop him from doing it again. In other words, by pulling his stop and winning, all he did was delay or post-pone the pain for some future date. **"*How You Win Matters*!"**

This trader is operating out of an "I analyze to be right" perspective, that won't let him get into a trade until he's analyzed to the point where he's convinced his analysis is right about what direction the price is going to move. He will continue to operate out of this perspective until he comes to the realization that his analysis, whether it's fundamental, technical or otherwise, can't assure him of a winning trade. In other words, no amount or quality of analysis can make the risk of losing go away. If and or when he ever does come to this realization, he will be confronted with a critical, career altering decision about how he wants to use his analysis:

"Does he want to be right or does he want to produce a consistent, reliable income?"

As strange as this may sound to those of you who are just getting into this business, striving to be right and making a reliable income are not mutually compatible objectives. In fact, the two objectives contradict each other. The traders who eventually make it, are those who come to realization that their long term, consistent success is not a function of using analysis to try and be right about what ***"will"*** happen, but rather as a function of using analysis to tell them what to do and when to do it because of what **"*may*"** happen.

To produce consistent results, we have to fully acknowledge, accept and then properly manage the ever present possibility that other traders will enter a predominance of orders that will cause the price to move in the opposite direction our analysis predicted.

When we fully acknowledge and accept the risk of the price moving in the opposite direction our analysis predicted, that acceptance implies the existence of an underlying belief that says:

"A*lthough my analysis can give me some perfectly accurate predictions, those predictions are still nothing more than a guess about what other traders intend to do after I get into a trade.*"

By believing that my analysis is ***"always"*** giving me predictions that are ***"guesses"*** about what other traders intend to do, it implies that I understand the reasons why any type of market analysis will ***"never"*** give me a prediction that's a ***"sure thing."*** As a result, I'm ***"never"*** going to get trapped in the illusion of being convinced my analysis is ***"right"*** and go into a trade thinking that "I know" what the market is going to do next; even if my analysis gave me a perfectly accurate prediction on the last trade or the last several trades.

It's my belief that my predictions are guesses and that ***"I can never be sure"*** of what other traders are going to do or why they're going to do it, that compels me to always properly manage the risk. Otherwise, if I were operating out of an "I analyze to be right" perspective, the instant I decide that I know what's going to happen, the risk of losing will ***"seem"*** to disappear. And if I believe there's no risk, then there's also nothing for me to manage in that regard. And if there's nothing to manage, then why would I think I'm making a trading error by not doing it. Not properly managing the risk is only a trading error if my objective is to use my analysis to tell me what may happen. If I'm using analysis to be right, so that I can seemingly avoid the risk of losing or because I like the way being right makes me feel like a genius when I win, then I'll "never" get consistent results. What I will get, however, is a case of analysis paralysis.

THREE: *Using analysis to try to be right on each individual trade is a sure fire way to contract a severe case of analysis paralysis.*

As I indicated above, we can use market analysis operating out of two very different perspectives. We can operate out of a perspective where the objective is to use market analysis to be right on every single trade, or a perspective where the objective to get favorable win/loss ratio over a predetermined series of trades, and the amount of money lost on trades that don't work is considerably less than profits we make from the trades that do work.

When we trade with the objective of trying to be right on every single trade, we're obviously not expecting to find ourselves in a situation where the price is moving in the opposite direction of our prediction. As a result, we're going to be surprised and not properly prepared either technically or psychologically to cut our losses if the market continues to move against us. Without the proper preparation, pain becomes our only resource to save our equity. As I indicated earlier, for most people the emotional dynamic for cutting their losses and finally stopping the financial hemorrhage is when the pain of losing one more dollar becomes one degree greater than the pain of admitting that they're wrong.

Admitting that we're wrong, even for something seemingly insignificant or inconsequential can be extremely difficult, because it has the potential to tap us into what could be a vast reservoir of negatively charged emotional energy. As we move through life and accumulate experiences, our minds, as a function of the way they're wired, will automatically associate and organize similar experiences into various categories based on the beliefs we're formulated about the nature of the way life works. Most, if not all of us, are going to have a category in our mind that defines "what it means to be wrong." The kind of experiences that typically accumulate under the definition of "what it means to be wrong" are those where we've been berated, ridiculed, screamed at or physically punished for "not getting something right."

As we encounter now moment life situations, as in the market for example, where we are faced with the reality of admitting that we're wrong about the direction of the price, doing so can tap us into the full force of the accumulated negative energy of every time we've been wrong in our lives. In other words, admitting that the price isn't moving in the direction our analysis told us to expect it too, can cause us to feel up to one hundred percent of the painful energy from the memories stored in the "what it means to be wrong" category. There are a number of belief systems variables unique to each individual that will determine how much of that pain we actually tap into. In any case, deciding to admit that we're wrong, or being proved wrong by the nature of the situation or circumstances we find ourselves in, has the potential to be extremely unpleasant and something we will naturally try to avoid.

Analysis paralysis is a common psychological condition that develops when our desire to avoid the pain of being wrong, coupled with a belief that to be successful every prediction we make about the direction of the price has to be right, compel us to consider ever increasing amounts of market information or add ever increasing layers of technical filters to the decision making process before we can come to a conclusion about the direction we think the price is going to move.

The more information we factor into our decisions, the greater the likelihood that some percentage of that information will be conflicting and contradictory. If we can't find a way to reconcile the conflicts and contradictions in the information, we'll find it difficult, if not impossible, to come to a definitive decision about what to do. And even if we do manage to reconcile the conflicts and contradictions to make a decision, the process of having to do so will usually leave us with enough lingering doubt in our minds to make it extremely unlikely we'll actually be able to put an order in the market to execute a trade. The potential conflicts, contradictions and the over-whelming desire to know and be right, as well as wanting to, void tapping into a reservoir of negatively charged energy, can cause us to become completely paralyzed with fear, preventing us from doing anything regardless of how good our analysis may turn out to be.

It's possible to free yourself from the debilitating fear and emotional pain associated with analysis paralysis. That is, if you're willing to make what will amount to be a 180 degree shift in your trading perspective. Instead of operating out of a perspective where you believe that the purpose of analysis is to convince yourself that you've found or formulated "the right reasons" for making a prediction, you adopt probabilistic perspective, where you believe that:

> *a) as a speculator, the purpose of analysis is to find characteristics in the markets behavior that give you favorable odds of success over a series of trades (statistically viable edges) and*
>
> *b) you adopt a belief that each individual trade (edge) within the series has a probable, as well as, an unknown outcome.*

The reason why an "I analyze to be right" perspective doesn't work is because it's not grounded in reality. It's an approach that makes it seem, as if, it's ***"not"*** possible to be wrong, when in reality is there's absolutely no way to avoid being wrong. There isn't a rationally based analytical process in existence that can cause us to "know" the type and size of the orders traders intend to submit to the exchange and how those orders are going to effect the direction of the price after we get into a trade. If this last statement is true (and it is), it implies that if you operate out of an "I analyze to be right" perspective, no matter how much analysis you do, you will always be susceptible to experience some degree of emotional pain (anger, disappointment, and betrayal) when other traders don't behave "the right way" after you get into a trade. The more pain you experience, the more debilitated you become, eventually making it impossible to do anything.

It's also an approach that makes it appear as if you can eliminate the risk of losing when your predictions turn out to be right. However, in reality, like being wrong, there's no rational, analytical possible way to eliminate the possibility of losing, making you susceptible to a psychologically induced catastrophic drawdown, as you try to avoid in your mind, what cannot be avoided through your analysis.

On the other hand, if you decide to switch to a probabilistic perspective, you can eliminate your susceptibility to experience emotional pain and the errors associated with that pain, because a probabilistic approach isn't based the rightness or wrongness of each individual prediction, but rather the odds of success of a predetermined number of predictions in a series. For example, in the coin toss illustration above, you analyzed a coin and discovered an inherent characteristic that would give you a distinct winning edge in a situation where you get to predict the outcome of each flip of the coin. You found that over a series of flips, there's a reliable tendency for heads to appear seventy percent of the time and tails thirty percent of the time.

Now, let's say you were offered an opportunity to predict the outcome of ten consecutive flips of the coin with the stipulation that you would win one hundred dollars for every correct prediction and lose one hundred dollars for every incorrect prediction. Your maximum profit potential is one thousand dollars, if you try and correctly guess the exact sequence of head and tails on all ten flips. And of course, you maximum risk is one thousand dollars if you guess wrong on all ten flips. However, trying to predict the exact sequence of heads and tails wouldn't make much sense in light of the fact that you have an edge with a seventy percent win/loss ratio. So instead of trying to correctly predict the exact flip by flip sequence of heads and tails, you decide you're going to call heads for all ten flips and let the 70/30 win/loss ratio built into the characteristics of the coin work in your favor. All you have to do to realize the potential profit built into your edge is to execute properly, meaning be able to call heads before every flip of the coin.

Take moment and ask yourself if there's anything about the way this situation is set up that would create an internal conflict preventing you from following your plan to predict heads as an outcome for every flip of the coin? If you're thinking there's nothing that would stop you, then what about the possibility of being wrong? Unless you think you're going to see ten heads in a row, which, of course, is possible but extremely unlikely; there's a certain number of times where you're going to call heads and tails is going to show up.

Will the possibility of being wrong about the outcome of any particular individual flip within the ten flip series cause you to perceive what you're doing as threatening, so that you're afraid and feel compelled to deviate from your plan in any way.

Looking at the set-up from a probabilistic perspective or mind-set, it wouldn't even occur to me to think that the outcomes to any of the predictions have anything to do with being wrong. I wouldn't be predicting heads for all ten flips because I believed I was going to see heads come up ten times in a row. It would be great if that happened, but as I said above, it's extremely unlikely and as a result, it's not something that I am expecting. I'm calling heads every time to let the 70/30 win/loss ratio built into my edge work itself out, not because I think heads is going to be the right call for every flip. As I look at this set-up from a probabilistic perspective, no matter what the outcome is to each individual flip, there's nothing to be wrong about because;

- *I'm not going into the situation believing that I know what the sequence between heads and tails will be for the ten flips. I can't be wrong about something that I genuinely believe I don't know.*

- *I'm not expecting to see an outcome of heads for every flip even though that's what I'm predicting. What I'm expecting is some percentage of the outcomes to be heads and some percentage to be tails in a random sequence. Since I'm expecting to see both heads and tails, then I'm not going to be surprised and think I was wrong when the coin is flipped and the outcome is tails. Quite the contrary, because I'm expecting both heads and tails, I'm going to be right regardless of the outcome of each individual flip.*

- *I believe that getting a positive return over a series of occurrences (flips) has nothing to do with having to correctly predict the outcome of each individual occurrence (flip) within the series. If I know that I don't have to correctly predict every individual outcome to end up a net winner, and I'm not trying to*

> *correctly predict the outcome to each individual flip, then what would otherwise be defined as an adverse outcome (tails) becomes* ***"just an outcome,"*** *where there's no negative emotional charge attached. There's no emotional pain associated with the experience because I'm operating out of a belief that each individual prediction (correct or incorrect) is serving a larger objective of capturing the odds that are in my favor. As a result, there's nothing about the process that falls within my definition of what it means to be wrong.*

Embrace the truth about the nature of price movement, and it will set you free of your fear of being wrong. At a rational, analytical level of thinking we don't know, as a provable fact, anything about the actual reasons that are going to cause the price to move. This simple fact makes all of our predictions guesses. The truth is, all of our predictions are guesses. If we believe our predictions are the result of something that we know, then there's nothing to be wrong about. And if you go into a trade believing there's nothing to be wrong about, you are setting yourself up for pain. You choose the most functional approach. If we believe our guesses are based on incomplete information, then there is nothing to be wrong about.

If you apply a probabilistic perspective to your trading, you will be operating out of a belief that says, regardless of what your analysis predicted and why, you still don't know what's going to happen after you get into a trade. As a result, there aren't any illusions about the possibility that any given individual prediction produced by your edge could be wrong. Without the illusions, your expectations will be in line with the reality of your situation. You're going be expecting a certain percentage of your predictions not to work. Just as in the coin flipping illustration, you would be operating out of a belief that you don't know which predictions are going to be correct and which ones aren't. If you genuinely belief that you don't know, then there's nothing to be wrong about.

Once the potential to experience emotional pain is gone, you won't feel threatened by the possibility of a non-performing edge. Free of the threat, there won't be any fear. Without the fear, you'll be able to do (execute) exactly what you need to do, as called for by your trading method. When you can trade without fear based errors or internal conflict, you'll be able to take maximum advantage of the profit potential built into that method. Then, if you're in possession an edge with a high probability of success, along with the ability to execute that edge properly, you'll be in a position to produce consistent results.

A little further on the book I'm going to show you exactly how to build a trading perspective that's free of the fear being wrong and losing, and at the same time compel you to always do the right thing with respect to an objective of producing consistent results. However, before we get to that point, we still have some more foundation building to do.

CHAPTER ELEVEN

In The Trading World Mental Perspectives Are Considered Primary Skills

Back in 1981 while attending my first trading conference, I was exposed to a warning about one of the psychological challenges I would be facing as a trader, but didn't have enough experience to place any value on what I was being told. The conference was hosted by three people, who at the time were considered leading market or trading gurus. Along with some general trading advice, they were also going to teach us the technical indicators they developed and supposedly used in their own trading.

The first morning of the conference I was full of excitement and anticipation about what the speakers would say that would help me be a successful trader. I remember having that "real eager to learn feeling." However, what I heard in the first ten minutes of the conference left me shocked and dismayed. The first speaker was a system developer and the author of several books on trading. I don't remember exactly what he said to start out his presentation, but within ten minutes or so after starting, someone in the audience raised their hand to ask a question. The speaker politely acknowledged him and said go ahead. This person in the audience stood up and said "if your system is so good, then why are you selling it?"

I didn't think there was anything particularly wrong with the question, but I was really surprised with the challenging, almost indignant tone that he asked it with. I think the speaker was also taken by surprise. He remained silent for a moment and the responded by saying:

"Ya know, I'll sell my system to however many want to buy it, because our of all the hundred or so people that are in this room today, there probably

isn't one of you who will be able to execute it properly once you get home. So it doesn't matter to me how many I sell."

He didn't go on to explain what he meant by that statement and nobody asked. I didn't know what to make of what he said. I had no reason to think he was lying and the arrogant tone of his answer didn't make it seem as if he was kidding around either.

So I was confused. I listened to the rest of his presentation hoping that what he said wasn't true or that it didn't apply to me. Unfortunately, my hope was unfounded. After going through some very painful trading experiences over the next two years, I came to the realization that I was one of guys in the room that he was referring too; someone who didn't have the ability (mental skills) to properly execute the signals of a technical indicator or trading system.

THE DIFFERENCE BETWEEN PHYSICAL AND MENTAL SKILLS

If you decided you wanted to be a golfer, you would start out by focusing on the fundamental mechanics how to swing a golf club, so that you could hit the ball where you wanted it to go. The golf club, the ball, and the characteristics of the course are all physical in nature, so the skills you would start out developing would also be physical in nature. The objective would be to practice the most appropriate mechanics of swinging the club to create and reinforce a muscle memory of how it's done. Once the muscle memory has been established, you won't have to consciously think about how to do it properly, because the process of hitting the ball where you want it to go will be automatic.

The same basic process will also apply to trading, with one very notable exception. As traders sitting in front of a computer screen, we are not interacting with anything that requires any physical skills to speak of to be successful. If you have the eye/hand coordination necessary to move the cursor to the appropriate spot on the screen and then click the mouse, you already have the physical of trading down pat.

As traders we have to interact with the dynamic flow of market information. Therefore, all of the processes and skills we need to interact with that information in a way that assures us of producing a consistent income, are all mental or psychological in nature. There's a huge difference between the way a professional trader thinks and the way a typical trader thinks. This difference enables the professional to perform at a level that usually mystifies the typical trader. Their abilities are mystifying because most people aren't intimately familiar with mental skills, especially those we need as traders.

To make this a little less abstract and hopefully easier to relate to, I'll give you a generic, non-trading example to illustrate the nature of the kind of mental skills I am referring too. Imagine a college basketball player who practices making baskets from the free throw line anywhere from two to three hours a day. And as a result, he's developed his (physical) skills to the point where he can regularly make twenty-five to thirty baskets in a row. Hitting twenty-five consecutive baskets from the free throw line may seem like a lot, but for top college or professional player, it would not be unusual at all.

Now let’s put this player in a situation where his team is in the final game of the NCAA Championship. There is two seconds left on clock and his team is losing by one point. And as unlikely as this scenario may be, he gets fouled by a player on the opposing team giving him the opportunity to go to the free throw line and shoot two baskets. If he makes the first one, his team will get one point. The game will be tied and go into over-time. If he makes the second basket, he wins the game for himself, his team, school and everyone else who wants his school to win the championship.

Obviously, this is an extremely high pressure situation. You may be wondering, how could the challenge portrayed in this example, have anything to do with trading. Well, as we breakdown and look at the variables that will determine whether the player makes or misses those two shots, we're going to find that the skills he'll need to win the game are virtually identical to the skills we have to develop as traders to be able to produce a consistent income.

First, let’s look at the resources our college player has working in his favor. He has practiced this shot with the exact same physical variables thousands of times. The ball, the distance to the basket from where he will have to stand, the height and diameter of the basket are all identical to what he has practiced with. From a physical perspective his muscles are trained to perform with a precise combination of moves that are deeply engrained in his muscle memory. From a mental perspective I am going to say that he is completely confident in his ability to make the basket. Not only has he done it thousands of times. He’s also made exact same shot a substantial number of times in a row, surely engendering a genuine sense of confidence in his ability to perform the task.

With both the physical and mental components required to fulfill his objective seemingly in complete harmony, would it be safe to conclude that he will make the shots and win the game? Without having a lot more information about this player’s personal psychological make-up, I wouldn't bet on it, one way or the other. There is certainly no question that "he knows or believes" that he can do it. But there are a number of other intangible (thinking) variables that have the potential effect his ability to make those two shots that we haven't yet taken into consideration.

The Choke Factor

How many times have you seen a situation, as in the above example, where the outcome of a game will be decided by the ability of one player and just before that player takes the shot as in basketball, or attempts a last second, game winning field goal, as in football, the coach for the opposing team calls a time out. Why would he do this? Is the opposing teams coach just being gracious by giving the player additional time to prepare himself?

No! Quite the contrary, the opposing coach's intent is to put the player on "ice," as it is commonly referred to in sports. The opposing coach knows that if the player is really skilled, the process of successfully making the basket or kicking the field goal will be virtually automatic. No different than any other physical skill that has been nurtured through intense practice. By calling a time out, he wants to give the opposing player the opportunity the interrupt that automatic process by thinking some distracting or self-sabotaging thoughts that could cause him to lose his focus and miss. In other words, the opposing coach hopes he will think about failing and the consequences of failing. He knows the less time the player has to think the more likely he will simply engage his muscle memory and let the process work automatically. Call a time out, give him more time to think, and he might choke and blow it.

Here are some examples of the kind of thoughts that could easily take our basketball player out of the process he's already established for making the free throws.

- *"Everyone is counting on me, if I miss these shots my life will be complete shit."*
- *"If I miss, I will go down in the history of this school as the guy who could have won a national championship and choked."*
- *"If I let everyone down by not making these shots, I know the fans will hate me, but what about my friends. Will I still have any?"*
- *"I'll never live it down if I don't win the game."*
- *Or he could start to hear voices from past coaches who would call him a loser when he didn't perform to his potential or when he made a mistake. And think "If I miss these shots, I'll be the biggest loser of all time."*

These are just a few examples of the kind of fear provoking thoughts that would cause him to focus his attention on not missing the shot, instead of staying positively focused in the process of making the shot, as he does in practice. There's a huge difference in perspective here that can have just as big of an impact on the outcome.

However, it’s not just fear provoking thoughts that could cause him to miss. What if he starts taking the process for granted and becomes over-confident. He could think, "I've done this a million times, the championship is in the bag." This type of thinking would fall into the category of someone who’s confident to the point of being cocky. Having an absolute belief in his ability is a good thing, unless it causes him to get excited and start celebrating the championship in his mind, before he actually wins it. That excitement could make just enough of a difference in the way the ball leaves his fingers so that he "just barely" misses the first shot.

By the way I have this laid out; it would seem as if he doesn't have much of a chance to win the game. Not So! All he has to do is keep his thoughts positively focused on the immediate objective. Meaning, he can't let himself entertain any thoughts that would cause him to become distracted in any way. This is where the mental skills come into to play. The ability to keep one’s mind undistracted and positively focused on the task at hand is a learned skill.

I think that out of the general population as a whole, very few people realize or appreciate the inordinate amount of attention and effort great athletes put into developing their mental skills along with their physical skills. The field of sports psychology came into existence as athletes increasingly came to the realization that the difference between someone who could consistently win in championship type moments and those who almost win, was not a function their physical skills, but rather what they were thinking about while they were performing. In other words, the successful utilization of their physical skills depended on the nature and quality of their self-talk.

If the development of mental skills will give an athlete a distinct advantage, then I would say, coming to the realization that they even exist would have be a critical first step in there development. I am pointing this out because, I think there's a lot of fans, non-athletic people and even many athletes who attribute the characteristic of consistently performing at 100% of one’s potential in high pressure, critical situations to luck. Let's say, the perfect combination of coincidence with highly developed physical skills.

If someone is relying on the coincidence of several variables coming together in exactly the right way, at just the right moment (luck), then the only thing they can really do for themselves is hope. I'm not sure if I could make the argument that hoping for a coincidence is a skill. However, what I am sure of is, great athletes don't have to hope everything comes together in exactly the right way, at just the right moment, because they have learned how to make it happen.

Great athletes can consistently perform at, near, or even above 100% of their muscle memory potential for several reasons.

ONE: ***They have a passion for knowing.***

Great athletes genuinely love their sport. That love cultivates a passion for knowing exactly what they have to "do" from a physical perspective and how they have to "be" from a mental perspective to succeed. Anyone attempting to be an athlete understands the importance of developing the physical skills. But not everyone understands the role that perspective, state of mind, and thoughts play in an outcome. At some point, great athletes learned it’s the quality of one’s mental skills that separate the best from the best of rest. They're acutely aware of the profound role the "how you have to be" part plays in how they perform in any given moment, especially in high pressure situations. And as a result, are open to learn whatever they have too, to get the edge. Even if it means changing the way they think.

TWO: ***They have a championship perspective.***

a.) Belief:

Great athletes have a strong, unshakeable belief in their ability to succeed. For many of them that belief was intentionally instilled from the earliest days of their childhood by their parents and coaches. But if it wasn't, they learned how to do it themselves. Building a belief system to specifically to accomplish certain objectives is something that the average athlete does haphazardly. In other words, it just sort of happens, if it happens at all. The best athletes build these unshakeable belief systems systematically with conscious intent.

b.) Clarity of intent:

Champions always seem to find a way, because there is usually nothing standing in their way, at least not from a mental perspective. Their "single minded" intent to win is so clear and resolute, there is little or no room left for the kind of distracting thoughts that would cause them to lose their focus, even for a moment. As a result, they are often thought of as having nerves of steel, or ice water running through their veins.

However, it's their mental perspective, not the physiology of their nervous system that allows them to remain so calm, cool and collected in the face of what everyone else would perceive as an extremely tense, or nerve rattling situation. They're not rattled because they don't define the situation as tense or adverse. Quite the contrary, they live for these life defining, championship moments. On the other hand, most everyone else would certainly love the idea of being a champion, but would absolutely dread the prospect being put in a situation where they actually had to make it happen.

a) *Resiliency:*

Great athletes have learned how to become undaunted by failure. They don't beat themselves up for making a mistake or not achieving their objective in any particular moment. They recover quickly from a misstep, if they have to recover at all. In other words, unlike the typical athlete who would have to stop berating themselves before they could get their mind positively re-focused and back into the game, it wouldn't even occur to a championship caliber athlete to beat themselves up in the first place.

The reason why is because they've learned to operate out of a belief that "they are always doing the best than can in any given moment regardless of the outcome." And "if they could have done better they most certainly would have." How did they acquire such an unusual belief considering our cultural obsession with winning? At some point in their development, they came to the realization that in spite of their best intentions and efforts, they may not be completely equipped to successfully deal with every possible external, physiological and psychological variable that could affect the outcome of an event. By genuinely accepting and embracing this concept at a core level of their identity, it enables them to stay positively focused and keep going without regret.

I'll give you a personal example to further illustrate the point. If you were watching me trade, you would probably describe me as being very resilient, as you observed me easily putting on the next trade after taking a loss on the last one. The transition would be so seamless you might assume that what enables me to lose without experiencing some form of emotional pain or discomfort is a genetically encoded characteristic that is a natural part of my psychological make-up. I assure you this is absolutely not the case, at least not with me.

When I first started trading it would usually take at least a week or more for me to recover from a losing trade. What I mean by recover is, get the point where I was capable of putting on another trade. I was immobilized, but not in the traditional sense where you see a trade set-up, but can't pull the trigger because you're literally paralyzed with fear. My immobilization took the form of a stubborn refusal to put on the next trade as a way of punishing myself for being wrong and a loser.

I suspect some of you may find this idea of punishing myself for being wrong and losing a bit abstract. So, if you're wondering how I came to this realization, I am about to explain it to you. However, I have a much larger purpose for doing so other than to satisfy your curiosity. My explanation will also provide you with a good illustration into the dynamics of how our beliefs and perspective act as skills.

The period of my life I am referring to was over thirty years ago when I first started trading, including the early 1980's when I became a retail commodities broker for Merrill Lynch at the Chicago Board of Trade.

I would say my style of trading back then would be classified as a long-term swing trader. I didn't make a lot of trades. I would "try" to patiently wait for just the right set-ups based on my criteria. And if the market went in my favor, my average winning trade usually lasted anywhere from one to two weeks. I watched and traded all of the major commodity groups and interest rate futures, but liked the silver, gold and the currency markets the best.

As a broker, I would assist my customers with trading ideas, as well as, make specific trading recommendations based on my own analysis. Of course, I was also responsible for the proper execution of the trades my customers choose to make, since personal computers and electronic trading platforms didn't exist.

Trading was very stressful for me back then, because I was under a lot of pressure to succeed. I moved to Chicago from the suburbs of Detroit so that I could be close to the exchanges and get to know people who knew how to trade. I also wanted access to the kind of intra-day market data you could only get, at that time, if you were on the inside of the industry. So I gave up a newly negotiated three year guaranteed income of $360,000 to manage a commercial casualty insurance agency, in the Detroit area, to go to work for Merrill Lynch in Chicago for a twenty thousand dollar a year draw against commissions.

How could I give up a $360,000 guaranteed income over three years for a $20,000 a year draw? It was easy if you consider that I didn't think I was giving anything up. Here's what I mean. Earlier that year I was long two 5,000-ounce silver futures contracts at a little less than ten dollars an ounce. I was in the trade for a couple of weeks and ended up getting out with a substantial loss not long before the silver market literally went straight up to $49.00 dollars an ounce.

If you're old enough to remember, the price of silver skyrocketed to $49.00 when the oil billionaire Hunt brothers tried to "corner" the silver market. They secretly accumulated huge long positions in silver futures, while, at the same time, buying as much of the available supply of cash (physical) silver as they could get their hands on. Their objective was to squeeze all of the traders who took the short side of their (the Hunt brothers) long futures positions. If you don't know what it means to get squeezed when someone is trying to corner a market, I'll briefly explain.

If you recall from earlier chapters, futures contracts have expiration dates. If you don't liquidate your position before expiration, the trader on short side of the contract is obligated to deliver the actual physical commodity to the trader on long side of the contract at the price both sides agreed too when they entered into the trade. If you're short and want to liquidate before expiration, you simply have to enter a buy order into the exchange, if there's another trader willing to take the sell side of that buy order, a trade is executed and you will be flat (relieved of your obligation). However, as it's getting closer and closer to expiration if there isn't enough sell order inventory to take the other side of your buy order, you're going to get stuck with having to make delivery. As in this case, you would have to deliver 5,000 ounces of silver per contract to the trader on the long side of the trade.

What typically happens at expiration is traders who are long and don't want to be obligated take delivery will enter sell orders and traders who are short and don't want to be obligated to make delivery will enter buy orders. The sell orders from the longs will get matched up with the buy orders from the shorts, essentially canceling the contracts and obligations the traders would otherwise have to each other.

Going into expiration, the Hunt brothers were on the long side of several thousand contracts (way more than allowed by the rules of the exchange), which turned out to be the vast majority of still open (un-liquidated) positions. Instead of entering sell orders to close those contracts, as would be customary, what they did is hold on and let the contracts expire, forcing the traders on the other side to deliver silver bullion to them. Since the Hunt brothers already owned a significantly large percentage of the world's supply of silver bullion, the traders who were being forced to deliver bullion to the Hunt brothers, where now in the unenviable position of having to go to the cash bullion market and buy silver from Hunt brothers, so they could fulfill their obligation to deliver silver bullion to the Hunt brothers in the futures market.

No this is not a movie, it's real life, and in the end the exchange made sure it was the Hunt brothers who got squeezed. However, in mean time, in their attempt to corner the market, the Hunt brothers drove the price of silver from the $9.00 an ounce range, all the way up to $49.00 an ounce. Once the rally started, it happened very fast and there were no retracements. In other words, if you were on the right side of the move, it was a perfect trending market.

I was on the right side of what would turn out to be a perfect trending market with two 5,000 ounce contacts at $9.75 an ounce. Of course, I had no idea of what was about to happen. In fact, I don't even remember why I went long silver. It was probably something my broker suggested, since at the time, I took all of his advice. Shortly after I got into my long position the price went against me, down to $9.55 an ounce. As a result, my broker suggested I spread my position between New York and Chicago. Meaning, since I was long two silver contracts at the COMEX Exchange in New York, I could put on a short position of two contacts at $9.55 an ounce at the Board of Trade in Chicago. He said spreading my position would have the effect of locking in my $2,000.00 loss, but it would also prevent me from losing any more, if the price continued to move against me. His strategy was to keep the short (Chicago) leg of the spread on until the price came back in my favor. When that happened, he would then take the short leg off, so that my profits from the two contracts I was long could accumulate.

In the next couple of weeks the market would rally back to my original entry point of $9.75 and then drop back down to the $9.50 area, several times. The market was basically in a 20-cent trading range, although I didn't know anything about chart patterns at the time. My broker probably didn't either, because instead of waiting for a confirmed breakout of the range, when the market rallied back up to $9.75, he took the short leg of the spread off, locking in as a realized loss of $2,000. Then when the market dropped back down to the $9.50 area again, he put the spread back on by going short two contracts. Then the market rallied back to the $9.75 area again and he took the short leg off, locking in another $2,000 loss. In that two week period, he put the short leg of the spread on at the bottom of the trading range and took it off at the top of the trading range, at least six times. I don't remember the exact number because I got to the point where it was too painful to open my brokerage statements. After several sleepless nights, I decided to just get out of the position no matter what.

When I got to the office that morning, the first did was call the broker and tell him to completely liquidate my position. Unfortunately, by the end of the day, silver finally broke out of the top end of its trading range and never went below my entry price again. Very shortly after that, it took off to $49.00 an ounce. As I'm watching the price relentlessly climb every day, I'm thinking if I would have just hung on until the end of the day I would have been in a trade that would have given me $400,000 in profit.

> Getting out of that trade without the money had a deeply profound effect on how looked at my life and what I thought was possible.
>
> So leaving the insurance business, something that I truly didn't enjoy, to be a trader in Chicago, was an easy decision, regardless of how much money I was giving up to do it.

On the other hand, everyone else in my life, and I do mean literally everyone (family, friends, new girlfriend etc.) thought I was making a really bad career move and a huge mistake. As a result, I couldn't help but feel that I had a lot to prove. So when I considered putting on a trade, it was always very well thought out with a great deal of analysis to justify the decision to do it. If the trade worked, everything was wonderful, especially because it made it seem if all the grief I went through to get to Chicago was worthwhile. On the other hand, when a trade didn't work, it would put me into an emotional tailspin. My mind would immediately be consumed with thoughts of self-loathing and regret. For me to be wrong and have to take a loss as a result, just wasn't acceptable. So after experiencing a loss, you could say that I wasn't exactly in the kind of "frame of mind" where I felt like putting on another trade for a while or even watch the markets for that matter. But I also didn't have much of a choice, because regardless of how much emotional trauma I was experiencing over my own account, I still had to fulfill my daily obligations as a broker.

As I described above, my customers expected me to make objective evaluations of their trading ideas, provide them with ideas based on my own analysis and, of course, properly execute their trades. Meaning, to be effective, I had to stay completely connected to the markets. As well as, keep up with my analysis of those markets to spot potential trading opportunities. If I didn't, I risked losing my job and I certainly didn't want that to happen. As a result, I found myself confronted with somewhat of a dilemma or conflict. On the one hand, I wanted to do the best possible job I could for my customers. On the other, if I was coming off of a losing trade, I really didn't feel like having anything to do with the markets, at all or at least not until I could get my mind right, and stop feeling sorry for myself.

Without having the level of insight into the nature of trading psychology that I do today, the only way that I knew how to deal with this conflict was to try to set aside my negative feelings and do the best I could to maintain a business as usual routine. And I would say, for the most part, that approach worked quite well, at least for my customers.

Because regardless of what was going on with me, I continued to point out various trading opportunities for them to take advantage of, as well as, tend to the rest of my duties as a broker. But most importantly, as a normal course of business, I routinely gave my customers my "best trading set-ups." The ones I reserved for my own trading account and that didn't change either.

Where this approach didn't work so well, or at all, for that matter, was with myself. It wasn't so easy to just "put aside" these negative thoughts and maintain a business as usual routine when it came to my own personal trading. In other words, when I was beating myself up, I found I had no impetus, whatsoever, to put on any trades for me. Regardless of how good I thought they were or how long I may have been waiting for them to set-up, which in some cases, may have been weeks. Now when you think about it for a moment, something pretty significant had to be going on inside my head for me to stop participating in my own trades.

As conscientious as I was about being a good broker, that’s not why I went to work for Merrill Lynch. I only became a broker to facilitate my dream of becoming a successful trader. Bottom-line, trading my own account was my highest priority. At the time, I believed it was:

> *a) the only way I was going to fulfill my dreams of financial independence;*

b) justify what everyone in my life thought were some very stupid decisions on my part; and

c) close the financial gap between what I left in the insurance business and what I was making as a broker.

So not putting on my own "best trades" or not being able to, was a big deal. Especially when you consider that since I was already executing these trades for my customers, all I had to do to get them on for myself was to fill out another order ticket at the same time as I was doing theirs. So why wouldn't I?

What was behind this lack of impetus?

> In fact, I went to great lengths to convince my customers not to expect every trade we make to be profitable. And although the words rang true when I talked to them, it was only lip-service when it came to me.

At the most general level, you could say that I didn't have the kind of resiliency necessary to be a successful trader. In other words, I wasn't trading from the most appropriate perspective. There as a part of me that knew it was unrealistic, even absurd to expect that every single trade was going to work.

I may have understood that not all trades are going to work. But, at the same time, I was under so much pressure to succeed, I convinced myself otherwise. So you could say that my understanding existed only at a surface level of knowing. Where it wasn't nearly powerful enough to counteract what I really believed. Because deep down at the very core of me, what I really believed is that somehow I could find a way to make every trade work. That if I did all of the right things, or if I found or figured out all of the right things to do, that I could, in fact, be right every time and therefore eliminate the risk of losing.

As you already know, believing that it’s possible to be right every time and eliminate the risk of a trade is a prime example of an erroneous belief about the nature of trading. It’s an erroneous because there’s no analytical method, or system that can correctly predict the direction of the price one hundred percent of the time. It doesn't exist. However, believing that it’s possible, like I did, caused my expectations to be completely out of whack with reality. As a result, when one of my "best trades" didn't work, I felt betrayed by my own analysis. I reasoned that somehow I should have known better and not put the trade on in the first place.

So when the next set-up presented itself after I experienced a losing trade, I didn't have any problem giving it to my customers, because every trade I gave them came with a disclaimer that it might not work. But the thought of doing it for me, created a huge conflict. I don't remember the exact words but, there was this inner voice that would say something like, "you were wrong on the last trade, so you don't deserve to benefit from the potential reward of this next opportunity." That must have been the voice of the part of me that believed that I needed to be punished for screwing up. Of course, I wanted to do the trade anyway, but the war going on in my head created enough of a conflict to immobilize me to the point where I did nothing.

I'm sure you can imagine the pain and anguish I would be in if this next trade was a winner and they almost always were, some of them huge. If that was case, I would be over-come with feelings of despair that were so intense and unbearable that it had the positive effect of popping me out my conflicted state of mind. Not wanting to go through that kind of pain again, I would be determined to take the next trade. And I did, that is, until one of my "best trades" didn't work again and the cycle would start all over.

With such a debilitated trading style, it probably wouldn't surprise you to learn that it didn't take too long for me to lose everything. Within a year after arriving in Chicago to fulfill my dreams of becoming a successful trader, I was filling for bankruptcy. However, contrary to what you may be thinking, it wasn't trading losses that caused me to go under; because I didn't have that many losing trades and certainly not big ones. What caused me to have to file, was that I simply ran out of money. I ran out of money because at the time I had a very extravagant life style. And I was so sure I would be producing the level of trading profits I needed to support that life style that I continued to spend until there was literally nothing left.

Now, if you're thinking, as my situation became increasingly desperate, why didn't I just cut back on my expenses? That would be a very good point, except that to do so would have required that I admit to myself that "*things weren't exactly working out*." That I was, in fact, failing. Obviously, admitting that one is failing is not an easy thing to do. But I had another reason that made it doubly difficult to admit I wasn't making it.

My trading methodology was really quite good. It generated a very high percentage of winning trades and therefore more than capable of producing the profits I needed. So it was a bit difficult for me to recognize the dire situation I was in, especially when it seemed as if I was always just a few trades away from everything being alright. And I would have been alright, if I was operating out of a set of beliefs that enabled me to lose without regret, so that I could move on to the next trade and take full advantage of my methods winning percentage.

For example, imagine how different my experiences would have been if I believed then, as I do now, that just because a trade didn't work, it didn't mean I was a "loser."

- *Or just because the analysis I used to predict the direction of the price was wrong, it didn't mean there was anything wrong with me.*
- *Or that trading losses are an inevitable, unavoidable cost of doing business, no different than the over-head expenses that one would incur in any other kind business.*

In a normal business an over-head expense is the price one pays for the opportunity to sell a product or service that can generate a profit. As traders, losses are the over-head expenses we pay to make ourselves available to experience winning trades.

If the ability to readily recover from a loss or any adversity is a skill that we define as resiliency, then the underlying beliefs that facilitate one's ability to be resilient also have to be considered skills. I used to be completely UN-resilient. Now, as I stated when I first started this example, I can move from one trade to the next, regardless of the outcome of the last trade, without any difficulty, whatsoever. I became resilient by re-defining the nature of a losing trade in relationship to what I was trying to accomplish. Since I no longer define losses as failure, I don't have a negative emotional reaction when I experience one.

My perspective changed because my underlying beliefs about the nature of trading changed. I learned how to become resilient, just as you can too, if necessary and if you so desire.

Chapter Twelve

Building a Mental Foundation to Produce Consistent Results

INTRODUCTION

Hopefully, at this point, there isn't any question about the fact, there's a lot more to becoming a successful trader than just learning how to win. If there were some analytical technique in existence that was accurate enough to predict the intentions of other traders to the extent that we would never have the confront the possibility of ever being wrong or losing, then the only thing we would need to be consistently successful is a technique that was always right and never puts us into a losing trade.

Does such technique exist? Well, the more you understand about price movement within the context of buy/sell order flow dynamics, the more difficult it becomes to believe that it's possible for any analytical technique to always be right about what direction the price is going to move. Then, once you get to the point where you come to a full realization that the forces that drive the buy/sell order flow are just too diverse for anything like an "always right" technique to exit, it will become readily apparent that the skill of learning how to win (analysis), can't shield you from feeling betrayed, like a loser or feeling like there's something wrong with you, when you have to admit that your analysis was wrong and put you into a losing trade.

Being wrong, losing and leaving money on the table in a winning trade are unavoidable occurrences in the life of anyone trying to make money speculating on the effect other traders buy and sell orders are going to have on the direction of the price. There are plenty of excellent analytical techniques available to help us with our predictions, but they're not always going be right. But, the good ones will be right enough to give us the opportunity to produce consistent profits. However, to realize the profits these techniques make available, we have to be able to execute our trades properly. To execute properly we have to be psychologically prepared cut our losses and to the best of our ability let our profits run. We won't be able to do either one effectively until we can be wrong, lose and leave money on the table without fear, regret and self-recriminating thoughts.

It's our beliefs that cause us to define the circumstances and situations where the threat of being wrong will cause us to experience fear. It's our beliefs that determine what we can't lose and the amount of pain we experience if we do. And it's the beliefs were operating out of that say what it means if we happen to get out of a winning trade before the market is finished moving in our favor, and how much pain we will experience as a result.

The ability to lose, be wrong, and leave money on the table without getting emotionally rattled are all belief based trading skills. They're the skills that separate the best traders from everyone else and contrary to what many people erroneously assume, they're all very learnable. That is, if you're willing to change some of the ways you may think about trading. Meaning, you may have to give up some long held cherished beliefs about what it means to be a trader and how to be successful at it. For example, remember in the first chapter where I introduced the concept of beliefs acting as invisible barriers. Invisible in the sense that once we've acquired a belief, it will cause to see and respond to the world in a way that seems so self-evident, that we will rarely, if ever, question if it's really useful or serving our purpose. Beliefs also act as barriers because they have effect of blocking from our awareness alternative possibilities, especially if those possibilities conflict with what we already believe to be true.

Well, here in the United States, one of the most cherished of our culture beliefs is "winning is everything." I don't think I would be over-stating it by characterizing our society as being obsessed with winning. If I grow up being indoctrinated with the idea that "being a winner is everything," implying that only "losers" lose, when I decide to become a trader, how could it possibly occur to me that to achieve the success I desire, learning how to lose is a trading skill that has the same degree of importance as learning how to win. The idea that I needed to learn anything other than how to win, would get blocked from my awareness by my belief “winning is everything.”

Think about the implication of the concept "winning is everything," with the emphasis on the word "everything." "Everything" is all inclusive, meaning I would naturally assume there would be nothing that exists beyond knowing how to win that I would need to learn to be successful. And if exposed to the idea that learning how to lose was just as important as learning how to win, I would completely dismiss it, without consideration. When you combine a belief that winning is everything, with a distinct lack of understanding of how prices move from an order flow perspective, the idea that I would also have to learn how to lose to be successful would present me with an irreconcilable contradiction. On the surface it may seem irreconcilable, but only if we don't understand the probabilistic nature of the relationship between analysis and price movement; because ***from a probabilistic perspective, learning how to lose, and be wrong without the potential to experience emotional pain, is part of the over-all process of being a winner.***

I've organized the skills we need to produce consistent results into three broad categories.

One:

Objective Perception: Learning how to perceive market information from a perspective that is free of fear, perceptual blindness, and illusions.

Two:

Flawless Execution: Leaning to let the laws of probability work in our favor so that we can execute the signals from our analysis without making emotionally damaging and financially costly trading errors.

Three:

Unencumbered Accumulation: Learning how to recognize and compensate for a.) any self-sabotaging beliefs that would argue against success and, b.)

the negative effects of euphoria.

To objectively perceive market information and flawlessly execute the buy and sell signals generated from our analysis, we need to be operating out of a probabilistic perspective that takes what we are doing out of a context of what it normally means to be wrong and lose money. If we change our perspective, we can correspondingly change our emotional response to the outcome of our trades. There's already a probabilistic perspective available we can apply to trading that's being used by millions of people around the world who play slot machines on a regular basis and do it without the slightest bit of emotional discomfort when they lose. So what we're going to do is borrow from slot machine players what I call "the slot machine perspective," because it just happens to incorporate all of the beliefs we need to observe objectively and execute flawlessly.

The third skill set of "unencumbered accumulation" is a function of learning how to monitor your thoughts or state of mind and then build a framework to determine if and when you may be susceptible to the effects of self-sabotaging beliefs or the potential negative effects of having crossed the threshold from being confident into a state of euphoria. I'll cover what you need to understand about "unencumbered accumulation" towards the end of the course.

PERSPECTIVES

At any given moment, when we are interacting with the market, we are doing so from a particular perspective. I am going to define a market perspective as a belief or set of beliefs about what we think will work in relationship to what we are trying to accomplish. These beliefs will act as an underlying force that will determine:

a) how we see the market,

b) the decisions we make,

c) the actions we take,

d) the expectations we have of the outcome and

e) how we feel about the results.

Below is a brief explanation of each category.

***Perception*:**

If we're trading using technical analysis, we have learned to identify opportunities to buy and sell in the form of collective behavior patterns. The patterns we've learned about become a part of our trading perspective in the form of a set of beliefs about the opportunities they make available to enrich ourselves. The energy of these beliefs will enable us to perceive the patterns we learned about. All of the other patterns the market generates, the ones we haven't learned about yet, will exist as invisible or unperceivable opportunities, until they become a part of our perspective.

***Decisions*:**

The decisions we make about what to do, or not do and the particular set of steps we take, will be consistent with what we perceive as available in relationship to our objective.

***Expectations*:**

Expectations are what we have learned to believe is true, projected out into some future moment. Therefore, we will naturally expect the environment, life or the market to show up in a way that is consistent with what we believe it should look like, sound like, taste like, smell like or feel like, in any given moment.

Behavior:

How we express ourselves (what we do and how well we do it) in relationship to what we have decided and expect, will be determined by a number of factors;

1. *the clarity of our intent and the resoluteness of our desire,*

2. *the relative degree of confidence or fear we are experiencing in any given moment,*

3. *a distinct lack of distracting thoughts or compelling energy arising out of competing agendas, or beliefs that contradict or conflict with what we're trying to do or why we are trying to do it. In other words, when we're completely clear and resolute about what we want to accomplish, without the potential for distracting thoughts coming from conflicting beliefs that want to hold us back, or cause us to get in our own way, we will naturally perform to our maximum capability.*

Experience:

For the purposes of helping you understand the psychological dynamics behind how to properly execute the signals from your analysis, I'm going to define "experience" as how we feel about the results of our efforts. When we get an outcome, we will feel something within a range of positive or negative emotions that will reflect the degree to which our expectations were fulfilled or not. For example, if our positive expectations (something we desire, need or demand) of what's going to happen in the environment or the market in particular, become realized, we will naturally experience the feeling of positively charged emotions flowing through our mind and body.

These emotions could be expressed as; I'm feeling great, wonderful, happy, satisfied, confident, and excited or just having an over-sense of well-being because life showed up the way we expected it too.

On the other hand, the degree to which our positive expectations are not realized could cause us to experience the feeling of negatively charged emotions flowing through our mind and body. These negatively charged emotions are commonly referred to in the general sense as emotional pain. Emotional pain can be expressed as fear, betrayal, anger, resentment, disappointment, dissatisfaction, stress, anxiety, confusion, unhappiness or just a general sense of feeling horrible.

What can cause us to feel just as unpleasant, if not worse, is when our negative expectations, as in a perceived threat of pain, become realized. In other words, what we don't want to happen occurs, causing us to actually experience what we were afraid of. On the other hand, if our negative expectations do not become realized, we will experience a sense of relief.

The beliefs that exist at the core of a perspective create a closed loop, where every part of the process from perception to what we experience and everything in between is consistent with and reinforces the belief that started the process in the first place. That's why our beliefs seem so self-evident to us and as the truth beyond question, even when they are completely dysfunctional and not serving our objectives. So let's take a brief look at how we acquire core beliefs.

> *1) We can be told something by somebody we respect and trust, and then simply choose to believe (take their word for it) that what they're telling us is true.*
>
> *2) We hear or read something in an area where we no previous experience or preconceived ideas about what is true and adopt these new ideas as core beliefs, simply because at the time they either resonate as being true or they seem to make sense.*

3) We learn to believe something is true from our direct experience.

4) We can literally think a core belief into existence by using our own logic and reasoning process.

ADOPTING A PERSPECTIVE THAT MAKES IT EASY TO DO THE RIGHT THING

As I indicated above, if you're going to extract the maximum amount of profits your indicator has the potential to make available, then you have to be able do exactly what need to do without hesitation, reservation, or fear.

I am going to presume you want the process to be easy. And if that's the case, then you will have to adopt a set of beliefs (a perspective) about trading that will:

- *Manage your perception of information in a way that you don't perceive any part of the process as threatening or potentially painful.*
- *Manage your decisions in a way that it wouldn't even occur to you make the kind of trading errors I talked about in Chapter Two.*
- *Manage your expectations in a way that reflect a complete acceptance that "anything is possible" from an order flow perspective.*
- *Manage your behavior in a way where you always feel compelled to do what's right with respect to your objective, instead of having to fight off impulses to do something you've learned could get you in trouble.*
- *Manage how you experience the outcome of your trades in a way that you feel terrific when you win, but at the same time be able*

to lose and be wrong without feeling;

- like you were betrayed by your indicator,
- regret,
- need to get revenge,
- like a loser, or
- there was something you should have known that would have changed the outcome.

With the right set of beliefs about how trading works, you can take the threat of being wrong and losing out of the process and easily master flawless execution of your indicators. When you do, you will quickly find out what it's like to "cut your losses without the slightest bit of emotional discomfort and let your profits run" in an efficient, organized and methodical fashion. You'll be learning how to be successful the easy way. As opposed to the typical way, where you try eliminate the threat of pain by using analysis; which hopefully, by now, you understand can't be done. In other words, you're going to learn how to "think like a professional trader," and in the process, save yourself from contracting a severe case of analysis paralysis, a mind freeze experience, or going through the pain and frustration of possibly years of boom and busting.

What we are looking for is a set of beliefs that accurately (truthfully with no illusions) reflect the relationship between analysis and the chaotic nature the buy\sell order flow, so that we don't have any potential to experience emotional pain from the outcome of our trades.

This may seem like a tall order. But like almost everything else about the nature of trading, appearances are deceiving. Because, if you've ever played a slot machine for any extended period of time, where you lost several times in a row, and kept on playing without experiencing fear, anger, disappointment, dissatisfaction, regret, or a sense of betrayal, then you probably already have many of the beliefs you need to execute the buy and sell signals from your analysis properly.

In fact, what I'm about to demonstrate is, there's absolutely no difference between the beliefs you operate out of to play a slot machine for hours on end without emotional pain and trauma and the beliefs you need to flawlessly execute the signals from your analysis, without emotional pain, resistance, hesitation, or second guessing yourself. So, if you can enjoy yourself playing a slot machine in spite of your losses, then once you learn how to apply your slot machine perspective to your trading, you won't find the experience any different. On the other hand, if you've haven't ever played a slot machine, it won't matter, because I am going to help you build the most ideal trading perspective from scratch.

CHAPTER THIRTEEN

THE SLOT MACHINE PERSPECTIVE

What we're going to do now is dissect the typical perspective people operate out of when they play a slot machine into its component parts, and then see how it compares to kind of perspective you need to be objective and execute properly. I am going to assume that most everyone (taking this course) reading this book have some familiarity with how a slot machine works. But just in case some of you don’t, I will give you a brief description.

Originally a slot machine was a mechanical devise that housed at least three separate and independently moving wheels mounted next to each other. The wheels were divided into specific number of slots or sections with various symbols painted in each of sections.

A handle on outside of the machine was attached to an internal mechanism that housed the wheels. When the handle was pulled down, it would cause all three wheels to start spinning. When the three wheels stopped moving the symbols on each wheel will line up next to each other in a particular pattern. For example, the left wheel could show a star in the section where the wheel stopped, the center wheel could show a diamond, and on the right wheel a square.

Depending on the number of sections and the number of different symbols on each wheel, the total number of possible combinations of symbol patterns between the three wheels could be in tens, if not the hundreds of thousands.

As a player, you would be looking for certain symbol patters to show up next to each other that are designated to give you a payoff or jackpot. For example, three diamonds in a row may be designated to pay you 100 to 1. Meaning, if you put twenty five cents in the machine, you would get back twenty five dollars, that is, if a diamond on each wheel line up next to each other. Sounds good, but the actual odds of three diamonds lining up may have been ten thousand to one. This is why the machines were affectionately referred to as "one arm are bandits," where the handle was considered the arm. From a statistical perspective, the greater the odds, or less likely that certain symbols patterns will line up, the bigger the payoff or jackpot. Of course, if one of the designated payoff patterns doesn't show up, you don't get anything back. As a result, whatever amount of money you put into the machine to play is spent or lost.

The slot machines that you will see in a casino today work off the same principles as the original mechanical versions, but they are now almost completely electronic in the form of computers. The graphics software simulates wheels spinning and the patterns that show up are determined by a computer chip specifically designed to produce random outcomes. And though some machines still have a handle to pull to start the simulated wheels spinning, most people find it much easier to just push the button provided to do the same thing.

I think it would be safe to say there are two primary core beliefs that people establish about the characteristics of playing a slot machine. One, that its pure unadulterated gambling and two, the outcome to each event is random. I am going to define gambling as the "willingness to risk losing" a certain portion of our assets, usually in the form of cash, for the "chance" to win something of value. The operative concept here is "chance." Meaning that it's possible we could win, implying that it's also possible we could lose whatever amount of money we had to put into the machine to play.

How do we know there's only a chance of winning something of value? All we have to do is play several times to realize that sometimes we will get paid by the machine and most of the time we won't. And most importantly, there doesn't seem to be any way of knowing in advance when the machine will pay us. Implying that the patterns designated to pay us, show up on a purely random basis. I am going to define a random outcome as an absence of a discernable cause and effect relationship between the forces that set an event in motion and the final result of that event.

In other words, we put our money in the machine, push the button to start the wheels spinning and we have absolutely no way of making any rational, cause and effect connection between the action of pushing the button and pattern that shows up when the wheels stop spinning. We can try to guess where the wheels will stop, or we may have a hunch. But otherwise, today's slot machines have so many possible symbol combinations, where the randomness is so definitive, and beyond question, I would say that most people believe it's pointless to guess what will happen after they push the button, so it doesn't even occur to them to try.

Now, let's look at how believing that "playing a slot machine is gambling" and believing that "the machine determines when we win on a purely random basis," manage our over-all perspective.

Perception: If we don't have any other beliefs that conflict or contradict with what it means to gamble, then most people will find playing a slot machine an enjoyable activity. If, of course, they enjoy the possibility of winning money, because we can easily perceive the opportunity to do so clearly exists.

Decision: Considering that most everybody desires to have more money, as well as, love the feeling they experience from winning, if we put both possibilities into one activity, then deciding to play will basically boil down to how much money one is willing to risk to find out if they're going to win.

Notice how there's no illusions about the risk involved. We can decide to play but we can't actually play without reaching into our wallet and physically putting our cash into the machine. We also have to make a decision about whether we're willing to spend our money each time we're about to push the button. Because once it's pushed, we won't be able to get the amount we risked back unless we win.

Expectations: If we believe the machine is generating outcomes on a purely random basis, then what are we going to expect after we push the button each time? We would certainly love to win, we hope to win, but we aren't necessarily expecting to win each time we decide to push the button. In other words, our belief in random outcomes will cause us to expect to win some of the time; otherwise, we wouldn't decide to play in the first place. On the other hand, are we expecting to lose? No, not really, not each individual time we push the button, but at the same time, we can't play without realizing that on the average we will have far more spins where the outcome doesn't produce a payoff, than outcomes that do.

Behavior: To play the machine requires that we are able to insert the required amount of money and then pull the handle or push the button. If you will recall from above, what we actually do in relationship to what we intend to do, is a function of the clarity of our intent, the resoluteness of our desire, the degree of confidence or fear we are operating out of and whether there are any conflicting or contradictory beliefs distracting us or compelling us to do something different.

Obviously, how all of these variables apply in each person's case is going to be unique to that individual. However, we can make some generalizations that will basically apply to everyone. First, if we're not experiencing any resistance, second thoughts, or guilt putting our money in the machine, then we can safely say we probably don't have any conflicting or contradictory beliefs about what we're doing. Second, if we're enjoying ourselves and more importantly not experiencing any fear or hesitation pushing the button, then we must not be anticipating any threat of pain.

Now, I want you to consider, if the typical player knows going into the experience that they're going to lose some undetermined percentage of the time, then how is it possible that they're not afraid to push the button. Why aren't they debilitated with fear? Under normal circumstances losing anything is emotionally painful. So, how can the millions of people who consistently play the machines, push the button after losing and keep on pushing the button, even after losing several times in a row, without feeling like a loser, a failure, or that there's something wrong with them.

Experience: What we have here is a perfect example of how perspectives work to determine our emotional response to the things that go on in our lives. People who love playing the slots have to be operating out of a set of beliefs that don't define losing in a way that would cause them to experience the typical painful emotions that would ordinarily be associated with losing. Otherwise, they wouldn't be able to play unencumbered with fear. There's no fear, because from their perspective, ***"there's no emotional risk."*** So, how exactly do slot players get to this ***"no risk"*** state of mind? I would say, for the most part, it happens quite naturally as a function of how the slots work.

Here's what I mean.

First, since slot machines produce outcomes on a purely random basis, we immediately learn that winning and losing can happen at any time, in any sequence. As a result, we learn not to expect to win each time we play. And if we're not expecting to win every time, then we know, without any doubt that the only alternative is that we will be losing.

Second, even if we know there's a computer chip in the machine designed to generate the random outcomes, we still we don't have any idea of how the underlying forces within the chip interact to cause us to win or lose. As a result, we don't have any rational way of making any kind of consistently correct predictions of what will happen after we push the button. As I indicated above, the randomness is so definitive, we quickly learn that it's pointless to even try and predict what will happen.

Third, there's no part of the process of playing that requires a decision on our part. In other words, there's nothing we do or can do that will have any impact on the outcome. As a result, we have no control over what happens. We can't assure ourselves of winning and there's absolutely nothing we can do that will prevent us from losing, except not play.

Fourth, knowing that we don't have any control over the conditions that govern whether we win or lose, or any way to predict what will happen, takes away any responsibility we may otherwise feel for whatever outcome we end up with. If we're not responsible for the outcome, then we don't have any reason or justification to think of ourselves as losers, failures or that there's something wrong with us when we don't win.

Without a reason or justification to beat ourselves up when we lose, the experience of losing won't feel like we're really losing; especially when you consider the multitude of emotional rewards we get when we win:

a) we get to feel like a winner, even though we didn't actually affect the outcome, we still made the decision to push the button,
b) winning will always be a surprise and who doesn't love being surprised with getting money, and
c) depending on how much money the machine gives us, we can easily slip into a heaven like, euphoric state of mind, that could last for quite awhile.

The most common response when we lose at slots is "Oh well, I'll try again, maybe I'll win the next time. And what are we experiencing emotionally? We're enjoying ourselves, we're having fun. Without having to take any responsibility for what happens, losing at slots gets defined as simply part of the process of enjoying the anticipation of getting surprised again. Where "not winning" is not actually losing, but rather the amount of money we have to spend to find out if the machine is going to pay off the next time we push the button.

Even after we're finished playing, where we end up with less money than what we started out with, we still don't look at the experience as having lost anything. We paid to enjoy ourselves for however long we played.

If the whole process of playing (winning and losing) wasn't fun, and "RISKLESS FROM AN EMOTIONAL PERSPECTIVE," most people wouldn't do it.

The primary factor that makes this emotionally riskless perspective possible when we play a slot machine is the belief we're not in any way responsible for what shows up each time we decide to push the button. We believe we're not responsible because we learn that the machine is purposefully set up to produce random outcomes. At some point, in the process of interacting with the machine, we come to a full and complete acceptance that:

a) *we don't know what's going to happen,*
b) *there's no way to know what's going to happen and*
c) *there's nothing we can do that has any effect on what happens.*

That's about as uncertain and random as it gets –
complete uncertainty with *no control.*

Knowing we're not responsible for the outcome, puts playing the slots outside of the context of what it normally means to be wrong and lose. We can't be wrong about something that we legitimately have no way predicting or controlling. So, as I said above, losing simply becomes a matter of the machine didn't pay this time; let's see what will happen the next time. So no matter what the result is after we push the button, we get to experience all of the joy of winning, without having to experience any of the negative consequences normally associated with what it means to lose.

Now, if accepting the randomness dictates that we're not really wrong or losing, then we won't perceive any threat of emotional pain. And if we're not anticipating any threat of emotional pain, we won't be experiencing any fear, and with no fear we are free to behave in a way that suits whatever our objective is, in the moment. This emotionally riskless, slot machine perspective is exactly what we need to execute our analytical predictions indicators properly.

So now we have to ask ourselves, is there enough of a correlation between the way a machine works and using analytical techniques to speculate on price movement so that we can apply a slot machine perspective to our trading? Considering everything I have explained so far about the relationship between order flow dynamics and how technical indicators work, the answer should be apparent. Yes, there is definitely a correlation. In fact, except for a few variations the correlation is almost one hundred percent.

Let's compare the similarities.

The Slot Machine:

The computer chips imbedded in a slot machine are programmed to scramble the symbols so that the patterns designated to pay jack-pots show up on a purely random basis.

Trading:

The collective behavior patterns that emerge out of the chaos of the buy/sell order flow will give us a prediction about the direction of the price after the pattern completes itself. If we look at the predictions associated with the patterns within the context of how a slot machine works, we could say that each prediction represents a potential jack-pot in the form of a winning trade, with one important difference. When the symbols line up into a pattern on a slot machine, we know exactly what's going to happen next. The machine is going to give us money, because the payout is guaranteed. On the other hand, unlike a slot machine, when a pattern shows up in the market, the prediction associated with the pattern is only telling us there's a possibility of hitting a jack-pot in the form of a winning trade – nothing is guaranteed.

The Slot Machine:

The winning pay outs from a slot machine are based the odds that are programmed into the machine. However, the machine is also programmed to cause a completely random distribution between the outcomes that will pay a jackpot and the outcomes that don't. Over a large series of outcomes, the law of probabilities will cause whatever winning percentage the casino programmed into the machine (for the player) to eventually assert itself. But since the machine is also designed to cause a completely random distribution between the sequence of individual wins and losses, there wouldn't be way to determine the actual odds of winning each individual time we decide to pull the handle or press the button.

Trading:

When we decide to push the button on a slot machine, we don't have the slightest idea what pattern is going to show up or how favorable the odds are that we'll see a pattern that pays us a jackpot. By the same token, when we get a prediction from our analysis, we don't have any way to determine what the market will do after get into a trade or determine the odds that the trade will turn out to be a winner.

The effect of the various conflicting and competing reasons all of the different types of traders use to justify entering a buy or sell order, turn the order flow into the human equivalent of a computer chip in a slot machine programmed to generate a random outcomes. Just like a slot machine, the chaos of the buy/sell order flow will cause there to be a random, as well as, unpredictable distribution between the predictions that turn out to be correct and those that don't. How do we know for a fact there's a random distribution between winning and losing predictions?

First, we are always losing randomly because nothing can predict the order flow. There are too many sources and too many diverse objectives, where the ratio between buys and sells is constantly changing. A single large order in one moment could get completely absorbed and not have the slightest impact on price movement. Whereas, minute or two earlier or later that same order could have put the market in a state of panic. In other words, in any given moment, the order flow can cause anything to happen; regardless of what anyone's analysis predicted.

Second, we are always winning randomly because no other trader is going to put on a trade for the purpose of making our trade a winner. Here's what I mean, remember if you can't trade with size, you need other traders to make your trade a winner. It would never occur to you, for example, to take out all of the offers at nine so that you could bid the price up to ten, for the express purpose of helping all of the traders who got long at nine – win. The thought would never enter you mind. By the same token, it would never enter the mind of any other trader to put on a trade to help you become profitable.

Therefore, anyone who does happen to make a trade in the same direction as the prediction of our analysis is doing so for their own reasons. Rarely, will those reasons correspond with the reasons we used to justify our trade. And if the reasons don't correspond, then their contribution to the order flow in our favor will, by definition, be a coincidence. If we're relying on a coincidental synchronicity with the order flow to produce a winning outcome for us, then how can the results of our trades be considered anything but random.

Third, our experience will tell us there's a random distribution between wins and losses. If you don't already believe it, you can prove it to yourself quite easily by setting up a simple demonstration. First, on a piece of paper, list the numbers one through twenty. Second, use whatever method you want to determine what you think the exact sequence of winning and losing outcomes will be for the next twenty occurrences of whatever you use (your edge) to tell you why, where and when it is time to get into a trade. For example, if you think the outcome to the first occurrence of you edge will be a winning trade, then write the word win beside the number one. Then designate beside each number whether you think that trade in the sequence will end up being a winner or loser.

Now all you have to do is compare the actual outcome to each trade in the sequence with what you predicted the outcome to be. You'll undoubtedly get some of the outcomes correct. But unless you're extraordinarily psychic, it would be extremely unlikely for you to predict the exact win/loss sequence for all twenty trades. When we come to the realization that we don't have a rational way to accurately predict the sequence of wins to losses for any particular series of trades designated by our edge, it would be very difficult not to come to the conclusion that the unforeseeable intentions of other traders will cause the wins and losses from any edge to show up on a random basis.

Slot Machine: When we play the slots, we have absolutely no control over what happens. We don't have any control because there's nothing we can decide or do that will have any impact in what the machine does.

Trading: We have no control over what the price does after we make a prediction and get into a trade. The exception would be if we can trade with enough size to bid the price up or offer it lower. Otherwise, just like a slot machine, there's nothing we can decide or do that will have any impact on creating an imbalance in the buy/sell order flow ratio in our favor.

Slot Machine: The random manner in which the patterns show up is so definitive that it's pointless to try and predict what will happen after we push the button – complete uncertainty with no control.

Trading: Unlike a slot machine where it's pointless to predict what will happen, the behavior patterns that emerge out of the chaos of the buy/sell order flow definitely have predictive value. That is, on a percentage basis over a series of predictions. In other words, we’re getting favorable odds that we will experience more winning than losing trades, but the winners and losers will show up in a random sequence. Each individual prediction within the series isn’t telling us what will happen; it’s only telling us what may happen.

Slot Machine: When we push the button on a slot machine there’s no question that we know we don’t have the slightest idea how the computer chip determines whether we win or lose. Slot players operate out of a state of complete unknowing, at least at a rational level of thought.

Trading: As traders what we can actually know about what will happen, depends on what kind of information we have access to and what type of trader we are. There's a range between two extremes where someone knows they are acting on information that will make their trade, for all intents and purposes, a "sure thing," and traders at the other end of the spectrum who may as well be playing a slot machine, because they don't have the slightest idea why their trade may or may not turn out to be a winner.

One: *Inside information*

The traders who are operating out of the highest degree of knowing about what the market will do, either have access to inside information or they're trading with enough volume to cause the price to move in the direction they desire. If a trader is using inside information, his trade may be a sure thing or as close to it as one can get, but if he's caught he risks going to jail. Laws pertaining to trading on "inside" information have been in place for many years.

Basically, if you work for a company that has publicly traded stock, or you're an employee of a governmental agency that has access to information and decisions that can affect the price of a publicly traded stock, you cannot make trades based on this information unless and until this information has been made available to the general public. For example, let's say you're an executive for a publically traded corporation and the first to learn that your company is going to lose one of your biggest customers. When "the market" finds out about this loss in income, it will undoubtedly have a very negative impact on the price of the company stock. Based on your inside position, if you start selling stock in the company before there's a public announcement so that everyone has the same opportunity to sell, or tell your relatives or friends about the situation so that they can short the stock or buy put options, all of you would be subject to prosecution for violating insider traders laws.

To my knowledge there is only one group of people who can't be prosecuted for making trades based on inside information - Senators and Representatives of the United States Congress. Members of congress pass laws, make rules and regulations that have a profound effect on the price of stocks, commodities and any number of financial instruments. But at the same time, they have made themselves exempt from being prosecuted from acting (profiting) on how their deliberations and decisions are going to affect the market. They can put on or take off trades before they reveal to interested parties or the rest of the world what they've decided. As traders, they have the opportunity to make what would have to be considered virtually risk free trades. And therefore, we can say they are operating out of a state of almost complete, absolute certainty.

Two: *What do we know trading the news events?*

If you don't have access to inside information, every other (legal) trading technique or method has some degree of uncertainty associated with it. However, there are some trades that are about as close to a sure thing as you can get. The following is a really good example of an almost sure thing trade based on a news event that caused a one way market.

Just before the first Gulf War in 1991, I was coaching a professional Treasury Bond trader. At that time, meaning before the existence of electronic trading platforms, he had what I considered the best of all worlds;

the immediate execution of a floor trader and the peace and solitude of an off the floor trader with, in the moment, access to the news. He had an office at the Chicago Board of Trade, where he was also a member, so he was allowed to lease a phone on the floor of the exchange adjacent to the 30 year Treasury Bond Futures pit.

Instead of trading on the floor, he would sit up in his office where he could peacefully study his charts and watch multiple news feeds. When he wanted to put on a trade, he would send his buy and sell orders directly to the floor via the clerk he hired to man the phone next to the pit. That clerk, would in turn use hand signals to tell the broker in the pit responsible for executing his orders what he wanted done. If this process seems a bit cumbersome, keep in mind that in 1991 there were no electronic exchanges or computerized trading platforms.

In the period leading up to the actual start of the first Gulf War, President Bush gave Saddam Hussein a deadline for pulling his troops out of Kuwait. James Baker (the US Secretary of State) was in Geneva, Switzerland doing some last minute negotiating with his Iraq counterpart trying to talk some sense into the Iraq’s so we could avoid going to war. It was widely understood that if these negotiations failed there would be no turning back from a major conflict. As a result, the markets, as well as, most everyone else were a bit tense. There was an enormous amount of uncertainty about what effect a war of this magnitude in the Middle East would have on the world economy, especially the price of oil.

No one knew exactly when the negotiations would end, so there were TV reporters from just about everywhere in the world providing around the clock coverage waiting for some news about what was going to happen. Sometime during trading hours US time, James Baker appeared before the media to make an announcement. He walked across the stage, stopped at a podium set up for the occasion, turned, faced the cameras and started his announcement by saying the word "regrettably." At the same time, the professional bond trader I referred to above was sitting in his office watching CNN, intently waiting for any news that would justify putting on a trade. When he heard the word "regrettably," he immediately told his clerk manning the phone next the 30 year bond futures pit to sell 50 contracts at the market.

The clerk, in turn immediately signaled the order to the executing broker in the pit. The broker in the pit made eye contact with some local who had his hands up indicating that he was bidding (wanting to buy) 50 contacts one tic below the last posted price and signaled to him that he was hitting his bid. The local acknowledged the trade was consummated and the broker then signaled back to the phone clerk the price his sell order was filled at.

According to the professional bond trader, he was short 50 Treasury Bond futures within about thirty seconds of James Baker saying the word "regrettably." Within a minute or so of being filled the market dropped a full point or the equivalent of $1,000 per contract. In other words, he was up $50,000 in a little over a minute and the local on the other side of the trade lost $50,000. That is, if we assume the local was unable to find a buyer to take the other side of the 50 contract sell order he would have to fill to get out of the trade.

What did the professional bond trader know? He knew how bond traders think, especially the locals, and how they're likely to react to certain types of reports and news events. I don't remember the reasons why he thought the bond "market" would sell off the way it did once the word got around we were going to war. But I do remember him saying that he was confident that everyone in the "pit" would be trying to sell if the negotiations failed.

He certainly wasn't the only one who had that idea, but he did have an edge over most of the other traders, especially the floor traders. He was in a position to get the news in the moment, and in a position to get instantaneous execution. He also had the psychological resources to react immediately upon hearing the word "regrettably," instead of waiting to hear the rest of the message.

Once a flood of sell orders starting hitting the floor, the traders in the pit quickly realized something happened. And if they were bidding at the very least they put their hands down. Then the moment they found out we were going to war, they probably started trying to execute a sell order just like everyone else.

Was the professional bond trader operating out of state of absolutely certainty?

Absolutely not!

Even though he thought his trade had an extremely high probability of success, he was experienced enough to know that "anything can happen." So he didn't take it for granted the market would respond the way it did, and was prepared to take as quick a loss as possible, if it didn't.

Three: *What do we know when we base our trades on fundamental criteria?*

Fundamental analysis is referred to as the "rational" approach to price prediction, because it is based on a systematic and thoughtful analysis of all of the factors that determine the value of something now in relationship to what the value should be at some point in the future. When you analyze the market from a fundamental perspective you are taking into consideration what you believe to be all of the relevant (pertinent) criteria that is necessary to determine if some stock, financial instrument or commodity is currently at fair value, under-valued or over-valued.

If, based on your analysis you determine that something is undervalued, you can "reasonably" expect the price to go up. That is, if and or when other traders also come to the same realization. On the other hand, if you conclude that something is over-valued you can "reasonably" expect that the price will go down. Again, that is, if and or when other traders also come to the same realization.

Assuming that you don't have the resources to have a significant impact on the buy/sell order flow ratio, when you use fundamental analysis as a justification for making a trade, you are basically hoping or betting that the rest of the market will be as "rational" as you in their assessment of value and as a result, feel compelled to put on a trade in the same direction as yours. Furthermore, you are also hoping their enthusiasm for doing so will be so strong that they'll buy at a higher price than you did, or sell at a lower price than you did; otherwise, how will the price move in your favor.

I've found that one of the biggest problems confronting traders who primarily use fundamental analysis is their inability to grasp that majority rules in the market. Meaning that regardless of how rational, logical or even perfect by all standards of measurement ones analysis is, there are always a significant number of market participants who are putting on or taking off trades for reasons that may be completely outside any fundamental factors that determine the value of something. Which means that other traders, for a multitude of reasons, can feel compelled to buy something that the fundamental analyst has determined is over-valued, forcing the price higher or sell something that he has determined is under-valued, forcing the price lower, and do it for indefinite periods of time.

To a fundamental analyst who doesn't understand how other non-fundamental traders think, or isn't sufficiently schooled in order-flow dynamics, this behavior is completely irrational and shouldn't be happening. So someone basing their trades on fundamental analysis may know the value of something, but what they don't know, or will ever know, for that matter, is how long it may take other traders to come to the same rational and logical conclusions with enough volume to cause the price of something to be an accurate reflection of its value.

In the history of the markets there are untold numbers of traders using very sound fundamental analysis who went broke waiting for the rest of the market to "get rational" and do the right thing.

Four: *What do we know when we base our trades on technical analysis?*

From the limited perspective of trading in front of a computer screen, the purely technical trader doesn't know much of anything about what's really going on. He doesn't know who's in the market submitting buy or sell orders or the real reasons why they're doing it. Implying that he doesn't know the real reasons why the patterns he trades come into existence or know whether the prediction the pattern produces will turn out to be correct.

Chapter Fourteen

Are Traders who use Analysis to Speculate on Price Movement Gambling?

We know as an undisputed fact that playing a slot machine is pure unadulterated gambling. Now we have to ask ourselves, is there enough of a correlation between speculating on price movement and the way a slot machine works to say that trading is also pure unadulterated gambling? Your answer to this question is of paramount importance, because at the core of the emotionally riskless, free of fear perspective we need to trade successfully, is a belief about what we're doing as traders that says ***"I am gambling."***

As you're contemplating how you want to answer the question, keep a few points in mind:

a) if you don't have access to inside information,
b) if you don't trade with enough volume to move the price yourself,
c) if you don't have any way of knowing the actual underlying reasons that are motivating other traders to enter their buy and sell orders, and
d) you can't ever verify as correct what you think those reasons might be, then every prediction you make about the direction of the price, regardless of how you arrived at that prediction, is a guess.

The order flow is either going to make any given individual prediction a winner or it's not. In either case, there's no way to know in advance, and nothing you can do about it. So if all of your predictions are guesses and you're going lose money if that guess is incorrect, then how can you define what you're doing as anything but gambling?

Yes, as trader's speculating on price movement, we're gambling, but that doesn't mean that we can't assure ourselves of producing consistent, reliable profits. There's a huge difference between the way we're gambling as traders and someone who walks into a casino and starts pumping money into a slot machine; where his odds of experiencing consistent results are virtually non-existent. The reason why someone playing the slots at a casino has no chance of producing a consistent income is because the casino has the machine programmed so that the odds of winning are stacked in their favor. Casinos are so successful because they make sure they always have the odds stacked in their favor. With the odds in their favor, all they have to do to produce a consistent income is participate in every event, so that the law of probabilities can work its magic. By participating in every event, they also know they're going to have losses. But from their perspective, those losses are simply the expense of making themselves available to experience the wins; which, because they have the odds, are going to come more frequently than not. As a result, the casino will always come out a net winner over a large series of events.

If you were sitting in front of a shot machine and someone walked up to you and asked If you were gambling, you would probably give them a look like "are kidding me" and answer, "of course I'm gambling, what else would you call it." If you asked the typical trader who's sitting on front of his computer screen using what he believes to be a bona fide analytical method to predict the direction of the price if he was gambling, he would probably give you the same look like "are you kidding me" and answer "no I'm not gambling, I don't put on any trades unless I believe my analysis is right."

The typical trader desperately wants his analysis to tell him what will happen next so that he can avoid the risk of being wrong and losing. He won't avoid either, but in the process of trying, he will make his losses far bigger than what they need to be to tell him a trade isn't working and he will repeatedly make the kind of trading errors that will guarantee that he will never produce consistent results. What he doesn't realize is, if he has an analytical method with a good win/loss ratio and a better than one to one risk to reward ratio, that he doesn't ever need to know what will happen next to produce a consistent income. All he has to do is let the law or probabilities work its magic in his favor, the same way it does for someone who owns a casino. In other words, with good analysis, he's not gambling at the level of someone who goes to a casino, he's gambling at the level of someone who owns a casino.

As a result, the typical trader has the same opportunities to produce consistent profits from events that have random outcomes, as a casino does. There's already a plethora of excellent technical indicators, methods and systems available to the general public and have been for a long time. So you don't have to re-invent the wheel with respect to the analytical component of trading. All you have to do is find something that suits your trading style and tests out with a satisfactory income potential. Then once you've made your choice, you can start making money - ***IF-*** (and this is a big if) you have the psychological resources (skills) to participate in every prediction and, of course, execute flawlessly.

To participate in every prediction produced by our analysis without making errors we need to operate out of a probabilistic perspective. At the core of a probabilistic perspective is a belief about trading that says "I am gambling." A belief that we're gambling will give us the same emotionally riskless state of mind that enables millions of people of all walks of life, from around the world to play slot machines and lose, without being debilitated with emotional pain or afraid of playing again.

THE BENEFITS OF ADOPTING A BELIEF THAT SAYS "I AM GAMBLING"

ONE: *Adopting a belief that we're gambling takes our predictions out of a right or wrong context and puts them into a probabilistic context.*

From a probabilistic perspective, all of our predictions become guesses subject to a random, unpredictable sequence between the ones that are right and the ones that aren't. If you truly believe the sequence between the right and wrong predictions is random and unpredictable, then you also have to believe that you don't know what's going to happen. When you genuinely believe you don't know what's going to happen, that belief will prevent your mind from associating the predictions that aren't correct with what it normally means to be wrong. ***You can't be wrong about something you truly believe you don't know***. In other words, if you're going into your trades believing that you don't know what's going to happen, it won't even occur to you to think your analysis is ever wrong when a trade doesn't work. This may seem like a contradiction, but not if you believe that you're gambling and analysis is just giving you an edge.

TWO: *A belief that we are gambling takes the trades that don't work of the context of what it normally means to lose.*

When we trade from a probabilistic perspective, non-performing edges are considered an unavoidable component of what it means to speculate on price movement. If we have to participate in every trade to allow the law or probabilities to work in our favor and non-performing edges are unavoidable, then like a casino the amount of money we spend on trades that don't work are not losses. On the contrary, they're business expenses in the sense that we need to spend a pre-calculated amount of money to make ourselves available to experience the profitable trades. What we spend to win wouldn't be any different than owing a restaurant and having to write a check for the food we have to buy to prepare meals for our customers. Food costs are a normal business expense we have to incur to make it possible to produce a profit from our menu. The exact same principle applies to trading from a probabilistic perspective; non-performing edges are a normal business expenses. If you genuinely believe the amount of money you spend on trades that don't work are normal business expenses, you mind won't associate them with what it means to be lose or be a loser.

THREE: *Adopting a belief that we're gambling takes away any responsibility we otherwise might assume for what the market does in relationship to what our analysis predicted it would do*.

Having to assume responsibility for something we don't want in our lives can be tap us into the same degree of emotional pain as having to admit that we're wrong. When we're operating out of a belief there's nothing to be wrong about, we don't have a reason to take responsibility for knowing what's going to show up. Considering the wide variety of forces that impact the direction of the price, anything can show up. If we believe we're not responsible for knowing, then our mind won't have a reason to categorize an experience where the market doesn't do what our analysis predicted, as painful.

FOUR: *Adopting a belief that we are gambling takes trading out of the context of having to find the "right' reason to get into or out of a trade.*

As a technical trader, I only need one reason to justify entering a buy or sell order and that reason is always the same, "is the pattern that defines my edge now present?" If I genuinely believe I don't know what the consistency of the order flow will be, it's the only question that I have to ask or be right about.

Chapter Fifteen

Review

If our objective as a trader is to generate income from price movement, the reality of our situation is, we're speculating on the impact other trader's reasons for getting into or out of a trade are going to have on the direction of the price in some future moment. As typical screen based traders there isn't any verifiable way for us to know what those reasons are or the size of the buy or sell orders these other traders intend to use to express those reasons. However, in the process of traders submitting their orders to the exchange, collective behavior patterns will emerge out of the order flow as the buy and sell orders are matched up into trades and those trades, in turn, create price movement.

These behavior patterns show up in every time frame and continually repeat themselves. As a result, they have a predictive value, but not in the way we would normally think. The predictions the patterns produce are not telling us what will happen, as a normal analytical process would imply, but rather what may happen; as in, the outcomes to the predictions are always probable. What we're getting from the pattern is a prediction with a statistical edge in our favor over a series of trades, where there's a random, unpredictable (unknowable) distribution between the outcomes where other traders submit enough order volume in the same direction of our prediction to make it a winner and the outcomes where they don't. The implications of a random, unpredictable distribution between winning and losing predictions over a series of trades, is that it makes each individual prediction within the series nothing more than a guess. Bottom line, regardless of how sophisticated the analysis we use to produce a prediction, we're still guessing and if we're guessing, by definition we're gambling.

However, we’re not gambling like someone who goes to a casino where the odds of success are always against them. We’re gambling like we own the casino, where the odds can definitely be in our favor, depending on the quality of our analytical method we use. With the odds in our favor we can let the law or probabilities work for us the same way a casino does. That is, of course, if we have the psychological skills to participate in every prediction and can execute the trades without making errors. To trade without making errors means we have to be able to do what we’re supposed to do, precisely when we’re supposed to do it, every time we get a prediction from our analysis.

The physical skills we need to do what we’re supposed to do every time we get a signal are about as simple an easy as they can be. Place the cursor in the appropriate spot in our trading platform and click the mouse or tap the keyboard. On other hand, if like most people you haven’t acquired the appropriate belief based psychological skills, you could find taking every trade in a series of predictions and executing them flawlessly anything but simple or easy. In fact, it may turn to be one of the hardest things you’ve ever attempted to do.

What can make it so difficult? What we’re typically afraid of. If experiencing losing trades is an inherent characteristic of what it means to be a trader, then we’re naturally going to have difficulties executing properly if we’re operating out of a fear of losing or of being a loser. If a certain percentage of our predictions are going to be incorrect as an inherent characteristic of using analysis to predict other people behavior on a collective basis, and we’re operating out of a fear of being wrong, then we’re going to have difficulties executing properly.

Yes, it's possible to execute the signals from our analysis from a fearless, emotionally risk-free state of mind. The best, most consistently successful traders do it all of the time. And tens of millions of people from all walks of life, who play slot machines every day, prove that it’s possible to lose and not experience the slightest bit of emotional pain or discomfort. What makes this emotionally pain free response to being wrong and losing possible is their perspective.

The best traders are not afraid of being wrong because they're operating out of a belief that their success doesn't depend on being right on each individual trade. They don't expect to be right every time because they genuinely believe there's a random, unpredictable sequence between the predictions that work and those that don't. When they learned to believe the sequence was truly random and unpredictable, they no longer had a reason to think they were wrong when the market didn't respond as predicted. They also don't believe they're losing when they get stopped out of a trade for a loss, because they operate out of the same belief a casino's does. That trading is a business that has expenses. Our primary business expense as traders is the amount of money we have to spend to make sure we're participating in the trades that turn out to be winners. When you believe that losing trades are an integral part of the process of producing consistent results, then you also won't have a reason to think you're "losing" or being a loser when your edge doesn't work.

The easiest and most efficient way to acquire this emotionally risk-free perspective is to understand how speculating on price movement is pure unadulterated gambling almost identical to psychological characteristics of playing a slot machine, and then adopt a belief that says "I am gambling." Other than the need to find or develop an analytical method that puts the odds in our favor, adopting a belief that says "I am gambling" is such a fundamental component to our success that I classify the belief as an essential trading skill.

If we believe that we're gambling it implies we know that:

The risk always exists - it never goes away – no exceptions. A belief that we're gambling will never let us indulge ourselves in the illusion that we've eliminated the risk of a trade not working. As a result, we will never have a reason to get into a trade without determining what the market has to do to tell us it is not behaving in a way that's consistent with the criteria that defines our edge. A belief that we're gambling will eliminate the need to rely on pain as a means to cut our losses.

The cost of trades that don't work are business expenses. For the law of probabilities to work its magic the way it does for a casino, we have to be available to experience winning trades that are going to show up in a random sequence. The cost of trades that don't work is the price we pay to experience the trades that do work. When we genuinely believe that a non-performing edge is a normal business expense, our mind won't have a reason to associate trades that don't work with what it means to lose or be a loser.

From a psychological perspective, adopting a clear, un-conflicted belief that you are gambling will have more of a positive impact on your results than anything else you could do.

There's a random, unpredictable distribution between winning and losing predictions making each individual prediction a guess. Believing that we're gambling implies we have a functional understanding that, like a computer chip embedded in a slot machine designed to produce random outcomes, the reasons behind the orders that are impacting the direction of the price are usually so diverse, that the buy/sell order flow acts as human equivalent of a computer chip designed to produce random outcomes. When we genuinely believe in a random sequence between wins and losses over a series of trades, we won't have a reason to associate the possibilities of next prediction with the outcome we experienced from the last prediction. Disconnecting the current event from the previous will have the effect of keeping our mind focused in the now moment opportunity flow. The belief that "I am gambling" will act as a psychological resource giving us the emotional resiliency we need to effortlessly move on to the next trade in the series, regardless of what happened with our last trade or last several trades.

For those you who may have some very powerful, long held social, philosophical or religious beliefs about trading that are in direct conflict with the idea that speculating on price movement is gambling, or any of the other belief based trading skills I am going to offer you, choosing to adopt “I am gambling” as a primary operating principle implies you're going to have to step into a process of learning how to manage some of your beliefs.

At first glance this may seem like a daunting, abstract or complicated task. I promise you this is not the case. Quite the contrary, if you're truly resolved to produce consistent results, and can see a clear path to the fulfillment of that objective, you will find the process of installing your new trading beliefs and neutralizing any dysfunctional beliefs you may have acquired, relatively simple and easy. On the other hand, if you do have some deep seeded religious or philosophical beliefs that are in conflict with gambling, the nature of trading in general, or have any self-valuation beliefs that would argue against making a lot of money, then you could find reconciling these conflicts a bit more challenging, to say the least. But certainly not something that you won't be able to deal with, once you become familiar with how the process works.

In the next chapter I'm going to give you a trading exercise designed to install a probabilistic perspective as a primary operating principle; as well as, neutralize many of the typical dysfunctional trading beliefs that are the root cause of the fears that will compel you to make trading errors. After you've successfully completed the exercise, you will not only be on a clear path to a reliable income, you will also have a resource on how to manage your beliefs in general.

Once you've experienced what it’s like to cut your losses without feeling the slightest bit of emotional discomfort or what it’s like to put on a trade and not to be afraid of being wrong; or how easy it is to take your profits in a consistent, methodical manner when you're not afraid of leaving money on the table or missing out, you can use the insight you gained from doing the exercise and apply it to other areas of your life to change your perspective.

That is, if you find that your inner resources are not in harmony with your objectives, goals, dreams or desires.

Chapter Sixteen

Installing a Probabilistic Mindset

In Chapter Twelve I organized the psychological skills we need to be successful traders in into three broad categories:

a) *objective perception,*
b) *flawless execution and*
c) *unencumbered accumulation.*

To perceive market information from an objective perspective, we can't be susceptible to illusions about the nature of the risk or formulating expectations that limit the ways in which the market can express itself. To execute flawlessly we need the emotional resiliency to lose and be wrong without the threat of experiencing emotional pain. Both the ability to perceive objectively and execute flawlessly are a function of operating out of a probabilistic perspective.

Unencumbered accumulation is a function learning how to build a framework of self-awareness so that we can recognize when we're in a state of diminished capacity to make the kind of decisions that are in line with our objective of producing consistent results. And then have the discipline to either stop trading altogether or at the very least scale back the instant we realize the quality of our state of mind isn't what it needs to be to trade effectively. The typical sources that diminish the quality of our state of mind are beliefs that conflict with our desire to be a trader, accumulate a lot of money, stressful life circumstances or crossing the threshold from normal confidence into a state of euphoria. I'll get into the dynamics of unencumbered accumulation in Chapter Eighteen. However, for the rest of this chapter we're going to focus on setting up a protocol, in the form of a trading exercise, to install a probabilistic (slot machine) perspective as a core operating principle.

CREATINGA RESOLUTE BELIEF SYSTEMIN THE PROBABILISTICNATURE OF TRADING

Step One: Make sure you have a clear understanding why it's so important for you to do the trading exercise I am about to give you.

Your ultimate objective is to have the ability to realize (to make real) the maximum profit potential built into your edge. To realize the maximum profit potential built into any edge, you have to be able to execute flawlessly. To execute flawlessly there can't be any potential for you to experience fear, regret, second thoughts, resistance, hesitation or changing your mind about what you're supposed to do, when you're supposed to do it. Operating out of a probabilistic (slot machine) mind-set will manage your expectations in a way that you disassociate your predictions about the direction of the price and the outcomes of your trades with what it normally means to be wrong or lose. Remember people can play slot machines - lose and keep on playing without experiencing the slightest bit of emotional pain because they don't define not getting a pay-out as losing. Instead, they're spending money to find out what will happen after they press the button. And since it doesn't occur to someone playing the slots to think that they "know" what the machine is going to do next, there's nothing to be wrong about. We can't be wrong about something we genuinely believe we don't know.

It's extremely difficult for a slot machine player to have any illusions about the risk of not winning or what it costs to find out if they will win, simply because the machine won't function unless the player makes a conscious decision to spend their money and then have the ability to act on that decision by putting their money in the machine. The ability to put the money in the money machine implies that the risk of playing has been accepted. Acceptance of the risk implies they're reconciled (meaning no conflicts) or "OK" with any outcome. Otherwise, if they haven't accepted the reality of any outcome, while at the same time knowing that any outcome is possible it would be difficult for them to play. In other words, the degree to which they are not reconciled to expect any outcome would be in exact proportion to the degree of difficulty they would experience putting their money in the machine and pushing the button.

Traders speculating on price movement don't have to pay anything in advance to put on a trade nor do they have to accept the risk of finding out if a trade is going to work; which can make it seem like risk of having to pay never really existed if the trade turns out to be a winner. This is an illusion. *A reminder, that just because our analysis puts us into a winning trade, it doesn't mean that our analysis ever eliminated the risk of that trade not working.* Accepting the risk of a trade not working wouldn't even be an issue if we were one of the small minority of traders fortunate enough to be born into a successful trading family, and as a result introduced to trading in a way that made it crystal clear from the beginning that "the risk always exists, it never goes away, no matter what."

Unfortunately, the rest of us typically start trading with the exact opposite influence. We get inundated from a variety of sources to ideas and information that say “yes there’s risk” but at the same time imply that with the right analysis, broker, or trading platform we can make that risk go away and assure ourselves of a winning trade. This simply isn’t true. So unlike the traders whose expectations are grounded in reality because they were exposed to the truth about the nature of the risk from the very beginning, our expectations will cause us to experience fear when we’re convinced, imagine or it appears like a trade may not work, denial if the trade isn’t working and pain when we have to come to realization the trade didn’t work. Adopting the following probabilistic beliefs about the nature of trading will keep your expectations grounded in a reality that will eliminate the potential to experience fear and emotional pain.

The underlying premise and beliefs of a probabilistic (slot machine) trading perspective:

1) The extreme diversity of the underlying reasons that motivate traders to enter their buy and sell orders will act as a force on price movement creating a situation where:

1. *anything can happen,*
2. *there’s a random distribution in the sequence between wins and losses over a series of predictions produced by an edge,*
3. *the risk of an edge not working always exists*

2) Not having access to the reasons, size and type of orders other traders intend to submit to the exchange after my edge gets me into a trade, creates a situation where:

1. *I don’t know what is going to happen or why*
2. *the predictions that result from my analysis are guesses*

3. *anything I claim to know about the reasons why the price is moving in a particular direction is something I am making up*
4. *since I don't know, there's nothing to be wrong about*

3) Since I don't have any control over the type and size of the orders that are destine to hit the order flow, it creates a situation where:

1. *I don't have any responsibility for what direction the price moves after my edge puts me into a trade.*

4) As long as, I have an edge with a good win/loss, risk to reward ratio over a series of trades, the law of probabilities will create a situation where:

1. *I can produce consistent profits without having to know or strive to know the outcome of each individual trade my edge puts me into.*

5) The amount of money it costs to find out if an edge is going to work is a normal business expense associated with speculating on price movement, no different than the expenses I would have to pay to be in any other business. If I owned a restaurant it would never occur to me to think I was a loser because I had to write a check to pay for my food inventory.

1. *The cost of a non-performing edge is not a loss, it's the price I am willing to pay to make myself available to experience the trades that turn out to be winners.*

To establish new beliefs, especially if they're in conflict with something we already believe to be true, or at the very least want to be true, we have to be thoroughly convinced. To be thoroughly convinced, we need indisputable proof. The best way to indisputably prove or disprove the usefulness of a belief is direct experience. What the exercise is going to do is set up a situation where you will experience a direct conflict between any non-probabilistic beliefs you may have already acquired about how trading is supposed to work, with the beliefs that make-up a probabilistic (slot machine) mind-set. I'm going to show how to use that conflict to neutralize the beliefs that aren't serving your purpose and correspondingly energize (strengthen) the beliefs that make it possible to execute your edge flawlessly.

Step Two: *Choosing a market.*

Choose any actively traded stock, futures contract or currency market. As long as, the market is liquid and you can afford the margin requirements, if doesn't matter what market you decide to trade.

Step Three: *Pick an edge.*

There are several ways you can go about picking an analytical edge.

1) You can learn how to read price charts, so that you can identify and evaluate the patterns on your own.
2) You develop your own combination of buy and sell indicators from the vast array that charting services, trading platforms and brokerage firms make available.
3) You can find buy and sell indicators that have already been developed and available in books.
4) You can buy trading systems in finished form from a professional system developer or vendor.

For the purposes of the exercise what you are looking for is an edge that has absolutely precise entry and exit rules. By precise, I mean exactly what it implies. Your edge has to define the exact market conditions that trigger a trade entry, and the exact market conditions that tell you the trade isn't working, as well as, when it's time to take profits. To get the desired benefit from the exercise there can't be any subjective judgments on your part about what you need to do and when you need to do it. Having precise rules to follow is an absolutely essential component of the exercise.

Step Four: *Testing*

Once you've found, bought or developed a methodology that looks like it has the possibility of giving you a satisfactory win/loss and risk to reward ratio, and it has precise, non-subjective entry and exit signals, you have to test it. You can test it over a period of time using computerized back testing software, but for the purposes of what we're trying to accomplish (installing a probabilistic trading perspective), forward testing with a simulating trading account will give you the most valuable results.

How far ahead do you forward test? At least two sample sizes. A sample size is a limited number of trades in a series, usually between 20 or 25. A sample size of trades is based on the principle that the win/loss, risk/reward ratio of any particular speculative trading edge over a series of trades is dynamic, not static. Meaning, unlike a slot machine where the win/loss ratio programmed into a computer chip that will not change over time. The win/loss, risk/reward ratio of a speculative trading edge can and usually does change over time.

The market is a dynamic event where the underlying forces (trader's reasons for entering or exiting a trade) that act on the direction of the price are constantly changing. Speculative trading edges that have precise entry and exit signals can't compensate for these changes. In other words, the behavior patterns our edges identify can be exactly the same, but the win/loss, risk/reward ratios can vary because of the way the underlying character of the market is changing. The way to compensate for the changes that can occur in the win/loss or risk/reward ratio is by trading in groups of trades that I call a sample size. The idea is to make our sample size large enough to give our edge a fair evaluation and at the same time, keep the sample small enough to find out if the ratios are deteriorating to unacceptable levels. I have found that a twenty five trade sample is ideal for testing the effectiveness of an edge.

Once you've decided on something to test, all you have to do is execute the next twenty five predictions in a simulated (not real) trading account to find out what the actual win/loss and risk/reward ratio is. What kind of results are you looking for? For the purposes of doing the installation exercise you want to see a minimum of a 50/50 win/loss ratio and a 1/2 risk to reward ratio. Meaning, we want to see that close to half of the twenty five predictions put you into winning trades and the profits on those winning trades be at least twice what you have to spend on the trades that don't work. When you've completed executing all twenty five trades in the sample, if you find that the edge you tested meets these minimum requirements then I would recommend you do one more twenty five trade sample as confirmation before you start the installation exercise.

Otherwise, if your edge doesn't meet the minimum requirements, the first thing I suggest you do is analyze the variables to see if there's any adjustments that might make a difference in your results. For example, you could find that moving your stop loss location closer to your trade entry won't make any difference in the number of winning trades the edge produces. If that's the case, you will be spending less on the trades that don't work, improving risk to reward ratio and bottom line results. Or you could find just the opposite; that moving your stop loss further away from your entry would keep you in winning trades that you otherwise would have been stopped out of. You can also look at adjusting your profit objective or using a trailing stop in conjunction with a fixed profit objective to see if it improves your results. In any case, keep on adjusting, looking, developing and testing until you find something that meets the minimum requirements.

I want to be sure you're clear that you have to execute all twenty five predictions in the sample exactly as the entry and exit signals specify. No picking and choosing which predictions to trade, and you can't change any of the variables that define where or when you enter a trade, your stop placement or profit objective once you've started a sample.

You have to give each twenty five trade sample the opportunity to play itself out, exactly as it is designed, as if it were only one trade.

Also, some of you will undoubtedly feel compelled to keep on looking and testing until you have something that's much better than the minimum requirements. Please don't, for the purposes of the installation process it's not necessary to have anything more than a mediocre edge. In fact, I would rather you do the installation exercise with a trading method that isn't much better than the minimum requirements, so that you can experience how it's possible to produce profits over a series of trades, even though only half of the trades are winners. Lastly, don't be surprised if you end up having to put a lot time and effort into finding a suitable edge. Like everything else about the nature of trading, finding or developing a completely non-subjective edge, even a mediocre one may not be as easy as it appears.

But regardless of how long it takes, you will learn a lot about trading systems in the process and the outcome will definitely be worth it. As soon as you're confident you've found an edge that meets the minimum requirements you can start the installation process.

Step Five: *The installation process*

The installation process is the equivalent of loading an operating system on to the mother board of a computer. However, instead of downloading a program from a website or transferring a program from a DVD, you're going to use the energy of your desire to trade without fear, in conjunction with the energy generated from your experiences executing your edge, to install your probabilistic (slot machine) mind-set as a primary operating principle. In other words, the installation mechanism is your desire to change the way you think about trading. Your experiences will magnify that desire with experiences that prove the validity of your new probabilistic beliefs and disprove the validity of any non-probabilistic beliefs you may currently be operating out of.

The first thing you need to do to start the installation exercise is shift your trades from a simulated to a real (funded) trading account. The next thing you have to do is determine your position size. When you were testing your edge in a simulated account, it didn't really matter how many shares of stock or futures contracts you traded, as long as, the amount was consistent throughout the entire sample size. Now that you've switched to a real account your position size matters. The degree of fear you have the potential to experience about being wrong and losing will be magnified by the number of shares or contracts you trade. So you're going to start the installation process with the smallest position size possible. For example, if you're going to be trading a stock, then I want you to start the first sample with a position size of one share. If you're trading a futures contract, I want you to start the sample with one mini-contract.

Why so small? Because I want there to be as little at stake as possible, but at the same time be real. When you were in the testing phase, there wasn't anything to lose, because you can't lose money in a simulated account. And if we assume you went into the test to find out something you believed you didn't know, not knowing something implies there's nothing to be wrong about. With nothing to be wrong about, you wouldn't have a reason to be afraid. However, once you switch to a live account, it will automatically activate any beliefs that have the potential to connect the outcome of each individual trade in the sample with your beliefs about what it means to be wrong and lose. Which means, until any non-probabilistic beliefs are neutralized you will be susceptible to experiencing fear and errors.

So the principle behind keeping the position size as small as possible is to make it as easy as possible to take the steps you need to accomplish an effective installation. Now, for those of you who see yourself as "heavy hitters" and find it insulting to trade a position size that's the absolute minimum, keep in mind, this is an exercise to acquire the psychological skills you need to trade without fear, so that you can produce consistent results. After you've successfully installed the skills, you can trade whatever way and position size that suits purposes and financial resources.

Also, some of you may feel compelled to assume that because you understand the nature of probabilities and observed from the testing process how it applies to trading, that you already have a probabilistic perspective. In other words, as you proceeded thru the testing process, you may have come to a definitive, resolute conclusion – that yes – there is a random sequence between wins and losses over a series of trades; and as a result, assume that you now have a functional probabilistic perspective and don't have to do the exercise. Please don't make this assumption.

Any new ideas or concepts we adopt as beliefs will only be functional to the extent the energy is drawn out of any conflicting and contradictory concepts and ideas we believed to be true before we adopted the new beliefs.

To achieve a successful installation requires energizing the new ideas and concepts you're adopting, as well as, discharging the energy out of (collapsing) any beliefs you may have acquired that connect the results of your trades with what it means to be wrong and lose. Energizing new ideas can be as simple as being exposed to information that makes sense or resonates as the truth. We can also energize new ideas by opening ourselves up to the creative process, where we find ourselves thinking ideas that aren't coming from our existing base of knowledge. We normally don't have any problem bringing new ideas to life as a belief once we become aware they exist and understand the extent to which they can benefit our lives in some way.

On the other hand, neutralizing the impact of any pre-existing beliefs that may be in conflict with the new beliefs we're adopting, is not a process most people are familiar with or may know that it's even necessary for that matter. To fully experience the benefits of the new beliefs we're adopting, the conflicting beliefs they're replacing have to be rendered completely non-functional. To get a belief to the point where it's completely non-functional, it has to be collapsed by discharging all of its energy. To illustrate what I'm talking about, let's look at a tree that's been cut up into logs. The logs are made up of atoms and molecules that form into a substance we define as wood. At the sub-atomic level the wood exists as energy. If we set the logs on fire, the energy in wood will be released, collapsing the logs into a pile of ashes. The wood, now having been transformed into ashes technically still exist, it just doesn't have the energy to express itself as a log.

Collapsing a belief we've decided no longer serves our purpose can work exactly the same way. When the energy is discharged out of a belief, the belief itself doesn't disappear as if it never existed; it just no longer has the energy to impact how we experience our lives. For example, as a child I had a belief that Santa Claus existed and delivered presents at Christmas time. When my parents told me that Santa Claus didn't exit, my first reaction was disbelief. I insisted that what they were saying wasn't true. Eventually they convinced me that Santa Claus wasn't real. You could say the process of convincing me established and added energy to a belief that says "Santa Claus is not real," while simultaneously discharging the energy out of the belief that says "Santa Claus is real," eventually collapsing it, rendering it non-functional.

By rendering it non-functional, my belief that "Santa Claus is real" didn't disappear, as if it was something I never believed in the first place. It's still, to this day, a component part of my mental environment. But as a non-functional, collapsed belief, it no longer has the capacity to release energy and express itself. For example, as a five year old with a fully energized belief that Santa Claus exists, if someone told me Santa was at the front door, that information would have immediately tapped me into a huge reservoir of positively changed energy, compelling to stop whatever I was doing and run to the door as fast as I could. Nothing would have been able to stop me. Now as an adult, with a fully functioning belief that "Santa Claus isn't real and doesn't exist," if someone said to me Santa Claus was at the front door, I wouldn't react at all, except to wonder if something weird was going on.

> *We can't make a belief disappear, as if it never existed, but we can extract enough energy out of a belief so that it no longer has the potential to have any impact on our perception of information or how we behave. In other words, a belief can have so little energy that for all intents and purposes it may as well not exist.*

The Santa Claus illustration is an example of a successful installation of adopting a new a belief that was diametrically opposed to a pre-existing belief. It's successful because even though the two beliefs completely contradict each other, I don't experience a conflict because only the new belief has any energy to express itself. A successful installation requires that "all" of the energy be extracted out of the belief that's being replaced. Otherwise, anything less than all of the energy coming out of the pre-existing belief will result in a condition that I refer to as an "active contradiction."

I am defining an "active contradiction" as two diametrically opposed beliefs having a presence in our mental environment, where both beliefs contain energy. If the belief that's being replaced is not fully collapsed it has the potential to:

a) express itself as distracting thoughts, causing us to lose our focus,

b) create internal arguments, causing us to become confused or indecisive,

c) compel us to behave in ways that are inconsistent with our intentions or what we would say is true about ourselves and

d) cause us to experience fear when our new belief would say there's nothing to be afraid of.

To get a clean installation of your new probabilistic trading beliefs, it's essential that you understand the non-probabilistic beliefs you're replacing, don't have the capacity to extract energy out of themselves. In other words, our beliefs (of their own volition) can't replace themselves with another belief. Once an idea or belief becomes energized, it will stay energized for the rest of our lives, unless

> *a) we experience a painful forced awareness that causes us to change the way we think,*
>
> *b) have a profound realization at the level of an epiphany that causes us to change the way we think, or*
>
> *c) we resolutely with unwavering conviction "make up our mind" to change the way we think.*
>
> > *i. painful forced awareness, a profound realization in the form of an epiphany, or resolutely "making up our mind," all have the potential to instantaneously and completely collapse a belief.*

Otherwise, if we don't get an instantaneous and complete discharge of the conflicting energy in the pre-existing belief, then we will have to set-up a process and work at "letting it go." In some cases, depending how much energy is in the belief we want to collapse, it could take a considerable amount of effort on our part, over some indeterminable period of time to get to the point where we have a clean, un-conflicted installation. I'll give you a couple of examples to illustrate the point.

In my second book "Trading In The Zone™" I gave an in depth explanation of a situation where a very young child has a first time experience with a dog and is severally bitten. The child formulates a belief that "all dogs are dangerous." He goes through life believing this is true simply because he feels terrified every time he sees a dog, any dog. However, later on in his childhood he has an unanticipated experience of watching other kids his age playing with dogs and having a lot of fun doing it. The experience of watching other kids that he identifies with, have a great time with dogs is enough of a realization to start breaking down (drawing energy out) his belief that "all dogs are dangerous," to the point where he starts energizing a belief that says "dogs can be friendly and fun" and, at the same time, become attracted to the idea of playing with a dog. He can clearly see that it’s not true that “all dogs are dangerous” and these other kids were having so much fun, he finds himself wanting to experience what it’s like to play with a dog.

Whether or not he ever fulfills his desire to experience what it’s like to play with a dog is a matter of simple energy dynamics. I’m going to assume that after years of being terrified every time he saw or even thought about a dog, he undoubtedly will have a lot of negatively charged energy built up in his belief that says “all dogs are dangerous.” But he’s also had an experience that clearly indicated to him that something he believed was absolute and beyond question, is not true. Not all dogs are dangerous. However, if the experience of seeing these other kids having a great time wasn’t profound enough to dissipate all of the energy in his “all dogs are dangerous” belief, his encounter with the conflicting information will create an “active contradiction;” one that in all likelihood will be very heavily weighted on the side of his pre-existing belief that “all dogs are dangerous. If that’s the case, as long as, there’s an extreme imbalance in the energy between his belief that says “dogs can be friendly and fun” and his dominate belief that says “all dogs are dangerous,” regardless of what he may now understand about the positive nature of dogs, the negative energy in the dominate belief will make it virtually impossible for him to interact with one.

Now, does this mean that he will spend the rest of his life never experiencing what it’s like to interact with a dog? It all depends on the strength of his desire. If he “made up his mind” that playing with a dog is something he really wants to do, and has a tenacious personality, then he will undoubtedly find a way to do it. Most likely it will be in a way where he’ll do the best he can to get close to a dog that’s behaving in a very friendly or playful manner. However, his “all dogs are dangerous” belief generates a lot of fear, so he could find any attempt to get close very difficult, if not impossible. But that’s all right, because every time he tries, regardless of how far away he is, will have the effect of drawing energy out of his “all dogs are dangerous” belief and adding energy to the “dogs can be friendly and fun” belief. Every attempt creates a head on collision between the two conflicting beliefs. Every positive outcome will allow him to get closer with the next encounter. As he gets closer and closer with each attempt, the imbalance in energy between the two beliefs will eventually tip in favor of his new belief. Once that happens, we will be able to actually touch a dog. And once he has the experience of physical contact by petting and playing with a dog, whatever energy is left in his "all dogs are dangerous" belief will dissipate instantaneously.

It may have taken him awhile, but he now has a successful installation of his belief that "dogs can be friendly and fun." Just to maintain continuity, the child's now un-conflicted belief that "dogs can be friendly and fun" implies that it's also possible for dogs not to be friendly and fun. Dogs have a range of expression from super friendly and loving to vicious and mean. When the "all dogs are dangerous" belief got collapsed, it was the "all" part of the belief that was rendered non-functional. The pain the child experienced with his first encounter with a dog was real. Collapsing the belief wouldn't do anything to the memory of that experience, except to put it into a different context that says, "not all dogs are dangerous, but some dogs can definitely be unfriendly or mean." As a result, he will be cautious, but otherwise free to interact with dogs in any way that pleases him. When the child becomes an adult and encounters a situation where he observes a child who is afraid of dogs, his reaction will probably be something like, "I remember when I used to be afraid of dogs, but I grew out of it."

The next example is a middle aged man named Jerry who came to me for coaching in the early 1990's after reading my first book "The Disciplined Trader™." Jerry owned two very successful construction companies in the Dallas area. He decided to buy a seat at the Chicago Board of Trade so that he could trade 30 year Treasury Bond Contracts on the floor of the exchange. Initially he was trading off the floor through a retail broker, and found it to be an extremely frustrating experience, especially after taking some very heavy losses, so he hired someone to manage his companies and moved to Chicago. For those of you too young to know, I'm going to give you a very brief history lesson on what trading was like before we had electronic exchanges, so that you can get a sense of his frustration and understand why he would leave Dallas for Chicago.

Having to trade through a broker is a very different experience than having access to the instantaneous execution you get from being able to trade electronically. To find the current price, place an order to get in or out of a trade, as well as, find out the price you got filled at, you had call your broker. Compared to the point and click features of electronic trading platform, every part of the process of working with a broker took time and if it was a busy market, everything could take a lot of time. Consider that dialing the phone takes time. Getting connected and waiting for your broker to pick up, takes time; during particularity busy periods it was not unusual to get a busy signal. Then once we're finally talking to our broker, you could be subject any number of un-solicited comments or judgments about what you've decided to do. The broker has to fill out an order ticket, time stamp it and send it to the floor of the exchange. That takes time. Once the order is on the floor, the ticket has to be time stamped again and then given to the applicable floor broker for execution. That takes time. Once your trade is consummated the broker has to send the ticket back to an employee of the brokerage firm, who then has to either call or wire your fill price to your retail broker in the office. That takes time. Then to top it off, depending on how important of a customer you are, your broker may call you to tell you price you were filled at, otherwise you will have to call him. And if he doesn't have the fill back from the exchange, you just have to keep on calling back until he does.

Every order and every change you want to make to an order goes thru the same time consuming process. But what I just described isn't the worst of it. When you use a limit order and the market hits your price but doesn't trade thru it, you are not guaranteed a fill. This may seem like a strange way of putting it because trading on an electronic platform you will immediately know one way or the other if your order has been filled and whether or not you're in a trade. So the issue of being guaranteed a fill wouldn't seem relevant. Not so years ago. When you used a limit order the market could hit your price, not trade thru it, reverse its direction in your favor and you wouldn't know whether or not you're in a trade until the executing broker on the floor reports back. If he's busy, that could take a considerable amount of time. The market is moving in the direction of your order, so you may want to take some profits. The price may have even hit your profit objective, but you can't do anything until you find out if your order was filled. So, I think it fairly easy to see why someone who's very interested in trading would get really frustrated and want to get to the source of the action.

By the time Jerry came to me for help, he been trading in the bond pit for a while and finding that although he had immediate execution of his trades, the experience of trading in the pit was just, if not more frustrating than when he was trading through a retail broker in Dallas. He wasn't making any money because he found it difficult to cultivate the kind of relationships he needed with other traders in the pit to be a successful scalper. And, at the same time, his chart reading skills were rudimentary, so he wasn't very good at identifying direction related edges. Basically, he was trying to get a sense for what direction the price was going to move based on what it looked and sounded like everyone else in the pit was trying to do in the moment. It wasn't working.

It was obvious that he needed some structure. So the first thing we did was set-up a trading plan. Using point and figure charts, I helped him learn how to identify intraday, short term support and resistance points within a seven to ten tic range. The plan was for him to wait for the price to hit one of his target support or resistance points, execute a one contract trade and then wait for the price to trade up or down too his profit objective, usually seven to ten tics away. If the market didn't hold support or resistance and traded thru his entry price, we determined that all he needed to risk was three tics ($98.25 for one contract) to find out that the trade was unlikely to reverse and hit the profit objective. It was a simple plan. Since he was trading on the floor, he was in a position to immediately execute his trades. His method had almost a 3 to 1 risk to reward ratio, and based on our very limited testing, the plan had approximately a 60% win rate.

How did he perform? We'll get into that in a moment. First I want to give you a little more background, before we get into the specifics of how well he did. As the owner of two construction companies, he was a real task master who didn't tolerate any deviation from what he told his employees to do. If he wanted something done, he expected it to be done precisely the way he said, no excuses permitted. At least that’s what he told me. Also his net worth was in the tens of millions of dollars, he was the kind of guy who wouldn’t give a second thought spending several hundred dollars on a bottle of wine at dinner or even lighting one of his cigars with a hundred dollar bill.

Do you think he was able to execute the plan? Not even close. The first opportunity he had to get into a trade, the market came down to his support point. However, by the time the price reached the target, he was convinced it was going to keep on going lower, so he didn’t get in. He was wrong, the price stopped at his target and bounced a couple of tics up, so he went ahead and bought one contract three tics higher than his target price. Keep in mind, all he needed to spend was $98.25 (3 tics) to find out if the price was going to stop at his target entry and reverse.

The trading plan called for him to stay in the trade and wait for a rotation to the resistance level, which was 10 tics away from his target entry price, He got into the trade 3 tics higher than he was supposed to, so now his objective is only seven tics away. However, it didn’t make any difference how far away it was because as soon as he had a one tic profit he bailed out of the trade. Not too long afterward the price rallied to the projected resistance level where he was supposed to take his profits on the original trade and then reverse his position by going short.

But, as the price approached his target, again he became convinced it was not going to stop, so he didn’t put a trade on. And again, just like the first trade, he was wrong about what he thought the market would do. The price stopped at his target price and then dropped a couple of tics lower, so he sold one contract. Now short one contract, he was supposed to wait for a rotation back down to support, but as soon he had a 1 tic profit he bailed out of the trade. When he came to my office later that day to talk about what happened, he was clearly agitated. He had his first winning day in a long time, but two things really bothered him. He couldn’t follow his rules and he left a lot of profits on the table in relationship to what he ended up with. He said that he couldn’t hang on for the rotation because he had been burned too many times in the past.

Over the next three or four days his support and resistance levels worked quite well. He found himself in several winning trades and although he was doing better at getting in at his price, he still couldn't hang on for more than a one or two tic profit. What made the situation even more exasperating is, a couple of times he sold at a resistance level that turned out to the high price of the day and bought at a support level that turned out to be the low price of the day. Of course he didn't know it at the time that he was buying the low of the day or selling the high of the day, but the fact that he did and only ended up with a one tic profit was just killing him. After the fourth day he stopped calling to report his progress. I presumed the reason was because he found it very difficult to listen to himself make excuses about why he couldn't do what he was supposed to do, especially since he didn't tolerate excuses from anyone else.

When I heard from him again, it was a couple of weeks later. His support and resistance levels were working like a charm, so he was experiencing a lot of winning trades. But they were mostly all one tic winners with a few that were two tics, but nothing more. He was now confident that he had the ability to identify a high percentage of winning trades, but found it impossible to stay in those trades for a full rotation. So he wasn't getting anywhere near what they were making available in the way of profits. He didn't call to ask me for any advice, he just wanted to tell me what was going on and that he decided up his trade size from one contract to twenty contracts. It was apparent that he was going to use the size of his positions to compensate for his inability to stay in his winning trades and let his profits run. Although it was unsolicited on his part, I did comment that I didn't think such a dramatic increase in his size was a prudent step for him to take considering he hadn't developed either the psychological or mechanical skills to handle a transition of that size. He grunted and hung up the phone.

The next day after the close, he called and it was very apparent he was in a desperate state of mind; the kind of state of mind where one is so exasperated that they're genuinely open to new ideas and sincerely willing to try anything that might work. His venture into a twenty contract positions was a disaster. He told me he lost all of the money he had made from the last two weeks of trading. However, based on how emotional he was, I suspected it was a lot more. The transition from a one lot trader to a twenty lot trader is not automatic, especially when you're trading in a futures pit. The solution to his problem was really quite simple, but not necessarily easy to implement. He didn't need to learn how to make the transition from a one lot to a twenty lot trader, because he really didn't enjoy pit trading in the first place. He was a late forties and found it exhausting competing with hyper competitive guys, most of whom where half his age.

What Jerry needed to do was work through his inability to hang on to a winning trade. Like the boy and the dog example above, Jerry was operating out of an "active contradiction." He had two conflicting beliefs that both had energy, and the belief generating the fear was dominate. His experiences of identifying support and resistance points first created and then added energy to a belief that said "yes - it's possible to pick a high percentage of winning trades that have a profit potential greater than what he had to risk to find out if they would work." But his realization of what was possible didn't generate enough of a shift to collapse all of the negatively charged energy out of whatever pre-existing belief he had that said "once he's in a winning trade the market is going to take is profits away." The exact wording of this belief is conjecture on my part, because Jerry and I never really had any in-depth conversations about his previous trading experiences. But it isn't necessary to know or be able to articulate the exact wording of a belief to effectively collapse it.

To solve his problem, I gave Jerry a very simple exercise. Conceptually, identical to the one I am about to give you to make sure you get a clean, un-conflicted installation of the probabilistic beliefs you need to trade without fear and errors. I explained to him that he could free himself from his fear that the market was going to turn his winning trades into losing trades, if he was willing to do a psychological exercise designed to collapse the beliefs that were causing him to panic and bail out of his trades too soon. He didn't hesitate for an instant and enthusiastically replied, **"I'll do whatever I need to."**

Here's what I said to Jerry about he needed to do to work thru his fears.

First, right now you can only express yourself as someone who can only hang on to a trade that may be going in your favor for one tic. You want to change that by transforming yourself into someone who can hang on to winners and let their profits run. In your case, you want to be able to hang on to your winning trades for a full rotation to your profit objective. Transformation is a function of the clarity of your intent and the intensity of your desire. In other words, the degree to which we are successful at growing into a new version of ourselves is a function of how clear we are about the way we want to change and how much energy is behind our desire to make that change. If we're crystal clear and the energy behind that clarity is unwavering and resolute, the transformation can happen in an instant, from one moment to the next. As an example, I pointed out there probably isn't anyone who's hasn't had the experience of radically changing, from one instant to the next, some view, idea or belief about something or someone, if we had sufficient justification to do so. The definition of what is sufficient justification is going to be unique to each individual. The larger point is, what we become aware of, attracted to and desire is not necessarily limited by what we already believe to be true. The energy behind our desire and "making up our mind" with complete resolve has the capability of moving other forms of energy like beliefs, in an instant, if we're completely clear about what we're doing and why we want to do it.

Changing the energy ratio between two contradictory beliefs is not a function of time. It's a function of our clarity of intent and how much energy is behind our desire to make the change. When we "make up our mind" about something with complete resolve conflicts instantly disappear. To the degree we lack sufficient clarity and determined energy to effect an instantaneous change, we will have to compensate by using some form of technique over-time.

You could say that Jerry had an epiphany or Ah-Ha type of experience to the extent that it moved enough energy to make him completely open to any ideas that would get him out of his current situation. Otherwise, to free myself from his fears, he was going to have to use a technique over some indeterminable period of time. How much time will depend on how much positive energy he puts into doing the exercise.

What I said he needed to do is:

- *identify his support and resistance points exactly the way he had been doing for the previous two weeks,*
- *when the price gets to one of entry points, put on a one contract trade,*
- *if the price doesn't reverse in his favor, exit the trade three tics beyond his target entry price,*
- *immediately after confirming he is in a trade, to remind himself, that his sole purpose for getting into the trade was to learn how to let go of the fear that wouldn't let him stay in his winners beyond a one tic profit,*
- *then "make up his mind" with a resolute commitment to do absolutely nothing for ten minutes, unless he had to stop himself out of the trade,*
- *as a symbol of his resolute commitment to do nothing, he is to put his hands in his pockets and then stare at the clock while he waits for the ten minutes to expire or the price rotates to his profit objective, whatever comes first.*

Putting his hands in his pockets and staring at the clock is a simple thing to do, but Jerry didn't have any illusions how difficult it was going to be to do it. He knew the moment he found himself in a situation where the market started to reverse in his direction his mind was going to be bombarded with thoughts telling him bail now and not to wait for a full rotation to his profit objective. To collapse the energy out of the belief these thoughts were coming from, he needed to purposefully create experiences that invalidated the belief. In other words, he is using his trading activities as a technique to free himself from his fears. This isn't any different than the boy in the above example trying to get close to a dog. He was purposefully creating experiences that invalidated the belief that "all dogs are dangerous."

I also instructed Jerry to pay attention to what he was thinking while he was staring at the clock and, as best he could, interrupt the flow of fear based thoughts, with positive thoughts of self-encouragement. Continually repeating affirmations as simple as "I can do this," or "I'm determined to stay in this trade," will draw energy out of his conflicting belief, especially if the market happens to be more than one tic in his favor while he's saying it.

The first couple times Jerry engaged in the exercise, he didn't think that he did very well, but considering the intensity of the energy behind his fear, I thought he did great. In both cases, he wasn't able to stay in the trade for the full ten minutes. But he did manage to get more than a one or two tic profit. He said staring at the clock made each second feel like a minute and each minute like an hour. So, as far as I was concerned if he managed stay in a trade three minutes in real time, for him it was the equivalent of staying in the trade for three hours. He said the encouraging self-talk really helped and he realized that the longer he could stare at the clock and tolerate the uncomfortableness, the easier it got to stay in the trade the next time. I don't remember the exact number of days it took Jerry to work through his fears, but it wasn't very many. Very shortly after he was at the point where he could hang on to his winners, he stopped trading in the pit, which never really liked anyway and got some office space at the Board of Trade. Jerry went on to become a very successful "long term" off the floor bond trader.

The reason why I said above that I didn't want you assume that you already have a fully functioning belief in probabilities, is because you may have any number of "active contradictions" that will prevent you from operating out of a probabilistic perspective. You could have a perfect understanding of the nature of probabilities, as well as, believe that all your trades have a probable outcome. But even if you're relatively new to trading you've undoubtedly been exposed to ideas and concepts about the nature of the markets and how trading works that are in conflict with the principles of a probabilistic mind-set. For example, let's say that everything you've read up to this point makes a very persuasive case that the risks associated with speculating on price movement never goes away, no exceptions. We can distill that statement into a belief that says "the risk always exists, no matter what." Let's also say that even before you thought about trading, you acquired a belief that says "if I expend time, energy and financial resources to analyze the properties and characteristics of something, then whatever conclusions or predictions I come too, as a result of that analytical process, should tell me what's going to happen.

What you would have are two conflicting beliefs that will create an "active contradiction" to the degree they both have energy to express themselves. A belief like "the "risk always exists" would say that any predictions that result from a process that analyzes collective human behavior are only guesses telling us what may or may not happen. If we know we're guessing, we also know that we "don't know" what's going to happen, only what "may" happen. Believing that we don't know, keeps our expectations neutral, so there's nothing to be wrong about. On the other hand, a belief like "predictions that result from my analysis tell me what's going to happen," will cause us to expect a specific outcome. Then, if other traders don't do what we expect them to do, it will tap us into the pain of what it means to be wrong.

Considering the nature of price movement, believing that "the risk always exists," "we're guessing," and "don't know" could make perfect sense to you and, as a result, you decide to adopt these concepts as beliefs. But, after making your decision to do so, you find you're not completely free of the fear of being wrong. You still don't have the objective, care-free state of mind you're looking for. The down tics in the price still take on a threatening quality when you're long and the up tics in price take on a threatening quality when you're short and getting out of a trade that didn't work, still matters. Maybe not as much as before you made your decision to adopt the above probabilistic beliefs, but to some degree the negative emotions are still there.

Our fears and conflicting thoughts have a source. In this example, the source would be an expectation that's being created by the belief that "the conclusions or predictions I derive from my analysis tell me what is going to happen." As long as, a belief has energy, it has the potential to express its version of reality on how we interpret information, what we do and how we feel about the results.

At a conscious level of awareness you're operating out of the new beliefs you've adopted, but sub-consciously you're also operating out of beliefs you may not remember acquiring or even have any knowledge of their existence.

> *Beliefs will function regardless whether or not we have any conscious awareness of their being a part of our identity.*

Also keep in mind, that beliefs don't have the capacity to draw the energy out of themselves. It's certainly possible that your exposure to the ideas and concepts presented in this book was enough to completely convince you (from an energy perspective) that the way we normally think about how an analytical process works doesn't apply when we're using it to predict collective human behavior. However, if what you've read wasn't enough to completely convince you, then a belief like "the conclusions or predictions I derive from my analysis will tell me what's going to happen" is just one example of any number of potential "active contradictions" that can keep you from achieving a state of mind that's objective and completely free of fear.

Now, before you get over-whelmed thinking, to get a clean installation you're going to have to root out, one by one, all of your beliefs that have the potential to create an "active contradiction" with your new probabilistic beliefs, that's absolutely not the case. Your conflicting beliefs, if any, will make themselves known as you as fear, resistance, hesitation, second thoughts, internal arguments, or a compellingness to do more analysis, as you attempt to follow the rules of the exercise I'm about to give you. You don't need to specifically identify these conflicting beliefs or be able articulate their structure for the exercise to work. What you do need for the exercise to work is to be crystal clear about why you're doing it and be resolutely committed to follow-thru until all of the conflicting energy has completely dissipated.

To start the exercise you should already have a tested edge with precise, non-subjective rules that define the conditions that specify a trade entry. As well as, precise, non-subject rules that define exactly how far the market has to trade against your entry to stop you out and precise rules defining where or how you are going to take your profits. The exercise is simple. It calls for you execute twenty five trades in a row, based on the entry and exit rules that define your edge. In other words, instead of saying to yourself, I'm going to take the next trade; you commit yourself to take the next twenty five trades, no matter what. The "no matter what" part of your commitment implies that you will do everything in your power to follow the rules that define your edge, by doing exactly what you're supposed to do, precisely when you're supposed to do it, for each individual trade in the series.

Hypothetically, let's say that your edge, as applied to a particular stock tested out to have a 55% win/loss ratio. So based on the markets previous collective behavior, the next twenty five occurrences of your edge should result in fourteen winning trades and nine trades that don't work. Also, from the testing process let's say you found that once the market traded a $1.50 in the opposite direction of your entry point that the likelihood of the trade working was so remote that it wasn't worth spending any more money to find out if it will. Since the exercise calls for a minimum position size of one share if you're trading stocks, the most you would have to spend in a worst case scenario of all twenty five trades not working is $37.50 plus commissions. All twenty five trades not working is possible, but extremely unlikely. On the profit side, let's say in the time frame you're applying your edge, you found that the market will move at least $2.00 in your favor an average 55% of the time before retracing back to your entry point or beyond. So if the market behaves in a way that's consistent with the percentages established from your testing, with perfect execution, at the end of twenty five trades you should end up with a net profit of $28.50 minus commissions. It's also possible that all twenty five trades turn out to be winners, but that's probably as unlikely as all twenty five trades not working.

However, for the purposes of this exercise, the question is not how well the edge performs, but rather how easy or difficult it is for you to follow thru on your commitment to flawlessly execute the entry and exit signals of your edge for every trade in the series. If you're operating out of a fully functioning (meaning no conflicting beliefs) probabilistic (slot machine) perspective, then executing every signal will be easy and seem-less. It'll be easy because your expectations will be in harmony with the reality of your situation. If your edge is telling you to go long, you would certainly like the price to go up, but since you believe that *"anything can happen,"* you know that *"maybe"* the price will move in your favor and *"maybe"* it won't. So what you're expecting is *"something to happen"* (you can't be wrong about that) and you *"don't know"* what that something is going to be or why (no illusion there). And if you're willing to accept the dollar value of the cost to participate to see if the trade works, then you will not have any difficulty flawlessly executing the each individual entry and exit signal of your edge.

With an un-conflicted probabilistic perspective, you won't feel compelled to make the typical trading errors that will distort the results of your edge and turn it into a random trading system. For example, hesitating to execute a signal is a typical trading error. We hesitate because second thoughts creep into our mind expressing reservations about why we should wait or not put on the trade at all. If we're operating out of an un-conflicted belief that we *"don't know what's going to happen after we get into trade or why,"* then what would cause us to hesitate? To entertain any thoughts or information that would argue for inaction would be a contradiction to our belief that *"we don't know."* Beliefs, as a natural characteristic of the way they exist, don't like to be contradicted. An un-conflicted belief that *"we don't know"* will automatically dismiss any information or ideas suggesting that we wait or don't do anything at all. If we do find ourselves hesitating or entertaining the idea of not taking the trade, it means we have an active contradiction that needs to be collapsed.

The same dynamics are at work when it comes to moving or pulling stops. If we have an un-conflicted belief "*there's a random distribution between in the sequence of wins and losses over a series of trades," and "whatever we have to pay for the trades that don't work is the cost to make sure we're participating in the trades that do,"* there wouldn't be anything compelling us to move a stop further away from our entry or pulling it altogether. Just like owning a casino, we would let the odds built into our edge play themselves out. If we win, we'll naturally feel great. If we get stopped out, we move on the next trade without feeling like a loser. Otherwise, any compellingness to pull or move a stop would have to be coming from a contradictory belief or beliefs essentially expressing their lack of acceptance of a trade not working. In other words, we're not free of any conflicting beliefs that would say "it's not ok to lose."

With an un-conflicted probabilistic perspective you won't have any problem taking the next trade after experiencing several non-performing edges in a row. Whereas, traders who haven't developed an un-conflicted probabilistic mind-set will usually toss their edge and look for a new one if they experience three losing trades in a row. Three consecutive losses is a common threshold where most traders will feel betrayed by their edge. That sense of betrayal is going to come from expectations about the performance of their edge that simply does not include the possibility of losing three times in a row. So when they get the next signal after three consecutive losses, they're usually paralyzed with fear and thoughts that are screaming *"don't take the trade, it's a loser for sure."* The truth is, they don't know what the outcome of the next trade will be. It only feels like it's a sure loser because of the way their mind is associating the next signal with the last three trades. Otherwise, in reality, there's no relationship. The outcome of that next trade is a unique event that has absolutely nothing to do with the outcome of any trade that preceded it; even though the signals to get into the trade were produced by the same pattern.

Traders who have developed a probabilistic perspective won't feel betrayed, because they're beliefs won't associate the next signal to get into a trade with the outcome of any trade that preceded it. As a result, it wouldn't occur to someone who thinks in probabilities not to take the next trade any more than it would occur to someone playing a slot machine not to push the button again because the machine didn't give them a payout the last several times they pressed it. They're going to push the button again because they know the outcomes are random, implying there's no discernible relationship between one outcome and the next. To whatever degree you believe otherwise, will be proportionate to the degree of difficulty you have getting into that next trade on after you've had two or three losers in a row.

Your commitment to execute every entry and exit signal of your edge will cause you to experience a head on collision between your intent and any belief or idea you have that's in conflict with your intent. The exercise is specifically designed to bring these conflicts to the surface so that you have the opportunity to draw the energy out of the contradictions and add energy to the probabilistic beliefs you're adopting. You will be stepping into a process of change that isn't any different than what Jerry had to go thru to hang on to a trade that was working in his favor, or the boy who wanted to experience what it was like to play with a dog. For Jerry and the boy to satisfy their desire to express themselves in a new way, they had to consciously choose to create experiences that validated the new version of themselves by demonstrating a willingness to confront whatever was causing them to experience their fear and generating conflicting thoughts.

The boy making a choice to get closer and closer to a dog displaying friendly, playful behavior created positive experiences that proved to him that not all dogs are dangerous. Every second Jerry managed stare at the clock and replace his negative stream of thoughts with affirmations and positive self-talk created a positive experience (moment) that contradicted whatever energy was compelling him to get out of the trade before the price hit his objective. He was proving to himself that regardless of how it felt or seemed otherwise, that he didn't know what was going to happen, that he didn't have to know what was going to happen to be successful and as long as, he was fine with the dollar value of the risk of finding out, it didn't matter what happened. By doing the exercise, Jerry developed a probabilistic mind-set that gave him the ability observe market behavior objectively (without feeling threatened by what is or isn't happening) and the emotional resiliency to execute his edge flawlessly.

The exercise will give you the same results, if you keep some very important points in mind.

First: If you can't do what the signals of your edge call for, or if it requires any conscious effort your part in the form of will power, it means you don't have an un-conflicted probabilistic mind-set. As a result, every head on collision between your intent to execute a signal and any thoughts or feelings that would argue for something different is giving you the opportunity to collapse the source of the conflicting thoughts or feelings.

Your most productive of what I'm going to call a "Jerry moment of conflict," will be when, for whatever reason you're "*convinced"* the signal you're getting from your edge isn't right, will not work and the signal turns out to be a winner. When, for whatever reason, you're *"convinced"* you're going to get stopped out and you don't. When, for whatever reason you're "*convinced"* the market isn't going to hit your profit objective and it does. When, for whatever reason you're *"convinced"* the signal from your edge is right and the trade doesn't work. When, for whatever reason you're *"convinced"* the market is going to hit your profit objective and it doesn't.

Eventually you'll accumulate enough of these "Jerry moments of conflict" to be totally convinced (from an energy perspective) that a "definitive" analytical conclusion about what other traders intend to do or not do, is in reality a dangerous illusion. In the world of speculating on the impact other trader's behavior is going to have on price movement "nothing is definitive." As screen based speculators we operate in a world of "maybe," making our predictions nothing more than a guess. Use the exercise to make sure you are absolutely convinced of this and you will experience a dramatic shift in how see the market and respond to it.

Second: You don't need to be able to specifically identify or articulate the source of the conflicts for the exercise to work. You just have to know that the source exists, and if it didn't have any energy, it wouldn't even occur to you to do anything other what your edge called for.

Third: To collapse the energy out of the conflicting beliefs you need a sincere desire to change the way you think about trading. That desire has to translate into a willingness to intentionally interrupt the conflicting thoughts or feelings and replace them with ideas and affirmations that represent what it means to operate out of a probabilistic mind-set. So the instant you realize you're feeling threatened or thinking about doing or not doing something your edge calls for, do the best you can to interrupt the thought process and consciously choose to focus your thoughts on the probabilistic principles you're adopting for your new mind-set.

Memorize or write the following probabilistic ideas and principles on something you have easy access to and repeat to yourself as an affirmation or positive self-talk when you're in a conflicting moment.

- *I'm completely reconciled to spend the amount of money my edge says is necessary to find out if this next trade turns out to be a winner.*
- *The outcome to each individual edge in a series is a unique event that has no discernible relationship with the outcome of any previous or future outcomes.*
- *The diversity of the intentions of other traders who are about to submit buy and sell orders to the flow can cause anything to happen. Since I don't know what that anything might be, I'm going to execute the signal my edge calls for and make myself available to either win and collect my profits or pay my expenses. Either way "I'm fine!"*
- *There's nothing definitive about speculating on price movement.*
- *The risk of an edge not working always exists.*
- *Each prediction that results from my analysis is a guess.*
- *Capturing the favorable odds built into my edge over a series of trades has nothing to do with being wrong or losing.*

If you have others that you believe are suitable, add them to the list.

Four: You will know you have a clean, un-conflicted installation of your probabilistic mind-set when you can execute one complete twenty five trade sample without making any errors and in the process, it doesn't even occur to you do something other than what your edge calls for. In other words, the energy shift between the non-probabilistic beliefs and your new mind-set is so complete that you don't have to deal with any conflicting thoughts or feelings. At that point, traders who haven't developed the skill of objective observation and fearless-flawless execution would likely characterize you as a highly self-disciplined trader. But that would be an inaccurate assessment. We don't need self-discipline to behave in a way that's consistent with "who we are." Needing self-discipline implies that we have "active contradictions" and need to consciously choose to apply additional force to supplement the imbalance in energy between our intent and our beliefs that are in conflict with our intent. Otherwise, our behavior will automatically be consistent with the way our beliefs are aligned. It doesn't take any extra special effort in the form of self-discipline to be who we already are.

Five: Many of you are undoubtedly wondering how long it's going to take or how many times you will have go through a twenty five trade sample to get a clean, un-conflicted installation?

There's no way for me to answer that question. As I indicated above in the Jerry illustration, transformation is not a function of time. It's a function of "clarity of your intent" and the amount of energy (resolute conviction) behind your desire to transform yourself into a different person; in this case, someone who can operate out of a probabilistic perspective. To make the transformation you are using one form of energy (desire) to move another form of energy (beliefs that no longer serve your purpose). In other words, you are using the energy of your conscious desire to move the energy of anything you've learned and accepted as the truth, that's in conflict with your desire.

I say that transformation is not a function of time because energy travels so fast that the time it takes to move from one point to another can't be perceived by our senses. For example, when we turn on a light, the room is illuminated instantaneously. How much time did it take for the energy released from the light bulb to reach the walls of the room? It happened so fast that the amount of time it takes can't be measured by our senses. As I indicated above, it's possible to "make up our mind" about something with so much conviction and resolve that we collapse the energy out of conflicting beliefs in an instant, or as long as it takes for light to travel from one point to the next.

So achieving an instantaneous transformation is certainly possible, but don't be surprised if it doesn't happen that way, especially for those of you who have been trading for a while. Some of your non-probabilistic beliefs could be so powerful and deeply entrenched in your psychic that it would take an extremely high degree of clarity and considerable amount of energy (resolute desire) to collapse them instantaneously. You might have the clarity but not the required amount of conviction behind your desire or have the required amount of conviction but not the clarity. In either case, not knowing the amount of energy in your non-probabilistic beliefs and the degree you to which you may not be completely clear about what you're trying to accomplish would make an instantaneous transformation a remote possibility. In lieu of an instantaneous transformation, the exercise is a simple technique that will create the kind of experiences that will bring you to the degree of clarity you need in incremental steps. And as you are coming to clarity, you will simultaneously be building the degree of conviction you need to get a complete energy shift from your non-probabilistic beliefs to your probabilistic perspective.

Note: 01-06-15, I just got an e-mail enquiry from an R.M. in Saskatchewan, Canada, asking me "I need to know why I can build my own systems to trade, then cannot trade my own profitable system!!!!??

How many times you may have to cycle through the exercise is an unknown variable, so do yourself a favor and don't develop any expectations about when you will have a complete installation. Because even if you can flawlessly execute a full twenty five trade sample without any conflicting or competing thoughts, you're still not done. If you recall, you're supposed to start the exercise trading with an absolute minimum position size. The next step after you've successfully installed you're probabilistic perspective at a minimum position size is to increase the number of shares or contracts to a reasonable level and see if you can still execute flawlessly without any conflicting or competing thoughts. If you can, then keep on increasing your position size, in reasonably small incremental steps until you're no longer comfortable or trading any additional size would no longer be prudent from a money management perspective, whichever comes first.

Now, some of you might be thinking, this seems like an awful lot of work, and you're right it is. However, if you decided you wanted to become a professional golfer or just get very good at the game, would you be thinking it was an awful lot of work if a golf pro took you to a driving range, showed you the correct way to swing your club and then told that it might take two or three thousand practice swings before you get the correct combination of movements ingrained in your muscle memory? If your desire was really strong, you would be thinking you'll do whatever it requires to get good.

By saying that the exercise is a lot of work, I am not implying that trading itself is a lot of work. The most challenging work is undoing all of the erroneous ideas and misconceptions that we're typically exposed to about how to be successful. Almost all of start us out with ideas that eventually turn into very powerful deeply entrenched beliefs that do not facilitate our success, but rather cause a great deal of frustration. Is it erroneous to believe that good analysis is the key to our success? The answer is both yes and no; it depends on how use it. If we are taught to use it from a probabilistic perspective, then yes good analysis will be a primary factor contributing to our success. Assuming we have the ability to monitor our susceptibility to euphoria and self-sabotaging beliefs.

On the other hand, if we use analysis to make sure we're right on every trade we decide to get into, then the answer is no – good analysis will not be the primary factor contributing our success. Good analysis will only play a primary role in our long term success if we learn how to think in probabilities first. Unfortunately very few of us learn how to think in probabilities before we adopt the belief that analysis is the key to our success. So we immerse ourselves in market analysis without understanding the probabilistic nature of price movement and in the process accumulate an enormous amount of contradictory energy that will eventually have to be collapsed. That is if we really want to make in this business.

CHAPTER SEVENTEEN

Mechanical Trading

INTRODUCTION

From an analytical perspective there are three basic types of analysis we can use to predict the direction of the price - technical analysis, fundamental analysis and current events (the news). From a psychological perspective there are three distinctly different thinking paradigms we can operate out of that will govern the amount analytical information we expose ourselves too and determine the developmental context in which we make our trading decisions.

The first developmental paradigm is the mechanical mode of trading. The mechanical mode is best characterized as limiting and inflexible. We purposefully limit the amount analytical variables we expose ourselves too so that we can learn what patterns or edges work on a consistent basis, and how well. It's inflexible in the sense that all of our entry and exit decisions are made in advance and we can't deviate from our trading plan. When we're trading out of the mechanical mode any compellingness to deviate from our trading plan would be an indication that we haven't acquired the psychological skills we would need to successfully trade from the next developmental context.

The next developmental paradigm is the subjective or discretionary mode of trading. Unlike the mechanical mode, the subject mode is completely flexible. We can make our trading decisions in advance, or in the moment and change our mind about what to do or not do based on whatever we perceive is going on in the market at the time. There are a number of skills, both analytical and psychological (especially psychological) we need to have firmly in place before we can produce consistent results at the subjective level of development. The skills we need to successfully trade in the subjective mode are learned in the mechanical mode.

The third developmental paradigm is the intuitive mode of trading. I'm going to define intuition as guidance in the form of a hunch or sense of knowing about what or what not to do that's coming from a source outside of our rational, logical or analytical thought process. When we engage in a rational, logical or analytical thought process to determine a course of action, our conclusions are being drawn from a base of knowledge that already exists. Intuition, on the other hand, is creative in nature. Creativity, by definition brings forth something that didn't previously exit. So when we get an intuitive impulse, hunch or sense of knowing about what the market is going to do, or what we need to do, that guidance is not coming from our rational thought process or existing base of knowledge, and as a result, cannot be justified by what we already know.

The mechanical mode is "rigid," the subjective mode is "flexible" and the intuitive mode is "creative or non-rational."

The Mechanical Mode: The underlying objective for trading in the mechanical mode is to

- *limit our analysis to a fixed set of variables so that we can determine what works on a consistent basis,*
- *build a perceptual framework to learn how to read the markets and*
- *acquire the psychological skills we will need to produce consistent results.*

To determine how well a pattern or edge works, the pattern or edge has to be defined with a fixed set of precise analytical variables and applied to a relatively large sample size of occurrences. In the mechanical mode we know exactly what market conditions have to exist to execute a trade. We also know before we start a sample the potential win/loss and risk to reward ratio for the entire sample of trades we intend to execute. The mechanical mode is the developmental context where we let the law of probabilities do the work. As a result, there's nothing to analyze, judge, weigh or even think about with respect to each individual trade within the sample. We do our analysis and ask questions about how to improve our results when the sample is complete.

Now, since all of our analytical variables are constant throughout the entire sample, it will be relatively easy to determine what works, how well and under what conditions, and then, if necessary make any adjustments that could improve the results. Otherwise, if we're constantly interjecting extraneous, random analytical variables on a trade by trade basis, we won't be able to pin point what needs to be changed. On the other hand, if we're satisfied with the results we got, we simply initiate another sample and repeat the process.

> *A consistent, methodical approach will yield consistent, reliable results.*
>
> *A haphazard, non-methodical approach will yield inconsistent, unreliable results.*

TWO: *Learning how to read the markets.*

The constant uneven flow between the number of buy and the number of sell orders being submitted to the exchange cause the price to be in a state of perpetual motion. Occasionally pausing, but for the most part always changing. To the untrained eye that movement can look completely chaotic and random. Learning how to read or interpret what the price changes are telling us about the potential for the market to move in a particular direction is a sophisticated trading skill that could and usually does take years to learn. However, it doesn't have to take that long if you're willing to go about it in a way that on the surface may not seem very logical.

If we're in the process of learning how to read the markets so that we predict what other traders intend to do based on the price patterns their previous activity has already created, then it would be logical to assume that the more analytical information we evaluate the more likely we will make an accurate prediction. I'm not implying there isn't any value to this logic. However, if you consider the enormous volume of analytical information that's available, the hundreds of analytical tools that are available, the almost endless number of ways we can apply those tools, which can and often will give us contradictory predictions applied to the exact same price data, then it shouldn't be too difficult to understand why it can take years to learn how to get a good read on what patterns or type of price movement is telegraphing a significant move or change in the direction of the price.

More is not better when we're trying to learn how to read the markets. Contradictory analytical information creates conflicting possibilities. The more conflicting possibilities we expose ourselves to the greater the potential to become over-whelmed and confused. To avoid the confusion, which could last for years, I am proposing that you drastically limit the amount of analytical information you expose yourself to by observing price movement through the context of one fixed reference point.

A fixed reference point could be any technical tool or study, as long as the variables that define it are precise and constant. For example, you could start with a three or four period moving average applied to a five minute bar chart. When you're setting this up, your trading platform is going to ask you how many time periods you want the average to calculated for, if you want a simple or exponential average, the data points you want the calculation to include, for example (high+low+close)/3, and if you want the line plotted on the chart to be offset. Meaning, you can have the line plotted at the current bar, in advance of the current bar, or behind the current bar.

Once you set up your parameters, a line representing the moving average will be plotted on the chart giving you a fixed reference point to observe and then evaluate the markets behavior in relationship to the line. What you're looking for is some recurring pattern in relationship to the line that consistently telegraphs a significant move in the same direction the price is already moving, or a pattern that tells you the direction of the price is likely to change. There are several data points you can compare to the line to see if there's any cause and effect relationships.

1) *The range of the bar (high to low) and where the line is in relationship to the range. Is the line in the middle of the range at the top or bottom of the range?*
2) *Is the range of the bar completely above the line, where there's a gap between the low of the bar and the line? If so how wide is that gap? Is there a relationship between the width of the gap and the direction of the next or next couple of bars?*
3) *Is the range of the bar completely below the line, where there's a gap between the high of the bar and the line? If so how wide is that gap? Is there a relationship between the width of the gap and the direction of the next or next couple of bars?*
4) *What about the slope of the line in relationship to the bars.*
5) *You can compare the up and down tic volume of each bar in relationship to the range of the bar, where the bar closed in relationship to the range and the position of the bar in relationship to the line.*
6) *Are there any noticeable bar patterns that repeat themselves when the price is approaching a significant reference point like previous high or low support and resistance?*

There are a lot more questions you can ask yourself and data points you can compare to the line when you include multiple bars in relationship to each other and the line. Use your natural sense of curiosity and imagination and you might discover a significant relationship that no one else knows about.

The primary purpose for establishing a fixed reference point is to eliminate the potential for confusion by learning how to read the markets in systematic, non-random, step by step fashion. Otherwise, we can't expect to learn, at least not very quickly or efficiently, what's significant and what isn't if we observe price movement within a changing, non-fixed context by constantly adding or subtracting any number of random variables.

If you immerse yourself in learning one particular pattern or study, limited to one market and one time frame, you will eventually become an expert on how the market behaves in relationship to whatever fixed reference you choose. You'll get a sense for what's significant, as opposed to what may look significant on the surface, but is essentially "background noise," as it is referred to in the industry. I'm defining "background noise" as price movement that isn't really telling us much of anything about the markets potential to move or change direction. All price movement is not created equal. When you become an expert at one reference point in one market, you will start to see things that are invisible to other traders and sense things they won't be aware of. When you've built a solid base of knowledge, you can easily expand that base by including other markets, and other indicators, in multiple time frames.

THREE: *Learning the psychological skills we need to be consistent.*

Regardless of how good our analysis is, to achieve consistent results, we have to be able to trade without fear. To trade without fear we have to trust ourselves. To trust ourselves, we have to know without a shred of doubt that we will always act in our own best interests without having to experience pain first. To trade without the potential to experience pain we have to be able to analyze market information and observe price movement objectively. To observe price movement and analyze market information objectively our expectations have to be grounded in reality. The markets reality is probabilistic. To get our expectations aligned with the markets reality, we have to completely and authentically accept the risk of being wrong and losing money, so that we don't have any reasons to rationalize, justify, build cases or create illusions by making stuff up about what is happening or going to happen. To genuinely accept the risks associated with trading, we have to train our minds to think in probabilities by adopting beliefs that create a probabilistic perspective and also make sure those beliefs are un-conflicted.

The fastest and most effective way that I know of to train our minds to think in probabilities is to trade mechanically with fixed analytical variables in limited sample sizes. Trading mechanically automatically manages our expectations because it forces us to take a "series of trades" approach where we are not focused on the outcome of any given individual trade in the series. From a "series of trades" approach we are not picking or excluding individual trades based on what we think, want or expect to work or not work. In other words, we're operating out the belief that we don't know what the outcome of each individual trade in the series will be. As a result, there isn't any information that the market can generate about its potential to move that we will find threatening. If we're not threatened, then there's nothing to avoid, distort, dismiss or become invisible from perceptual blindness. If we don't have a reason to avoid, distort, dismiss or become susceptible to "perceptual blindness," we'll have access to all of the distinctions we've learned about the market's behavior that tell us its potential to move. Otherwise, any degree of threat will correspondingly diminish our ability to be objective or worst-case scenario cause us to experience "perceptual blindness."

"Perceptual blindness" is an extreme form of denial. It's a psychological phenomenon where distinctions about the market's behavior that don't correspond with what we want or expect that would otherwise be perceivable, get blocked from our conscious awareness and literally become invisible. I'll give you a hypothetical example to illustrate how easy it is as traders to be susceptible to the potentially devastating effects of "perceptual blindness."

Let's say we have a typical trader who's operating out of the fear of losing and being wrong because he hasn't gone through the process of training his mind to think in probabilities. He's watching the market and the price bars have been making consistently lower highs and lower lows. This is a distinction in the markets behavior that he has learned to recognize and define as a down trend. At the moment, the price is between a previous swing high and swing low. The chart shows that the last two times the price moved down to the swing low it reversed its direction and eventually rallied up to what is now the previous swing high. Our trader has designated the two previous swing lows as significant reference points indicating, that for whatever reason, other traders were willing to "support" that price level by submitting enough buy orders to cause a significant imbalance in the buy/sell order flow ratio in favor of the buyers. Having defined technical support as an edge, he decides that if the market gets down to support (the swing low) again, he's going to be a buyer. That's exactly what happens, the price eventually moves down to support level, where he puts a buy order in the market, and gets filled.

Now, we have to ask ourselves, since he's operating out of a fear of losing and being wrong, what's the likelihood he will go through the process of determining how far the market would have to move below his buy point to tell him that other buyers are probably not coming into the market with enough volume to make his trade a winner? If he's a typical trader he won't go through the process at all, or at least not a level beyond "lip service," where he has genuinely accepted the risk. From his perspective what would be the point, considering he wouldn't have entered the trade in the first place unless he was thoroughly convinced his analysis was correct and that the trade was going to work.

Since he's getting into the trade convinced it's going to work and without knowing where he's going to get out if the price doesn't move in his favor, what do you think his capacity will be to observe price movement objectively? Not good! The degree to which he is committed to this trade working or the degree to which he is expecting this trade to work, is the same degree to which he will lose his ability to perceive price movement from an objective perspective. Or worst-case scenario he experiences "perceptual blindness;" where any distinctions he has learned to make in the markets behavior that would tell him he is in a losing trade will become invisible or unperceivable to him. Here's how critical information can disappear from our conscious awareness when our expectations are not in harmony with the situation we're in.

At the most basic level of awareness the market gives us two polar opposite forms of information for us to evaluate - up tics in the price and down tics in the price. From an objective perspective the up and down tics in the price are neutral in the sense that they just convey information about the imbalance in the buy/sell order flow ratio. Meaning as neutral, the up and down tics are not expressed as positively charged (happy) information or negatively charged (threatening/painful) information. On the other hand, from an un-objective perspective, one that isn't rooted in probabilities or a belief that "anything ***can*** happen," the up and down tics in the price will not be perceived as neutral, unemotionally charged information. The up and down tics will represent information that has the potential to tap us into states of pleasure or emotional pain, depending on whether we are long or short.

The trader in our example is long, so the up tics in the price will represent winning and as a result, tap him into a positively charged, joyful state of mind. No problem, unless his joy crosses the threshold into a state of euphoria. As traders, euphoria is a very dangerous state of mind because it creates a sense of omnipotence where we believe that nothing can go wrong. If nothing can go wrong, there's no risk associated with the trade. If it feels like there's no risk it will make it impossible to objectively consider the implications of any information indicating it's time to take profits; that the winning ride is over or almost over. The down tics, on other hand, are another matter entirely. Since he's operating out of a fear of being wrong and losing the down tics are going to be perceived as threatening and potentially painful if he has to admit he's wrong and take a loss.

So let's say that right after he gets into his trade the price immediately starts moving in his favor. The market is giving him more up tics in the price than down tics, so he feeling pretty good. However, the price hasn't gone far enough in his favor where he is actually contemplating taking any profits. Now, the upward movement in the price slows down, there is a bit of a sell off, then rallies back to the previous swing high and sells off again. But this time it keeps on going lower.

The price is now trading below his entry and falling at an accelerating rate. As the up and down tics are being produced, they are forming into a very symmetrical and orderly downtrend. There are some minor rallies along the way, but otherwise, these up retracements are not violating the symmetry of the trend that is moving against him. He certainly has the ability to recognize a trending market, and he understands negative implications of a market going into a trending mode against a position that's already losing money, but his understanding of a trend and ability to perceive one don't translate into a capability if he's operating out of an intense fear of being wrong and losing. His fears are going to act on his perception of the up and down tics in a way that cause him to create an outcome that is the exact opposite of what he wants and expects.

From his un-objective perspective the market is giving him two polar opposite types of information to consider – pleasurable, represented as the up tics and painful, represented as the down tics. If we take it for granted that he doesn't have any abnormal psychological maladies, if given a choice, he's going to choose to experience pleasure and avoid experiencing pain. The way he can do that is to simply place an inordinate amount of importance or significance on the up tics in relationship to the down tics. In other words, since the up tics give him exactly what he wants, as well as, take him out of his pain every time he has to endure a series of down tics against him, they become very important and assigned a great deal of value. The value that he places on the up tics is so significance in relationship to the down tics that it makes it possible for him to discount, deny or ignore the importance of the fact that the down tics are out numbering the up tics by an average of three or four to one. As a result, he could be looking at a chart that would clearly indicate that market is trending against him and he wouldn't see it.

Our trader may be may be in a state of temporary blindness preventing from seeing that the price is trending against his position, but he won't be able to hide from the fact that he's losing money, not forever. As his potential loss grows, at some point the possibility of losing one more dollar will become so unacceptable or intolerable to him that he'll get out of the trade. And the instant that he does, it will seem like these blinders fall off of his eyes allowing him to perceive what a moment before, was invisible. The significance of the imbalance between the up and down tics will become immediately apparent, causing to him slap himself on the side of his head and say ***"why didn't I just sell."***

Perceptual blindness doesn't just occur when the markets are moving against us. We can also experience it when the price is moving in our favor. The trader in our example bought support and the market started trending against him. Because he was operating out of a fear of losing and being wrong, the up tics made it appear he was right and they also gave him a sense of relief from the pain he experienced when the market generated a series of down tics. As a result, he placed an inordinate amount of significance on the up tics in relationship to the down tics causing the price trend in the opposite direction of his position to disappear from his awareness.

> ***We instinctively avoid pain and in the process of doing so we end up creating the very experiences we are trying to avoid.***

Now, let's reverse the scenario, he buys support like above, but instead of the price moving against his position, the up and down tics form into an orderly, symmetrical trend in his favor. In this situation he is getting exactly what he wanted and expected. So he should be just fine - right? Not quite! Unfortunately, if he's a typical trader he will not only be operating out of the fear of losing and being wrong, he's also going to be afraid of missing out and leaving money on the table. It would be impossible to speculate on price movement and not experience being in several trades where the price moved in our favor, reversed its direction and we end up with nothing or worse, have to take a loss. As a result, it would be difficult not to acquire a fear of "leaving money on the table" or the fear of "missing out" on what could have been if we had taken our profits before the market took our money away.

The market may be giving him exactly what he wants but every down tic represents the possibility that the market is ready to take his profits away. He doesn't want to lose what the market has already given him and since he's afraid that's going to happen, he places an inordinate amount of significance or importance on the down tics in relationship to the up tics. It doesn't matter that the market is trending in his direction and other than some minor retracements, hasn't done anything to indicate, the trend is coming to an end. His fear of missing out and leaving money on the table will cause him to place so much importance on the down tics that the uptrend in his favor becomes invisible and he ends up getting out of the trade long before the trend completes itself. In other words, his fears caused him to create the very experience he was trying to avoid. He was afraid of missing out and leaving money on the table and that's exactly what his fears caused him to experience. If the market goes against him his fear of being wrong and losing will cause him to let his losses run. If the market goes in his favor his fear of missing out and leaving money the table will cause him to cut his profits short.

To be objective we have to eliminate our potential to perceive market information as threatening, so that we're no longer susceptible to illusions, distortions, denial or perceptual blindness. We're not responsible for knowing what the market will do after we make a prediction and get into a trade. How can we ***"know"*** what's going to happen if we don't have access to information that would tell us how many other traders intend to submit orders to the exchange, the size of those orders and whether they're going to buys or sells. However, we are responsible for:

- *the number of distinctions we can make in the market information we do have access to,*
- *the quality of those distinctions and*
- *the degree of objectivity with which we can perceive those distinctions. When the up and down tics in the price or market information in general take on a threatening quality, the source of the threat is our expectations.*

Expectations are what we believe to be true projected out into some future moment. If we stay in the mechanical mode of development until we've genuinely learned to think in probabilities, we will be able accept the possibility of any outcome, because we would be going into every trade with neutral expectations and no opinions. From a probabilistic perspective we will be operating out of a belief that says "anything is possible and we don't know what that anything will be." Believing that anything can happen and that we don't know, will keep our minds open and prepared to see and accept the implications of any particular way the market expresses itself. When we're prepared to see anything we won't need illusions, distortions, denial or increasing levels of pain to force us into acknowledging what the market is telling us about its potential to move in a particular direction.

> *A trader operating out of an objective perspective can make predictions about the direction of the price without any attachment to the outcome.*

Thinking in probabilities turns what would otherwise be an arguable opinion about the direction of the price, into an edge. Remember an edge is a simply guess. Even an edge that's based on a sophisticated analytical process is still nothing more than a guess. Whereas, when we formulate an opinion it is usually based on what we consider to be a knowable fact. Otherwise, there would be nothing to argue about. As screen based traders we don't have access to any facts about the orders other traders intend to submit to the exchange, which means any arguable opinions we come up with are not fact based, but rather based on unverifiable assumptions or illusions, something we have to be making up.

There's nothing we can do to avoid a loss that results from an edge that doesn't work.

But we can definitely avoid losses and missed opportunities to accumulate more profits that are the result of perceiving market information from an un-objective state of mind.

Although trading in the mechanical mode is a perfectly viable way to be successful in this business, the primary purpose for trading mechanically is to:

1) *Limit the number of analytical variables we expose ourselves to so that we can learn to make distinctions in the markets behavior in a manageable, organized and systematic manner.*
2) *Build a foundation of belief based skills that will give a sense of trust that we can perceive the distinctions we have learned to make from an objective state of mind. The losses we experience as a result*

of edges that don't work are normal business expenses that can't be avoided. The losses and the missed opportunities to accumulate profits that are the result of not properly aligning our expectations with how the market functions can be avoided, that is, if we're willing to go through the process of changing the way we think.

3) *Learn to execute our trades flawlessly.*

Purposefully subjecting ourselves to the rules, limitations and the inflexibility of the mechanical mode is not an easy process to go through. The effort we have to expend in order to master the mechanical mode is what makes trading "the hardest easy money we will ever make." The money is only easy after we're learned the appropriate skills. Depending on the beliefs we're acquired before we decided to become a trader and our genetic predisposition with respect to risk tolerance, learning the appropriate skills can turn out to be one of the most challenging educational processes we ever go through.

Understandably most people will want to skip the mechanical mode and go directly into operating out of the subjective mode, where we have the complete freedom to do whatever we want, when we want for whatever reason we want. If we have a choice between freedom and restrictions, we will naturally pick freedom. But in the trading world that freedom will come with a very high price tag if we don't have a resolute sense of self-trust that our perception of market information isn't being altered by fear and as a result, need pain to force is to see what the market is really doing and act in our own best interests.

How you know when you are ready to make the transition from the mechanical to the subjective mode of trading? Ask yourself the following three questions:

1) *Have you learned to make distinctions in the markets behavior so that you can identify high probability edges on a consistent basis?*

2) *Can you do your analysis and make a prediction about the direction of the price without forming an opinion or have a specific*

expectation about what's going to happen?

3) Can you get in or out of your trades without it resonating the slightest bit of negative feelings or emotional discomfort?

If you can't answer yes to all three of these questions, then I would strongly suggest you trade in the mechanical mode until you can.

CHAPTER EIGHTEEN

SUBJECTIVE TRADING

The Subjective Mode: In the mechanical mode we can only take trades where the markets behavior conforms to a fixed set of pre-planned entry and exit rules. Doing anything that deviates from the plan is considered a trading error. Even thinking about not following the plan is a trading error. On the other hand, if and or when we decide to transition into the subjective or discretionary mode, these restrictions no longer apply. Unlike the inflexibility of the mechanical mode where "in the moment" analysis, evaluations, and decisions are not allowed, in the subjective mode we are free to decide and do whatever our “in the moment” analysis of the situation says *“may”* result in an outcome that suites our purpose.

Although trading in the mechanical mode is a perfectly viable way to be successful in this business, the benefit of transitioning to the subjective mode is, we can use the sum total of everything we’ve ever learned about the markets potential to change direction or continue to move in the same direction to generate an entry or exit signal. And then apply that knowledge based on an “in the moment” evaluation of the situation. In other words, trading in the subjective mode we don’t have to wait for the market to conform to a strict set of analytical variables that define a mechanical edge. Meaning, we can plan our trades in advance and then based on our “in the moment” analysis of the market’s behavior change our mind and decide not to execute our plan or do something completely different. We can get into a trade, put a stop and profit objective in the market, and then based on our “in the moment” assessment of the situation decide to change the location of the stop, the profit objective or both.

For example, let’s say the market just produced a pattern that I define as an edge and I decide to take the trade. To determine the risk I will simply ask myself, “where would the market have to be trading to tell me this edge isn’t working or at what point is the risk to reward ratio is so diminished that it isn’t worth spending any more money to find out if the trade is going to work?” I answer these questions based on my understanding of the current market structure and put a stop in the market. After I’ve been in the trade for a while, the market has moved both for and against my position, but not far enough in my direction to reach my profit objective or far enough against me to get stopped out. In the meantime, the market has behaved in a particular way that tells me that my stop is probably too close to my entry and it needs to be moved a little further away. In other words, the markets “in the moment” behavior is indicating that I need to give it more room to see if my trade is going to work than I originally thought when I got into it. By deciding to move my stop further away from my entry, am I committing a trading error? No, not if I’m operating out of a fully functioning belief in probabilities. If that’s the case, I wouldn’t be moving it because I’m afraid of something happening or not happening. I would be moving it based on an objective re-assessment of the situation; which, in turn, prompts me to re-define the parameters of my edge.

There's no guarantee that moving my stop is going to result in a better outcome than if I just left it in its original location. However, for someone who's successfully installed a belief in probabilities, has learned to recognize a substantial number of patterns (edges) and developed a sense that can distinguish between what market behavior is significant and what isn't, making "in the moment" evaluations and decisions ***"can produce"*** far better over-all results than having to wait for the markets behavior to conform to a very specific set of pre-planned entry and exit criteria. I'm going to emphasize the word ***"can"*** because although "in the moment" evaluations has the potential to produce better results, to realize those results on a consistent basis will require learning some very sophisticated self-monitoring skills that aren't required to be successful in the mechanical mode.

WHAT DO I MEAN BY SELF-MONITORING SKILLS?

Before I explain what I mean by self-monitoring skills, I want to point out that it would be perfectly natural to assume that once we've mastered the ability to produce consistent results in the mechanical mode, that achieving consistent results in the subjective mode will be a relatively easy or seem-less transition. Please don't make this assumption, because it's just not the case. As you will see in a moment, there's nothing easy about achieving consistent results when we're evaluating market information and making trading decisions "in the moment." Once we make the transition from pre-planned trades where we are doing our analysis and making our trading decisions in advance, to evaluating the market conditions and making our trading decisions based on our "in the moment," observations, the underlying psychological dynamics of how we produce consistent results changes dramatically and becomes exponentially more difficult.

In the mechanical mode, producing consistent results is a straight forward, precise process because we are dealing with tangible variables that are easy to know. If we get an edge that has a good win/loss, risk to reward ratio over a predetermined series of trades and develop a mind-set that will enable us to execute that edge precisely as it was designed and tested, we will experience whatever degree of consistency that's built into the edge. It's that simple. Not so trading in the subjective mode. In fact, just the opposite is true.

If we start out with the assumption that we wouldn't be in the subjective mode of trading unless we had a solid base of analytical awareness and a fully functioning belief in probabilities, so that we can take advantage of the opportunities we see, free of the fear of being wrong, losing, missing out and leaving money on the table, then the variable that's going to determine whether or not we produce consistent results is our "state of mind." As in, the relative degree of positive or negatively charged energy that's flowing through our consciousness when we're "in the moment" of observing market behavior, making analytical evaluations and decisions about the direction of the price, trade location, risk, position size and profit objective. For example, confidence and fear are "states of mind" that have polar opposite characteristics. A confident state of mind has the quality of being positively charged and gives us a sense of well-being and the freedom to step into an experience. Whereas a fearful "state of mind" is composed of negatively charged energy that has the characteristic of causing us to close up, withdraw, or run from an experience.

When we're trading "in the moment," we need to learn how to monitor our "state of mind," because not all "states of mind" are ideal for observing objectively or processing information in a way that facilitate making the best possible choices and decisions we're capable of. Our best choices of what market information to consider in relationship to what we choose to filter out, our best evaluations of that information, meaning the reasoning process we use to weight the significance of the information we've chosen to evaluate and our best decisions will all arise out of a positively charged state of mind. Positively charged as in, when we're feeling confident, happy, enthusiastic, calm, flexible, and trust ourselves. On the other hand, when we're feeling fearful, angry, agitated, frustrated, dissatisfied, exasperated, revengeful, betrayed, guilty, despondent, depressed or hopeless we tend to make our most un-objective choices of what information to consider and how we weight that information, resulting in a bias evaluation that ultimately results in our least effective decisions about what or what not to do.

If you had a buddy who's been a successful trader for several years and was facing some very difficult personal life issues, causing him to experience varying degrees of emotional trauma or fits of rage, would you encourage him to trade as usual, or would you suggest that he suspend his trading activities until his situation got resolved and he felt better? The answer is obvious, you would suggest that he not trade, because he wouldn't be in a good "state of mind" to make objective evaluations of market information or come to his best decisions about what or what not to do. If your buddy insisted that he was going to trade anyway, despite your advice, would you be concerned that he was setting himself up to do some serious financial damage to himself? The answer again is yes, because if that were not the case, you wouldn't have suggested that he stop trading in the first place.

Remember in Chapter Eleven where I used a situation of a college basketball player who had the opportunity make two free throws and win a national championship to illustrate how any negative or overly positive (euphoric) thoughts flowing through his consciousness could cause him miss one or both shots. From a physical perspective he was perfectly capable of making both baskets because in practice he would routinely make the exact same shot twenty five times in a row. So there was no question he had the physical ability to win the game. But with a national championship in the line, his physical ability was not the only variable that was going to determine whether or not he could take full advantage of his physical potential to make both baskets. Along with his physical skills he's also going to need to be in a clear, confident and positively focused state of mind.

If he's feeling confident, enjoying the opportunity to be in a championship moment and, at the same time, he's able to keep his thoughts positively focused on the steps he would normally take when he's getting ready to take his free-throw, I'm going to say he will make both shots and win the game. If, on the other hand, he starts thinking about the possibility of choking or the negative impact that missing the shots will have on his life, those thoughts will put him into a negatively charged, fearful “state of mind,” where he’ll be focused on “not” missing or not losing the game, instead of being positively focused on the incremental steps he needs to take to win. As a result, I’m going to say that regardless of his physical ability, he will miss at least one, if not both shots.

He could also miss one or both of the shots if he starts celebrating the championship before he actually makes the baskets. He could be so sure he’s going to do it, that he starts thinking about what a hero he’ll be and in the process of imagining the extreme adulation that’s going to be bestowed on him from the rest of the team and fans, that he flips into a euphoric “state of mind.” Euphoria is a “state of mind” where it’s impossible to perceive the possibility of the risk of anything going wrong. However, what can go wrong in this is case is, the intensity of the added, excited energy flowing through his mind, body and specifically his hands can cause enough of a variation in the way the ball leaves his fingertips making the impossible (missing the shot) a reality. In any case, if he doesn’t make the baskets and win the game it won’t be because of a lack of physical ability. It will be because of the impact his “in the moment state of mind” had on his capability to use his physical ability to its fullest potential. In other words, to win, he’s going to have to be in his best “state of mind.”

The exact same psychological variables that have the potential to impact the execution of a physical task also have the potential to affect the execution of a mental task. Each of us has acquired a certain amount of analytical expertise to recognize distinctions in the markets behavior that give us an edge in predicting the direction of the price, make risk assessments and identify profit objectives. The number and quality of the distinctions we’ve learned would represent our maximum potential to identify what may turn out to be profitable trading opportunities. If the basketball player is in a good “state of mind” the moment the ball leaves his fingers tips, he will fulfill one hundred percent of his physical potential and win the game. If we’re in a good “state of mind” in the moment we’re evaluating market information and making trading decisions, we will fulfill one hundred percent of our analytical and decision making potential, whatever that may be.

Now, I'm not implying here that operating out of one hundred percent of our analytical and decision making potential is going to assure us of a winning trade, because as you already know, all trades have probable outcomes. What I am implying is, there's a correlation between our "state of mind" and how objectively we gather information, and how effectively we use our reasoning process to arrive at a decision about what to do. The more positive our state of mind (up to the maximum level of confidence, but below the threshold of euphoria), the more likely we'll have conscious access to the full range of knowledge and insight we've accumulated about the nature and characteristic of price movement, Making it more likely we'll be using our reasoning process at its fullest potential, because it won't be encumbered or diminished by any negative emotions. What we end up with is the best possible decisions and choices we're capable of making for the particular circumstance or situation.

On the other hand, as our "state of mind" diminishes in degrees of positive energy, so does our ability to perceive and appropriately apply what we've learned. Instead of being clear, open and flexible, once we cross the threshold into a negatively charged state of mind we become closed and inflexible. Our capacity to objectively assess the situation diminishes as information and the insight we would otherwise have access too starts getting filtered out or blocked from our consciousness awareness. What we end up with are decisions and choices that represent something less than what we otherwise would be capable of.

We'll know, for a fact that we're capable of doing better because, in hindsight, the analytical expertise we needed to make the most ideal choices about the direction of the price, where to place our stops or take profits, fell within the range of our current capabilities. In other words, what undoubtedly became painfully obvious to us in hindsight could also have been obvious to us "in the moment," but for some seemingly inexplicable reason it wasn't. The best choices and decisions weren't obvious "in the moment" because we had one or a combination of what I call psychological "equity busters" asserting themselves on our "state of mind," causing our observation, evaluation and decisions making skills to be impaired to one degree or another.

Equity Busters

"Equity busters" are the psychological variables that have the potential to negatively impact our performance, making it difficult and for some people nearly impossible, to accumulate profits on a consistent basis. Psychological "equity busters" fall into four broad categories:

1) *emotionally disturbing life circumstances,*
2) *self-sabotaging beliefs,*
3) *personal agendas that sabotage our ability to be objective, and*
4) *euphoria.*

FIRST - Emotionally Disturbing Life Circumstances: Back in the late 1980's I was hired by a prominent clearing/brokerage firm at the Chicago Mercantile Exchange as a trading coach to help their floor traders (locals) work through whatever issues that were causing them to be chronic boom and busters. One day after the close a floor trader named Jim walked into my office and asked if he could talk to me. I didn't know Jim very well because he wasn't one of the chronic boom and busters who would normally show up after the close. What I did know is Jim made a good living as a floor trader, somewhere around $250,000 per year, on a regular basis.

After he sat down, the first thing Jim said was that he just had the worst day he's ever had as a trader. That he wiped out his trading account and would have to go into his saving to re-fund it. He then proceeded to explain to me the way the S&Ps traded that day, who was doing the major buying and selling and where he decided to get in and out. After he went on for a while, I stopped him to ask if anything was going on at home. He looked a little surprised that I would go there and answered, what do you mean? I repeated the question, with a little elaboration, “is there anything going on in your personal life that’s unusual?” He responded with this long drawn out “WELLLL” my wife and I did get into this really bitter argument last night.

I’m not going to get into the details of what they argued about, except to say that it didn’t get resolved. They both went to bed extremely angry and woke up the same way. As he was getting ready to leave for the exchange, they were still screaming at each other. He said that by the time he was ready leave the house he was so pissed off that he started yelling at his kids and to top things off, he kicked his dog on the way out the door. It immediately became apparent to me why Jim had the worst trading day of his otherwise, exceptional trading career. He may have felt perfectly justified screaming at his wife, but there was no way he could reconcile screaming at his five and seven year old kids and kicking his dog, who was probably just following him to the front door to say good-by

Now I want to ask you, as he was on his way to the exchange undoubtedly rehashing everything that happened, do you think it’s possible that, at the very least, he deeply regretted the way he treated his kids and dog. And if he deeply regretted his behavior towards his kids and dog, do you also think it’s possible that by the time he got to the exchange he could have been feeling very guilty over his behavior? In most people’s belief systems, being guilty implies having done something unacceptable or wrong. And depending on the severity of the transgression some sort of punishment is usually justified.

As our conversation got into greater depth, Jim acknowledged that he did feel extremely guilty about the way he treated his kids and dog. I explained to him that his guilt combined with his sense of fairness dictated that he deserved to be punished. And that’s exactly what he did to himself. When he walked into the pit, he may not have known it at a conscious level of awareness, but his agenda that day was not make money, quite the contrary, his agenda was to use his trading to punish himself for his “bad” behavior. How is he going to use his trading to punish himself? Simple, since as a scalper, his reaction time to what he sees as an opportunity is critical component to his success, he found the amount of time it was taking him to react to the recognition of what he defined as an edge, was way off. He was consistently getting beat by other scalpers and as a result, not getting what he considered to be his "best" trades.

> *There are times when not trading can be the equivalent to putting on a winning trade.*

So instead of thinking that it probably wasn't a good day for him to be in the pit and leave, he started making trades that he otherwise would avoid. Low quality trades he defined as marginal, at best. But that's not all, he said felt this compelling, almost irresistible force to take on more size than he would normally trade. Now, I'm not implying that he walked into the pit with the conscious intent to lose, because it was clear from our initial conversation that he had no idea that his guilt was going to impair his judgment in a way that would cause him to make consistently marginal trading decisions and consistently disastrous money management decisions. But that's exactly what he did, and the behavior was completely out of character. Just as I'm sure his behavior towards his kids and dog were completely out of character. What was out of balance in his everyday life caused there to be a corresponding imbalance in his trading life.

At some level of awareness, virtually everyone knows their thoughts and "state of mind" will have an impact on how well they perform an analytical and decision making task, but only the most accomplished and sophisticated traders take this knowing into consideration when it comes to their trading activities. If we're making "in the moment" observations, evaluations and decisions, and experiencing emotionally disturbing life circumstances, or for whatever reason not feeling good about ourselves, ***"not trading is the equivalent to putting money in the bank,"*** because the possibility of our judgment becoming impaired increases proportionally with the degree of negative energy we're experiencing. If you were a professional football, basketball, or baseball player and pulled one of your calf muscles, and could barely walk, much less run would you go to your coach and insist on playing anyway, of course not. In the world of subjective trading, emotionally disturbing life circumstances and situations that we can't immediately reconcile is the performance equivalent of being a professional athlete, pulling a muscle and not being able to play until you're healed.

As subjective traders we have to learn how to recognize when we're not in the best "state of mind" to perform at our highest analytical and decision making potential. This may seem a bit abstract, but it's not as difficult to find out as it may appear on the surface. One technique is to simply ask ourselves before we begin the trading day if we're ready to give ourselves money. After we ask the question, if the first thought that comes to mind is not a resolute "yes" or any other answer that comes to mind doesn't imply or resonate as a genuine "yes," then we should consider not trading or at the very least scale back and trade only our very best set-ups with less size than we would normally trade.

In any case, until we're clear about the relationship between our state of mind and our results, not trading or scaling back could be difficult, because it seem like we're missing out on something. However, quite the opposite is true, we're not missing out on anything if we're going to be making observations, evaluations and decisions from a "state of mind" that's impaired from operating at its fullest potential.

SECOND - Self-Sabotaging Beliefs: Beliefs that have the potential to sabotage our performance will fall into three general categories. 1) Work ethic beliefs. 2) Religious beliefs. 3) Beliefs that determine the extent to which we value ourselves.

> *1.) Work ethic beliefs - For those of you who grew up in a family that had the philosophy of instilling a strong work ethic in their children, trading for a living can set up an active contradiction between your work ethic beliefs about how you earn your money as a speculator. Speculating on price movement just doesn't fall within the traditional definitions of what it means to work for a living. For example, some of your best, most profitable trades could have been completely*

effortless. You could have looked at a chart saw an opportunity, put on a trade and immediately rewarded with profits far beyond what you imagined was possible. It will feel like free money. In other words, within the context of your work ethic beliefs are you really working to earn your money and if not do you deserve to keep it. Based on your conscious intent to make a living as a trader, you will answer the question with a resounding "yes." But would the beliefs you were taught about having to work to earn your income also answer the same way? Probably not! As a result, the conflicting energy will find a way to sabotage your performance.

2.) Religious beliefs - Many religions indoctrinate their followers with very specific beliefs about the appropriate and more importantly the inappropriate ways in which they can make money. Being paid for doing something that doesn't render some sort of worthwhile service in return usually doesn't make the list of appropriate occupations. If you grew up being taught receiving money without providing a worthwhile service in return is wrong or that gambling is evil, then the potential for you to have an active contradiction is very likely when you consider that speculating on price movement is an exercise in extracting money from other peoples trading accounts with no services rendered.

3.) Beliefs that determine how much we value ourselves - If we could inventory every active belief in our mental environment, we would find beliefs that would say that we are an inherently worthy person deserving of happiness, prosperity and success. Possibility beliefs that would say we're not deserving of happiness, prosperity or *success no matter what, and others that would imply that we're not deserving if we violate the principles of a particular moral code or value system.*

If we haven't acquired any beliefs that would flat out state that we're an inherently unworthy person, then the potential for self-sabotage is a constantly changing variable that will be determined how we are living our lives. Jim's experience is a perfect example of what I'm talking about. He didn't have any beliefs that said that he was unworthy of happiness, prosperity or success because didn't have any problem performing at a level that assured himself of an income that he and his family were satisfied and comfortable with. But when his actions violated his own standards of what he believed to be correct behavior by verbally beating up on his kids and physically beating up on his dog, he was no longer worthy of happiness, prosperity and success. He expressed that degree of unworthiness by performing at a level that caused him to experience his worst day as a trader.

THIRD - Trading For Reasons That Sabotage Our Ability To Be Objective: To make objective "in the moment" observations and evaluations of the markets potential to move in a particular direction, we have to be genuinely open to observe anything and everything we're capable of perceiving, as well as, be completely detached from the outcome of our predictions. In other words, our perceptual filters have to be wide open and it can't matter what the market does after we make a prediction and get into a trade. Most people never reach this level of objectivity, even when they're not encumbered with emotionally disturbing life circumstances or have any self-sabotaging beliefs, because most of us have the tendency to factor into our observations and analysis non-relevant, extraneous reasons or agendas for getting into or out of a trade. Reasons and agendas that rarely, if ever, have any relationship with what the market is telling us about its potential to move.

I am going to list a few of typical non-relevant, extraneous agendas we have a tendency to factor into our observations and evaluations of market information and you decide if they contribute or detract from your ability to be objective.

- *I want a big winner or make a killing.*
- *I want to prove to myself, my family or my friends I can do this.*
- *I want to show people I'm a risk taker.*
- *I like being hero.*
- *I need to get my money back.*
- *I can't miss out on any more opportunities.*
- *I want to prove to myself by showing others how smart I am.*

Objectivity requires an open mind, where we are making ourselves available to perceive the various possibilities for movement from the markets perspective. In other words, the behavior the market is expressing, in any given moment, indicating its potential to move, doesn't have anything to do with our personal desire to make a killing, prove something, be a hero, get our money back, not miss any more opportunities or make it look like we're smart. Personal agendas are equity busters because they create perceptual filters that will cause us to observe and evaluate market information in a way that, to one degree or another, satisfies the priorities of the agenda.

If there's no relationship between what the market is expressing as its potential to move and our personal agendas, then to whatever degree we are factoring our agendas into our observations and evaluations, is the same degree to which we will be "out of touch with what the market is telling us." Being out of touch with the market doesn't necessarily mean we won't win, because we can experience a winning trade regardless of how or why we get into it. But being out of touch certainly increases the likelihood we'll place too much significance on information that doesn't warrant it, or too little significance on information that does, causing us to get into less than ideal trades, or pick less than ideal places to put our stops or take our profits. Eventually, the personal agendas that we factor into our trading will take its toll on our bottom line results. The only agendas we should be factoring into our trading is to be detached as possible from our results, so that we can make the clearest observations and best evaluations we're capable of.

FORTH - Euphoria: Euphoria is an equity buster because it's a state of mind that makes it impossible to perceive the risk of anything happening other than what we want or expect. As I've said many times throughout this book, as traders speculating on price movement, from the markets perspective the risk always exists, it never goes away. On the other hand, from our individual perspective, once we've crossed the threshold into euphoria "nothing can go wrong." Obviously there's a huge reality gap between "nothing can go wrong" and "anything can happen," making euphoria an extremely dangerous state of mind to be in while we're interacting with the markets.

The problem with being in euphoria is, it's the least likely time that it will occur to us to stop trading and enjoy this very special "state of mind" doing something else. Developing the awareness and discipline we need to recognize we've crossed the line from normal confidence into euphoria and then be able to step away, are very sophisticated skills that are, for the most part person specific. Meaning I don't have a generic, one size fits all technique to teach traders how to recognize when they're euphoric, much less develop the discipline to stop trading. These are the type of skills that need to be designed to conform to each individual's unique mental ecology.

Summary

Before we go any further there are several key points and important insights about mechanical and subjective trading that I want to make sure you understand.

ONE: The subjective mode will give us the "in the moment" flexibility to utilize the best of our analytical capabilities. However, the extent to which we actually perform at our best will be determined by our "state of mind," or how good we feel about ourselves when we're evaluating market information and making our trading decisions. If we're in a good state of mind without any reason to feel guilty or unworthy of winning, then we will just find ourselves making what turn out to be our best possible choices about what to trade, where to place our orders, where to place our stops, the size of our position and where or when we take profits. In other words, if our life is running smoothly, that sense of well-being will be reflected in the quality of the choices we make when we're interacting with the markets. On the other hand, if we're not feeling good about ourselves, have reasons to feel guilty, unworthy or some other equity busting force is asserting itself on the observation, evaluation and decision making process, then our performance will be suffer, most likely, in proportion to how degraded our state of mind is. In hindsight, we'll find that the quality of choices we made did not reflect the best of what we were capable of.

TWO: If, a) we're not aware of the correlation between our state of mind and the quality of our "in the moment" choices, b) haven't developed the self-awareness skills to detect when our state of mind is diminished or diminishing in quality, and c) can't stop ourselves from trading even if we do recognize we're not in best state of mind to be interacting with the market, then we will be susceptible to losses or drawdowns that exceed our analytical capabilities. In other words, we could be a phenomenal analyst who's accumulated a vast repertoire of edges and insight into how other traders think and what they are likely to do under certain circumstances and conditions, as well as, be able to put on our trades on without the slightest bit of fear. But if we don't have a handle on the mental performance component of trading subjectively, we may find it very difficult to produce consistent results, or at the very least produce results that consistently reflect our analytical capabilities.

THREE: If you've ever read about or heard professional traders refer to subjective or discretionary trading as "the ultimate mental sport" and didn't know what they were talking about, now you do. If you've also read about or heard professional traders talk about journaling their thoughts and learning how to mediate and didn't understand what possible connection journaling and mediating had to do with trading, now you do. But just in case you don't, journaling our thoughts will make the relationship between our state of mind and the quality of our choices more tangible and easier to measure. And certain types of mediation will build a framework enabling us to become aware of our stream of thoughts as we're thinking them. The purpose is to eventually get to the point where we become an objective observer to our own thoughts, so that we can get let go of the ones that don't facilitate our intent and consciously choose to think thoughts that do. In other words, learning how to mediate will make it easier to keep our mind positively focused on our objective.

FOUR: If you're getting the impression that producing consistent results trading in the subjective mode is a daunting task, well your impression would be absolutely correct. In any given moment there's an unlimited combination of analytical variables that we can chose to take into consideration to decide what to do and how to do it. Add to the unlimited combination of analytical variables all the equity busting psychological variables that have the potential to negatively impact how we process what we choose into a trading decision and what we have is a situation that is far and away beyond the capability of all but the most skilled traders to manage successful on a consistent basis.

I've lost count of the number professionals (specifically discretionary hedge fund managers), I've worked with over the years, who by industry standards were considered successful traders, but at the same time couldn't produce results that were remotely close to their analytical potential. The reason – they were still susceptible psychologically induced drawdowns from one or more of the equity busters and didn't have the self-awareness skills to know "***when not to trade***" or when to compensate by scaling back their activities and position size in proportion to the quality of their "state of mind." As far as I'm concerned, anyone trading subjectively who can produce consistent results beyond industry standards, or something close to their analytical potential, will only be able to do so because their functioning at a level of psychological development that's equivalent to a world class championship athlete.

FIVE: *It's a lot easier to assure ourselves of producing consistent results if we trade mechanically, or at the very least pre-plan all of our trades with a resolute commitment to execute the plan as designed*.

We don't need to be operating out of a high level of objectivity, nor do we need any sophisticated self-awareness skills to produce consistent results in the mechanical mode of trading. Everyone enjoys having the freedom to do whatever we want for whatever reason we want, which is what the subjective mode of trading represents. However, the freedom the subjective mode affords us has a serious downside of making it extremely difficult to produce consistent results. That is, if we're not willing to develop the corresponding psychological skills that can tell us we're getting in our own way or better yet, we're about to get into our own way. In the mechanical mode, we don't have the freedom to do what we want when we want, but the benefits of trading mechanically more than compensate for the freedom we're giving up, if we choose ***"not"*** to trade subjectively.

In the subjective mode producing consistent results is a function our level of our analytical expertise in relationship to how well we can apply that expertise "in the moment. How well we apply our analysis in any given moment is a function of the quality of our "state of mind." The more positive our "state of mind" is, up to but not crossing the threshold into euphoria, the more objectively we will observe, evaluate and process market information into choices that represent the best of what we're are capable of. However, we're not always going to be in the best "state of mind" to be objective, causing us process information into choices that do not reflect the best of what we are capable of. Choices that usually result in losses we otherwise wouldn't have experienced or profits that we otherwise would have booked, but didn't. Since, in the subjective mode the ability to effectively use our analytical expertise is a function of the quality of our state of mind, then learning how to recognize and compensate when some equity busting energy is asserting itself, will be just as important of a factor in determining if we produce consistent results, as how good our analysis is.

Trading mechanically or preplanning our trades minimizes the “in the moment” mental performance factor. In the mechanical mode, we just need enough “in the moment” objectivity to determine if the markets behavior has conformed to the precise criteria that defines our edge. It’s a simple yes or no question that doesn’t require a great deal objectivity on our part to answer it correctly. If the answer is yes, we already know exactly what we need to do with respect to our position size, the direction or our entry, where to place our stop, and what our profit objective is, because all of these variables were decided upon when we devised our trading plan. Otherwise, there’s nothing “in the moment” we have to consider, weigh, judge or think about. As a result, the quality of our “state of mind” isn’t anywhere near as important of a factor in determining our results as it is in the subjective mode, unless we’re experiencing some difficulty executing. If we have an edge with a consistently good win/loss/, risk to reward ratio and we can execute that edge according to the rules of the plan, we will experience the level of consistency that’s built into the edge.

I’ll give you an analogy to illustrate the difference in difficulty between producing consistent results in the mechanical mode compared to the subjective mode of trading. Imagine a situation where you’re the designated field goal kicker on a professional football team. You’re in a regular season game late in the fourth quarter and your team is ahead by three touchdowns. Unless your team has a complete defensive meltdown, for all intents and purposes the game is already won. However, your team has the ball on your opponent’s five yard line, but it’s also fourth down. So instead of going for another touchdown, your coach decides he wants you to kick a field goal. Kicking a five yard field goal with only a few minutes left on the clock and your team is already ahead by three touchdowns is about as easy of a situation as a field goal kicker could ask for. A professional kicker, even a one considered by professional standards to be mediocre, would not find it difficult to make a successful kick and do it several times in a row without any problem.

Now let's say your team is in a divisional championship game. If you win, you go to the Super Bowl. However, in this case, there's only a few seconds left in the game, the ball is on the opponent's forty five yard line and you're losing by one point. With only a few seconds, left your coach has a choice of running one more play to try and get a forty five yard touchdown for six points, or have you kick a fifty five yard goal for three points. He decides the best shot at winning the game would be to have you kick a field goal. Obviously this is a high pressure situation. Making a fifty five field goal is doable but not easy under any circumstances. Add a trip to the Super Bowl riding on the outcome and it becomes exponentially more difficult. To be successful you're going to have to operating out of your peak physical and psychological potential.

Whether or not you have everything lined up to successfully kick this field goal in this particular instance is not what's important about this analogy. What's important for you to understand is that producing consistent results in the subjective mode is the equivalent of having to kick this field goal two or three times a day or week, depending on how often you make "in the moment" evaluations and decisions before you put on a trade. Considering that we're not always going to be in the best "state of mind" to be objective, without the self-awareness skills to recognize when we're not, it's little wonder why it can be so difficult to produce consistent results. On the other hand, if kicking the five yard field goal with virtually nothing at stake represents trading in the mechanical mode, you could kick a five yard field goal ten times a day if you had too because you don't need to be in an almost perfect "state of mind" to do it.

If we're good analysts there's no question that from an analytical perspective, we can usually get better results on any particular individual trade making discretionary "in the moment" evaluations and decisions. However, from a psychological perspective it's exponentially easier to produce consistent, more reliable results trading mechanically. "Plan your trades and trade your plan." This is a gem of trading wisdom you will hear a lot, with good reason. If you're not ready to develop the mind-set of a world class championship athlete, then I would strongly suggest you trade in the mechanical mode or at the very least pre-plan all of your trading decisions with a resolute commitment to trade the plan as you designed it.

Chapter Nineteen

Intuitive Trading

I'm going to give you what I consider to be a really good example of a trading decision that was based on an intuitive feeling or impulse. Back in the early 1990's I was trading with a coaching client named Mike. I would describe our approach to the markets as long term swing trading. We were looking for patterns on higher timeframe charts that gave us an indication of a relatively big or sustained move.

I don't remember exactly when or at what price, but we sold thirty future contracts in the 30 year Treasury bond market at what we defined as long term resistance. To define the risk we asked ourselves, what's possible, how probable is it and how much are we going to have to risk to find out. Although we didn't know how likely it was, we decided it was certainly possible the market could break out to the upside of the resistance level we intended to sell at and if that happened trade up to and test the next resistance level. However, as long as, the market didn't break through this next resistance level it would still conform to our definition of a viable trade. That next resistance level was a little less than one full bond point away from our entry. So we put our stop exactly one point above our entry price. One full bond point in the 30 year treasuries is 32 tics. Each tic is worth $31.25. Since we sold 30 contracts, we were risking $30,000 to find out if this trade was going to work.

After we got into the trade the market bounced around our entry price a bit and then not to long afterward broke out to the up side. It took three or four days, but the price eventually traded up too that next resistance level and got within 4 tics of where we had our stop. In the following week the market went into a trading range, where the upper end of the range was about 4 tics below our stop and the lower end of the range was about 15 tics above our entry point. In that week the market tested the upper end of the range three or four times which means we came within 4 tics of getting stopped out of the trade for a $30,000 loss.

Now, it's Friday morning at the end of the second week of being under water in this trade. I got to the office my usual time, about an hour before the open, but Mike was going to be late because he had some appointment. I don't remember what it was for. As I'm looking at charts of other markets, this feeling hit me that I should move our stop 1 tic higher. There was no reason that I could think of to justify why I should move our stop and risk an additional $1,000 on this trade. I just ***"felt"*** like it was something that needed to be done, so I did it. This may sound strange to many of you that I just went ahead and moved the stop without having any rational reason to justify my actions. But by that point in time, I had been working on cultivating an ability to act on my intuitive impulses or hunches for several years.

On other hand, I can say without a shred of doubt that if Mike didn't have an appointment that morning there's no way he would have agreed to risk another $1,000 on a trade that had been under water virtually from the moment we got into it. And he especially wouldn't have agreed to do it based on a feeling I had, with no tangible evidence (chart pattern or otherwise) to support why we should possibly spend another $1,000 to see if the trade was going to work.

Well, you've probably already guessed what happened. The market opened that Friday morning and rallied right up to the price where we had our original stop, and then reversed its direction and dropped like a rock almost two full points by the close. By the time Mike strolled into the office we had already recovered all of our losses and showing approximately a $10,000 profit. I didn't mention that I moved the stop, but eventually he noticed that high of the day was where our stop was and wondered why we didn't stopped out. I told him I had a feeling it needed to be moved 1 tic further away. Considering that we had a $40,000 equity swing in our favor, he didn't seem to mind that I risked an extra $1,000 based on a feeling or a hunch.

Do we have more than the sense of sight, sound, taste, smell and touch in which to navigate the environment? I believe that all of us have access to a non-rational, creative based "sense of knowing" that will percolate up to a conscious level of awareness in the form of a feeling or a hunch. Over the years I worked with several traders who had a strong intuitive connection to the markets. But generally speaking I would say that most traders are not in touch with their intuitive capabilities even if they believe that receiving intuitively based information is possible. And of course, there are those who don't believe in the existence of intuition at all. By providing you with an explanation about the nature of intuition, I am not in any way implying that you need to be intuitive to be successful in this business, because you don't. However, as you learn to become less attached to the outcome of your trades and better at operating out of an objective, care-free state of mind, it's very likely there will be moments when you find yourself in complete sync or harmony with the collective consciousness of the market.

When your mind is in sync with the market, it will feel like there's no separation between you and everyone else who's participating in that market. This feeling of oneness can result in an intuitive "sense of knowing" about what other traders intend to do and how their collective actions will impact the direction of the price. A good analogy to being tapped into the collective consciousness of the market is a flock of birds or school of fish who have to linked to one another in some invisible way that enables them to all change direction simultaneously, as if they were operating out of the same mind. A trader who's tapped into the collective consciousness of the market can anticipate a change in direction in the price as if he were a bird in the middle of a flock or a fish in the middle of a school.

Intuitive feelings or hunches can make a huge difference on your bottom line results. But there is a challenge. If you do start tapping into intuitively based information and don't have a framework for understanding what's going on, it's very easy to unknowingly sabotage it in a way that will make it extremely difficult to ever trust it. You don't want that to happen. So my explanation, although brief compared to vastness of the topic, is meant to help you avoid some of the more common pitfalls that can ruin your ability to act on your intuition.

It's easier to understand intuition if you understand the creative process first.

Intuition is a "sense of knowing" that comes to us in the form of a feeling or a hunch. These feelings or hunches are ***"creative"*** in nature, because they represent information or insight about a situation or circumstance that transcends our current base of knowledge or any conclusion we would come too using a logical or rational reasoning process. For instance, in the above example where I moved the stop one tic, there wasn't anything in my current base of knowledge that would have told me that I needed to move that stop. Quite the contrary, based on the markets behavior up to the point, if anything, I would have argued there was a very strong likelihood the market would break out of the resistance to the upside and blow right through our stop. So from a rational or logical perspective, moving the stop would have been a waste of money.

Creativity brings forth something that didn't previously exist. Any thought, idea or imagining that transcends the boundaries of what we would otherwise claim or argue is true or real would, by definition, be creative in nature. The idea to move the stop was creative, because it didn't come from a rational, logical thought process. I didn't willfully choose to think about the possibility of moving it. The idea came to me spontaneously. We know it's possible to receive inspiring ideas, as well as choose, with conscious intent, to think outside of the boundaries that define our current beliefs. If it wasn't possible to get inspiring ideas or willfully think beyond our current beliefs, we would still be living as our distant ancestors did thousands of years ago. The evolution of technology is a perfect example of our ability to think creatively. Many of the technological devices that are such an essential part of the way we live our lives today were, not long ago, considered inventions that didn't exist anywhere on earth except in some persons mind as a creative thought.

Where Does Creative InformationCome From?

I don't know if there's a generally accepted theory among artists, writers, inventors, scientists, engineers or the academic community that explains where intuitive feelings or creative, innovative or inspired ideas come from. So the answer I'm going to give you is based on the conclusions I've come to about the creative process from writing three books, several workshops, numerous presentations, and studying spiritual principles from a Metaphysical perspective for approximately 35 years.

I personally believe that when we intentionally engage in the creative process or we spontaneously get information or insight that transcends the boundaries of our current level of awareness or understanding that what we are receiving is coming from what some people have referred to as "The Universal Mind" or what I am going to say is the "Mind Of God." I believe that all of the information and insight humanity needs to continue to grow and evolve beyond our current level of development is already available and waiting to be accessed in the "Mind of God." You could say, the "Mind of God" is the ultimate internet.

How I Inadvertently Discovered The Creative Process

If you'll recall from Chapter Eleven within a year of moving to Chicago to fulfill my dream of becoming a successful trader, my fear of losing and being wrong essentially drove me into bankruptcy. That was in March of 1982. Losing my house in Michigan, my Porsche, my trading account and flawless credit (I was obsessed with having pristine credit) taught me a lot about myself and, of course, trading.

After going through a period where I was forced to deal with this huge change in my life, something really interesting started happening. I was experiencing what I would have considered to me my worst fears, but once everything was really gone there wasn't anything to be afraid of any longer. In other words, all of the fear and the stress associated with trying to prevent those fears from manifesting just went away. As the fear and stress dissipated, I started coming to the realization that my identity consisted of far more than my possessions and having flawless credit. I was also overcome with this sense that I was going to be just fine. I had my health and my ability to think. And one of the things I was thinking is that being wrong didn't diminish me as a person. I was learning there was a certain freedom in granting myself permission to be wrong. And furthermore there was no such thing as failure, unless something positive and useful isn't learned from an experience. What made many of these realizations possible, especially so quickly, is I was in a unique situation that allowed me to experience what it was like to trade without being debilitated with fear. Here's what I mean.

Normally when you lose everything, it might be a long time before you can start trading again, considering the financial requirements. However, as long as still had my job at Merrill, I could stay connected to the markets and continue to trade for my customers. Fortunately, I was able to go through the bankruptcy and keep my job, because I had two legal residences, one in Michigan and one in Illinois. So I had my choice as to where I filed. If I filed in Illinois there was a good possibility that the management at Merrill Lynch would find out and probably fire me. On the other hand, if I filed in Michigan it was likely no would find out and I would be able to keep my job as a broker. So naturally I filed in Michigan and to my knowledge no one in Chicago found out.

Once I was free of my fear of losing, being wrong and stopped trying to avoid the unavoidable, I started seeing and experiencing a different market. It appeared as if the market was different in the sense that it was much easier to read, but the reality was I was different, because I was operating out of a new perspective. It was as if someone had taken these blinders off of my eyes that I didn't know were there. Once the blinders were gone many of the moves the market was telegraphing were very easy to see and act on.

By June of 1982 I was making consistent money for my customers who relied on my recommendations for their trades. I was having winning days, that were turning into winning weeks and months. The transformation from who I was before I lost everything to who I became afterwards had such a profound effect on my ability to observe objectively and execute appropriately that by August of 1982 I felt compelled to write a book or at the very least a seminar on the psychology of trading. I believed that if the material I produced gave traders enough clarity about the nature of the business and why they may have to change the way they think to be successful at it, there was a good possibility they would choose to step into a process of transformation at their own conscious direction, instead of being forced to change through pain. I was hoping that I could turn what I had learned into something that could genuinely help other traders understand they can fulfill their dreams of being successful, as long as, they're open to the idea that the way to go about doing it may be very different than what they assumed it would be.

I was really excited about doing the project because in 1982 there was very little insight available about the psychology of trading. To my knowledge, only one book had been written on the topic and that was Jake Bernstein's "Investor Quotient" published by Wiley and Sons in 1980. Back then, ones "state of mind" was not recognized, either by the trading community in general or the academic community as having a role in ones results, except in extreme cases where someone blows up their account in a dramatic fashion. Almost everyone believed that success was ***strictly and solely*** a function of good analysis. As a result, you could go to college and get a degree in finance, but not behavioral finance, because courses in behavioral finance did not exist.

I had what I believed to be a very good idea. The challenge, how was I going to turn that idea into a reality? Other than my enthusiasm, I didn't have much going for me. First, I didn't have a background in psychology. In college I started out majoring in political science and changed it to communications because in political science you needed two years of a foreign language to graduate. I tried, but I just wasn't into learning another language. Second, I didn't have the slightest idea how to write a book in general or more specifically how to write a book on the psychological of trading. Other than some free-flow journal work, my writing experiences were very limited. If a professor announced at the beginning of a class that a term paper was a requirement, I would drop the class. Third, except for Jake's book, there wasn't any reference material available and I didn't intend to refer to Jake's book. The material really wasn't suitable for what I was trying to accomplish. Jake wrote "The Investors Quotient" from a clinical psychological perspective. By 1982 I had already been studying Metaphysics for several years and felt that the reader would best be served if I wrote the book from a more spiritual perspective, without making it obvious that's what I was doing.

Considering that:

- *I didn't have a background in psychology,*
- *I didn't know how to write a book and*
- *I didn't have any reference material to draw from, and it would appear as if I was severely lacking the appropriate resources to step into this project. From a rational perspective this assessment would be correct.*

However, from a creative perspective, everything I didn't have turned out to be a blessing.

The benefit of not having a background in psychology meant my mind wasn't indoctrinated by the academic community to think about what I was attempting to do in a particular way. In other words, I was free to go in any direction that made sense or resonated as something that would work, without having to deal with the restrictions imposed by what someone else may have taught me.

The benefits of not having any idea how to write a book were considerable. Knowing that I didn't know how to do it, or what information needed to be in the book to accomplish my objectives, meant that I had no preconceived notions about how the book was going to unfold. Not knowing how the book was going to unfold left me free to just start writing down ideas. So that's what I did, I started writing down any idea that related to either the psychology of trading or how to teach the psychology of trading that popped into my consciousness awareness. It didn't matter where I was or what I was otherwise doing, if I got an idea I stopped and wrote it down, uncensored and without consideration to grammar, punctuation, or spelling .What I mean by uncensored is, I didn't make any evaluations or judgments about the validity of whatever it was I was writing down. The only rule I had was to make sure my handwriting was legible enough for me to be able re-read what I had written.

The free-flow ideas I was accumulating started generating a lot questions that I didn't have answers too. Since there wasn't any resource material available, I didn't have any place to go to get those questions answered. What I found is that I didn't have to go anywhere, all I had to do was ask and the answers to my questions would just come to me. In today's world what happened would be the equivalent of data being downloaded to a computer from somewhere on the internet. Everyone has probably read or heard the saying "necessity is the mother of all invention." Well, you could say that my need for insight about the psychology of trading inadvertently taught me how to use the creative process to tap into the "Universal Mind" or the "Mind of God," and get the answers I needed to satisfy the objectives of the book. Here's how it happened.

I would ask a question or sometimes I would put a question at the top of a piece of paper and eventually information relating to the answer would start flowing into my brain. Sometimes the information would come right away, but not very often, most of the time it took a day or two. When the answers did come, again I would stop whatever I was doing and write them all out immediately. Since the answers were always something I didn't have any previous awareness of, I found that if I didn't get the words on paper right away they had tendency to evaporate and I would lose them. I was very conscientious about making sure that didn't happen. I would estimate that as much as ninety percent of the ideas, concepts and the particular way in which they were presented in "The Disciplined Trader" came from utilizing the creative process. In other words, as little as ten percent of the material reflected what I knew and understood about the psychology of trading before I started writing the book.

Another blessing from not knowing how to write a book was, I didn't have a frame of reference to make a realistic assessment as to how complex the issues were, how difficult it was going to be to explain them and, as a result, how long it was going to take me to do it. Somehow very early on in the process I got in my head that I could get it done in six months. I added another three months just to be on the safe side. This was an illusion, in reality it took me eight years to write "The Disciplined Trader." However, at any given point during that eight year period, if you asked me when I would be done with the book, I would have responded six or nine months. I had myself completely convinced I was always only six or nine months away from pulling it all together. This illusion turned out to be a blessing, because if I had way of knowing for sure it was going to take me eight years, I have some very serious doubts I would have stepped into the project or ever completed it.

Why did the process take so long? There were several reasons. I brought forth a lot of really good material that I was anxious to get into a finished format. Although some of the material was in a word processing program, much of it was on assorted napkins from the restaurant I was at when an answer came to me, legal pads or random scraps of paper. None of it was in finished form with respect to sentence structure, grammar, punctuation and most importantly context. What I had was over a thousand pages of ideas that I believed would fit together in way that would give the book continuity, but I accumulated these ideas in random order. Putting them into a sequence that best facilitated the objectives of the book was by far the most challenging thing I had ever attempted to do in my life. To say it extremely difficult and time consuming would be a huge understatement. As a side note, I signed a publishing contract with the New York Institute of Finance, the financial book division for Simon and Schuster in August of 1987, where I agreed to deliver a finished manuscript six months later in February of 1988. They didn't get the manuscript until December of 1989, two and a half years after I signed the contract.

As a result, of my studies in Metaphysics and experiences writing "The Disciplined Trader™," I acquired a belief that an answer to every possible question already exists and a solution to every possible problem already exists in the "Mind of God" or "Universal Mind." The key to accessing the answers to our questions, or an innovative solution to a problem is to ask a question that creates what I call a mental vacuum. A vacuum is a completely empty space. A mental vacuum is an open space in our mind that's ready to be filled with information, insight, innovative ideas or inspiration. All we have to do to get that information, insight, innovative ideas or inspiration is to ask with a genuine open mind. For example, "The Disciplined Trader™" came into existence not because of what I knew about the psychology of trading, but rather what I didn't know. When I asked questions, they weren't what I call lip service questions. A lip service question is not really a question. It's a statement in the form of a question where we are looking for confirmation of what we already believe to be true or want to be true. Genuine questions coming from a perspective of not knowing create a space for the "Universe" to fill with an answer that's going to be unique to the person answering the question. Think of it this way, if a person already knows the answer or thinks he knows the answer, then there's no point in a asking a question in the first place.

A really good way to use the creative process as traders is to ask for ideas on how to improve the results of our mechanical trading system. Remember after twenty five trades you can change any of the variables that you want.

Ask if there's a way to change the parameters of your variables to improve your results and then let it go. Meaning, don't dwell on the question or try in any way to force an answer. Just go about your business and eventually ideas on how to improve your results will pop into your mind.

Intuition

Intuition is a more spontaneous form of creativity. We can use various techniques to access information that's creative in nature, whereas the feelings and hunches that represent intuitive insight can come to us at any time, under any circumstance or situation without having asked for the insight or information. I look at an intuitive feeling or hunch as a gift from God.

However, since intuitive information isn't coming from what we know or can be verified as true through some logical reasoning process, the part of us that needs to know can make it very difficult to act on it. The normal reaction would be to question the veracity of what we're feeling and argue against it or just dismiss it entirely. To act on our intuition we have to learn how to trust it. Now you might assume that once we come to the realization of how accurate these illogical feelings or hunches can be, that they would be easy to trust.

Here's the challenge.

Genuine intuition is usually, if not always, going to be in conflict with what we would say that we know.

Without the trust we need to reconcile the conflict, what we know will always prevail causing us ***"not"*** to take advantage of the opportunity our intuition is giving us. As a result, we end up experiencing regret over what could have been. Some of the intuitive outcomes we dismiss or talk ourselves out of experiencing can be quite significant. As a way to make-up for what we missed or prevent ourselves from having another experience of regret, sometimes our rational mind will take it upon itself to create what I call counterfeit intuition. In other words, our rational mind can duplicate the feeling of intuition, making it seem as if we are getting a genuine feeling or hunch, but these feelings or hunches are not based on creative information, they're something our rational mind is making up. Since it is not real intuition, we will find it much easier, if not compelling to act on these counterfeit feelings. When we do and don't get the expected results, we'll naturally be disappointed and probably feel betrayed. Once we've been betrayed by what we assumed was genuine intuition, it can be very difficult to develop the trust you need to act on it in the future.

We don't want that to happen.

However, learning how to trust our intuition at a rational level of thinking is a process that goes way beyond the scope of this book. So I'm not going any further with an explanation, at least not in book form. What I do plan on doing, however, is to make myself available in an online chat-room format or do some workshops to answer questions about the book in general, as well as the nature of intuition. By addressing questions live, I can do my best to formulate an answer that's most consistent with the mental ecology of the person asking the question. In other words, I want to be able to answer a question within the context of the belief system of the person who's asking the question, so there's less potential for misunderstanding or confusion. In the meantime, if you do have a tendency to get intuitive feelings or hunches about the direction of the price I suggest you acknowledge the feeling or hunch and write it down, but otherwise, trade the way you normally would.

CLOSING

In closing I would like to say a few words about why I wrote a third book on the psychology of trading. As I have already explained in the beginning of this chapter I wrote "The Disciplined Trader™" because I wanted to share what I learned as a result of my personal trading experiences and in doing so add to the almost non-existent body of work (one book) that focused exclusively on psychology as it related to trading.

About four years after “The Disciplined Trader™” was published I started writing “Trading in the Zone. ™” One of the reasons why I started a new book is because I had a lot of good material left over from the “The Disciplined Trader™” that didn’t get into the book. The main reason however, is what I learned about how to teach the psychology of trading grew exponentially in the four years after “The Disciplined Trader™” come out. I worked with a lot of traders in the capacity of a coach, and just like when I was writing “The Disciplined Trader™” if in the course of my coaching I heard myself speaking a new concept or a concept in a way that made it easier to understand, I diligently wrote it down. As my collection of notes grew, so did my compellingness to write the next book. “Trading In The Zone™” was also published by The New York Institute of Finance in December of 2000. At that time, however, The New York Institute of Finance was a division of Prentice Hall Press.

In the spring of 2007 I was contacted by a very large and popular trading organization to speak at their annual conference. They were expecting over 5,000 people in attendance. I said I was open to the doing it, but before I said yes I wanted to attend one or more of their user group meetings in the Phoenix area. This company claimed they had an excellent trading platform that consistently gave profitable trading signals in multiple time frames and just as importantly they went above and beyond the call of duty in the area of customer service. Basically before I said yes to doing a presentation, I wanted to see how true their claims were by taking to as many of their customers as possible.

There were about a hundred and fifty people at the user group I attended, without any company representative. There wasn’t anyone who had anything negative to say about the platform, the signals or the customer service. In fact, just opposite was true, everyone there seemed to hold the company in very high esteem. They thought the platform was easy to use, the buy and sell signals had a very good win/loss ratio and customer service was a good as the company claimed it was. However, very few, if any, of the people at the meeting were making any money. These people were not hard core traders. Almost all, if not all of them had other careers and trading was basically a hobby they wanted to turn into a career.

I wasn't at the meeting very long before it became evident that for the most part the group was clueless about how to be successful as traders, even though most of them said they had read both "Trading in the Zone™" and "The Disciplined Trader. ™" There were a lot of really nice people in that room who were very enthusiastic and trying very hard, but there was so much they didn't understand about the nature of the business. And even though the insight in my books certainly had the potential to fill in the gaps, it was unlikely that was going to happen considering neither book was written with the expectation they would be read or understood by novice traders.

In 1994 when I started writing "Trading In The Zone™" the industry was still completely fixated on the idea that more or better analysis was the only solution for any difficulty a trader may encounter. Someone new coming into the business was usually so thoroughly indoctrinated by the industry that analysis was the key to everything, that it usually took three to five years of frustration before someone came to the realization there had to be something missing in their approach, which then prompted them to seek out solutions in the area of psychology. Here I had a situation I never anticipated when I was writing "The Disciplined Trader™" or "Trading in the Zone,™" they were actually being read by novice traders. What I didn't foresee in 1994 was the internet or how much it would change our world.

By the year 2000 when "Trading in the Zone™" came out, the internet was growing by leaps and bounds with the proliferation electronic trading platforms, chat-rooms, and webinars. And don't forget the trading infomercials on late night TV attracting all kinds of people into the business who otherwise may never have considered doing it. I was really surprised to find out that many chat-room leaders and webinar presenters were recommending, if not insisting their audience at the very least read "Trading in the Zone.™" So here I had a room full of novice traders who read my books but still couldn't properly relate to the insight in a way that facilitated their success.

At some point during the meeting I decided that I needed to write a book for the novice trader and do it in a way where they could immediately understand why they needed to develop certain mental skills before they would be able to use their analysis without getting in their own way. Then something really interesting happened. The moment I locked the idea into my psyche that I was going to do this book, I had an epiphany that hit me like a ton of bricks. The fastest and most efficient way to help someone understand the need for developing the mental side of trading is to give them a comprehensive understanding of how prices move at the order flow level. I knew that very few people really understood price movement from an order flow perspective, but it never occurred to me until that moment that teaching the psychology of trading within the context of order flow dynamics would be the key to helping someone embrace the mental side of trading without having to go through years of pain and frustration first.

As I took a moment to contemplate stepping into another book project, I was astounded that after years of coaching, doing presentations and writing books that it never occurred to me that the key to understanding the psychology of trading would be to understand price movement from an order flow perspective first. My early experiences of hanging out with floor traders when I was a broker for Merrill Lynch taught me the dynamics of order flow. I just didn't realize until that moment how much those experiences contributed to my development and how much from an educational perspective I took those experiences completely for granted.

The process of transforming yourself into a top notch trader starts with a comprehensive understanding of precisely how prices move from an order flow perspective. Once that understanding is in place, many of the ways you need to think to be successful in this business will be self-evident.

And once you know how to "think like a trader," you'll be able to use whatever analytical methodology or technique you have to generate you're buy and sell signals to its fullest potential.

Chapter Twenty

The Importance of Keeping a Trading Journal

Please note – I asked Paula to write this chapter because I feel she understands the benefits of keeping a trading journal, and can teach that very effectively.
Mark Douglas

Many of you reading this book may have heard from different sources during your trading career about the benefits of keeping a trading journal, or what I call a trading workbook. And there is definitely a great benefit to keeping a trading workbook. However, what I have found through consultations and some of the traders in my "Trading in the Moment" live chat room ~ there seems to be somewhat of a mystery or degree of confusion, as to just what the actual benefits would or can be for keeping and studying a trading workbook.

Most traders agree that, other than to keep track of their trades ~ even though not many traders do even that ~ they really don't see the purpose of doing all that work. So, what I will do in this chapter is to try to explain, in more detail than you may have heard previously, just how beneficial keeping your trading workbook can be to you in assisting you to accomplish the goals of consistency and accumulation, or whatever trading goals you may have.

The importance of using a trading workbook is priceless.

Why? That's simple as well. As you step into the game of trading, and by that I mean, more than likely going from one career to another, you will be bringing a mindset that has been created, defined, and refined to another endeavor. An endeavor, that may, for the most part, be part of an organization that may not have been owned or created by you. Meaning, you could be changing from a medical, law, tradesman, restaurant, office, caregiver, homemaker career ~ which would entail working/caring for someone, or some other group ~ other than yourself.

As such, your mind has been conditioned to think a certain way to accomplish whatever daily tasks and/or goals that were set forth in front of you. Now, those tasks or goals may have taken days, weeks, or months to accomplish, but during that time before completion, your mind was solely focused on getting things done. Getting things done in a manner or way that someone else has prescribed, and that you have followed. So, it may be of no surprise that when you begin, or continue trading, you may find yourself unable to focus on creating the types of results you desire. The reason why is simple. Your mind needs to re-program, re-define, and refine the way you think about approaching and completing the daily task, or goal of trading.

One of the most simple and effective ways to allow your mind to expand and encompass this new endeavor, is to write down your thoughts and actions throughout the trading day. Sounds simple, doesn't it? In my consulting work with traders, you would be surprised how many traders cannot, or will not, keep a trading workbook ~ for whatever reasons. So, break out of the norm ~ be different! Begin by formulating your concept of a trading workbook.

What is a trading workbook?

Let's start with some simple definitions. What is a trading workbook? What does that definition mean to you? For those of you not familiar with my work, I like to use the Roget's Thesaurus a lot. Why? Because each one of us, although different, may have and use similar definitions of familiar words. Or, at least we think we do.

Meaning, my definition of a "trading workbook" may be similar to your definition, or it could be radically different. So, let's go over some terminology first.

In Roget's Thesaurus under the term trading we can find the following:

"…vocation, occupation, business, calling, mission, profession, pursuit, life's work…"

And under the term workbook we can find these definitions:

"…record, chronicle, account, memoir, minutes, statement, accounting, testimonial, attestation, certification…"

So, if we put these two different terms together, based on the definitions in Roget's Thesaurus, what might we come up with for a definition of a trading workbook? Simple. A trading workbook, or rather, your trading workbook could be viewed as your *business record*, or your *vocation's minutes*, or your *certification of profession* ~ and so forth.

Meaning, your trading workbook, however you choose to set it up, which we will go over shortly, can be a very helpful tool in setting and achieving goals. It can definitely not only reflect a record of your trades, but just as importantly, reflect the "minutes" (as in minutes written during a board meeting) or description of how you approached each trade, through your written thoughts.

Sound simple right? It can be.

However, as I stated earlier, it seems to be rather an enigma for traders to see the actual benefit of keeping one. One reason may be the term or title. I know a number of traders I have coached questioned me about keeping a "journal" ~ because isn't that "…*something only girls do*…?" Of course, I'm sure many of you reading this will agree that a lot of young girls keep, or used to keep, diaries ~ where they would write down their most private thoughts about life ~ but that action is usually something they grow out of once past their teenage years. And, keeping a diary or private journal seems to be somewhat of an outdated practice nowadays anyway, with all the social networking going on. The electronic 'social texting' has taken the place of physically writing down one's complete thoughts on paper ~ and in essence has taken away the beauty of what a diary or journal is all about.

I bring this up for several reasons.

How many of you, when you were in school were instructed at some point for some class to put together a story-board, or collage to represent something, or some things that you may want to achieve? Meaning, if you want to be a millionaire, your story-board might include pictures from magazines of mansions, high-end cars such as Ferrari or Bentley; or say you wanted to become a doctor, and your story-board consisted of titles such as 'board certified' or 'specialist' along with pictures of an attractive office in a prime location, or pictures of a large city hospital, or even a simple country scene representing a veterinary practice.

When I was in high school, our class was instructed to put together a 'collage' or story-board of our highest and most outrageous thoughts about what we might achieve or accumulate in our lives ~ and we then had to share our collage/story-boards in front of the whole class. Some collage/story-boards were simple ~ a suburban house, family sedan, and pictures of families with smiling children. But others were more worldly ~ I remember one young man in my class named Michael, had pasted only one word in huge letters on his story-board ~ **"success."** When asked what that meant, he replied that he didn't know, but he would find out as he went along. That stuck with me for many years as to how sure this young man was that he *would* be a success.

So, if we take a look at the simple act of putting together a story-board which is indicative of your thoughts and goals at that moment ~ we can see how keeping a trading workbook might be a story-board as well ~ and be just as, if not more so, beneficial to you achieving your trading goals. (See the chapter in my book "And So It Is" for more information on creating Image Boards for success by Bonnie Marlowe.)

I'll give you a good example of this process with an excerpt from my book "Independent Prosperity."

"Tom Monaghan is founder of Domino's Pizza. He is famous for walking around with a legal pad in his hand at all time. Why? This is his response:

"I sometimes compare my brainstorming on paper to the drilling of oil wells. The only way to strike oil is to drill a lot of wells."

As a child, Tom was placed in a Catholic orphanage and later entered seminary with plans to become a priest. He was kicked out of seminary, joined the Marines, and after his discharge, opened a pizza shop in a small town in Michigan with his brother. After several rough months, his brother quit ~ but for Tom, the business became an obsession, and he went on, alone, and learned along the way, that he could only count upon himself to build the business to what eventually, it is today.

How did he learn? Simply.

He learned, through is brother leaving, that it was his dream ~ not his brother's. Tom loved the feel of dough between his hands, as well as the cheesing technique. He learned, as he improved his artistic skills in creating what he considered the perfect pizza ~ that his goal of 100% proficiency and efficiency in the physical motion of making his pizza masterpieces ~ would only be accomplished once it was established in his mind, first. Hence, the legal pads of notes ~ keeping track of ideas and where he needed to go.

To this day, even, Tom is known for filling his legal pads full of ideas, promotions, notes, and strategies ~ all of which began with who he was in 1960, who he became by 1985 with his franchise industry, and who, ultimately, who he is today."

From this example, what can we see? Two things.

- *Tom learned that although his brother initially went into business with him, it wasn't his brother's dream, nor was he interested in running the business the way Tom knew it needed to be done.*
- *Tom also learned that it was, indeed, his dream and therefore he was the only one who could direct the business in a way to fulfill the possibilities and probabilities of making it as successful as he intrinsically knew it could be.*

So, is keeping some type of journal or workbook only for girls? I don't believe so.

And another part of the dynamic of these two points is this: just because you may hear from another trader what they are doing and how much money they may be taking out of the markets ~ *that doesn't mean that will work for you*.

And how will you learn just what will work for you with regard to your trading goals?

> ***By keeping a trading workbook you will have historical data ~ historical data about yourself ~ not only about your trades, but most importantly, what you were thinking and how you were reacting to the markets during trading.***

Simple.

This will be invaluable for you, if you have any challenges with regard to following your rules or taking all your system signals. How?

By going back and reading and re-reading what you were thinking during any given trading day, you will begin to see any patterns that may have developed with regard to limiting thoughts about yourself or the markets ~ which then may have led to limiting actions and less-than-profitable trades. Once you are able to see any patterns which may be there, you can then decide what you want to do to update those limiting thoughts.

For instance, let's look at it this way.

Let's say you go back and re-read your thoughts during a particular trading day, and you see that you have written down something to the effect that you are '*afraid the trade will be a losing one, and I don't want to lose*.' If you see that written down, you can then ask yourself:

- *What am I afraid of losing?*
- *Money?*
- *Prestige?*
- *Honor?*
- *Respect of my family?*
- *Security?*
- *Lifestyle?*
- *Some of the above?*
- *All of the above?*

These are all good questions, as well as others not listed here, to assist you in breaking down just what it is you are afraid of. Many traders that I have talked to, when asked those very questions, found it hard to answer. And, if they found it hard to answer, that usually meant *they had no idea why they were afraid of losing* ~ they only knew they didn't want to.

Of course, no one wants to lose! We live in a society that ostracizes those who 'lose' and, are not the most beautiful, the thinnest, the most successful, and so forth. However, losing trades are inherent in the very nature of trading. You will have losing trades at times, and one way to know that your losing trades are simply a by-product of market conditions, and not because you didn't follow your rules ~ is to keep a written trading workbook.

This is multi-dimensional. Here's how.

Most, if not all, traders today are coming from other careers. Many traders may have reached the top rung of the ladder in a particular career, while others may have never felt like they 'made it' it the degree they felt they could have. In other words, they may have entered trading to make up for some sense of lost earnings or lost money that never materialized in that particular profession. Meaning, they may have been passed over for a raise or promotion, for whatever reason(s), and therefore feel that they have "lost" money, and they want to recoup it by trading.

I'll give you some good examples of what I mean.

EXAMPLE #1

I received a call from a client looking to get back into the markets. He traded previously, but had blown out of the market and went back to work in his respective field, which was engineering. The reason for his call was to make sure he was approaching getting back into the markets from a positive perspective.

In the Initial Consultation, it became apparent that he had some daunting challenges. First and most important, he was angry over losing a fortune ~ six years prior, he had amassed a fortune ~ $4M to be exact ~ and had retired while in his late 40s. A friend convinced him to day trade, and within nine months, he had lost his entire fortune – and subsequently his wife. Fortunately, he was able to get a job again in his field, even at the age of 51 and in the lowered economy around 2007, however, he was so angry at having to work again, that he began to disrespect his superiors and co-workers by disparaging them even when talking with me ~ even though this very job had already allowed him to accumulate almost a million dollars to trade with again.

He was so angry about working again, instead of being retired and living off his millions, that he couldn't even say he had a job ~ all he could manage to get out was that his "**j-o-b**" (spelling the word out emphatically), was beneath him, his peers were beneath him, and his boss was an idiot. (His words, not mine.) When asked why his peers and boss were idiots and beneath him, he had no answer. He only wanted to know why he couldn't follow his rules, and my question to him was simple. What are your rules, and why don't you trust them? He replied he had not written his rules down ~ thinking that he didn't need to, that he would remember them as needed.

I asked him if that is how he approached an engineering project. Meaning, as an engineer, would he just "think" about his research, or would he keep track of the process by writing down each step, and what course of action may be needed next to accomplish the goals of the project. He replied *of course* he would keep track of all details while working on a project, otherwise any results would be suspect. I asked him if he was keeping any type of trading workbook ~ even something as simple as keeping track of his trades. He replied he was not. I asked if he had kept one previously, and he said no.

So, I then asked him, if he kept track of his approach in an engineering project, knowing that was key to accomplishing the project proficiently and successfully ~ they why wouldn't he do the same with his trading to accomplish his trading goals. Especially since he had not kept track of anything previously and lost a fortune. That was something that he had no answer for; I told him to think about the question to find the answer himself, because if he could not or would not, it would be virtually impossible for him to move forward in a consistent and profitable manner with his trading.

EXAMPLE #2

My first job after college was as administrative assistant to the Vice President of the MidAmerica Commodity Exchange. The MidAm, as I mentioned in the Introduction, was the first independent futures exchange to offer mini-contracts to the smaller investor. The exchange opened in Chicago in the late 1970s and existed independently until being acquired by the Chicago Board of Trade in the mid-1990s. During my tenure there, seat prices ranged from approximately $3,000 to $32,000, with a membership (number of traders who had purchased seats on the exchange) around 1,500; whereas the seat prices for the "big boards" as the Chicago Board of Trade, the Chicago Mercantile Exchange and so forth were called, ranged from $200,000 and up, depending on whether you purchased or leased a full or partial seat. (A full or partial seat was determined on whether you wanted access to all contracts traded on the exchanges, or just trade specific markets.) So you can see the MidAm, based on seat prices alone, was a good place to begin trading without having to provide a large amount of equity.

I loved my position at the exchange, and learned about trading from the inside out ~ from the exchanges' perspective first, and then from the traders I got to know; it was a fascinating job. After several years, the exchange had grown by leaps and bounds, and I was overwhelmed with work. After approaching my boss and asking for an assistant ~ he hired an assistant for himself instead, someone I now had to report to. She was also given a salary of $10,000.00 more than I was making ~ because she had a Master's degree and I didn't. Regardless of my boss' reasons for hiring her, I was not happy.

Over the next year, his assistant would regularly ask me for help in completing or redoing projects, and I would. I did this, so I thought, out of loyalty to my boss, but also to prove to my boss that I could do her job, and better. During this time, I continually made disrespectful remarks about my boss to anyone who would listen ~ the main point being how much money I had *lost*. Now, keep in mind, I had never been offered her job, nor was I ever offered anywhere near her salary ~ and yet, I blamed my boss for *taking money out of my pocket*.

Eventually, a year and a half later, the assistant was fired due to incompetence, and I was convinced my boss would *reward* me for all my hard work. I was wrong. Not only had he heard all my disrespectful comments from others whom I had spoken to about my situation, I had become so focused on what I considered losing out on, that I really wasn't pleasant to work with in the office. After explaining his position to me, based on the years we had worked together already, he offered me a $1,350.00 increase to stay, and see what might happen in the future.

At this point, my mindset was so focused on the money I felt he had *taken* from me, the loss that I felt had occurred, I could not see that the small raise might lead to bigger and better things ~ and he was giving me that possibility, or rather that probability. I did take the small raise and kept my job, but didn't see much purpose in changing my general attitude. I was, after all, the one who lost money. Over the next several months, several offers came my way from a couple of the large brokerage firms to work in their executive offices ~ several traders even offered to stake me with a small trading account while they taught me how to trade ~ but since I was so focused on what I felt I had *lost* and wanted to recoup from my boss ~ I stayed working for the exchange.

During this period, while having dinner with a group of my trading buddies one Friday night, I mentioned how I felt having lost all that money. One of them suggested I write down a business schematic or type of plan to recoup the money or get the raise I wanted from my boss. That night I began writing what I had been feeling for the past two years ~ writing late into the night thinking this was good planning, and the following Saturday morning, was surprised at what I had written. Not only was what I had written about the farthest thing from any type of plan ~ it was, plain and simple, an angry diatribe at my boss, the assistant, and the board of directors (who approved all salaries at the time). I was shocked at my negativity, lack of clarity, professionalism, and realized I was lucky to even have a job.

You will note that in this second example I highlighted certain words. These words, repaid, reward, taken, lost ~ these types of words kept me, and may keep you, focused on a loss, not focused on moving beyond that particular dollar amount you may feel you lost or are owed. In essence, those types of words create a closed loop mindset for me. I describe the closed loop to be similar to a hula hoop. You know, the plastic circular tube that a lot of us played with when we were younger ~ a circular tube that you had to balance around your hips or stomach to keep moving. *And, once you lost your evenly-distributed motion, the hula hoop would fall to the ground.*

Your 'mental' closed loop can have two definitions. The first definition of a closed loop mindset can mean you are focused on what you want to achieve ~ meaning, keeping a trading workbook, writing down your thoughts, keeping track of your mental environment to be able to update any limiting thoughts as needed. Meaning, to keep your mental hula hoop going (balanced), you would have to keep your thoughts focused on specific words and definitions ~ in other words taking your signals and following your rules.

The second definition of a closed loop mindset is one that many people, not only traders, find themselves in ~ *subscribing* to a mental closed loop of focusing only on what you don't have, what you didn't make, what you feel was taken from you ~ and not able to focus or see any possibilities or probabilities that are happening in the markets at any given moment ~ and in essence, your mental hula hoop will fall to the ground. In other words, what I have coined as the "Trading Zone of Lack" or TZL.

Keep in mind ~ it doesn't matter if you lose money trading the markets ~ or if you lose money by being passed over for a raise or promotion, whether in a previous or current career. The emotional pain, the traumatic experience surrounding the sense of loss ~ is the same. And, therefore, you cannot replace one type of business venture that was less-than-satisfying, or traumatic ~ with another, meaning your trading ~ and expect it to be stellar, if you have not addressed the emotional energy surround any type of past (whether recent or not) loss.

Over the years, I have found that keeping some sort of workbook/journal, (whatever you choose to call it) – can be key to achieving whatever goal I may be working at. For instance, when I wanted a new position with a higher salary, I would write down my criteria for getting into that "trade." What were my reasons behind getting hired at that salary; what I was thinking about the possibilities, the probabilities, the pros and cons of working for that particular company or executive ~ and then would go after what I wanted.

It's no different with trading.

You have your criteria for putting on a particular trade ~ you think about the possibilities and probabilities of that trade working profitably, weigh the options of taking every signal, and following all your rules ~ and you place the trade or set of trades. Whatever the outcome is, it will reflect the initial process that you set in place.

Meaning, if I didn't get a certain position, or wasn't offered a specific salary that I wanted, then I would go back over my notes; i.e., rules, to see what information I may have overlooked, or dismissed as not as important. And, eventually I got the position and salary I wanted ~ because I was firm in my resolve, that if I didn't get that particular position or salary, there was always opportunity elsewhere. But I wouldn't have understood that ~ more importantly ~ believed that, without keeping my workbook with my personal mental historical data to learn from.

And again it's no different with your trading. Whether you are a day trader, or an investor ~ meaning more long-term trading such as myself these days ~ *you still have to take and keep an inventory of your mental environment*. For instance, when I decided I wanted to trade "green" stocks I began researching what 'green' meant to the economy and the environment, local and worldwide, and then wrote down my thoughts about investing in what I had learned. Wrote down what I thought about the possibilities and probabilities of how investing in those types of stocks, whether short or long term, would help or hinder my goals for higher prosperity ~ in essence, taking an inventory, and keeping track of my mental environment for this venture.

Here we get back to definitions.

For example, my definition of the word discipline is simple: *doing whatever needs to be done to accomplish my goal.*

For other people and other traders, the word discipline is usually associated with something less-than-positive. For instance, most of us would probably agree that at some time in our younger years, we were "disciplined" by a parent, teacher or even an older sibling ~ whether through a spanking, getting yelled at, or embarrassed in front of our classmates. Hence, the word discipline may not necessarily mean something pleasant.

Now, we may not think about the word in our conscious minds, and yet, the energy from those experiences remains in our mental environment, and can create a conflict when you want to apply any degree of discipline to your trading regimen. So when a trader is told to have 'discipline' – it simply doesn't happen because more than likely their definition of that word is not positive. And if their definition of that word is not positive, then how can they "have" any discipline?

Let's take a look at the word workbook in Roget's Thesaurus. Under that word, we can find the following:

"…training, preparation, conditioning, grooming, development, cultivation, resolve, determine, purposefulness, resolute, definitive, make up one's mind…"

Simple – a positive set of definitions!

In other words - *make up one's mind*.

And you do that by writing down in your trading journal what it is you are thinking before, during, and after every trade.

And then you make up your mind to do what needs to be done.

And do it.

Very simple isn't it.

And, once you make up your mind to do what needs to be done – you *can* achieve your highest trading goals and dreams.

****