RULE #13

Know Your Profit Objective

If you don't know where you are going, you will probably end up someplace else.

—Yogi Berra

No trader will ever reach his full potential without some disciplined method of getting out of winners when it is time. The winning trade that continues to develop potential is a different issue. Profit objectives are necessary because you must have points in the market where you make choices. Sooner or later it is time to liquidate every trade and exit the market—the trade is over. When the time/price relationship reaches that point, you liquidate and wait for the next one.

The best time to make that choice is *before* you place your trade. Having a profit objective before you initiate provides good benefits for your developing trade methodology and your discipline. Profit objectives help you stay focused on getting paid the most from your winners.

Having a profit objective firmly in mind is crucial to lasting success for two basic reasons. First, it helps you maintain the proper risk-to-reward ratio on your open positions. As we discuss in detail later, the magic numbers are 42% winning trades and a 2:1 money won/lost ratio. At this level of performance you have a winning approach, but if you don't hold your winners you can't overcome your losers. Knowing how much money you are looking to take on any specific trade helps you keep your focus on this ratio. Just knowing these ratios and attempting to define your upside objective will keep you out of lower-probability trades. Placing your exit orders at or beyond price levels that will maintain this minimum winning ratio does not insure that those numbers will trade, of course, but having a resting order designed to take a profit allows you to benefit from winning ratios and helps you stay disciplined to take winners—to help your approach's inherent probabilities work for you more often than not.

Second, having a profit objective helps you fight the temptation to close a winner too early, cutting your profit short. As long as your trade is working, you have a better ability to sit tight; you are developing the much-needed discipline to leave a good thing alone. No matter how you want to slice it, no market will go straight up or straight down away from or toward your profit objective. It will take some amount of time for the trade to develop in order to eventually reach your objective. If you let every little switchback or price hiccup scare you out of your winners, you can't pay for your losers. Having an objective firmly in place will give you the perspective that is required to sit through and wait out temporary adverse price moves. Every market inhales and exhales.

Profit objectives are tools for effective trade management when holding your winners. They help you focus on finding good risk/reward ratios to begin with, but more important, they help you hold your winners for the largest potential gain. As long as you take the point of view that profit objectives are part of your tools, you will have more winners to start with that you can hold longer.

I have found a few helpful tools that allow me to remain confident in my profit objectives. First, look for a minimum three-to-one reward-to-risk ratio. This is not your actual price objective; this is the money you intend to risk compared to the market potential you hope to find. For example, if you believe that a market is developing a short-selling opportunity, where will you place your protective initial buy-stop order, and how far can the market go in your favor before the buyers step in and support it? If you are going to risk 50 points on a day trade, does the market have the potential to trade *at least* 150 lower on the day? If the answer is no, then you might want to pass on that particular short sale. You are looking for a high-quality relationship between your risk limit and your upside potential. If the market has never had a 150-point day in its entire history, then passing up that trade is a no-brainer; most likely the market doesn't have that much potential for the day. Your goal with a risk/reward ratio is to start from the premise that the ratio tells you how far the market must move if you take that position. Comparing your required profit objective to what you already know from your previous market study tells you better whether you really do have a potential trade with a higher or lower probability based on the parameters you have selected to trade with. You need to compare that risk with what you *have to get* if you take the position. In other words, if you can risk 50 points and the market can't pay you *at least* 150 (based on your study), knowing your required objective prevents you from placing a low-probability trade.

Having a profit objective also creates confidence to add to winning positions. Many trades will have much more profit potential than originally hoped for as they develop. When that potential becomes apparent, having an objective will help you ask good "if–then" questions to improve your net rate of return. When you see clearly that your original objective is only a small stopping point rather than the end of the trade, having a predetermined mind-set to add to the winning position is a great way to remain disciplined to work the winning trade until it is all over.

In my personal trading, I have two or three objectives for each position when I initiate for my first entry. The first objective is the area where I feel the market will have a pause, and a larger time frame trader must make a decision. For example, if I have bought an hourly low, my first objective would be the high of the day or previous day; that is most likely where the daily or weekly trader will take notice and either cap that rally with selling pressure or add to the net order flow on the buy side. No matter which happens, the first objective is not just price; it is time *and* price. I want to see the higher-time-frame trader push my trade with his order flow.

My second objective is the usual three-to-one reward/risk ratio. If I have correctly anticipated the net order flow, and the trader in the next higher time frame is joining the party, when the market gets to the *price* I am looking for I must decide if the trade has developed more potential in the same direction; that is a factor of *time*. If the rally has happened very quickly, and the market traded the second objective price and then backed off a bit, most likely that is stop-loss buying as the losing shorts cover and the larger time frame also liquidates. In this case, the rally may not have that much farther to go and I would either take the profit or at least roll a break-even protective stop. But if the rally took lots of time, there was good continued buying and selling from both sides as the objective was reached, and the price stayed at or around the objective for several hours, then it is possible that even larger time frames are coming into play. The entry of traders in the next larger time frame may mean that the potential for a further advance is still building. If the market continues to stay at or around the objective price while volume and open interest also increase, the market most likely has further to go. I would add to the position by some amount because the potential to reach the next objective has increased.

Should the market continue to advance after the position is added to, then the next objective level comes into play. That is usually a price area where the larger time frames take a stand from the other direction. For example, in this case, an hourly low was the right area to get long a market that has now made an advance that the daily or weekly trader is also interested in from the long side. As we approach the monthly opening range (for example), the monthly trader will now take notice. Since the market had been lower up until that point, the monthly trader is most likely either looking at placing shorts out, anticipating a failure of the month's opening range, or looking to go long if he is certain that the rally will continue. The net order flow will most likely start within a price/time relationship that includes everybody. Once the price reaches the monthly opening range, that price action will be a high on *everybody's* price chart.

So now we watch for the hourly price charts to show some selling, then the daily charts to show some selling, and finally the monthly charts. If the process takes 24 to 48 hours of clock time, and the market itself is lower for all those time frames, then most likely the traders in both the larger and the shorter time frames are all liquidating. The trade from the long side is running out of potential. The objective was reached and the trade is over.

However, if the price action continued to show strength—for example, the hourly price chart corrected lower and then prices returned to the high end of the range, the daily price chart closed near the high and just under the monthly opening range, it is a Friday afternoon and the profit-taking sell-off to close the week never happened, and so on—then the trade may be continuing to build potential. If the market advances further through the opening range, in this example, it would be a good time to add again to the position because traders in the larger time frame are now adding net order flow from the long side as well.

Having a series of profit objectives in place before you initiate the trade helps you to remain focused on the process of holding a winning trade. Markets are dynamic and conditions are always changing. Profit objectives help you maintain your edge for the simple reason that they keep your attention on the things that really matter: Changes in the net order flow as traders come in or leave the market. The important point of having a series of profit objectives is that you look for something changing at price/time points where it would make sense for something either to change or stay the same. As your objectives are reached, price action will provide important clues for you to review in order to have a degree of certainty about liquidating, holding, or adding to the winning position. But in all cases, price objectives are important areas to have predetermined in your mind. These are the places that you will do something or at least consider doing something. Whether the market ever trades to your price objectives or beyond them is really not important. It is important for a trader to remain proactive in his trade management.

Price objectives are stopping points that help you maintain focus on your trade. Having the price objective in mind before you place the trade will help you choose better-quality risk/reward ratios to start with. Having a series of objectives that are price- and time-sensitive and involve additional behavior from multiple time frames will help you get the most from your winners.

RULE #14

Don't Second-Guess Your Winners

In great affairs we ought to apply ourselves less to creating chances than to profiting from those that offer.

—François la Rochefoucauld,
Forbes Thoughts on Opportunity

Without a doubt, the most profitable market potential you can identify is a change in trend. When a market has stopped moving in one direction and is about to begin a move in the other direction, that potential might take time to fully develop but it is your lowest-risk, highest-probability opportunity. You are literally sitting on top of a gold mine. Getting in position early takes effort, but once you have established a base position, you need to let the trade work.

This is different from simply holding a winner. This is more an issue of maintaining proper focus, continuing to do the analysis needed to identify fundamental and technical potential, maintaining constant vigilance on net order flow as it changes, and sustaining a strong belief in yourself and your ability. Your trade hypothesis is developing and the time needed for a true change in trend to manifest might be quite long. The last thing you want to do is reevaluate what is happening and exit the trade early or, worse yet, reverse your position.

Personally, I can show you trade records where I have been at the précis point in both time and price to be long or short from the change in trend, sometimes from a yearly or multiyear high or low. Did I get paid? Yes, but not what I could have. I second-guessed my hypothesis.

Looking back, I can see that it was mostly because I lacked the focus and discipline to just leave well enough alone. What stands out in my mind most is the high in the orange juice market for 1991. I was short from $2.06/Lb. I covered at around $1.95/Lb. Yes, I made a nice gain on the trade, but within a year that market was over 50 cents a pound lower.

During the time the market was under selling pressure, I kept looking for another short position to put out on a rally. I convinced myself that the initial break was too fast and that a re-test of the highs was coming. But that rally never happened. Because I was content to book a nice gain instead of just letting the trade work, I missed one of the truly great short positions of the last decade or so. My trade hypothesis was the correct one and my initial timing was good, but I second-guessed myself. True, a lot of that was inexperience, but that is the whole purpose of developing trading rules that work: to place controls on your behavior until you can trade with enough discipline to *let profits run*.

Rule #14, "Don't second guess your winners," is first cousin to Rule #11 and a critical part of letting profits run. Of the mistakes many traders make, the mistake of second-guessing themselves is the most costly. Not only will they be out of the market when prices continue to advance favorably for their initial trade hypothesis, but often these same traders make the most costly mistake of all by second guessing themselves: Trying to be on both sides of the market. If you want to watch your trading stake go up in smoke as fast as possible, I recommend you try to trade both sides of a market that is developing a trend.

Because the temptation of unlimited profit potential is so strong, many traders attempt to trade from both the long side and the short side of a market that has true potential in only one of those directions. This is a common mistake to make after a market has made a hefty advance in one direction, because we all know a correction is coming and it will be a big one. For example, if you are long soybeans from the seasonal bottom at the end of the year and on into the spring, and if the market has advanced 80¢/BU up to planting, it is reasonable to expect a top may be in place if the acreage planted is higher than expected. It would not be uncommon for sellers to come in and for holders of open longs to liquidate at least some of their positions. Under those trading conditions, a 30 to 40¢/BU drop in price would not be uncommon, and that drop might take a week or longer to play out. If you are holding a nice open-trade gain on open longs, you might be tempted to liquidate and reverse with the intention of reestablishing longs after the correction, taking a gain from the short side as well.

The problem is, in this case, you might be shorting a bull market. Remember, it is the blood of the shorts that have been paying the bulls. You have now placed yourself on the side of the market that has *already proven to be the losing side*. Yes, a 40¢/BU correction is a lot of money, and yes, that correction would work against an open-trade profit. But the risk you are taking by second-guessing your original bullish hypothesis is that you will not time your participation well. In most cases, the anticipated correction will not happen exactly as expected, nor will it be precisely a certain amount, *if* underlying bullish conditions remain. If conditions remain bullish for a change in trend, and that uptrend has another three months to go, you won't know that for certain until later, but your new short position is in serious jeopardy. If those bullish conditions remain after a bearish fundamental is ignored or absorbed, it will only take one rally to take away a good portion of your previously closed gain *and* you won't have a position of any kind once you liquidate your losing shorts. A $1.50/BU price change in favor of the bullish hypothesis going forward might mean little or no gain to your account if you don't have your original base longs still working—you were short for a time against the trend and you were flat for a time, waiting to reestablish your longs that would have worked anyway.

All of this could have been avoided by holding to your original hypothesis and letting your positions work until that market was clearly over from the long side. By second-guessing yourself, you took money out of you own pocket when *your hypothesis was the correct one*.

Now, I'm not suggesting that you will see a $1.50/BU up-move in soybeans every year. Obviously, seasonal tendencies in the grain complex are different from year to year; I am not postulating that bullish or bearish trades will play out as anticipated under all market conditions. I am simply using an illustration. My intention is to show you that *no matter how* you come to a conclusion that a market has potential in one direction over another, you serve your self-interest best by staying with that hypothesis and not vacillating. You need to consider trading only from that side in most cases, and you need to find a way to leave your initial position on long enough for the potential you have found to develop fully. That could take time.

The psychology behind this rule is critical for your lasting success, because following this rule helps you follow all the other rules for letting profits run. If you second-guess yourself and your trade hypothesis, most likely you will cut an open-trade profit short, you will not add to your winners, and you will not have a profit objective you are willing to wait for. When you second-guess yourself you lose the benefit of using multiple time frames and of course, your records show that your personal results data remains inconclusive for true learning of your strengths and weaknesses. At best, changing quickly from one hypothesis to another prevents you from finding the truly profitable trades that make all the difference; and at worst, it prevents you from getting paid the highest return for the risk you are assuming. One reason short-time-frame traders never achieve the lasting success that long-term traders more often have is because the short-time-frame trader is not holding to a perspective that pays the most: identifying a change in trend and sticking with it.

To make this rule work, you as a trader need to be prepared to make additional choices for the long-term health of your trading account. To earn the highest rate of return possible, you need to prepare ahead of time certain trading behaviors and be ready to apply them. When a trade hypothesis is working and your initial base position is showing a profit, be prepared to ask the question, "How far could this go?" If you are willing to consider that your initial price objective may be only a small part of what might prove to be a huge move, you must be willing to consider entering from the same side again very quickly if you liquidate. Perhaps adding to the position as the market passes your objective is a better move. If you are remaining vigilant in your personal market study and your record keeping, perhaps you see that something is changing and your original trade hypothesis is more accurate than ever; in this case, holding at least some of your position is a better play.

This rule works for your best potential when you have the capacity to hold to your first conclusion and are willing to stay with it for as long as it takes. When you look at some past market moves, trends that lasted for years in some cases, there are always traders who were there and on the right side at the turns—when the risk was lowest and the profit potential greatest. Some were even there by accident. But as the trades developed, those very same traders chose to change their hypothesis for reasons of their own, either liquidating long before the full potential was realized or even entering positions from the other side and suffering losses. By remaining in the frame of mind not only that you can be positioned at the turns but also that you can hold those positions, add to them, and wait for the trend to fully develop without taking yourself out of the game early, you will be in position to hit the home run. But if you let the short-term fluctuations or pullbacks convince you that the trade is no longer going to work, or convince you that the trend has failed, you are not trading the net order flow or the market potential—you are merely trading your personal point of view. Your goal in making this rule work for you is to learn what you need to learn about your market first and be willing to give the market as much time as it needs for that trade to develop.

By combining the essential elements of "letting profits run" into an effective trade management technique, you will gain the confidence you need to sit tight on a winning trade and let traders in the other time frames come to the same conclusion and add order flow in that direction; and you will create the discipline required to hold for the objective. All the time this is happening, you are watching for more clues that this is really the beginning of a bigger development in the same direction. When you see that potential fully, you can then add to the winner and easily wait for the next objective.

Over time, as you practice holding winners and letting profits run, you will learn that the markets are a very big place. There are times when the hugeness of the move won't be seen at all by anyone at the start and only a handful of traders will have positions on. Once that trend develops and becomes clear to everyone, that power from the net order flow will push that trade farther than you might have initially expected. Remaining open to that possibility *right from the start* increases your probability for a windfall gain. If a change in trend is truly developing, those clues will show, and you need to be open to the possibility that you were in the right place at the right time; now you need to run with it.

Traders who have the ability to let a profit run are always the traders with an open mind to the possibility that anything can develop. Once they are on the right side they are looking for clues that this position might go a very long way. They tend to stay with that potential until the market has said either yes or no, but they rarely second-guess their initial hypothesis for the simple reason that it apparently was the correct one. Rather, they ask the question, "How right *could* this be?" If their initial trade hypothesis is the correct one, and it turns out to be the correct one for years, they will most likely have some trades on all the time. But they made that choice before the trade was entered. Those traders took the point of view that anything can develop, and if it does, and they are on the right side, they are sticking with it.