

RULE #15

Know the Limits of Your Analysis

Every ship at the bottom of the ocean has a set of charts on it.

—Old nautical saying

When I first started trading in May 1986, the first book I read on the markets was *Chart Your Way to Stock Market Profits*, by David L. Markstein (New York: Arco Publishing, 1972). I have since lost the book and I couldn't find it again searching the Web. I probably threw it out, now that I have a better grasp on what I am doing every day. About the only thing I remember about the book was how intoxicating it felt to read something for the first time that provided me with such a simple solution to my goal of getting rich in the markets. I was too uneducated (some would say naive) to understand that it wasn't going to be that simple. There were numerous books and services available for people interested in trading equities, but there was very little data available specifically for traders interested in futures or options. The cash FOREX markets were the exclusive domain of banks and private investors, so that market wasn't even available. For me as a new trader, the best course of action was to actually go to work in the industry and learn the business from the inside out. So I did.

After I began trading—and accumulating losses—I continued to ravenously devour anything I could find on market analysis. At the time, the alleged science of technical analysis was still in its infancy. Most of the technical indicators that are used by traders today were just concepts. Commonly used indicators such as Williams %R, MACD, and the

commodity channel index (CCI) had not been developed or were not licensed to all the available charting services. Many indicators were formulas you had to compute manually and then physically mark the results on a paper chart. At the time, having a real-time data feed from the exchanges was very costly and required dedicated computer hardware. There was no online access to information like there is today, and you needed an actual broker available to place trades and report fills. All of what we take for granted today as a professional-level, online market presence literally had not been invented yet; and this was only 20 years ago. (As a side note, I actually met George Lane, the developer of stochastics, at the Chicago Board of Trade just after I began working full-time in the markets in 1987. He was considered a god at the time.)

I continued to read, study, chart, and trade for years, spending huge sums of money on real-time data feeds, books, audio courses, charting services, live seminars, and so on. During this educational experience, *at no time* did any of these self-created gurus ever mention that the futures and options markets were zero-sum transactions. The only exposure I initially had to the concept of zero-sum transactions was when I passed my Series III brokers exam. I didn't know how critical that information would be until after I had my first blowout. In fact, when I teach my "Psychology of Trading" seminar today, there is always at least one person in the audience who has been trading for years but has never even heard the term and has no clue what it means. The inherent nature of zero-sum transactions makes analysis of the markets a very different thing than the analysts and chartists would have you believe.

During this part of my development as a trader I continued to have net losses. I searched and searched for the cause of my losses, believing, like most novices do, that the problem must be at least in part due to how I was doing my analysis. What made this period so frustrating for me was that the root problem was exactly that—how I was doing my market analysis—but *real* analysis of the markets has very little to do with technical analysis or technical indicators. Knowing that difference is what made all the education come together for me. You need to know that difference as well, or your results will remain net losses, because zero-sum transactions cannot be mathematically analyzed nor predicted with any certainty. Proponents of technical analysis methods will have a field day with that statement, but I am going to show you something that will help you understand that the limits of technical analysis, when properly viewed in the context of zero-sum transactions, are the very thing that makes it valuable.

The very nature of zero-sum transactions means that exactly 50% of executed contracts have profit potential. Once the net order flow has

moved the traded price away from the executed entry, it is impossible for both of the open positions to show a profit. Without advance knowledge of the net order flow, your actual mathematical probability for a winning trade once you have executed for your entry is 50%. Bear in mind, I am not using any trading hypothesis, analysis, or previous support/resistance information. I am merely stating the fact that once the market moves, you will have either an open-trade profit or a loss at that point. We are not discussing the market “coming back,” the potential to make a new yearly high/low, chart formations that have probabilities, or anything else. I am saying that from a mathematical point of view, it is impossible for everybody to be right.

The idea behind technical analysis is that by somehow combining or dividing previously traded prices, overlaying a type of constant algorithm to previously traded prices, comparing previously traded prices to some formula, and so on, you can thereby arrive at a number that the market has a potential to reach, predict the market will change direction, or be confident that it will continue in the same direction. The seduction of your will is now complete and you place yourself at risk.

But the market continues to move for the only reason that it will ever move—because of the net order flow. Most traders now believe that if you have an open-trade loss after this mental dance of technical analysis has been done, somehow the analysis was not done correctly—otherwise, they would have been on the other side or waited. This illusion is what most traders operate under for the entire life of their trading career. The more firmly entrenched a trader is in this illusion, the greater amount of study or analysis he will do or the greater amount of money he will spend trying to develop a better technical approach.

The important bedrock understanding you as a trader need to have about technical analysis is that it is not *predictive*; it is *historical*. Technical analysis *cannot* predict price action because it is mathematically impossible for everybody to be right in the first place, and everyone has the same technical analysis available to them.

A price chart with a 21-bar moving average and stochastics on my desk is *identical* to your price chart with a 21-bar moving average and stochastics on your desk. If we both conclude the same thing—that this data predicts a price rise, for example—and every other trader in the world using that same technical analysis sees the same thing we have been taught to glean from it, and we all decide to buy *because we trust the analysis*, the only way we can get into that market is if someone sells to us. What is the seller using to conclude that the time to get in is also now but that the market is poised to move lower? What is his analysis based on?

The really seductive part of this whole process is that if the trade makes a profit, the trader *assumes the analysis works*. That is the conclu-

sion most traders will come to. The only reason the trade worked is because the net order flow was from that side, but the trader concludes it was the analysis that found the trade. Once the analysis works *one time*, the trader extrapolates that to mean it will work *all the time*. If using the exact same analysis again results in a loss, the trader assumes the fault was in how the analysis was done. In other words, the crystal ball wasn't plugged in this time. But the trader is still convinced that he owns a crystal ball.

If you do your homework you will discover that any form of technical analysis has some level of probability of finding a winning trade. For the most part, all technical analysis or mathematical models developed for systemized use have a success rate between 38% and 52% winning trades based on the predictive hypothesis used by the developer. That is no better than chance. If you flip a coin 100 times you will have 52% heads or tails, or some random bell curve distribution based on probability theory. In fact, the entire industry based on this predictive illusion of technical analysis is very proud to document to you the winning trade to losing trade ratio of the system in question. If you want a real eye-opener, just count how many of these high-tech, systemized approaches have win/loss ratios lower than the 35% range, which is actually less than flipping a coin. What are these people thinking?

Since technical analysis will only help you 52% of the time *at best*, why would you trust it 100% of the time?

Answering that question and really *thinking* about what you are doing is the key to following this rule. You must know the limits of your analysis and what the analysis is really saying in order to use it successfully. In my opinion, the simplest way to effectively use technical analysis is to look at it from the loser's point of view.

Proper analysis of your market starts with the understanding that not all of the participants are going to be winners. The loser is in there somewhere and he must liquidate at some point. Looking at the market price action from the point of view that the loser is in there, thinking and trusting *something* that allows him to place himself at risk, puts you in a position to *anticipate* potential net order flow when it is about time for the loser to quit. Your best analysis is done by asking the question, "Where is the loser?"

The last thing you want your analysis to do is attempt to predict price action. You want your analysis to disclose *historical* information. You want information that discloses where the loser is, what he is most likely thinking, and where he will most likely be forced to liquidate the losing trade. You already know that the loser has trusted some form of analysis, he is using it to *predict* price action, and he can't be right. Armed with that point of view, you need to assess at what point a loser would come into

the market and where he would most likely liquidate. All of your technical analysis is best used to help uncover where the loser is and what he is most likely thinking in order to continually keep placing himself at risk. Your analysis is best used to help you understand *what has already happened* and then help you deduce *what must happen next*.

This is a different process than predicting price action. The process of critical deduction, intuition, and knowledge combined with the question “Where is the loser?” is not predictive. You really don’t need to answer the question, “Which price is coming next?” You need to answer the question “Where and when will the loser quit?”

Before we conclude this discussion on the limits and usefulness of technical analysis, I think it is best to make a few things clear so no one gets the wrong impression. I am not saying that technical analysis is bad or that it is without value. There are many parts of technical analysis that are very useful and should be part of a well-rounded trading methodology. I think you would be best served in your use of technical analysis if you would not trust it implicitly to find winning trades. I believe that it is best used in conjunction with sound knowledge of what ultimately drives prices.

Net order flow can only change if someone is certain enough that he will make a winning trade and he is willing to initiate a position to find out. Regardless of all the little nuances that happen around the net order flow or the degree of probability one kind of analysis has versus another, the bottom line is that only a fraction of open contracts will be on the right side of the price action long enough to have a profit. Technical analysis is designed to uncover this inequality, but charts cannot tell you what will happen. Charts and analysis can only provide a detailed history of what has already happened. It is up to the trader doing the analysis to deduce what is most likely to happen next from that historical information.