Chapter 22

A TRUE STORY

Recently, the following quote appeared in a financial publication: “Try to find something that works and stay with it.”

Is this sound advice for trading in the markets?”

Although on the surface this statement may seem correct and wise, a deeper look will show that it may be inappropriate advice for a trader.

We're going to give you an example based on a true story. We've changed it only enough to protect the identity of the individual involved.

Once upon a time there was a young man who came to the commodity markets with only $500. Through patient endurance, persistence, and intelligent observation, this young man traded his $500 into a fortune amounting to hundreds of millions of dollars. So great was his success that he was admired around the world for his accomplishment. Indeed, he had become a very famous and much sought after trader.

Then one year, on a series of trades in a crashing market, he suffered a loss in his account amounting to 10% of all the money he had ever made in the markets. Money he had made both for himself and others. In his case, such an amount represented a sum in the tens of millions of dollars. This major loss was quite sobering to the man, and he thought to himself, “I need a rest from the markets.” With that thought mulling about in his head, he decided to end his trading career and enter into a totally unrelated field of endeavor.

Not knowing much about any other way to make a living, he failed miserably in his attempt to undertake a new career, and after several frustrating and unproductive years of trying, he decided to go back to trading. His ego and his confidence level were quite low from his failed attempt at another occupation, but he had kept all his notes covering his many years of trading, and he decided that he would begin trading shortly after he had reviewed his notes, and then paper trade for awhile.

He followed through on his plan. He carefully and deliberately brought himself up to speed in trading. He read and studied all his notes. He went over and over countless charts that were the backup for the trades he had done – the very trades that had made him rich.

He then bought historical data covering the years in which his trading had reached glorious heights. Very carefully and thoroughly he back-tested that data, until he was sure he would have taken the same trades in the same way. On paper, with only minor variances, he re-created his original fortune. At that point he felt he was up to his former level of trading. There remained only to test himself with real trading.

He began to enter trades. He followed all the things he knew how to do. His discipline was magnificent. He was glowing with confidence that he would create yet another fortune from his trading. He began to lose! As was his habit and discipline from years of trading, he began to examine himself. He checked and double checked to see if he had traded the way he was supposed to trade. He checked every trading decision. He checked his order entries. He checked his reactions to crises that had arisen. He could find no error in his trading, so he pushed on.

By mid year, his losses amounted to almost twice what they had been in the year he had suffered his greatest loss.

What in the world was wrong? Everything seemed to be in place. Had he lost the skill that previously lifted him to lofty heights?

The answer turned out to be that he was trying to do something that had worked splendidly at one time, but now no longer worked. The one area he hadn't thought to check was that of the market itself. This great trader hadn't changed. He still had discipline. He still could trade the way he always did. He still had his systematic method of trading. What was wrong was that he failed to perceive that the ***market*** had changed. It had changed drastically by the addition of a whole new set of participants. It was not that his system or method in and of itself was no good. It was not that he lacked discipline in following what had usually worked before. No! What used to work was no longer working, and he had failed to realize the situation and adapt. His mistake cost him tens of millions of dollars. It took him five more years of consistently losing money before he finally came to the realization that what he needed to was to adapt his methodology to the changes that had taken place in the market.

This story has a happy ending. The great trader is once again back on course and reaping a harvest of money. He has learned a great lesson. You might call it a lesson on how to survive through adaptation.

On a smaller scale we knew a trader who borrowed $10,000 from a friend so he could start daytrading the stock indexes (never borrow money to start trading). He had never day traded a stock index before, but he had traded commodities for a few years (obviously not too successfully since he needed $10,000 to start trading again.) He started daytrading electronically, and for the next 12 months had profits of between $50,000 and $80,000 a month. He repaid his friend, purchased a red convertible Jaguar, wore a $7,000, watch and got married. Things were definitely going his way. But he traded using a certain method, that due to various rule changes, stopped working. He was determined to keep trading this strategy that gained him great success. We had numerous conversations with him. We explained the rule changes and told him why his trading strategy would no longer work. Finally he purchased a book which described a mechanical trading system. The book cost $100, and the trader was diligent in following the advice offered in the book. All he had to do was to purchase some software for an additional $200 that would enable him to use the mechanical trading system by merely pushing a few buttons on the computer. As it turned out, the combined cost for the book and software was approximately one-thousand times its real value.

After only three months, our trading friend had lost over $40,000. By the way, he also tried trading other peoples' money with the same disastrous results. This story does not have a happy ending. We recently spoke with the trader. He has moved at least twice during the last year, has spent or lost most of his money, and is fully acquainted with most of the characters on the daily soap operas. Hopefully he will get back on track soon. We have included this story so you do not think that all our trading stories end the way we would like them.

Speaking of stories, here is another interesting one. It teaches a lesson from which you are well advised to learn. We know two traders, one trading for about 10 months and the other about 2 1/2 years. Neither was a very large daytrader but both were quite consistent in their daily and monthly profits. Unfortunately, they both had bad tempers and were both quite lazy. They were both trading in the same daytrading office, and they both purchased a large number of contracts at a price of $4.00. Even though they were day traders, they did hold some positions longer term; this was one of those times.

Over the next 6 months the market soared, and the market they were in quickly became quite visible through news releases from the secretary of agriculture. The market had risen to a high of $6.90. Both traders were really making money, in fact so much so that they both had stopped trading and decided to start living the high life — spending more time with their families, playing golf, and anything else they felt like doing. They acted as if their lottery ticket had just come in. However, they never cashed the ticket because they believed that the market was going to rise forever. So they felt there was no reason to cover costs, or sell any to take any profits. Sadly, in the seventh month that they were holding the contracts, there was some really bad news. The next day the market opened down 1 point from the previous day's close of $7.00, and the next day down 2 more bringing them back to where they had gone long. They found themselves having not traded in seven months, and having never cashed in on a potential fortune. They had to start all over. This can be a really humbling business.

KISS

We're going to show you a technique that, if you will diligently follow it, will practically guarantee that you will be a winner in the market. It follows the U.S. Army KISS (Keep It Simple, Stupid) principle. This technique works well in trending but somewhat choppy markets. We want to take advantage of the probabilities. Statistics show that once a trend has begun, the percentages favor a continuation. When prices are in a chopping trend, it may be difficult to see an overall trend line.

However, it may be possible to delineate the trend by creating a channel using a trend line for the highs and lows.

We are assuming that you have read the Appendix but if you haven't, for understanding what follows, please review "THE LAW OF CHARTS." We have included an expanded version of TLOC in the Appendix, with more detail than has been previously presented.

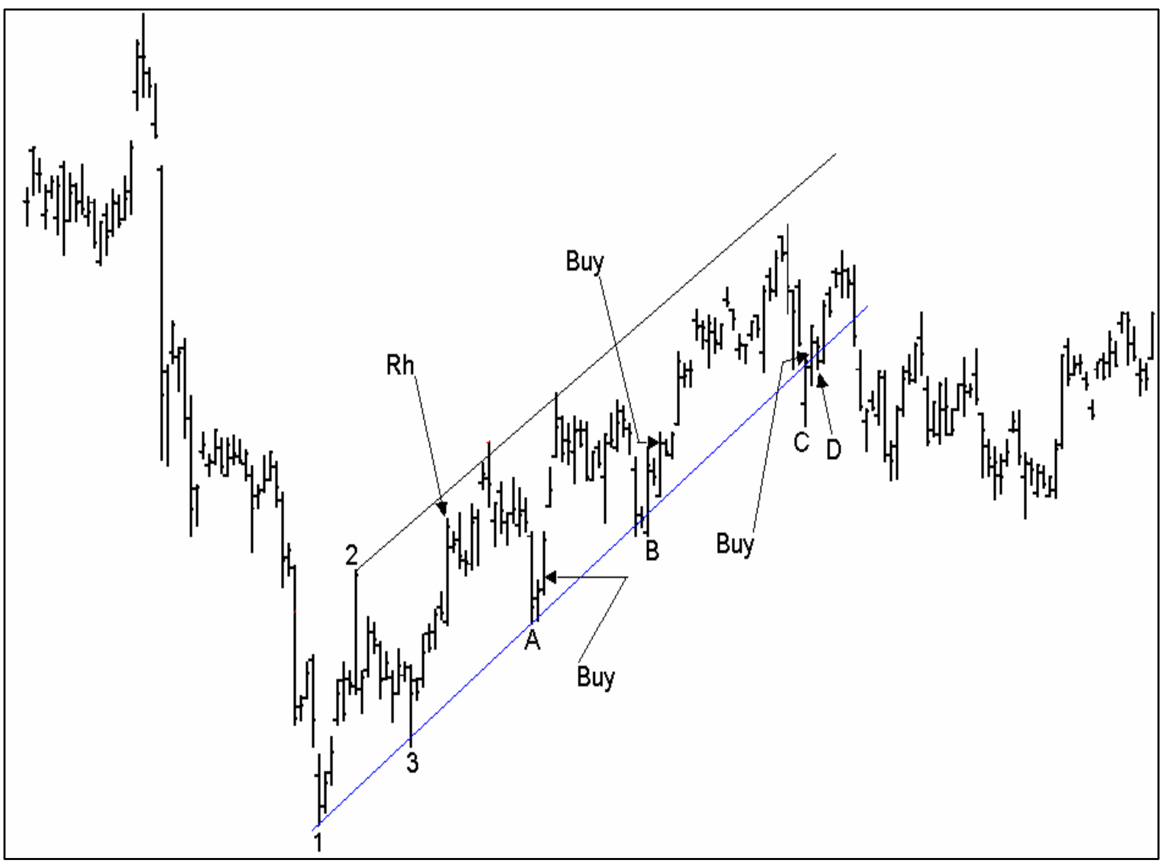
The first step is to identify the trend as being established. This we have done, and marked a 1-2-3 low which *defines* the trend. A breakout of the Ross Hook following the defined trend *establishes* the trend.

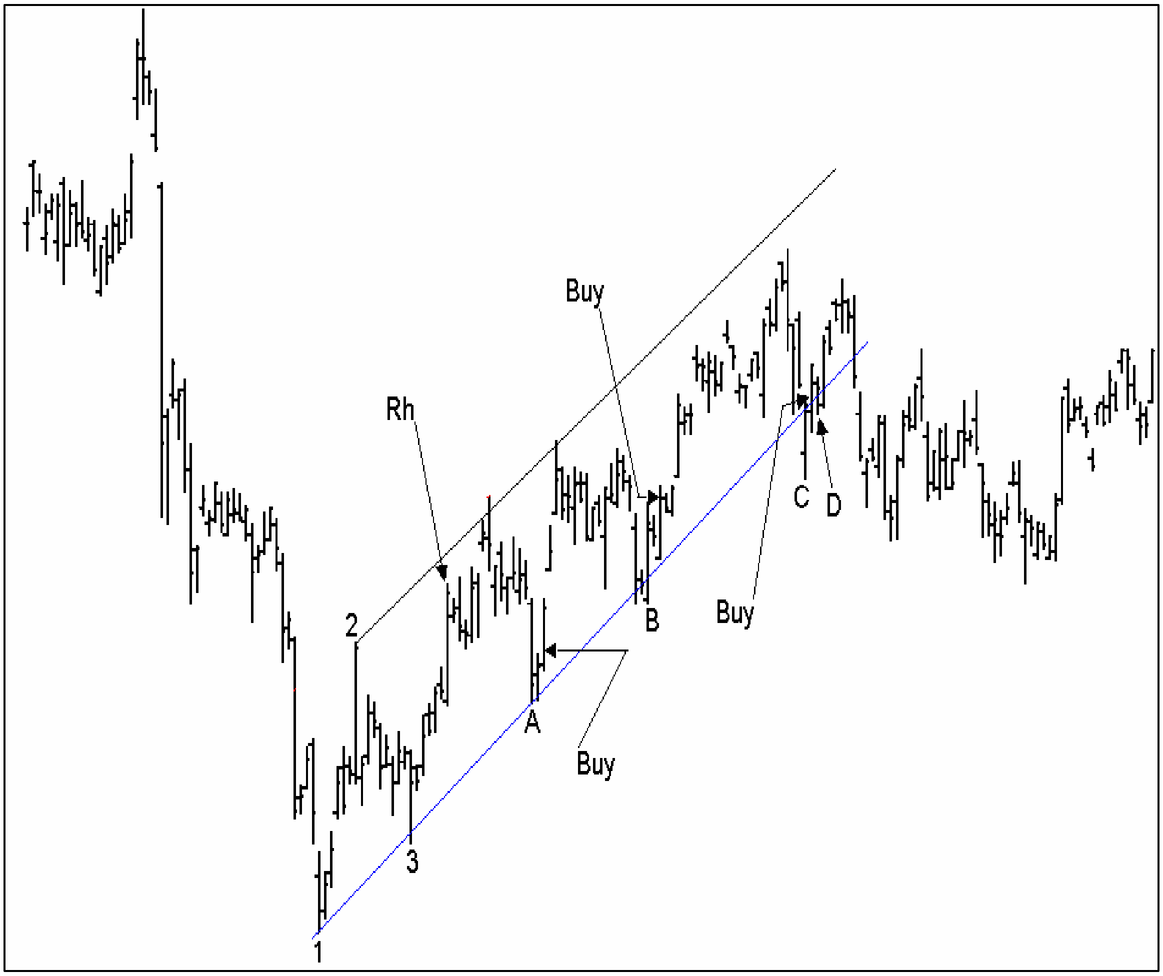
Originally, we drew a trend line between points 1 and 3. However, such a line is merely tentative because until the trend is *established*, we have only a *defined* trend in effect.

Once we had an established trend, we re-drew the trend line to include “A,” and then added the channel line so that it paralleled the trend line. The upper channel line is of little importance other than to assist in the visual delineation of the trend.

As has been mentioned in many places in our courses, the object of trading is to win. This is done by keeping losses small and maximizing gains. This in turn is done by keeping loss potential at a minimum while keeping the propensity for a win at a maximum.

A trending channel offers just such an opportunity when prices reach the channel line. In a trending channel, the momentum and direction of the trend are likely to continue once the channel boundaries are tested. To further enhance the probability that any loss will be small compared with what can be attained with a win, we want to see not only a touch of the channel line by prices, but also the completion of a reversal bar which is evidenced in this case by the close being higher than the open on a price bar in which prices touch or violate the up trend line (A,B and C).



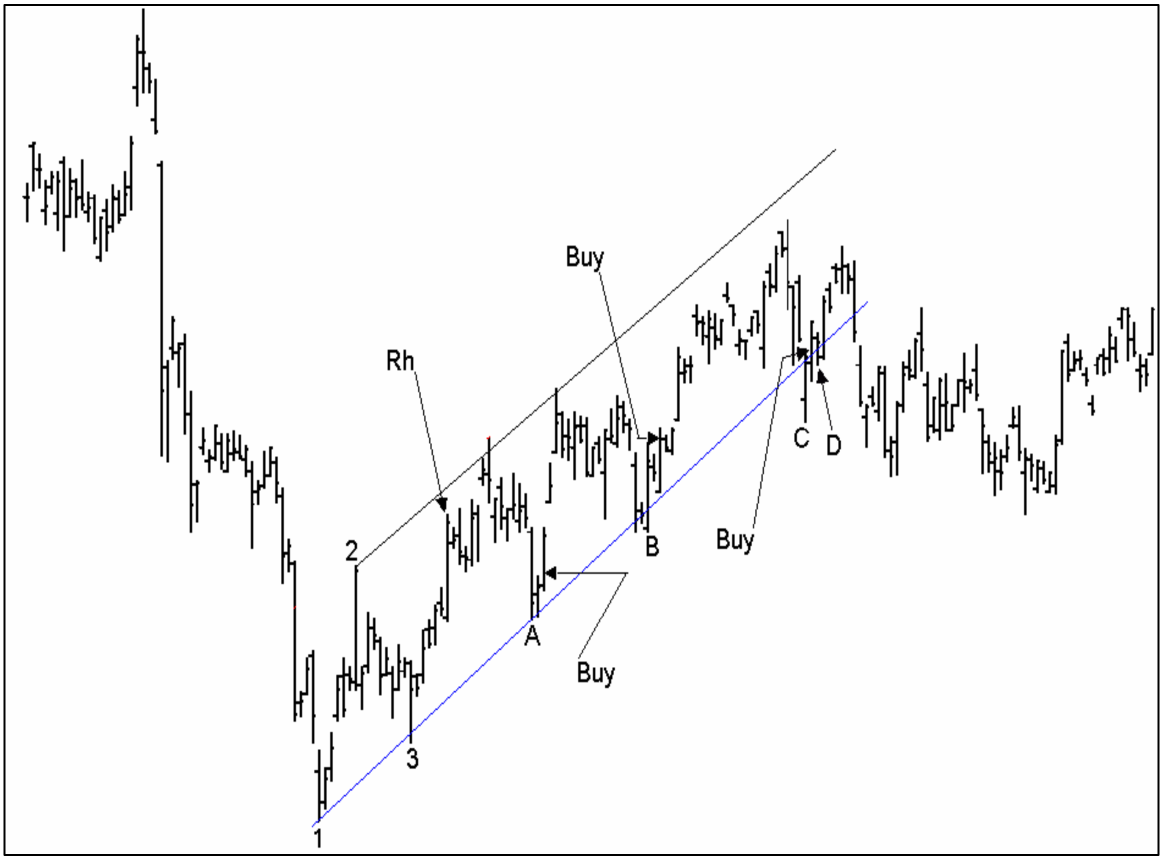


Let's take the possible trades one at a time:

- At "A," we have a price bar that touches the uptrend line. Following that there is a bar that not only touches the uptrend line, but also reverses price direction by closing higher than it opens. We buy a breakout of the high of the reversal bar.

- At "B," we have a price bar that violates the uptrend line. Preceding "B" there were two price bars that also violated the uptrend line, but neither one of them gave any indication of a price reversal. Therefore, our entry point is a violation by price of the high of price bar "B." That violation comes two bars later.

- At "C," we have a price bar that has most of its action well below the uptrend line, but which closes above the uptrend line. Because of the close being higher than the open, "C" is a reversal bar. We purchase a breakout of the high of bar “C,” and are stopped out on the following price bar “D.” Bar “D” violates the uptrend line as explained in the following paragraph.

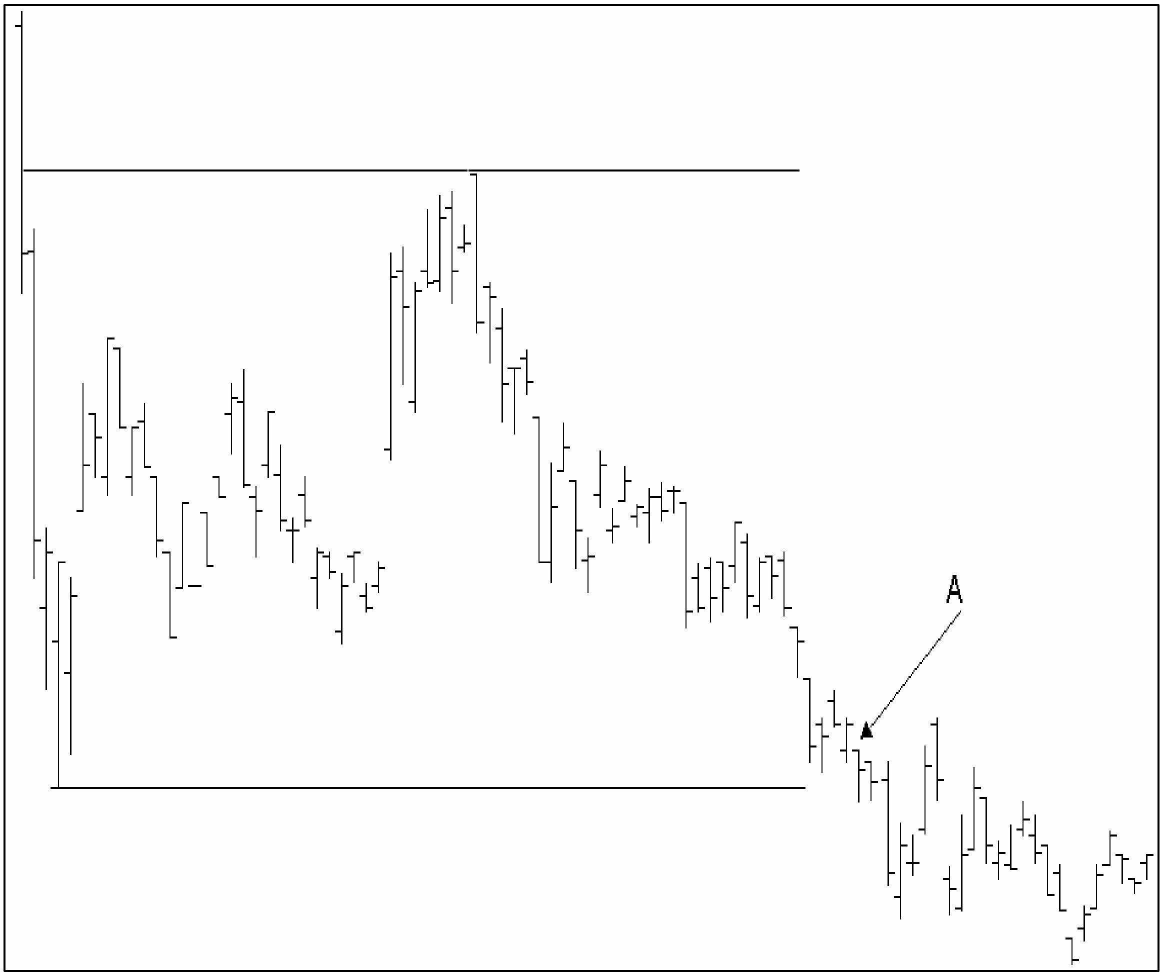


The stop for these trades initially goes below the trend line. Once the trend makes new highs on bars totally within the channel, any catastrophic stop is trailed at the channel line.

That doesn't mean you always sit and wait until prices reach the channel line to be stopped out. Profit taking exit stops should be placed so that you take some profits, as with any trade where profits are possible. Profits should be taken via any method that is more immediate to the price action than is the trend line. Just be sure to take profits while they are available.

Notice that another buying opportunity occurred two bars after bar “D” when prices violated the high of yet another reversal bar at the trend line.

Let's look at another chart:

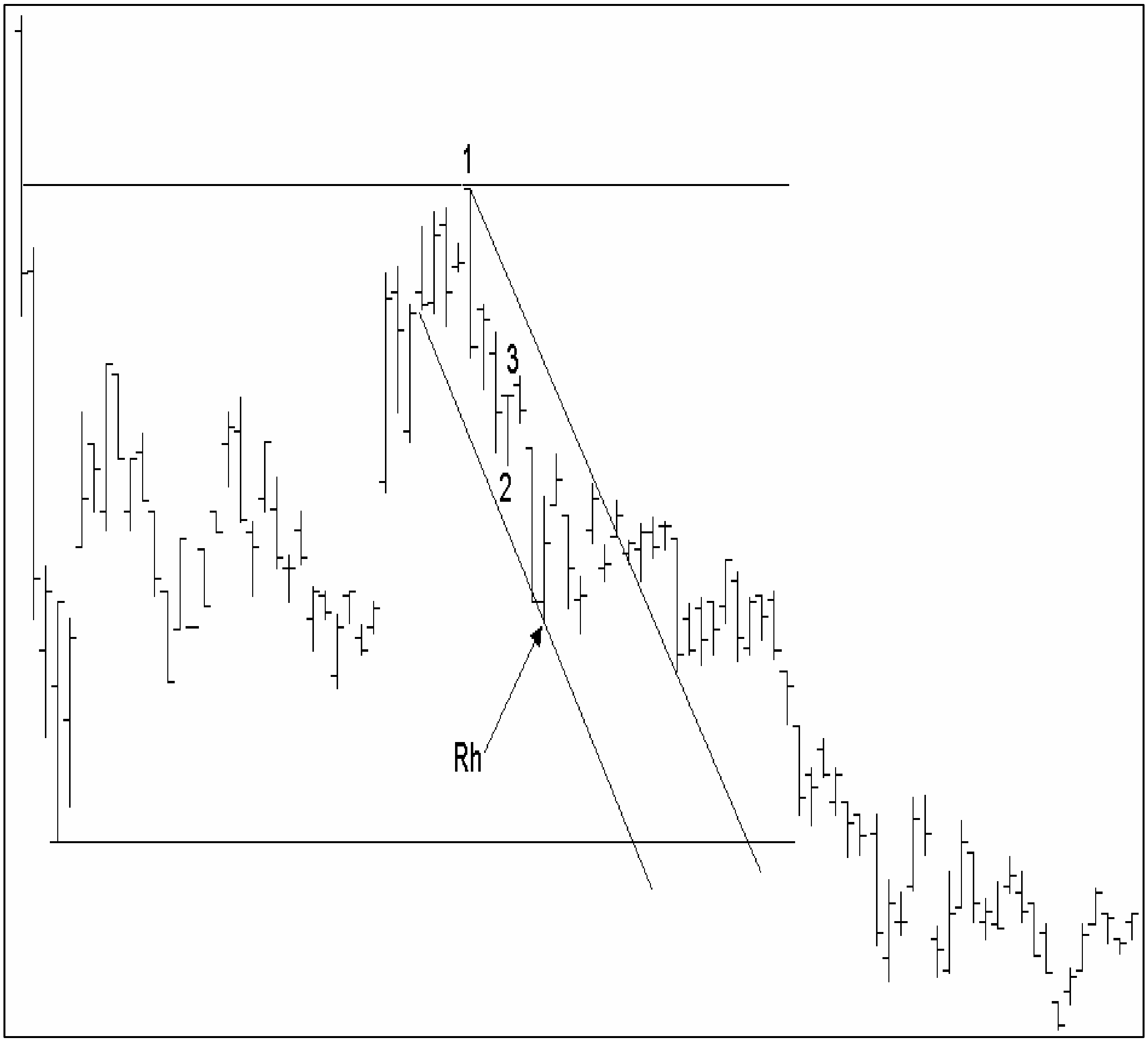


Once again we see prices trending, but it may be helpful to delineate the trend by drawing some channel lines.

The questions are: “Where exactly did the trend start and when, if ever, did it become tradable using the channel technique?” Was it after we see prices breaking below the lower horizontal congestion line at “A”? Was it sooner? Was it tradable at all?

Until prices broke below the lower horizontal line, which we drew to mark off what we perceived as chopping sideways prices, would it have been fair to say that prices were trending?

Besides delineating the congestion, would it have helped to also delineate a possible trending channel? Let's see. The answer may surprise you.



As you can see, although by definition we had both a defined and established trend, and we drew the channel lines by the same rules as we did for the uptrending chart shown earlier, there were no trades available using this technique, because prices went outside the channel and remained there.

Not once did we see a reversal bar subsequent to a violation of the Ross Hook that would have enabled us to enter a trade by selling short within the channel.

Should we have redrawn the downtrend line and also the channel line. No! We don't want to change the method unless we discover that it hardly ever works. In that event, the market may have changed and we have to come up with a new method or adapt this one in order to compensate.

We hope you can see the simplicity of this strategy and understand the tactics needed to carry it out. In a market that is clearly and less erratically trending, you won't need to draw channel lines.

In a clearly trending market, one consistently making higher highs and higher lows, or lower highs and lower lows, a simple trend line or moving average line may be a better way to show containment of a move. The strategy and management for trading a normal trend is somewhat different as well. We have shown some of these strategies and tactics in our manuals TRADING BY THE MINUTE© and TRADING THE ROSS HOOK©.

Remember, you don't necessarily want to find something that works and then stick with it. Such a strategy will be good for awhile, but you will end up the fool. It has happened to the best of traders.

Your goal as a trader must always be to have a toolbox from which you can draw the appropriate tool for each market condition you encounter. Keep in mind: what works today for one market may not work today for another. What works today for one market may not work in the same market tomorrow.

Markets trend, and they move sideways. The congestions can be short term, such as Ledges within a trend, or they can be long term, such as Trading Ranges. Trends can be gradual, with progressively higher highs and lows in an uptrend, and progressively lower highs and lows in a downtrend. But that description is an over simplification of market price action.

There is an old saying that a market can trend up, trend down, or not trend at all (sideways market). Don't you believe that for a moment. A market can move up in a gradual trend, a stair stepping trend, a chopping trend, or an explosion. It can move down gradually, it can stair step down, it can chop its way down, or it can collapse (meltdown). Each situation requires a different set of tools. It is a folly of mechanical trading systems that they attempt to trade all the ways a market can move using a single tool. It's like the repairman who tries to fix everything with a hammer.

Sideways markets, too, have differences. There are tight Trading Ranges and there are large chopping Trading Ranges. There are Trading Ranges that continually narrow over time. People have termed these "coils." There are Trading Ranges that continually widen over time. People have termed these "megaphones." The underlying reasons for each of these different formations are themselves different. Different circumstances call for different sets of tools to properly enter and manage them. Would you want to trade all of the different formations with an 18 bar Relative Strength Indicator (RSI)? What if you changed the RSI to 15, or 14? Would you still get the same set of signals? If not, which would be right? Using different time spans for indicators, or any oscillator for that matter, is like using different hammer sizes. A hammer is still a hammer. Sometimes you need a wrench!

You have heard it said, "If it works, don't fix it." People have misunderstood the full meaning of what is being stated. It is true that when something works in the market, you shouldn't fool with it by trying to make it better. Doing that is the downfall of many traders. But you should be prepared at all times for what has been working to stop working. Then it's not a matter of fixing anything. It then becomes a matter of adaptation subsequent to the realization that what you have been doing is no longer working because the markets have changed.

Our famous and great trading friend, after five years of frustration and agony, finally learned that lesson. We can all learn from his experience.

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