ROBERT PRECHTER

THE ELLIOTT WAVE THEORIST

STOCK MARKET INTEREST RATES PRECIOUS METALS

Elliott Wave International P.O. Box 1618 Gainesville, GA 30503

SPECIAL REPORT

WHAT A TRADER REALLY NEEDS TO BE SUCCESSFUL

Ever since winning the United States Trading Championship in 1984 (see footnotes, p.4), subscribers have asked for a list of "tips" on trading, or even a play-by-play of the approximately 200 short term trades I made while following hourly market data over a four month period. Neither of these would do anyone any good. What successful trading requires is both more and less than most people think. In watching the reports of each new Championship over the past three years, it has been a joy to see what a large percentage of the top winners have been *Elliott Wave Theorist* subscribers and telephone consultation customers. (In fact, in the latest "standings" report from the USTC, of the *top three producers* in each of four categories, *half* are EWT subscribers!) However, while good traders may want the input from EWT, not all EWT subscribers are good traders. Obviously the winners know something the losers don't. What is it? What are the guidelines you *really* need to meet in order to trade the markets successfully?

When I first began trading, I did what many others who start out in the markets do: I developed a list of trading rules. The list was created piecemeal, with each new rule added, usually, following the conclusion of an unsuccessful trade. I continually asked myself, what would I do differently next time to make sure that this mistake would not recur? The resulting list of "do's" and "don'ts" ultimately comprised about 16 statements. Approximately six months following the completion of my carved-in-stone list of trading rules, I balled up the paper and threw it in the trash.

What was the problem with my list, a list typical of so many novices who think they are learning something? After several months of attempting to apply the "rules," it became clear that I made not merely a mistake here and there in the list, but a fundamental error in compiling the list in the first place. The error was in taking aim at the *last* trade each time, as if the next trading situation would present a similar problem. By the time 16 rules are created, all situations are covered and the trader is back to square one.

Let me give you an example of the ironies that result from the typical method of generating a list of trading rules. One of the most popular trading maxims is, "You can't go broke taking a profit." (The brokers invented that one, of course, which is one reason that new traders always hear of it!) This trading maxim appears to make wonderful sense, but only when viewed in the context of a recent trade with a specific outcome. When you have entered a trade at a good price, watched it go your way for a while, then watched it go against you and turn into a loss, the maxim sounds like a pronouncement of divine wisdom. What you are really saying, however, is that in the context of the last trade, "*I should have sold when I had a small profit*."

Now let's see what happens on the next trade. You enter a trade, and after just a few days of watching it go your way, you sell out, only to stare in amazement as it continues to go in the direction you had expected, racking up paper gains of several hundred percent. You ask a more experienced trader what your error was, and he advises you sagely while peering over his glasses, "Remember this forever: Cut losses short; let profits run." So you reach for your list of trading rules and write this maxim, which means only, of course, "*I should NOT have sold when I had a small profit*."

So trading rules #2 and #14 are in direct conflict. Is this an isolated incident? What about rule #3, which reads, "Stay cool; never let emotions rule your trading," and #8, which reads, "If a trade is obviously going against you, get out of the way before it turns into a disaster." Stripped of their fancy attire, #3 says, "*Don't panic during trading*," and #8 says, "*Go ahead and panic*!" Such formulations are, in the final analysis, utterly useless.

What I finally desired to create was a description not of each of the trees, but of the forest. After several years of trading, I came up with —guess what— another list! But this is *not* a list of "trading rules"; it's a list of requirements for successful trading. Most worthwhile truths are simple, and this list contains only five items. (In fact, the last two are actually subsets of the first two.) Whether this list is true or complete is arguable, but in forcing myself to express my conclusions, it has helped me understand the true dimensions of the problem, and thus provided a better way of solving it. Like most rewards life offers, market profits are not as easy to come by as the novice believes. Making money in the market requires a good deal of education, like any craft or business. If you've got the time, the drive, and the right psychological makeup, you can enter that elite realm of the truly professional, or at least successful, trader or investor. Here's what you need:

1. A method.

I mean an *objectively definable* method. One that is thought out in its entirety to the extent that if someone asks you how you make your decisions, you can explain it to him, and if he asks you again in six months, he will receive the same answer. This is not to say that a method cannot be altered or improved; it must, however, be developed as a totality before it is implemented. A prerequisite for obtaining a method is acceptance of the fact that perfection is not achievable. People who demand it are wasting their time searching for the Holy Grail, and they will never get beyond this first step of obtaining a method. I chose to use, for my decision making, an approach which was explained in our book, *Elliott Wave Principle*. I think the Wave Principle is the best way to understand the framework of a market and where prices are within that framework. There are a hundred other methods which will work if successful trading is your only goal. As I have often said, a simple 10-day moving average of the daily advance-decline net, probably the first indicator a stock market technician learns, can be used as a trading tool, if objectively defined rules are created for its use. The bad news is that as difficult and time consuming as this first major requirement can be, it is the *easiest* one to fulfill.

2. The discipline to follow your method.

This requirement is so widely understood by the true professionals that among them, it almost sounds like a cliché. Neverthless, it is such an important cliché that it cannot be sidestepped, ignored, or excepted. Without discipline, you really have no method in the first place. It struck me one day that among a handful of *consistently successful* professional options and futures traders of my acquaintance, three of them are former Marines. In fact, the only advisor, as ranked by Commodity Traders Consumer Report, consistently to beat my Telephone Hotline record from 1983 to 1985 was a former Marine as well (he has retired from the advisory business). Now, this is a ratio *way* out of proportion to former Marines as a percentage of the general population! Why should this anomaly exist? Think about it. At some point in their lives, these people *volunteered* to serve in an organization which requires, above all, *discipline*. These are people who *asked* for the opportunity to go charging through a jungle pointing a bayonet and pitching grenades, surviving on roots and bugs when necessary. That's an overdramatization perhaps, but you get the point. These people knew they were "tough," and wanted the chance to prove it. Being "tough" in this context means having the ability to suppress a host of emotions in order to act in a manner which would strike fear in the hearts of most people. I was never a Marine, but years ago while attending summer school with Georgia's "Governor's Honors Program," I was given a psychological test and told that one of my skewed traits was "tough-mindedness" (as opposed to "tender-mindedness"). I didn't exactly know what that meant, but after trading and forecasting the markets for fourteen years, it is clear that without that trait, I would have been forced long ago to elect another profession. The pressures are enormous, and they get to everyone, including me. If you are not disciplined, forget the markets.

3. Experience.

Some people advocate "paper trading" as a learning tool. Paper trading is useful for the testing of methodology, but it is of no value in learning about trading. In fact, it can be detrimental, by imbuing the novice with a false sense of security in "knowing" that he has successfully paper traded the past six months, thus believing that the next six months with real money will be no different. In fact, nothing could be further from the truth. Why? Because the markets are not merely an intellectual exercise. They are an emotional (and in extreme cases, even physical) one as well. If you buy a computer baseball game and become a hitting expert with the joystick while sitting quietly alone on the floor of your living room, you may conclude that you are one talented baseball player. Now let the Mean Green Giant reach in, pick you up, and place you in the batter's box at the bottom of the ninth inning in the final game of the World Series with your team behind by one run, the third base coach flashing signals one after another, a fastball heading toward your face at 90 m.p.h., and sixty beer soaked fans in the front row screaming, "Yer a bum! Yer a bum!" Guess what? *You feel different!* To put it mildly, you will find it impossible to approach your task with the same cool detachment you displayed in your living room. This new situation is real, it matters, it is *physical*, it is *dangerous*, *other people are watching*, and you are being *bombarded with stimuli*. This is what your life is like when you are actually speculating. You know it is real, you know it matters, you must physically pick up the phone and speak to place orders, you perform under the scrutiny of your broker or clients, your spouse and business acquaintances, and you must operate while thousands of conflicting messages are thrown at you from the financial media, the brokerage industry, analysts, and the market itself. In short, you must conquer a *host* of problems, most of them related to your own inner strength in battling powerful human emotions, in order to trade real money successfully. The School of Hard Knocks is the *only* school that will teach it to you, and the tuition is expensive.

There is only one shortcut to obtaining experience, and that is to find a *mentor*. Locate someone who has proved himself over the years to be a successful trader or investor, and go visit him. You will undoubtedly find that he is very friendly since his runaway ego of yesteryear, which undoubtedly got him involved in the markets in the first place, has long since been humbled, matured by the experience of trading. Watch this person operate. Observe not only what he does, but far more important, what he *does not allow himself to do*. This person does exist, but it is hard to find him. He will usually welcome the opportunity to tell you what he knows.

4. The Mental Fortitude to Accept the Fact that Losses Are Part of the Game.

There are many denials of reality which automatically disqualify millions of people from joining the ranks of successful speculators. For instance, to moan that "pools," "manipulators," "insiders," "they," "the big boys" or "program trading" are to blame for one's losses is a common fault. Anyone who utters such a conviction is doomed before he starts. But my observation, after eleven years "in the business," is that the biggest obstacle to successful speculation is the failure merely even to recognize and accept the simple fact that *losses are part of the game*, and that they must be accommodated. The perfect trading system does not exist. Expecting, or even hoping for, perfection is a guarantee of failure. Speculation is akin to batting in baseball. A player hitting .300 is good. A player hitting .400 is great. But even the great player *fails to hit* 60% of the time! He even *strikes out* often. But he still earns six figures a year, because although not perfect, he has approached the best that can be achieved. You don't have to be perfect to win in the markets, either; you "merely" have to be better than almost everybody else, and that's hard enough. Practically speaking, you must include an objective money management system when formulating your trading method in the first place. There are many ways to do it. Some methods use stops. If stops are impractical (such as with options), you may decide to risk only small amounts of total capital at a time. After all is said and done, learning to handle losses will be your greatest triumph.

The last on my list is one I have never heard mentioned before.

5. The Mental Fortitude to Accept Huge Gains.

This comment usually gets a hearty laugh, which merely goes to show how little most people have determined it actually to be a problem. But consider. How many times has the following sequence of events occurred? For a full year, you trade futures contracts, making $1000 here, losing $1500 there, making $3000 here and losing $2000 there.

Once again, you enter a trade because your method told you to do so. Within a week, you're up $4000. Your friend/partner/acquaintance/broker/advisor calls you and, looking out only for your welfare, tells you to take your profit. You have guts, though, and you wait. The following week, your position is up $8000, the best gain you have ever experienced. "Get out!" says your friend. You sweat, still hoping for further gains. The next Monday, your contract opens limit against you. Your friend calls and says, "I *told* you so. You got greedy. But hey, you're still way up on the trade. Get out tomorrow." The next day, on the opening, you exit the trade, taking a $5000 profit. It's your biggest profit of the year, and you click your heels, smiling gratefully, proud of yourself. Then, day after day for the next six months, you watch the market continue to go in the direction of your original trade. You try to find another entry point and continue to miss. At the end of six months, your method finally, quietly, calmly says, "Get out." You check the figures and realize that your initial entry, if held, would have netted $450,000.

So what was your problem? Simply that you had allowed yourself unconsciously to define your "normal" range of profit and loss. When the big trade finally came along, you lacked the self esteem to take all it promised. You looked at a job requiring the services of a Paul Bunyan and decided that you were just a Pee Wee Herman. Who were *you* to shoot for such huge gains? Why should *you* deserve more than your best trade of the year? You then abandoned both *method* and *discipline*.

To win the game, make sure that you understand why you're in it. The big moves in markets only come once or twice a year. Those are the ones which will pay you for all the work, fear, sweat and aggravation of the previous eleven months or even eleven years. Don't miss them for reasons *other than* those required by your objectively defined method.

The I.R.S. categorizes capital gains as "unearned income." That's baloney. It's *hard* to make money in the market. Every dime you make, you *richly deserve*. Don't ever forget that. I wish you success.

In 1984, Bob Prechter won the United States Trading Championship, setting a new all-time profit record of 444.4% in a monitored real money options account in four months. That February through May period presented a difficult and choppy market to the effect that the second highest reported gain in the options division was just 84%, and 83% of the contestants lost money. According to contest sponsors, many market letter writers have entered the contest over the years, but almost all have lost money. In the average 4-month contest, over 75% of contestants, most of whom are professionals paying $200 to prove their abilities, fail to report profits.

I highly recommend the United States Trading Championship. It is the only trading contest which fairly allows each entrant to perform at his maximum ability, without arbitrary constraints. Most others are started by brokerage firms to create business; they impose minimum accounts, insist on trading one type of vehicle, etc. For information on the USTC, contact the Financial Traders Association, P.O. Box 7634, Beverly Hills, CA 90212-7634; phone 310-550-0062.

THE ELLIOTT WAVE THEORIST is published by Elliott Wave International, Inc. Mailing address: P.O. Box 1618, Gainesville, Georgia 30503, U.S.A. Phone: 770-536-0309.

FINANCIAL NEWSLETTERS INTERNATIONAL
FOUNDING MEMBER

EWT is published irregularly, one or more times per month. All contents are written by Robert Prechter. Correspondence is welcome, but volume of mail often precludes a reply. For best results, send concise e-mail to one of the addresses listed on the bulletin board of our website (**www.elliottwave.com**).

SUBSCRIPTION RATES: $**20** per month (add $1.50 per month for overseas airmail). Subscriptions paid via credit card automatically renew each month. Visa, MasterCard, Discover and American Express accepted; call our office for other payment options. Delivery available via Internet download, first class mail and fax, (Call for fax pricing.) Telephone 770-536-0309 or 800-336-1618, or send credit card number and expiration date with your order. Georgia residents must add sales tax.

Visit our website, **elliottwave.com**, listing Elliott Wave BOOKS, SPECIAL REPORTS, PRECISION RATIO COMPASS, and our EDUCATIONAL VIDEO SERIES.