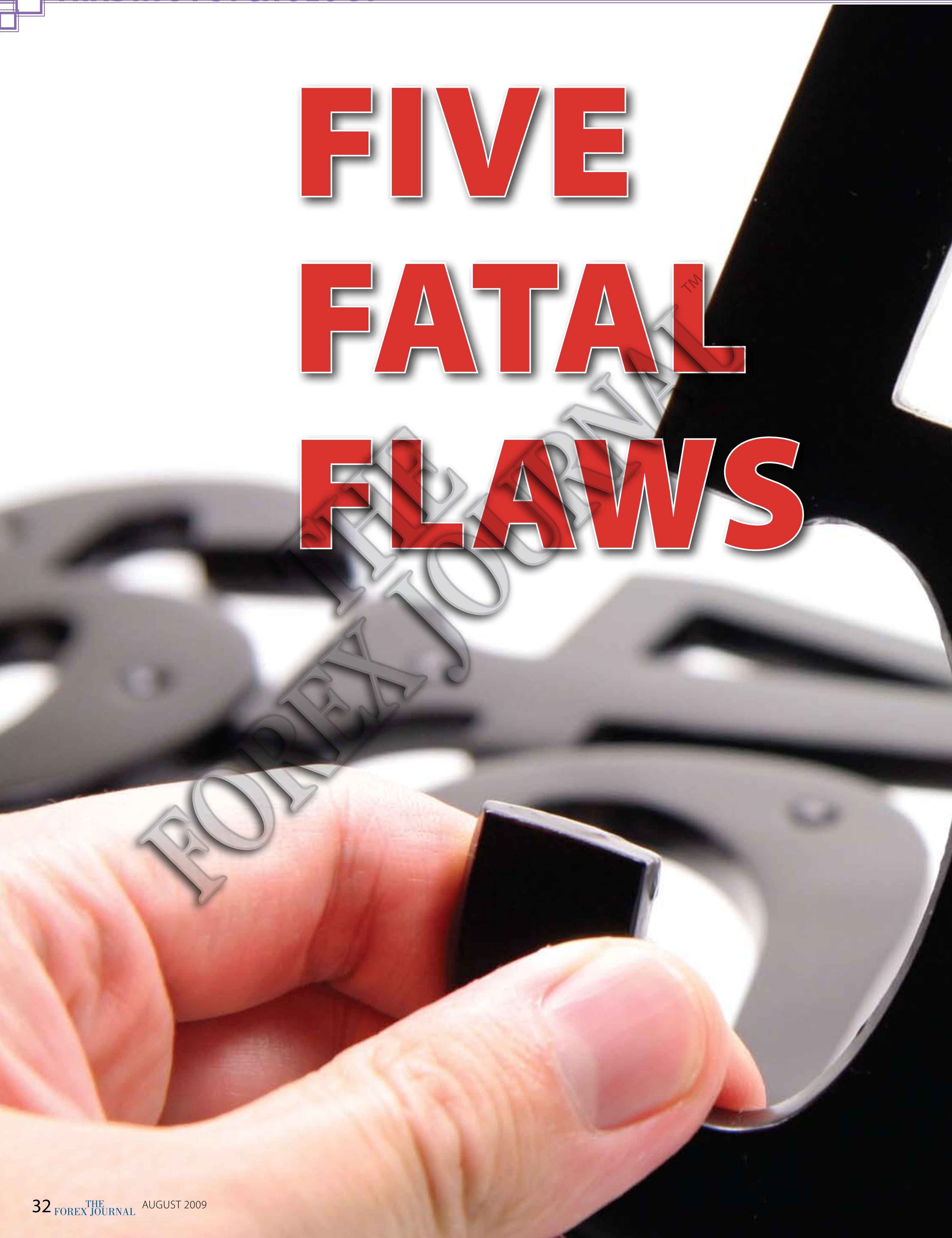
FIVE FATAL FLAWS



OF TRADING

If you have been trading for some time, you have no doubt felt like an invisible 'hand' sometimes reaches into your trading account and takes out money. Jeffrey Kennedy looks at the five fatal flaws that help that 'hand' keep taking money from your account.

Some ninety percent of all traders lose money. The remaining ten percent somehow manage to either break even or even turn a profit – and more importantly, do it consistently. How do they do that?

Why Do Traders Lose?

If you have been trading for a long time, you no doubt have felt that a monstrous, invisible 'hand' sometimes reaches into your trading account and takes out money. It does not seem to matter how many books you buy, how many seminars you attend or how many hours you spend analyzing price charts, you just cannot seem to prevent that invisible 'hand' from depleting your trading account funds.

Which brings us to the question – "Why do traders lose?" Or maybe we should ask, "How do you stop the 'Hand?'" Whether you are a seasoned professional or just thinking about opening your first trading account, the ability to stop the 'Hand' is proportional to how well you understand and overcome the Five Fatal Flaws of trading. Each fatal flaw represents a finger on the invisible 'hand' that wreaks havoc with your trading account.

Fatal Flaw No. 1 – Lack of Methodology

If you aim to be a consistently successful trader, you must have a defined trading methodology. This is simply a clear and concise way of looking at markets. Guessing or going by gut instinct will not work over the long run. If you do not have a defined trading methodology, then you do not have a way to know what constitutes a buy or sell signal. Moreover, you cannot consistently identify the trend.

How is it possible to overcome this fatal flaw? Write down your methodology. Define in writing what your analytical tools are and, more importantly, how you use them. It does not matter whether you use the wave principle, point and figure charts, stochastics, RSI or a combination of these. What matters is that you actually make the effort to define it (i.e., what constitutes a buy, a sell, your trailing stop and instructions on exiting a position). The best hint I can give you regarding developing a defined trading methodology is this – If it cannot be fit it on the back of a business card, it is probably too complicated.

Fatal Flaw No. 2 – Lack of Discipline

When you have clearly outlined and identified your trading methodology, you must have the discipline to follow your system. A lack of discipline in this regard is the second fatal flaw. If you view a price chart or evaluate a potential trade setup differently than you did a month ago, you have either not identified your methodology or you lack the discipline to follow the methodology you have identified. The formula for success is to consistently apply a proven methodology. So, the best advice I can give you to overcome the lack of discipline is to define a trading methodology that works best for you and follow it religiously.

Fatal Flaw No. 3 – Unrealistic Expectations

Between you and me, nothing makes me angrier than those commercials that say something like, "...$5,000 properly positioned in natural gas can give you returns of over $40,000..." Advertisements like this are a disservice to the financial industry and end up costing uneducated investors a lot more than $5,000. In addition, they help to create the third fatal flaw – Unrealistic Expectations.

It is possible to experience above-average returns trading your own account. However, it is difficult to do it without taking on above-average risk. What is a realistic return to shoot for in your first year as a trader – 50%, 100%, 200%? Whoa! Let's rein in those unrealistic expectations. In my opinion, the goal for every first year trader should be not to lose money. In other words, shoot for a return of 0% your first year. If you can manage that, then in year two, try to beat the Dow or the S&P. These goals may not be flashy but they are realistic, and if you can learn to live with them – and achieve them – you will fend off the 'Hand.'

Fatal Flaw No. 4 – Lack of Patience

The fourth finger of the invisible hand that robs your trading account is lack of patience. I forget where, but I once read that markets trend only 20% of the time. From my experience, I would say that this is an accurate statement. So think about it, the other 80% of the time the markets are not trending in one clear direction.

That may explain why I believe that for any given timeframe, there are only two or three really good trading opportunities. For example, if you are a long-term trader, there are typically only two or three compelling tradable moves in a market during any given year. Similarly, if you are a short-term trader, there are only two or three high-quality trade setups in a given week.

All too often, because trading is inherently exciting (and anything involving money usually is exciting), it is easy to feel like you are missing the party if you do not trade a lot. As a result, you start taking trade setups of lower quality and begin to overtrade.

How do you overcome this lack of patience? The advice I have found to be most valuable is to remind yourself every week that there is another trade-of-the-year. In other words, do not worry about missing an opportunity today, because there will be another one tomorrow, next week and next month ... I promise.

I remember a line from a movie (either Sergeant York with Gary Cooper or The Patriot with Mel Gibson) where one character gives advice to another on how to shoot a rifle: "Aim small, miss small." I offer the same advice in this new context. To aim small requires patience. So be patient, and you will miss small.

Fatal Flaw No. 5 – Lack of Money Management

The final fatal flaw to overcome as a trader is a lack of money management. This topic deserves more than just a few paragraphs because money management encompasses risk/reward analysis, probability of success and failure, protective stops and so much more. Even so, I would like to address the subject of money management with a focus on risk as a function of portfolio size.

The big boys (i.e., the professional traders) tend to limit their risk on any given position to 1% to 3% of their portfolio. If we apply this rule to ourselves, then for every $5,000 we have in our trading account, we can risk only $50-$150 on any given trade. Stocks might be a little different, but a $50 stop in corn, which is one point, is simply too tight a stop, especially when the 10-day average trading range in corn recently has been more than 10 points. A more plausible stop might be five points or 10, in which case, depending on what percentage of your total portfolio you want to risk, you would need an account size between $15,000 and $50,000.

Simply put, I believe that many traders begin to trade without sufficient capital in their trading account to trade the markets they choose to trade. And, that does not even address the size that they trade (i.e., multiple contracts).

To overcome this fatal flaw, let me expand on the logic from the "aim small, miss small" movie line. If you have a small trading account, then trade small. You can accomplish this by trading fewer contracts, or trading e-mini contracts or even stocks. Bottom line, on your way to becoming a consistently successful trader, you must realize that one key is longevity. If your risk on any given position is relatively small, then you can weather the rough spots. Conversely, if you risk 25% of your portfolio on each trade, four consecutive losers, puts you out all together.

Break the 'Hand's' Grip

Trading successfully is not easy. It is hard work ... damn hard. And if anyone leads you to believe otherwise, run the other way, and fast. But this hard work can be rewarding, above-average gains are possible and the sense of satisfaction one feels after a few nice trades is absolutely priceless. To get to that point, you must first break the fingers of the 'Hand' that is holding you back and stealing money from your trading account. I can guarantee that if you attend to the five fatal flaws I have outlined, you will not be caught red-handed stealing from your own account.

Jeffrey Kennedy is the Chief Commodity Analyst at Elliott Wave International (EWI). With more than 15 years of experience as a technical analyst, he writes and edits Futures Junctures, EWI's premier commodity forecasting package.