

Chapter 2: The Path to Successful Trading

In the broad category of “trading the markets,” there are basically three types of trading: discretionary, technical, and strategy-based. When I sat down to write this book, my intent was to write only about strategy trading. But then I realized that to fully describe strategy trading, it was also necessary to discuss discretionary and technical trading. It’s important that you understand the difference between them, which is not always clear. I’ve met many people who believe they are strategy traders when they’re actually technical traders, and vice versa.

I have known and taught many traders, and have observed that there are four distinct stages of trader education: discretionary trader, technical trader, strategy trader, and complete strategy trader. All successful traders have gone through them. It is almost impossible to be a successful strategy trader without going through all of these stages. My goal with this book is to help you understand and move through the stages at much less cost in both time and money.

Every trader usually starts out as a discretionary trader. The amount of money lost generally determines how long it takes the individual to start using technical indicators to make trading decisions. Eventually, as even employing technical indicators fails to move the trader into profitability, the trader moves into the third stage and starts to write strategies based on quantifiable data. It is at this stage that the trader ordinarily starts to make money. Finally, the strategies and money management approaches are refined and the individual becomes successful as a strategy trader.

The Discretionary Trader

A discretionary trader uses a combination of intuition, advice and non-quantifiable data to determine when to enter and exit the market.

Discretionary traders are not restricted by a concrete set of rules. If you are a discretionary trader, you can make buy and sell decisions using whatever criteria you deem to be important at the moment. For example, you can use both a combination of hot tips and relevant news stories from *The Wall Street Journal*, and enter or exit the market based upon this information. If you begin to lose money, you can immediately exit the market and change your trading method. You don't have to use the same techniques day in and day out. It's a very flexible way to trade that you can customize based on what you think the market is going to do at any given moment.

For the discretionary trader, trades are made using gut instinct and intuition. Unless a computer is generating a buy or sell signal and you actually follow the signal, your emotions will affect your trading. I explained in the introduction what problems instinct and intuition could be in trading. Remember fear and greed? In discretionary trading, technical tools such as indicators are sometimes used; however, when they *are* put to use, they are utilized sporadically as opposed to systematically.

Fascinated by the markets, the discretionary trader is ready to put on a trade at a moment's notice. The most uncomfortable part of trading for the discretionary trader is when there is no action. So he will jump on any piece of information, anything that will permit him to take a stab at the market. Above all, he craves the action.

INTUITION & HOT TIPS

The discretionary trader uses several sources for his trading decisions. One is intuition, for example, "I see a lot of people in stores, so I think the economy is good, and earning will increase, so the stock market should go up, and I should buy Sears." He usually spends a lot of time talking to his broker. "What do you think Joe, isn't Woolworth's going to turn around?" Another is reading and watching the news, "Retail sales are looking strong and Woolworth's is closing stores to lower their overhead."

Hot tips are a common way that a discretionary trader gets ideas. A call from his broker or good friend, or a tip from a discussion at a cocktail party are all places the discretionary trader gets his trading ideas. "Hey George, HTECH Corp. has a

hot new product in the works, here's a stock you can pick up cheap." If it gets dry in the summer, our discretionary trader may decide to buy Corn, Beans or Wheat. However, when he looks out the window and notices that it's raining, he sells the position immediately. A news story on the nightly news may cause a discretionary trader to short the airline that has just had a crash.

CRAVES EXCITEMENT

What a discretionary trader loves is the excitement. He loves being "in the markets," playing with the big guys. He craves the risk, the excitement of trading, and the gambling rush that he gets from calling his broker and putting in the order to buy. He loves being able to sell Gyro Corp. based on the news story of the health hazards of their top selling Gyrometer. He has a real obsession for buying Cotton based on the hot tip from his broker that the upcoming crop report was going to be bullish, and he covets the tip from his friend who called to say that he just bought Techno Corp. because the latest quarterly earnings were going to be a surprise on the upside.

Discretionary traders retain the flexibility of changing their buy and sell criteria from moment to moment, and change the way they trade from minute to minute and day by day. "Well, that last trade was a disaster, so tomorrow I will buy McDonald's only if it opens up from yesterday's close." They don't have any discipline, nor do they think they need any. They use their intuition and their gut instinct, and feel justified in doing so. They think, "Making money is easy, you just have to be smarter and quicker than the next guy."

I personally don't know anyone who has made money by discretionary trading. They may have been lucky and won on a few trades, but overall, over time, discretionary traders always lose money.

It is after enough money has been lost that the discretionary trader in some way stumbles across technical indicators. It may be from the chart book he just looked at where there was a Stochastic Indicator underneath the chart. Or he may have gone to the latest *Make a Million Dollars Trading the Stock Market* seminar and found out that using the Relative Strength Indicator is the sure way to stock market profits. He thinks, "So this is how they do it!" These indicators look like magic. They add some rationality to an otherwise irrational trading style. He thinks, "This must be how the big money players make the big money—they use technical indicators!"

DISCOVERS TECHNICAL INDICATORS

Once the discretionary trader discovers technical indicators, he or she incorporates some rudimentary ones into trading, usually as additional justification for making the trade. “Not only did Ralph (my broker) tell me to buy Gizmo Corp. but Gizmo has great relative strength. Gizmo’s moving averages are bullish, and the Stochastics are oversold and giving a buy signal as well.”

These newfound technical indicators give the discretionary trader a new lease on trading. Now our trader has a whole new world in front of him—the world of technical trading. For a while, this newfound world combines with intuition and the discretionary trader views himself as a strategy trader. He says, “I trade a strategy using moving averages and Stochastics with a dash of daily news and tips from my broker. I am now a real objective strategy trader.” While the trader may view himself as a strategy trader, this could not be farther from the truth. The discretionary trader’s style is still undisciplined, based on newly educated guesses, and he is probably still losing money.

For a moment, these technical tools were thought to be the answer, and while they add a little more rationale to his trades, the losses continue to pile up. Despite his continuing angst, our discretionary trader is now on the way to becoming a technical trader.

The Technical Trader

A technical trader uses technical indicators, hotlines, newsletters and perhaps some personally defined objective rules to enter and exit the market.

As a technical trader, you are beginning to realize that rules are important and that it is appropriate to use some objective criteria such as confirmation before making a trade. You have developed rules, but sometimes you follow them and sometimes you don’t. It depends how confident you feel today and how much money you are making or losing. If an indicator gives you a buy signal, you may override it because your broker told you the earnings report was going to be negative. Or maybe the bonds are up, which means interest rates are rising, and you better see how high rates go before you commit more money to this already overpriced market. You may think, “I have a profit, hmm, I just may take it now. Even though the Stochastic is not overbought, the markets are tough. It’s not easy to make money. Like my father said, ‘you can’t go broke taking profits.’ At least now I have a winning trade. I’ll sleep well tonight.”

Our trader now begins to realize that using the intuitive and hot tip approach will not lead to profitability. He now begins to focus on the technical indicators themselves. There are so many! Moving Averages, Exponential and Weighted. The MACD, Momentum, P/E Ratio, Rate of Change, DMI, Advance/Decline Line, EPS, True Range, ADX, CCI, Candlesticks, MFI, Parabolic, Trendlines, RSI, Volatility Expansion and Volume and Open Interest, just to name a few. So much to learn and so little time!

This whole new world of technical books, seminars, newsletters, and hot lines now begins to preoccupy our trader. He learns all he can about indicators. He wants to find the one indicator that will ensure profitability. He surrenders to what I call Indicator Fascination.

INDICATOR FASCINATION

The first assumption that our trader makes is that someone out there must know how to do this. There must be an expert, someone who knows how to make money, that has created the magic indicator to do it. This is the Holy Grail syndrome and our trader now embarks on a search for the Holy Grail Indicator. He knows intuitively that there must be an indicator that will give him the information he needs to make profitable trades...that there must be teachers out there that know how to make money trading. He thinks, "All I need to do is find him and his indicators."

This is the indicator fascination phase. How are indicators calculated, what do they represent, and are they the "secret" to making money? All of these questions need to be answered so he becomes a seminar junkie, travelling the country on the quest for that great technique, the one that everyone uses to make the big money. He visits Chicago one month...L.A. the next...followed by a visit to the Chicago Mercantile Exchange. He watches the CNBC expert technicians and surfs the net looking for that magic indicator.

Now he'll only buy when the ADX is moving up and the MACD is positive, and he'll sell only when the RSI gets overbought and turns down. His trading becomes more indicator-based and he listens less to his broker. For example, he may tell his broker, "No, I won't buy Apple Computer until the Earnings Momentum Indicator is over 80!" Unfortunately, even with all of this information, and all the assurances of his seminar leaders, he still is not making money. He even begins to wonder if he will be able to continue trading with all of these losses. He thinks, "If I could only control the losses, I will probably be able to trade a little longer before my money runs out."

It is at this stage that he learns the value of stop losses, known as *stops*. He learns the importance of managing the risk on each trade. He gets a hint that there is more to trading than just the indicator, and his ears perk up when people mention the concept of controlling risk and conserving capital. He thinks, “I just want to stay in the game, to keep enough money to make the next trade. I don’t want to quit a loser!”

But even with the newly found indicators, and controlling his risk with stops, he continues to lose money, although he also consummates some winning trades that keep his capital from depleting too quickly. And here he has another major revelation—markets can be trending or choppy. It is at this point that he realizes, “If I could only predict the choppy markets, where I lose most of my money, I could simply stay out of the market and get back in when it starts to make the big move.” So he starts another quest, that of leaning how to predict choppy markets.

PREDICTING THE MARKETS

Discontinuing the use of the old technical indicators, our technical trader now begins to flirt with the Elliot Wave theory, W.D. Gann techniques, and Fibonacci Targets and Retracements. These techniques generally claim to help you predict when the market will be choppy and where and when it should be bought and sold. He does all of this studying so he can learn to stay out of choppy markets. It makes a lot of sense. Someone out there must know when the markets are going to go sideways and then step aside waiting for the next big trend. When the trend comes, they get on it and ride it for big profits. They then exit and wait for the next trend. He hears promises that he should be able to forecast all of this by using these predictive techniques.

Unfortunately, after several seminars, our trader tries to predict a corrective stock market and ends up mistaking it for the next big wave up. He explains to his friends, “I missed the big move because I thought we were in Wave B but the market was really in Wave 2 ready to start Wave 3. If I had just used my old trusty indicators instead of trying to predict the move and waiting, I would have made big bucks.”

HISTORICAL PROBABILITIES

It finally occurs to him that he should back test some techniques and see how some of his indicators would have worked historically; he reasons that if he can do this, he would have more confidence and discipline in his trades. He begins to understand that no one (including himself) can predict the market. He starts to realize that he needs to have some confidence that the techniques he is going to

use have worked in the past. He now knows that he can't predict the market. He thinks, "All I really need to know is what the probabilities are when I put on a trade according to my rules, and I should make money."

Our technical trader has now passed the second big initiation and begins to sense the need for trading a strategy. He realizes that there is immense value in historical strategy performance data. He purchases TradeStation and dives into learning how to design and trade strategies.

The Strategy Trader

A strategy trader trades a strategy—a method of trading that uses objective entry and exit criteria that have been validated by historical testing on quantifiable data.

Strategy traders are restricted by a set of rules. These rules make up what is known as the strategy. As a strategy trader, you will not deviate from your strategy's rules at all, unless you have decided to use a different strategy altogether. When your strategy tells you to buy, you buy. When your strategy tells you to sell, you sell. And you buy or sell exactly how much your strategy tells you to. You read *The Wall Street Journal* and talk over the markets with your broker, but you don't make trading decisions to override your strategy because of something you read or heard from your broker.

The reason you are restricted by your rules is that your rules are sound. As a strategy trader, you've spent a lot of time and research in creating those rules. Your rules have been hand-designed by you and tested and re-tested on years of historical data. This testing has given you positive results and the conviction that lets you know it's time to take your strategy into the future. Your emotions might still fly as high and low as the market, but at least they are not causing you to make bad trading decisions.

Our strategy trader has now left behind the gurus, the hotlines, and the broker recommendations, and has stopped trying to predict which wave the market is in and how far it will go. He has purchased and learned how to use TradeStation. He is becoming knowledgeable about computers, data and technology. He has realized the value of quantifiable data and back testing, and starts to put on trades with the confidence that comes with knowing the historical track record of the same strategy for the last 10 years. He is slowly learning the business of trading.

QUANTIFIABLE DATA

One of the first things a strategy trader needs to understand is quantifiable data. This is the data that he will correlate to the market and use to develop his trading strategy. Without quantifiable data, he would be unable to trade a strategy.

Quantifiable data is measurable data. Stock and commodity prices are quantifiable, as is volume. All technical indicators that are derived from price and/or volume are quantifiable and useable in designing a strategy. Are phases of the moon quantifiable? Yes, as are the location of the planets. They occur in a regular pattern, and each occurrence is measurable and predictable. What about earnings per share or the price earnings ratio of stocks? Yes. These are also quantifiable and can be used in strategy trading.

Once you understand what quantifiable data is, it is easier to spot non-quantifiable data. Non-quantifiable data usually consists of random events that cannot be reduced to a number and that cannot be predicted. For instance, speeches by politicians are not quantifiable, although we know that they can have a profound effect on stock prices. Opinions of our broker are not quantifiable. Are earnings surprises quantifiable? No, but quarterly earnings reports are, and they usually have a significant effect on stock prices. Are weather patterns, droughts, or freezes quantifiable? No, although we know they too have a considerable effect on commodity prices, it is not possible to quantify droughts and correlate them to Soybean or Corn prices.

A strategy trader thus moves into a mode of acquiring and testing quantifiable data as it relates to historical price activity. This is a marked difference from a technical trader, who tries to correlate data to price but usually through observation and intuition, and from the discretionary trader, who doesn't use quantifiable data at all or feels he needs to in order to make money.

It is this acquisition and use of quantifiable data, along with the software to test it, that enables the strategy trader to investigate trading techniques historically and begin to put some rational and enlightened business practices to use in his trading. It is this process that enables him to start finally making money.

HISTORICAL ANALYSIS

For some time now, our strategy trader has been using TradeStation to develop trading strategies. He has learned rudimentary EasyLanguage and is actively testing various trading strategies. He has learned that just because something looks good visually and is profitable over a short period, it might not make money

over a long time frame. He has also experienced the confidence that comes from knowing that a particular strategy has been profitable in the past.

Even though he knows that the market will never quite replicate that past, it is much more comfortable to trade a strategy that has been historically tested than to trade intuitively. He knows that the success of a strategy is not directly tied to the indicator, but to other factors: exits, money management stops, and cash flow management.

Because of the extensive time he has spent working with TradeStation, he also knows the ins and outs of risk control. He has done extensive back tests and found out that if he puts his stop losses too close, the strategy takes too many trades and makes less money. He has studied set-up and entry and how they work together to get you in the market. He knows the difference between exits and money management stops. He can now historically test any indicator or technique and immediately know how profitable it was in the past. He doesn't have to rely on anyone but himself to make trading decisions.

The strategy trader has also learned much about himself in this process. For instance, he has learned how much money he is willing to risk on any trade. He knows he can't take a hit for, say, more than \$1,500. He knows that he can only take a certain amount of drawdown and can only stomach a certain number of losing trades in a row. He may refuse to trade a strategy that has more than four losing trades in a row. He just knows himself, and he knows he wouldn't be able to handle it. He adjusts any strategy he develops to account for this. However, maybe he can watch his account go through a \$12,000 drawdown if he knows that he won't have a lot of losers in a row; especially if he has the historical information that confirms that a \$12,000 drawdown is not unusual for his strategy.

The key is that he has learned to customize the parameters of his strategies to fit his personality. There is no point in designing a great, profitable strategy if you won't be able to trade it!

The Complete Strategy Trader

The complete strategy trader has learned to use advanced cash management principles, trades multiple markets, and may trade multiple strategies in each market.

The successful strategy trader realizes that the key to long-term profitability is how the cash flow is managed, not what indicator is used. He is done with trying to predict the markets and has stopped looking for the Holy Grail indicator. He understands that strategy trading is not unlike most other businesses and, as a result, has turned his trading into a sophisticated business based on sound business principles.

Remember the great fish restaurant that I mentioned in Chapter 1. It opened and immediately received rave reviews; it was ranked four stars (out of four) by all of the restaurant critics. It was hard to get in at peak times because you always got a great meal. Again, it is not the food that makes a successful restaurant.

Of course a restaurant needs a good chef and good food. But to stay in business it needs much more than good food. Costs, service levels, and cash flow need to be managed effectively. I realized that many successful restaurants have mediocre to poor food (just visit any fast food joint). But they stay in business because the management has mastered restaurant management, which has nothing to do with the taste of the food.

Trading is really no different. Traders become successful because they understand trading management. Trading management has nothing to do with indicators, but has a lot to do with the details of managing trades and cash flow effectively. The complete strategy trader can say, “Of course I need solid indicators, and I have my favorites. But I think with what I know about trading now, I could make any indicator profitable.”

Successful traders understand that to be successful and stay in business more is needed than simply a great indicator.

CASH MANAGEMENT & RISK CONTROL

Our strategy trader is now spending a lot of time using TradeStation to focus on cash management. He has found a group of indicators that he trusts, has back tested, and has worked with for enough time now so that he knows their strengths and weaknesses. He’ll tell you, “I have finally realized that there is no Holy Grail. There is only so much money in the markets and most indicators can be rigged to catch most of the moves. The real task is to manage your money efficiently to take advantage of market moves.”

Our trader is now focused on refining techniques concerned with how to scale into a potential big move, and how to scale out as the market moves in his direction. He is focusing on the value of pyramiding a position to maximize the

leverage of his open equity. He is using his accumulated net profit to be able to trade bigger positions without risking his own capital. The successful strategy trader focuses his TradeStation testing on the percentage of his account that should be risked with each trade, so as to maximize his profits and minimize the drawdown.

Don't underestimate how critical the size of your trade is, and how important it is to add to a position at the right time. This may be more important than the strategy itself!

TRADES MULTIPLE MARKETS

Our strategy trader has observed that to maximize his return, he must trade multiple markets. At any given time there may be only one or two sectors moving. If you are only trading one market, you will have to wait for the next big move and fund the drawdown. The more markets you trade, the greater the chance that one will be in a big move. It is also likely that the profits in the markets that are moving will be greater than the drawdown in the markets that are not. That is the ideal situation because you can then reduce the fluctuation in equity and have a more predictable cash flow.

Our strategy trader now understands the age-old notion of market diversification. With back testing, he is now able to test the combination of strategies and markets and how they integrate into a comprehensive trading strategy. An overall strategy is now coming into focus that includes trading several markets.

TRADES MULTIPLE STRATEGIES IN EACH MARKET

Our strategy trader has also learned to recognize that every market goes through different types or phases of movement. He is finding out that it is possible to define what that movement is and develop a strategy to profit from that action. He may say, "I used to only make money when a market was in a trend; I am basically a trend trader. But a few months ago I added a Volatility Breakout strategy to compliment the trend strategy. When a market is not trending, I can still get some money out with the VB strategy. This money to some degree funds the trend-following strategy drawdown in a non-trending market, and levels out my overall cash flow."

As you can see, our trader is now talking an entirely different language. He has become a sophisticated money manager, intent on maximizing the profits of his business. He has come a long way from being a seminar junkie, consumed with Indicator Fascination. He realizes the value of technology, and the immense

capacity of software like TradeStation. He adds, “I really don’t know how I would do this without today’s software and technology. It would be like trading blind.” Or like being a discretionary trader.

Decision Models

I have always been interested in the science of how we as human beings make decisions. Life is really all about making decisions. If we can improve the way in which we make decisions, it stands to reason that we will be more successful in life. If we can improve the manner in which we make our trading decisions, we will become a more effective trader and hopefully make more money.

In my early years of trading, I always wondered whether there was statistical proof that strategy trading was inherently more profitable than other types of trading. I knew from my own experience that it was but I was unable to prove it statistically.

I then picked up a book called *Decision Traps*³. This is a book about the process of decision-making and I picked it off the bookstore shelf when I was attempting to learn how to become better at trading. I didn’t know at the time that it would put forth the notion that objective decisions (i.e., strategy trading) produce far superior results than other non-objective forms of decision making.

In this book, nine different types of decisions were tested using each of the three different decision methods. The accuracy of the decisions was then compared and analyzed for effectiveness in predicting final outcomes. The investigator looked at different types of decisions, predicting grades, predicting recovery from cancer, performance of life insurance salesmen, as well as predicting changes in stock prices. He used three different decision making processes: an Intuitive Prediction Model, a Subjective Linear Model, and an Objective Linear Model. Interestingly enough, these can be compared to our 3 types of traders: discretionary, technical and strategy.

INTUITIVE PREDICTION MODEL (DISCRETIONARY TRADER)

Intuitive prediction is defined as making a decision without the use of any objective or quantifiable data. For instance, in trying to predict the academic performance of graduate students, the researches asked their advisors to do so without seeing their grades and just by talking to them. The decision-makers had to rely on their intuitive impressions and any other factors they thought relevant (how the students dressed, their language skills, grooming habits, etc.).

This is the same way our discretionary trader makes trading decisions—using intuition and gut instinct. Although he might think he does, he does not use any objective criteria. In predicting the stock prices, it is highly likely that the researcher engaged a discretionary trader to predict the future prices of stocks.

SUBJECTIVE LINEAR MODEL (TECHNICAL TRADER)

A Subjective Linear Model is a much more complex decision making process. It starts with interviewing experts in a field and learning how they make decisions. The researcher literally asks the expert how he or she makes decisions and they respond by explaining how they make their predictions. Although these experts are not using quantifiable data, they have enough experience and knowledge in their field to be successful. This decision making process is then outlined by the researcher.

For instance, a physician, highly experienced in treating cancer, probably has become fairly adept at predicting the life expectancy of his patients, even without using any objective data. The researcher interviewed the physician and attempted to determine exactly how the physician made this assessment. Then the researcher put this newly quantified data into a regression model and attempted to predict the life expectancy of cancer patients.

This is very similar to how our technical trader makes decisions. He goes to seminars and reads books to learn how the experts make decisions using technical indicators. He then takes what he learns and attempts to trade like the experts. In a sense, he does his own regression model of the expert's process to make trading decisions.

OBJECTIVE LINEAR MODEL (STRATEGY TRADER)

For the Objective Linear Model, the researcher developed an objective model based on historical tests and observations to predict results. This is defining and using quantifiable data, running historical tests, and then using the results of the tests to predict future outcomes.

For instance, the researcher would look at reams of physical data from cancer patients, and correlate the data with how long the patient lived. After running the historical tests, the researcher would then obtain the physical data from a cancer patient, and using the historical test data, attempt to predict how long that cancer patient will live.

This is exactly what a strategy trader does. He runs historical tests and then uses that data to take a position in the market. He uses objective, quantifiable data tested historically to make his trading decisions. Table 1 shows the results of the tests.

Types of Judgments	Intuitive Prediction	Subjective Linear	Objective Linear
Academic Performance of Graduate Students	.19	.25	.54
Life Expectancy of Cancer Patients	-.01	.13	.35
Changes In Stock Prices	.23	.29	.80
Mental Illness using Personality Tests	.28	.31	.46
Grades and Attitudes in Psychology Course	.48	.56	.62
Business Failures using Financial Ratios	.50	.53	.67
Student's Ratings of Teacher's Effectiveness	.35	.56	.91
Performance of Life Insurance Salesmen	.13	.14	.43
IQ Scores using Rorsach Tests	.47	.51	.54
Mean (Across all Studies)	.33	.39	.64

In every case, the Subjective Linear Model outperformed the Intuitive Prediction Model but only by a small margin. If you look at predicting the changes in stock prices, the Subjective Linear Model only slightly outperformed the Intuitive Prediction Model. This correlates very closely with my experience in trading. Technical traders do only slightly better than discretionary traders and neither of them make much money. While the difference in expertise and experience between a discretionary trader and a technical trader is substantial, the resulting profitability is hardly noticeable.

The real insight from this study comes when we look at the results of the Objective Linear Model. In every case, the Objective Linear Model outperformed both the Intuitive Prediction Model and the Subjective Linear Model. In some cases, the improvement was minor, and in others it was substantial. It is interesting to observe that the greatest improvement came when using the

Objective Linear Model in predicting the changes in stock prices. Here was the proof I was seeking—a definitive study showing the benefits of objective decision-making as opposed to other forms of decision-making.

This is my experience as well. The greatest improvement in trading results (profitability) comes when a trader begins to use objective quantifiable data and does historical tests to develop trading strategies. In this study, this is confirmed not only with changes in stock prices, but in the other disciplines also. If there ever was a case to be made for considering strategy trading, this is it.

The Benefits of Strategy Trading

I believe that a trading strategy, which has been properly developed and tested, can make you more money than trading any other way. However, this is not the only reason that strategy trading is the method of choice for most successful traders. There are other benefits as well. One of the most important benefits is that you can sleep well at night knowing that you're trading a strategy that has been tested and re-tested, and is proven to be successful. No matter what happens in the market during the day, the confidence you have in your strategy makes this type of trading easier on you.

Another advantage is that you can choose a market and a trading strategy that compliments your personality. The basic idea is that the trading strategy you select is based on the type of market action you are the most comfortable trading. Those who desire to always be in the market will select a different strategy than people who prefer short-term positions. If you get a thrill out of riding the big trends, then you will select a different type of strategy than someone who enjoys going against the trend.

Have you ever received an unexpected call like this, “Hi, Joe. This is Stan, your broker. We need to settle the margin on your account. Looks like the market really went against you this week”?

If you are a strategy trader, this is not likely to occur. Strategy traders always know where they stand financially. They know this from the financial results of the historical tests. If you do get a call like this, you will most likely be expecting it and will have planned for it. You have creatively designed a strategy based on the amount of money you have to work with. As a part of knowing the maximum equity drawdown associated with your strategy, you can determine the strategy's capital requirements and make adequate provisions to provide enough capital to maneuver through the eventual drawdown. There will be no financial surprises.

I've been talking at length about why strategy trading is the most viable way to make money in the markets and what type of skills and knowledge are necessary to be a successful strategy trader. I showed you a study that in my view gives very solid proof that strategy trading (objective decision making) is the most successful way to make decisions. If there was ever any doubt in my mind, this study cleared it up. I hope you are now convinced that if you want to make money you should be a strategy trader.

So let's go on to the nuts and bolts of creating viable trading strategies.

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