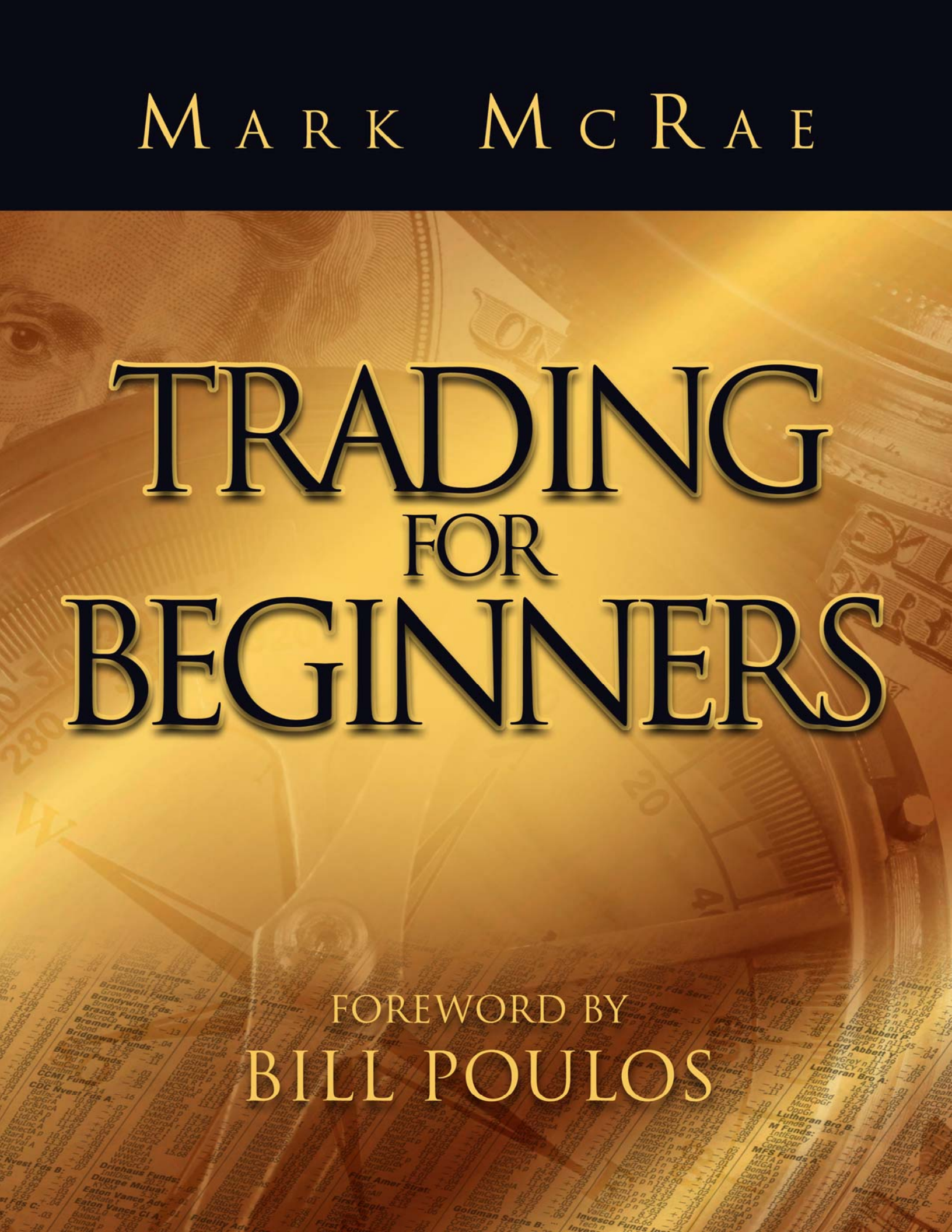
MARK MCRAE

TRADING FOR BEGINNERS

FOREWORD BY
BILL POULOS



TRADING FOR BEGINNERS

By Mark McRae

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Table of Contents

TESTIMONIALS

'Trading for Beginners' is a marvelous resource that even a person like me with no background in trading can understand. It is written in clear, short units, which enable a beginner to trial concepts one at a time until understanding dawns.

Its author, Mark, further enhances this understanding by answering any email promptly and in such a way that it encourages the learner to ask even the most trivial of questions.

I have learnt a great deal in a short time from this process and consider anyone with an interest in trading will benefit from 'Trading For Beginners'.

Patricia Berwick
Australia

Hello Mark,

Thanks for the time taken to answer my questions, all I can say is this is a great little book.

Thanks,
Donnie Spann

Hi Mark,

I wish to write to you personally to let you know how I much I appreciate your wonderful book.

Terry Durango

I received the book with joy. Thanks for the time taken to put this incredible piece together.

Thanks,
Abraham Rashid

I just want you to know that, of all the money I've spent on my trading education, you are one of the best deals out there.

Thanks a million,
Bill Cael

FOREWORD by Bill Poulos

My compliments go to Mark McRae on his excellent book, “Trading for Beginners”. This introductory trading book is among the finest I have ever read. Mark goes well beyond trading basics and gets right to the heart of the matter of what it takes to become a successful trader.

Mark separates fact from fiction in a sobering assessment of why most traders lose. This information alone could save those new to trading, and seasoned traders alike, years of frustration and losses.

Once the reader understands the realities of trading, Mark goes on to review the various markets that are commonly traded, fundamental vs. technical analysis, including an in-depth review of technical analysis basics which are key to trading the markets.

But that’s not all! Mark finishes up with a great discussion on how to evaluate risk vs. reward for proper risk management, the all-important subject of trader discipline and even discloses three different trading methods.

If you’re serious about trading, do yourself a favor and read this book. I believe it will help you dramatically shortcut your learning curve on the way to learning how to trade with a winning edge.

Good Trading,

INTRODUCTION

Congratulations on your great decision on learning how to trade. This little book will probably be the best investment you will ever make in your trading life.

Regardless of what financial instrument you will eventually trade, the most important thing is learning what to do and what not to do. There are many sharks out there who offer services to the novice trader with the sole intention of taking their money.

In this book you will learn what the best thing to trade for you is, the best way to trade it, and how to trade it. I will not be promoting any service or institution so I have no bias towards pointing you in any particular direction.

The purpose of this book is to teach you the basics of trading and how to make an informed decision on the best way to trade. We will cover all the basics that most people are too afraid to ask for fear of appearing silly. We will get into some advanced stuff later but we will take it one step at a time.

Very Important: This book is for educational purposes only. I am not suggesting or implying anywhere in the book that you should rush out and invest your hard earned money in the financial markets. In fact, I will teach you how to trade on paper without risking any of your hard-earned money first.

Never! Never! Never! Put money into anything you don't fully understand. This is where this book comes in. All the basics you need to know are included in the following chapters.

WHAT TO EXPECT FROM THIS BOOK

As the name implies, this book is designed for new and novice traders. It has also, however, become a reference point for many experienced traders. The concepts contained in the pages that follow can just as easily be adapted for the professional trader as well as the novice trader.

My hope is to guide new traders through the labyrinth of complex terminologies and market jargon and bring them out the other side infinitely more informed and better equipped to trade just about any market.

Because I am assuming that you are either new to trading, or are trying to further your education in trading, the scope of this book is fairly large and is intended for trading in general, as opposed to a particular market segment.

New traders often are unsure of, not only the best market to trade, but are also unaware of, the variety of markets that can be traded.

TRADING – THE REALITY

The fact that you have purchased this book indicates that you have either decided that you would like to learn how to trade, or that you have started to trade and are still pursuing a better way to trade.

If you are new to trading then I am glad you started with this book because there are a lot of misconceptions out there.

The first question I would like you to ask yourself is why you decided that you wanted to trade in the first place?

- The dream of working at home and earning loads of money?
- The thought that you could beat the markets?
- The images of what you have seen on T.V and the excitement of trading?

I ask these questions because, for the vast majority of professional traders, life is nothing like what it is perceived to be.

The early stages of your trading career can be frustrating, soul destroying, and financially unrewarding.

90% of Traders Go Bust

Believe me when I tell you that 90% is a conservative estimate. Some sources have it as high as 99% of traders losing their initial starting capital. I have also read that not only do over 90% of them lose their money, but 10% actually go bankrupt.

Why is it that so many traders fail? It is not because they are stupid. In fact, statistics show that the majority of traders are well educated, have above average incomes, and are generally highly motivated.

So why do so many fail?

Lack of Trading Education

By education I don't just mean learning how RSI works or drawing lines on a chart. I mean thoroughly educating yourself in all aspect of your chosen profession. Educating yourself on the correct psychological approach to the market! Educating yourself in the correct money management techniques relative to your account size. Educating yourself in the correct entry and exit methods for the trading style that suits you.

This, friend, is where I hope to be of some help. I don't have all the answers, nor do I profess to be some kind of guru, but I will do my best to point you in the right direction.

Common Misconceptions of New Traders

- They think they can trade consistently with 80% accuracy.
- They think they can turn $1,000 into $100,000 in six months.
- They think they can predict turning points in their given market to within minutes.
- They think they can buy a system that is 100% accurate.
- They think they will quit their jobs and make a living full time after a few months of trading.

What's the reason that so many new traders believe that trading is an easy way to make money? Propaganda!

We are continually bombarded in magazines, emails, and the general media by claims of making astronomical amounts of money by just applying the vendor's latest method or system.

Fundamentals of Trading

Trading is not an exact science. You can't do X and get Y every time. It is as much an art as it is anything else. There is no magic formula.

Trading is all about probability. It is the art of correctly applying a set of carefully thought out rules and allocating the probability of that event to result in success.

Each trade is an independent event. The market does not remember if you lost or made money the last time you traded.

The way you approach the market psychologically has as much to do with your success as any trading plan.

Money management is crucial if you want to have any hope of becoming a successful trader.

Matching a method of trading with your personality is the only way you will ever feel comfortable in the markets.

An adequately funded account is necessary not only to be able to take the trades you want, but also so you don't feel every trade is a live or die situation.

The journey to the road of successful trading will make you confront your deepest fears. Your armor on this journey will be confidence, knowledge, and believing that you can achieve your dreams.

Never, never equate your success or failure in the markets with who you are as a person!

The Flaw in Our Emotions

As humans we have a natural tendency to try and influence our surroundings and events we take part in. This is one reason, as a species, we have succeeded, but it is also one of the fundamental flaws we all have when trying to achieve success as a trader.

As traders we have to realize we have no control over the market and if we accept that then we have to accept that we can not influence the direction of the market.

The problem, of course, is we have a tendency to try and succeed and when inevitable losses come, it is easy to let those losses effect us emotionally. Becoming euphoric when you hit a winning streak is almost as detrimental as becoming depressed when you have a string of losses.

We traders have to try to achieve a state of impartiality. We have to accept that we will have losses as readily as we will gains. Reaching a stage where you can comfortably accept losses, in the knowledge that your method of trading will produce profits in the longer term, is the state we have to aspire to.

Trading is Not an Exact Science

No matter what anyone tells you, trading is not, nor has it ever been, an exact science.

Trading is an art. To date, there has never been an institution or individual who can guarantee you will beat the market every time you trade.

Just think about it, if one had an exact method that always won, they would have all the money in the world, given enough time.

Big institutions with all their expertise still only chug out 10% a year in a good year. Am I saying that you can't make money in the markets? Absolutely not. You can make money in the markets and, quite often, a lot more than the institutions.

One other reason some people don't make it in the trading game and probably the hardest for some people to own up to is: **some people are just not meant to be traders.**

Just like we are all not meant to be doctors or priests, some people are not cut out for trading.

Once you finish this book, take some time to ask yourself if this is really what you want to do. It might be a decision that could save you thousands of dollars. As I said at the beginning of the book, I am trying to give you an overview of trading, the pros and the cons.

Here's the good news! Once mastered, trading can be a rewarding profession, both financially and emotionally. It can give the financial independence to never work for a boss again and you will learn a lot about yourself as a person on your way to becoming a trader.

INVESTOR OR SPECULATOR

Even though you think you want to learn how to trade, it is a good exercise to ask yourself if you are really an investor or speculator.

Investor

An investor is someone who buys something in the belief that, over the long-term, the security (any investment vehicle that can be traded), whatever it may be, will go up in value.

Their period of time may be months, years, or even decades. They will be quite happy to own a security for a longer time period because they believe in what they have just bought or have researched the security and are happy that it will increase in value in the long-term.

An example of an investor is Warren Buffet, one of the most successful investors of all time.

Commonly Referred to Sayings of Warren Buffett:

- Never invest in a business you cannot understand.
- Risk can be greatly reduced by concentrating on only a few holdings.
- Buy companies with strong histories of profitability and with a dominant business franchise.
- You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right.
- Be fearful when others are greedy and greedy only when others are fearful.
- Unless you can watch your stock holding decline by 50% without becoming panic-stricken, you should not be in the stock market.
- It is optimism that is the enemy of the rational buyer.
- The ability to say "no" is a tremendous advantage for an investor.
- Much success can be attributed to inactivity. Most investors cannot resist the temptation to constantly buy and sell.
- Lethargy, bordering on sloth, should remain the cornerstone of an investment style.
- An investor should act as though he had a lifetime decision card with just twenty punches on it.
- Wild swings in share prices have more to do with the "lemming- like" behavior of institutional investors than with the aggregate returns of the company they own.

- As a group, lemmings have a rotten image. But no individual lemming has ever received bad press.
- An investor needs to do very few things right as long as he or she avoids big mistakes.
- Is management candid with the shareholders?
- Do not take yearly results too seriously. Instead, focus on four or five year averages.
- Focus on return on equity, not earnings per share.
- Look for companies with high profit margins.
- Growth and value investing are joined at the hip.
- It is more important to say "no" to an opportunity than to say "yes".
- Always invest for the long-term.
- Does the business have favorable long-term prospects?
- It is not necessary to do extraordinary things to get extraordinary results.
- Remember that the stock market is manic-depressive.
- Buy a business, don't rent stocks.
- Wide diversification is only required when investors do not understand what they are doing.
- An investor should, ordinarily, hold a small piece of an outstanding business with the same tenacity that an owner would exhibit if he owned all of that business.

Speculator

A speculator is someone who buys or sells something with no directional bias.

He has no loyalty to the thing he is buying or selling and will typically own something from one minute to a few days or even weeks.

An intraday trader may buy and sell a security a hundred times in both directions in the same day. An example of a speculator might be someone like George Soros.

George Soros

As a well-respected currency speculator, he once shorted the British Pound for one day and gained in excess of $1 billion.

Although not totally responsible, Soros' comments on the Russian economy contributed to their stocks plunging 12% in the first hour of trading. Five days later the currency had devalued 25%.

Best Quote:
"It's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong."

Now that you know the difference between Speculator and Investor, only you can decide which one you are.

If you intend to day trade the markets, then you are a speculator. The question of whether you are an investor or speculator is a personal question of your own psychology.

The good news is that our technical approach works for both types of character. Personally, I consider myself a speculator.

WHO TRADES THE MARKETS?

Let's just clarify what is meant by the term "trader", sometimes called "retail trader" or "day trader".

This is an individual who trades the financial market, whatever they may be, using their own money. They may or may not be dependent on the results of their trading for their income.

This does not include professionals who work for institutions or who manage other people's money. It does not include anyone who gives advice for a fee.

One of the reasons that I want to make this point clear is that many new traders that I have met fall into the trap of listening to too many people who have never traded their own money.

Many institutions have what they term “traders” working for them. The reality is that these people are often no more than someone executing an instruction given to them by the client.

They don’t have any analytical capabilities other than what is provided to them by their employer.

Unless you have experienced winning and losing your own money based on your own decisions you will never fully appreciate what the retail trader is going through.

It’s sort of the difference between being the manager of a company and being the owner of a company. For those of you have experienced the difference you will know exactly what I am talking about.

I don’t mean to take away anything from the many professionals out there who offer excellent services and have long and distinguished careers in the industry. I only wish to point out that there is a great difference between the mindset of the two groups.

Someone working for a large institution who is called a trader is very far removed form the guy sitting at his computer all day making decisions that affect his bank account.

You will only ever be successful as a trader if you rely on your own judgment to trade. At the end of the day it’s your money.

WHAT DO PEOPLE TRADE?

In today’s information technology driven economy you can just about trade anything you want. Whether it is currencies, metals, shares, wheat, pork bellies, you name it.

Not only can you trade the main security but also in most cases you can trade the derivative of it (e.g., Forwards, Futures and Options).

All financial instruments are commonly referred to as securities, regardless of their name. When I mention securities it encompasses everything that can be traded.

The main thing to remember when trading is, first, to decide if you are a speculator or investor.

If you are an investor it makes sense for you to know something about the thing you are investing in. It might be that you are in that field already or have a good knowledge base of what you are investing in.

On the other hand, if you are a speculator who only intends to hold something for a few hours and are covering many markets, you will not have time to research as much as an investor.

Even as a speculator though, you should know something about what makes that market tick. In the currencies, for instance, when the dollar strengthens it can affect all the major currencies at the same time.

In technology shares, you might find that the whole sector is strengthening at the same time.

If the interest rates are raised in one country how will that affect the market you are in?

The point in all of this is that I think it is a good idea for people to trade something they either like, have an interest in, or, at least, are familiar with. For example, I would not feel comfortable trading oil because I don't know what drives the market or who the main players are.

Commonly Traded Securities

Stocks

When you buy stocks you essentially own a little share of the company you just bought. The more shares you buy the more of the company you own.

When the company whose shares you have bought makes a profit you will receive that profit in the form of dividends.

Ownership of shares is normally called equity.

There are two main types of stocks: Preferred stock, which normally pays regular dividends; and Common stock, which often gives you more rights than preferred stock. Which one you chose will depend on what you are trying to achieve.

To buy stocks you normally need to have an account with a broker.

The type of broker you will need depends on what type of service you require from the broker.

If you want to have full access to reports on particular shares and be able to ask for advice from the broker, then you would normally opt for a full service broker.

If you are independently minded and don't require recommendations or reports and only wish the broker to execute your orders, then you would opt for a discount broker.

Opening an account with a broker is similar to opening an account with a bank. You will be asked for personal information and given forms to fill out.

Where are Stocks Traded?

The most common place for a stock to be traded is in a stock exchange. Stock exchanges are physical locations where market participants are brought together in once place.

The most famous of the exchanges is, of course, the New York Stock Exchange, where an estimated $12 trillion changes hands each year.

Stocks can also be traded over the counter (OTC). OTC transactions are done through a network of telephones and computers connecting dealers to form a market.

Below you will find a list of the majority of stock markets around the world.

African Stock Exchanges

- Ghana Stock Exchange, Ghana
- Johannesburg Stock Exchange, South Africa
- The South African Futures Exchange (SAFEX), South Africa

Asian Stock Exchanges

- Sydney Futures Exchange, Australia
- Australian Stock Exchanges, Australia
- Shenzhen Stock Exchange, China
- Stock Exchange of Hong Kong, Hong Kong
- Hong Kong Futures Exchange, Hong Kong
- National Stock Exchange of India, India
- Bombay Stock Exchange, India
- Jakarta Stock Exchange, Indonesia
- Indonesia NET Exchange, Indonesia
- Nagoya Stock Exchange, Japan
- Osaka Securities Exchange, Japan
- Tokyo Grain Exchange, Japan
- Tokyo International Financial Futures Exchange (TIFFE), Japan
- Tokyo Stock Exchange, Japan
- Korea Stock Exchange, Korea
- Kuala Lumpur Stock Exchange, Malaysia
- New Zealand Stock Exchange, New Zealand
- Karachi Stock Exchange, Pakistan
- Lahore Stock Exchange, Pakistan
- Stock Exchange of Singapore (SES), Singapore
- Singapore International Monetary Exchange Ltd. (SIMEX), Singapore
- Colombo Stock Exchange, Sri Lanka
- Sri Lanka Stock Closings, Sri Lanka
- Taiwan Stock Exchange, Taiwan
- The Stock Exchange of Thailand, Thailand

European Stock Exchanges

- Vienna Stock Exchange, Austria
- EASDAQ, Belgium
- Zagreb Stock Exchange, Croatia
- Prague Stock Exchange, Czech Republic
- Copenhagen Stock Exchange, Denmark
- Helsinki Stock Exchange, Finland
- Paris Stock Exchange, France
- Les Echos: 30-minute delayed prices, France
- Nouveau Marche, France
- MATIF, France
- Frankfurt Stock Exchange, Germany
- Athens Stock Exchange, Greece
- Budapest Stock Exchange, Hungary
- Italian Stock Exchange, Italy
- National Stock Exchange of Lithuania, Lithuania
- Macedonian Stock Exchange, Macedonia
- Amsterdam Stock Exchange, The Netherlands
- Oslo Stock Exchange, Norway
- Warsaw Stock-Exchange, Poland
- Lisbon Stock Exchange, Portugal
- Bucharest Stock Exchange, Romania
- Russian Securities Market News, Russia
- Ljubljana Stock Exchange, Inc., Slovenia
- Barcelona Stock Exchange, Spain
- Madrid Stock Exchange, Spain
- MEFF: (Spanish Financial Futures & Options Exchange), Spain
- Stockholm Stock Exchange, Sweden
- Swiss Exchange, Switzerland
- Istanbul Stock Exchange, Turkey
- FTSE International (London Stock Exchange), United Kingdom
- London Stock Exchange: Daily Price Summary, United Kingdom
- Electronic Share Information, United Kingdom
- London Metal Exchange, United Kingdom
- London International Financial Futures and Options Exchange, United Kingdom

Middle Eastern Stock Exchanges

- Tel Aviv Stock Exchange, Israel
- Amman Financial Market, Jordan
- Beirut Stock Exchange, Lebanon
- Palestine Securities Exchange, Palestine
- Istanbul Stock Exchange, Turkey

North American Stock Exchanges

- Alberta Stock Exchange, Canada
- Montreal Stock Exchange, Canada
- Toronto Stock Exchange, Canada
- Vancouver Stock Exchange, Canada
- Winnipeg Stock Exchange, Canada
- Canadian Stock Market Reports, Canada
- Canada Stockwatch, Canada
- Mexican Stock Exchange, Mexico
- AMEX, United States
- New York Stock Exchange (NYSE),United States
- NASDAQ, United States
- The Arizona Stock Exchange, United States
- Chicago Stock Exchange, United States
- Chicago Board Options Exchange, United States
- Chicago Board of Trade, United States
- Chicago Mercantile Exchange, United States
- Kansas City Board of Trade, United States
- Minneapolis Grain Exchange, United States
- Pacific Stock Exchange, United States
- Philadelphia Stock Exchange, United States

South American Stock Exchanges

- Bermuda Stock Exchange, Bermuda
- Rio de Janeiro Stock Exchange, Brazil
- Sao Paulo Stock Exchange, Brazil
- Cayman Islands Stock Exchange, Cayman Islands
- Chile Electronic Stock Exchange, Chile
- Santiago Stock Exchange, Chile
- Bogota stock exchange, Colombia
- Occidente Stock exchange, Colombia
- Guayaquil Stock Exchange, Ecuador
- Jamaica Stock Exchange, Jamaica
- Nicaraguan Stock Exchange, Nicaragua
- Lima Stock Exchange, Peru
- Trinidad and Tobago Stock Exchange, Trinidad and Tobago
- Caracas Stock Exchange, Venezuela
- Venezuela Electronic Stock Exchange, Venezuela

Futures

Futures are normally traded in contracts and are a legally binding agreement between a buyer and a seller. The seller must deliver the specific agreed upon asset at a future date but for the price agreed today.

Futures markets allow companies and individuals to protect themselves against fluctuations in the price of an asset that they are interested in. This allows them to sell an asset in advance giving them the ability to make plans for the future in the knowledge that they have a fixed price.

Futures have been with us for a long time. The first use of futures can be traced back to the 1650's during the Tokugawa era in Japan. Feudal lords used to collect rents from their tenants in the form of rice.

Not only would they trade the rice that they had collected, but they also would often trade their future rice delivery.

This was the start of what became the Dojima Rice Market. Even today, rice futures can be traded but the range of the market has expanded to include many other things.

For new traders, the word future can be confusing as the word implies that everything takes place in the future. What actually happens is that the settlement takes place in the future, but the price is agreed upon on that day (today).

It is also important to realize when trading futures that, just because you bought it, does not mean that you have to keep it until settlement. You can sell the contract long before delivery of the contract is due.

Like many other markets, you also do not need to necessarily own the asset before you sell it. You can sell a futures contract just as easily as you can buy it.

Because futures have been around for such a long time, nearly all markets around the world that trade in futures are highly regulated.

The fundamental principle of a future is fairly simple. You buy or sell something at today's price for delivery in a future date. This can prove to be extremely valuable to farmers and organizations to protect themselves against future fluctuations in price.

Let's use a farmer for example. This allows him to sell his crop before it is harvested. In times when the harvest is plentiful and many other farmers with the same crop have had bumper harvest, then there will be an over abundance of that crop. This will generally lead to a lower price.

In times when the harvest is bad and other farmers are also experiencing bad harvests, the price will be high, as there is a limited supply of the asset.

There will be times, however, when it is very difficult to know when a crop will be good or bad. For the farmer this can be devastating in planning his future.

One way he can overcome this is by selling his crop on the futures market at a price agreed upon today but only for deliver in the future.

If he agrees on a price today and there is a very short supply of that crop on the agreed delivery date, then the farmer may very well have been better waiting to deliver his crop at the market price. What the future does is take the uncertainty of the process away.

Futures contracts are generally divided into two distinct groups: financial assets, such as a group of stocks, a market index, or bonds; and commodity assets, such as coffee beans, wheat, and pork bellies.

Why Would You Trade Futures?

There are three main reasons for trading futures and they are:

1. Speculation – Many traders trade the futures market solely for the purpose of speculation. They have no intention of taking delivery of any asset but merely wish to speculate on the direction of the market.

2. Arbitrage – Arbitrage is simply trying to make a profit by exploiting the difference in two different markets. If, for example, you thought that the DJIA futures market was trading too high you might attempt to sell the futures and simultaneously buy the cash market.

3. Hedging – Hedging is common in both the commodities and financial assets. If you owned a portfolio of stocks and you thought that the market was about to correct but you still wanted to keep the stock, you might try to sell the market index of where the stocks where listed.

The Difference Between Cash and Futures Prices

Because of the costs involved with the physical ownership of an asset such as storage and transportation, the price between the cash market and the futures market differs. The difference in price is normally called the cost of ownership.

Ownership implies the cash market where you have additional costs, which leads to a difference between the cash price and the futures price where you don't have these costs.

As the delivery date nears, the difference between the cash price and the futures price will narrow and, on the actual delivery date, the two prices will be very similar.

Futures Exchanges

Chicago Board Of Trade: www.cbot.com
(CBOT Established 1848 and founded by 82 Chicago Merchants)

Chicago Mercantile Exchange: www.cme.com
(CME Established 1919. Originally The Chicago Butter and Egg Board which was founded in 1898 which then developed into the CME)

London International Futures and Options Exchange: www.liffe.com
(LIFFE Established 1982 and is now one of the world largest exchanges)

Forex

Forex is one of the fastest growing areas for new traders to get started. The main reason for this is the low entry level (only a few hundred dollars for mini accounts) and that it is fairly straightforward to trade.

The word FOREX is derived from **For**eign **Ex**change and is the largest financial market in the world. Forex is often abbreviated to FX.

As the name implies, Forex is the exchange of one currency for another at an agreed upon rate.

Unlike many markets the FX market is open 24 hours per day and has an estimated $1.2 Trillion in turnover every day. This tremendous turnover is more than the combined turnover of all the world's stock markets on any given day. This tends to lead to a very liquid market and, thus, a desirable market to trade.

Unlike many other securities, the FX market does not have a fixed exchange. It is primarily traded through banks, brokers, dealers, financial institutions and private individuals. Trades are executed through phone and increasingly through the Internet.

It is only in the last few years that the smaller investor has been able to gain access to this market. Previously, the large amounts of deposits required precluded the smaller investors.

With the advent of the Internet and growing competition, it is now easily in the reach of most traders.

You will often hear the term INTERBANK discussed in FX terminology. This originally, as the name implies, was simply banks and large institutions exchanging information about the current rate at which their clients or themselves were prepared to buy or sell a currency.

Inter- meaning between and *bank* meaning deposit-taking institutions normally made up of banks, large institution, brokers or even the government. The market has moved on to such a degree now that the term interbank now means anybody who is prepared to buy or sell a currency. It could be two individuals or your local travel agent offering to exchange Euros for US Dollars.

You will find, however, that most of the brokers and banks use centralized feeds to insure reliability of quote.

It is estimated that anywhere from 70-90% of the FX market is speculative. In other words, the person or institution that bought or sold the currency has no intention of actually taking delivery of the currency. Instead, they were solely speculating on the movement of that particular currency.

Currencies are traded in pairs and are each assigned a symbol. For the Japanese Yen it is JPY, for the Pounds Sterling it is GBP, for Euro it is EUR and for the Swiss Frank it is CHF.

So EUR/USD would be Euro-Dollar pair. GBP/USD would be pounds Sterling-Dollar pair and USD/CHF would be Dollar-Swiss Franc pair and so on.

You will always see the USD quoted first with few exceptions, such as Pounds Sterling, Euro Dollar, Australia Dollar and New Zealand Dollar. The first currency quoted is called the base currency.

Even though the mighty US dominates many markets, most of Spot Forex is still traded through London in Great Britain.

The Main Players in Forex

Central Banks and Governments

Policies that are implemented by governments and central banks can play a major roll in the FX market. Central banks can play an important part in controlling the country's money supply to insure financial stability.

Banks

A large part of FX turnover is from banks. Large banks can literally trade billions of dollars daily. This can take the form of a service to their customers or they, themselves, speculate on the FX market.

Hedge Funds

As we know the FX market can be extremely liquid, which is why it can be desirable to trade. Hedge Funds have increasingly allocated portions of their portfolios to speculate on the FX market.

Another advantage Hedge Funds can utilize is a much higher degree of leverage than would typically be found in the equity markets.

Corporate Businesses

The FX market mainstay is that of international trade. Many companies have to import or export goods to different countries all around the world.

Payment for these goods and services may be made and received in different currencies. Many billions of dollars are exchanged daily to facilitate trade. The timing of those transactions can dramatically affect a company's balance sheet.

The Man in the Street

Although you may not think it, the man in the street also plays a part in toady's FX world. Every time he goes on holiday overseas, he normally needs to purchase that country's currency and again change it back into his own currency once he returns.

Unwittingly, he is, in fact, trading currencies. He may also purchase goods and services whilst overseas and his credit card company has to convert those sales back into his base currency in order to charge him.

Speculators and Investors

We shall differentiate speculators from investors here with the definition that investors have a much longer time horizon in which they expect their investment to yield a profit as was discussed earlier.

Regardless of the difference, both speculators and investors will approach the FX market to exploit the movement in currency pairs.

They both will have their reason for believing a particular currency will perform better or worse as the case may be and will buy or sell accordingly.

They may decide that the Euro will appreciate against the US Dollar and take what is called a long position in Euro. If the Euro does, in fact, gain ground against the US Dollar they will have made a profit.

A very useful link for information on central banks is www.bis.org.

Options

Options are one of the oldest trading vehicles man has ever used. Around 1000 B.C. Aristotle Thales predicted by the stars that there would be a bumper olive harvest and bought options on the use of olive presses.

When the harvest did, in fact, prove to be a great harvest, Thales was able to rent the presses at a significant profit.

When you buy an option you have the right, but not the obligation, to buy **(call)** or sell **(put)** a specific underlying asset at a prearranged price on or before a given date.

Similar to futures, options can give the holder protection against adverse price moves.

Calls and Puts

Call options, when bought, allow you to buy an asset at a fixed price **(strike price)** on or before a specific ***exercise date.***

> ***Exercise date****: some options can only be exercised on a particular date and they are commonly known as European options. Options that can be exercised on or before the due date are commonly known as American options.*

Put options are the reverse of call options. When you buy a put option it gives you the right, but not the obligation, to sell an underlying asset at a predetermined date.

Options are frequently used in real estate deals. A property developer may take the option on a piece of land he wants to develop. He may, for example, buy **(call)** the right to purchase a particular piece of land at $100,000 on or before sixty days, beginning on the day he takes the option.

For the privilege of fixing the price for the next sixty days he agrees to give the seller $1,000. This now gives him time to arrange any permits he may need to construct the building he wants. He also has the knowledge that he can buy that piece of property at any time in the next sixty days at the price he has already agreed upon.

If, for some reason, he cannot get the permits he needs, then he simply does not exercise his option to purchase. He will, of course, forfeit the $1,000 that he paid for the option. The seller in this case was obliged not to sell that piece of land to anyone else for the next sixty days.

The same process can be applied to almost anything. If you apply the example of the property deal to the stock market you get the same situation.

Let's assume you buy a **call** (right to buy) for 100 shares of XYZ Company at an agreed price (**strike price**), on an agreed date (**expiration date**), at, say, $40 per share and you pay $5 for the option.

If, on or before the expiration date, XYZ is trading at less than $40 per share, then you would not exercise your option and you would have lost the price you paid on the option, which was $5.

If XYZ Company is trading at $50 per share, on or before the expiration date, your option is in effect worth $10. This is the difference between the price you have an option to buy XYZ at, in this case $40, and the price it is actually trading at, which is $50.

The reverse of this is a **put** (right to sell) option on an underlying asset. You might feel that the market is overheated at the present time and want to buy a **put** (right to sell) option.

This will give the individual who bought the **put** option the right to sell that option at an agreed price (**strike price**) on or before a specific date (**expiration date**).

You can also sell options (as opposed to buying a put). The writing of call options can be extremely high risk and I would not advise this for new traders until they thoroughly understand their liability.

Buying an option, either **call** or **put**, gives you rights. Selling (**writing**) options gives you an obligation.

The day after the **expiration date** an option has no value.

At this stage it may seem that the buyer of the option has all the cards. But don't forget the seller of the option receives money for granting the option. The money that is exchanged is commonly referred to as the **premium**.

Although options trading has more than its fair share of jargon, remember the essence of all markets is that there is a buyer and a seller and both believe they have an advantage and have the potential to make money.
Think of an option in the same way that you would pay your house insurance company. The premium you pay each month gives you the right to a benefit if some event in the future happens and you decide to exercise your right to have the insurance company pay you for that event.

The insurance company, on the other hand, has the obligation to pay you should you exercise that right in exchange for accepting your premium each month.

INTRODUCTION TO TECHNICAL ANALYSIS

Here is where we start to have some fun. Regardless of how you want to trade the markets you need an approach. It might be spinning a bottle, asking your Aunt Jenny what she thinks, or just gut feel.

However you do it, even though you may not think so, you have an approach.

The majority of traders will eventually use some form of technical analysis (also known as chart traders, market technicians and chartists).

Just before we go down this road of mystical wonder I think it is very important that you hear both sides of the argument of why technical analysis works.

For every book that there is on making money trading there is probably an opposite book explaining why it can't be done. Before you dismiss the last statement, let's explore the argument that no matter what you do you can't beat the market.

Random Walk

The Random Walk Theory dictates that security prices change randomly, with no predictable patterns. Now that is quite a statement but there are a number of very respected statisticians who have a very convincing argument to prove it.

It all started in London with a man called Maurice Kendall who presented a paper to the Royal Statistical Society in 1953.

The subject of the paper Kendall presented was the behavior of stock and commodity prices.

> *Ref. M. G. Kendall, "The Analysis Of Economic Time – Series" Journal of the Royal Statistical Society (1953)*

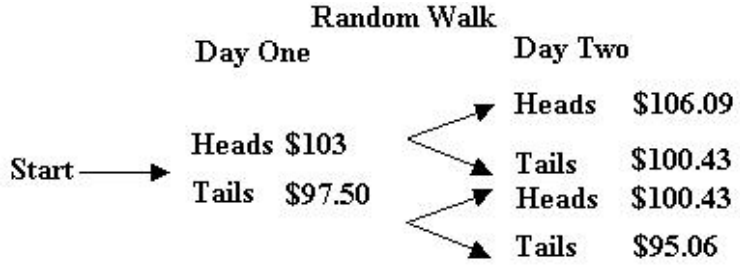
Kendall started out looking for predictable price cycles in stock and commodities prices. The problem was he couldn't find any.

Regardless of how he approached it, the price of a stock was just as likely to go up or down on any given day despite what happened on the previous day, which is where we get the term *Random Walk.* Prices seemed to follow a random walk as he observed them.

The best way to demonstrate this is with a game. Let's say we are going to make a bet on the toss of a coin. You start with $100.

We will toss this coin once per day. If it comes up heads you win 3% and if it comes up tails you lose 2.5%.

At the end of the first day you will either have $103 or $97.50. At the end of the second day we repeat the process so we eventually have something like the table below.

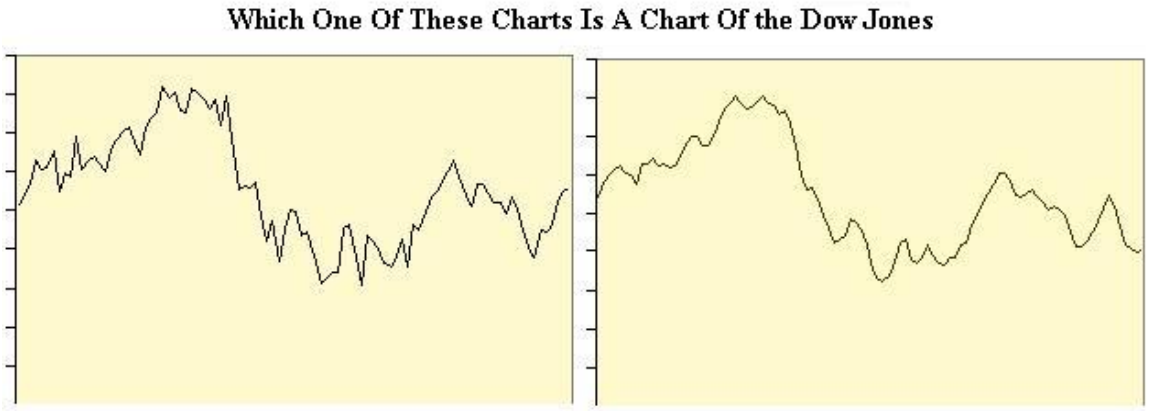


The probability of the coin landing heads or tails is exactly 50%. This is because, regardless of how many times the coin is tossed, each event is independent. The coin has no memory of what happened the toss before. This means that the results will be totally random.

Kendall's paper implies the same effect in the stock or commodities market. If each day is an independent event, then the markets must be random. We shall talk about more probabilities later.

Taking this idea slightly further, if the markets are random, then the history of the price of a stock or commodity has no bearing on the future price. It wouldn't help to look at charts or data, as each day there would be a 50% chance of the market going up or down.

You may be thinking by this stage that this theory is rubbish. I can trade the markets and make money! Try this simple test. Have a look at the two charts below. One is a chart of 100 daily closes of the Dow Jones Industrial Average and the other is a 100 random coin tosses.



Makes you think doesn't it? If each day in the market were, in fact, an independent event, then it would be impossible for you to make money from it consistently.

We will cover this a little more in the section on probability. By the way, the chart on the left is the chart of the Dow Jones. You will see any succession of events. Particularly, independent events can have an aberrant run. This is what kills the trader.

The Dow Jones Theory and Other Things

Now that we've had a look at the argument against using some form of technical analysis to help gain an advantage in the market, let's have a look on the bright side: the argument for using some form of analysis to help make buy and sell decisions in the market.

I have two main arguments of why technical analysis works when applied correctly to trading any financial market and they are simple.

1. I know of many professional traders who consistently, year after year, make money in the market. There are also thousands of traders across the world who make a profit in the market consistently.

   If it were not possible to make money trading because the markets are inherently random, then why do so many traders make money?

2. One of the main reasons I believe technical analysis works is because of the human element. When a market is in a raging bull market, traders know this and can exploit it.

   When a major support level is about to break, there are normally thousand of traders with some technical training who are aware of this and exploit the situation.

   Technical analysis is the science of human behavior. If you are in tune with the market sentiment then you can trade this knowledge effectively.

   That is why technical analysis is not an exact science. It is an art. Regardless of the indicator, what you are really studying is the science of **human behavior**.

Mr. Charles Dow and Edward Jones

Charles Dow was born in 1851 and spent most of his adult life as a newspaperman. His particular area of expertise was reporting on the financial markets.

This eventually brought him to New York where, in 1880, he found a job reporting on mining stocks. He was regarded, not only, as a financial reporter, but as a financial analyst.

It was around this time he met up with Edward D. Jones and they moved on to form Dow Jones & Company.

The main business of the Dow Jones & Company was delivering financial information to those who needed it.

The first news sheet of Dow Jones & Company was printed in 1883 and was the forerunner of what we now call “The Wall Street Journal”.

Ticker Tape Machine
From Around 1890

Dow then joined the New York Stock Exchange in 1885 where he remained a member until 1891.

All this is very interesting, but why is it important? Well, Mr. Dow is considered the father of modern technical analysis and his observations of the markets are considered some of the most important writings related to technical analysis.

The Dow Theory

You will hear a lot about the Dow Theory as you travel through your trading career. Dow, himself, never actually used the phrase. That came later as analysts began to use the term.

I should back up here slightly and mention that in 1884 Dow published his first stock market average of 11 stocks. From the original 11 stocks, there were some changes and rearrangements of the average. Until finally, in 1928, he settled on 30 stocks, which are now known as the industrial average and that is where we get the term the ‘Dow Jones Industrial Average’.

The actual theory is fairly straightforward to explain and sensible if you take the time to think about it. I shall simplify it slightly, as we have not covered some of the terms yet.

1. The market discounts everything. The price you see is the true value of the market. If you are following a particular stock and it is trading at $10, then that is a fair value of that stock. It assumes that all the known information about that stock has been taken into consideration by the market and is reflected in the price. If new information was introduced it would change the price of the stock, but it would still be reflected in the price.

2. The market has three main trends. We are starting to get into some technical expressions here, but just bear with me, as we will explain all these terms as we progress.

   Dow's interpretation of a trend was that each rally high be higher than the previous rally high and each rally low be higher than the previous rally low.

   The three trends were: primary, secondary and minor. Now this is important because later on, as we discuss this, it will play a major roll in our analysis.

   The primary trend is the main force behind the trend and is like a river flowing in a particular direction.

   The secondary trend is like tributary to the main trend. It may diverge for a time but eventually it will come back in line with the main river.

   The minor trend is like a small stream, which runs this way and that, but is headed in the general direction of the river.

   The primary trend may take years to come to an end and develops over time. The secondary trend can take anywhere from a few weeks to a few months in duration. And the minor trend may be in the opposite direction of the primary trend. Minor trends, such as a daily trend, last a few days or so and are of little significance.

3. In addition to the three types of trends, Dow then went on to further qualify the trend by saying that the trend has three phases: an accumulation stage, the public participation stage and finally the distribution stage.

4. As the original Dow average was composed of shares from different sectors, the next part of the Dow Theory was that the average of the different sectors must confirm each other.

5. Dow also considered the effect of volume on a trend. He stated that volume should expand in the same direction of the trend.

6. The last major part of the theory is the trend should be assumed to still be in force until there is a definite indication that the direction has, in fact, changed.

My interpretation of the Dow Theory above is very brief, as it is beyond this book to delve to deeply into any one particular subject.

It is also not necessary for what I am trying to achieve, and that is to give you a broad idea of how the markets work and some way to trade them. We will get more specific about things later.

The main point I want you to take away from the Dow Theory is that there are three types of trends: a primary trend, a secondary trend, and a minor trend. We can use this in our approach.

FUNDAMENTAL VS. TECHNICAL FORECASTING

Just before we get started on the technical section of the book I want to introduce you to fundamental analysis.

Fundamental

Fundamental analysis concentrates on the forces of supply and demand for a given security. This approach examines all the factors that determine the price of a security and the real value of that security.

This is referred to as the intrinsic value. If the intrinsic value is below the market price then there is an opportunity to sell. If intrinsic value is above the market price then there is an opportunity to buy.

A fundamentalist will often examine the true value of shares in a company based on its assets, earnings, and dividends. Once they have come up with a number they will then determine if the share is undervalued or overvalued.

Another example might be an economist who examines a country's currency based on all the underlying economic factors and purchasing parity to determine the true value of that currency against another currency.

Once he has come up with his evaluation he can determine if he thinks the currency is undervalued or overvalued against a given currency.

Technical Analysis

Technical analysis is the study of market action, mainly through the use of charts and indicators, to forecast the future price of a security. There are three main points that a technical analyst applies:

1. Market action discounts everything. Regardless of what the fundamentals are saying, the price you see is the price you get.

2. The price of a given security moves in trends.

3. The historical trend of a security will tend to repeat.

Of all of the above points, the most important of them is the first one. It is also important for you to understand this point, as it is the basis of our approach to trading.

When you look at the price of any financial instrument as a technical analyst you believe that is the true value of the instrument as the market sees it.

Using a technical approach, you believe that all the factors that affect price, including fundamental, political, and psychological, have all been built into the price you see.

All this means is that anything that can affect the price of a security has already been allowed for by the market participants. Technical analysts look at charts the same way a doctor would look at x-rays. They examine the charts for information on the future direction of the markets.

Conclusion

Most traders classify themselves as either Fundamentalists or Technicians. The truth is that there is a lot of common ground between the two and the best approach I have found is to take note of both approaches.

For the purpose of this book, we shall concentrate on technical analysis. This is how I approach the market. But at the same time, I am aware of any big announcements that may be coming out (e.g., interest rate changes).

LET'S GET TECHNICAL

You need to understand the basics of how the markets work before I can start to introduce more advanced concepts, such as trading methods and systems. So let's go over the basics.

The language of the markets can be confusing in the beginning so the following explanations may help.

Bull Market

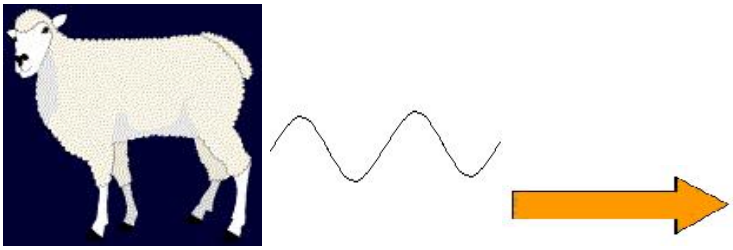
When the BUYING market is more predominate than the SELLING market here are some expressions commonly used:

BULL	HIGHER HIGHS
BUYING	HIGHER LOWS
BUYING LONG	NORTH
GOING UP	TRENDING UP DAY

Bear Market

Here are some expressions commonly used in the SELLING market:

BEAR	LOWER LOWS
BEARISH	LOWER HIGHS
SELLING	SOUTH
SHORT	GOING DOWN
SELLING SHORT	TRENDING DOWN DAY
DOWN	SHORTING THE MARKET



Lamb Market

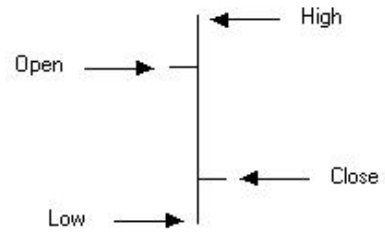
When the market you are looking at is not in a state of massive buying or selling. The market may be basically oscillating from one point to another point and repeating the process.

This may happen for hours or even days. This is often referred to as a lamb market or a trading day. The language for this day might be:

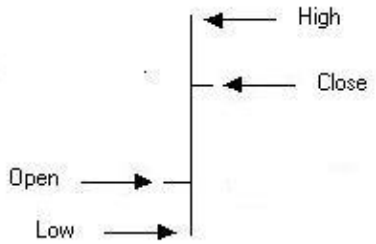
LAMBS	ACCUMULATION
FLAT	NOISE
ON THE FENCE	BRACKETING
CONSOLIDATION	TRADING DAY

Visual Recognition

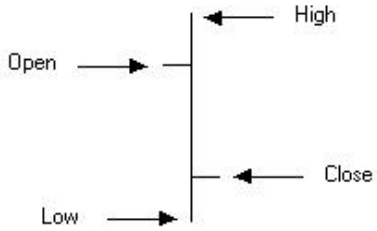
Bars



Bullish Bar



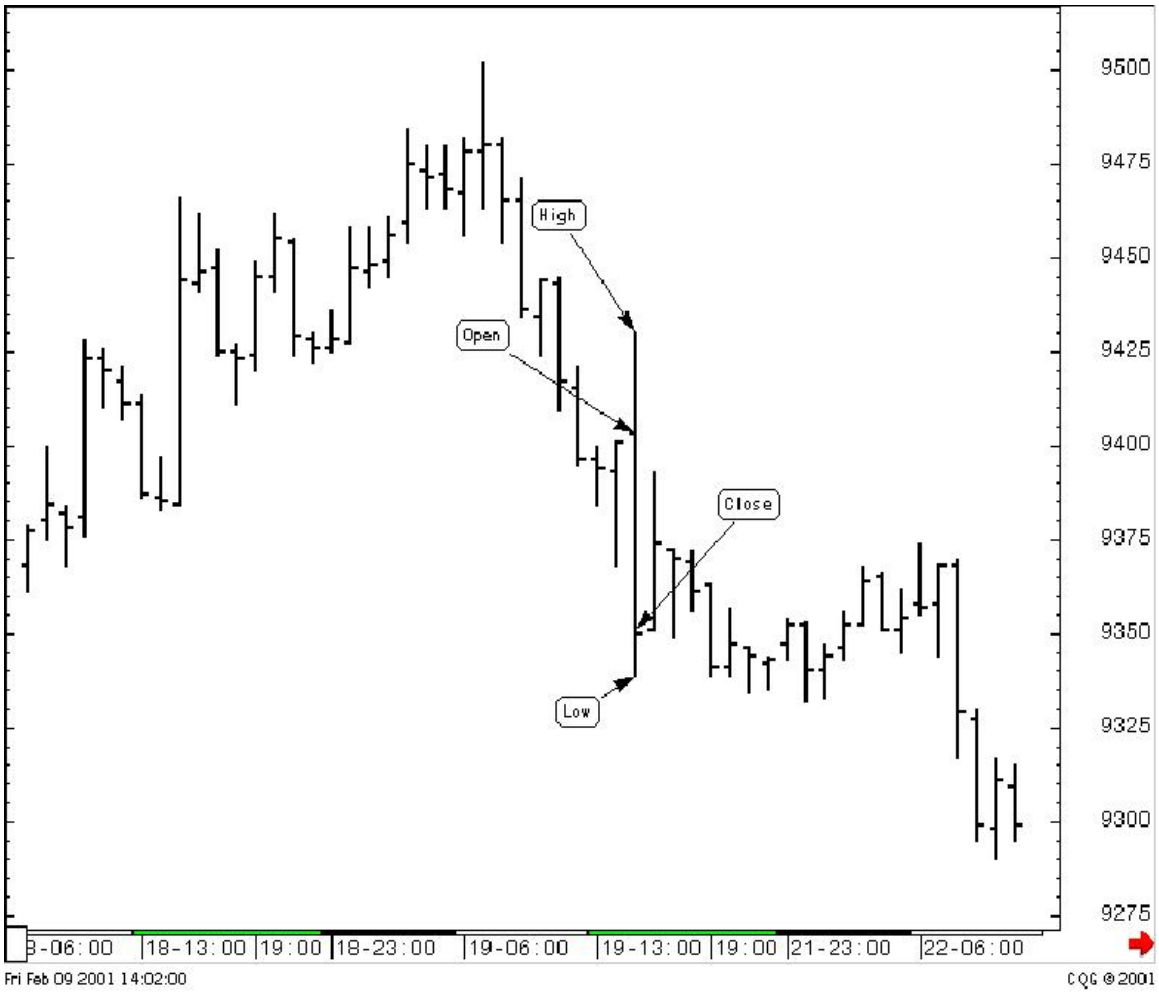
Bearish Bar



A bar represents one period of time. It is a means of measuring the duration of buying or selling within the market. The time intervals may be 5 minutes, 10 minutes, 30 minutes, 1 hour, 2 hours, 4 hours, 1 day, 1week, even 1 minute, if desired. You can use any time period you want.

Bar charts are among the most widely used charts in the world today. During our course we will be using them a lot.

Bar Charts


High
Open
Close
Low
9500
9475
9450
9425
9400
9375
9350
9325
9300
9275
18-13:00
19:00
18-23:00
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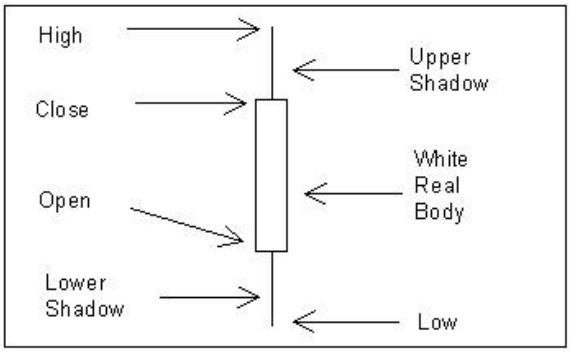
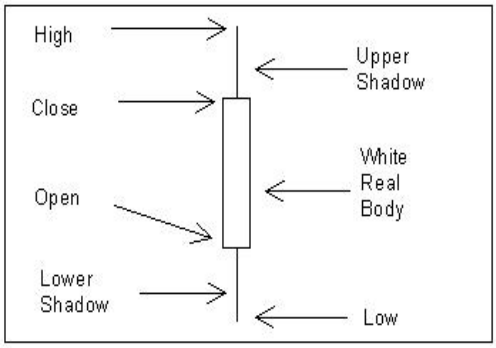
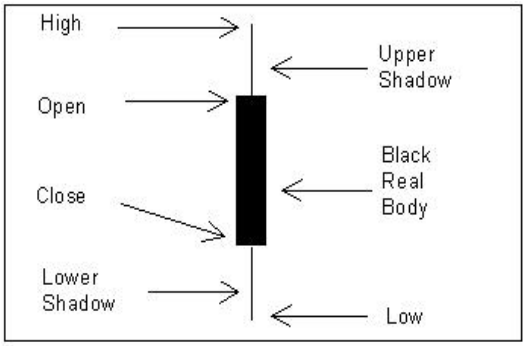
Candlesticks



Bullish Candle



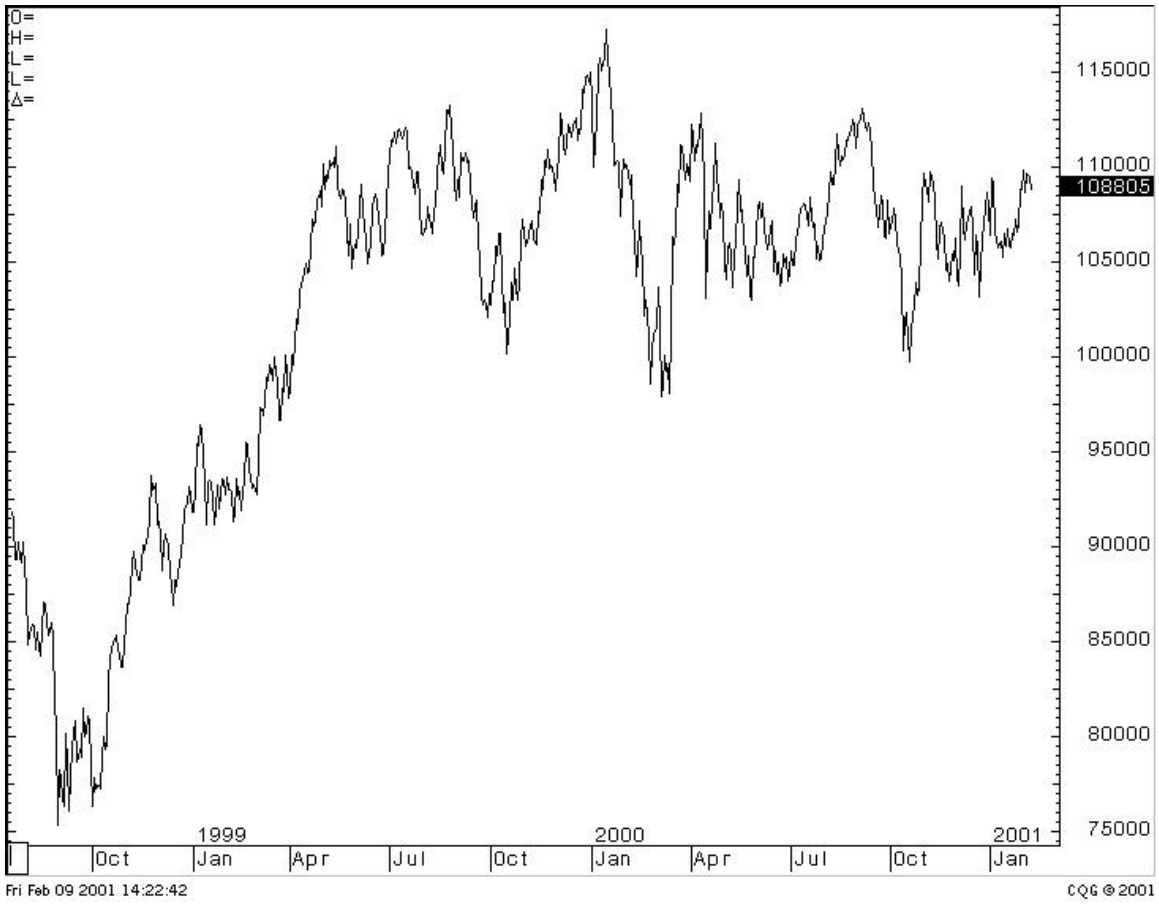
Bearish Candle



A candlestick represents one period of time. It is a means of measuring the duration of buying or selling within the market. The time intervals may be 5 minutes, 10 minutes, 30 minutes, 1 hour, 2 hours, 4 hours, 1 day, 1week, even one minute if desired. Just like the bar chart you can use any time period you want.

Candlestick Chart

Line Chart



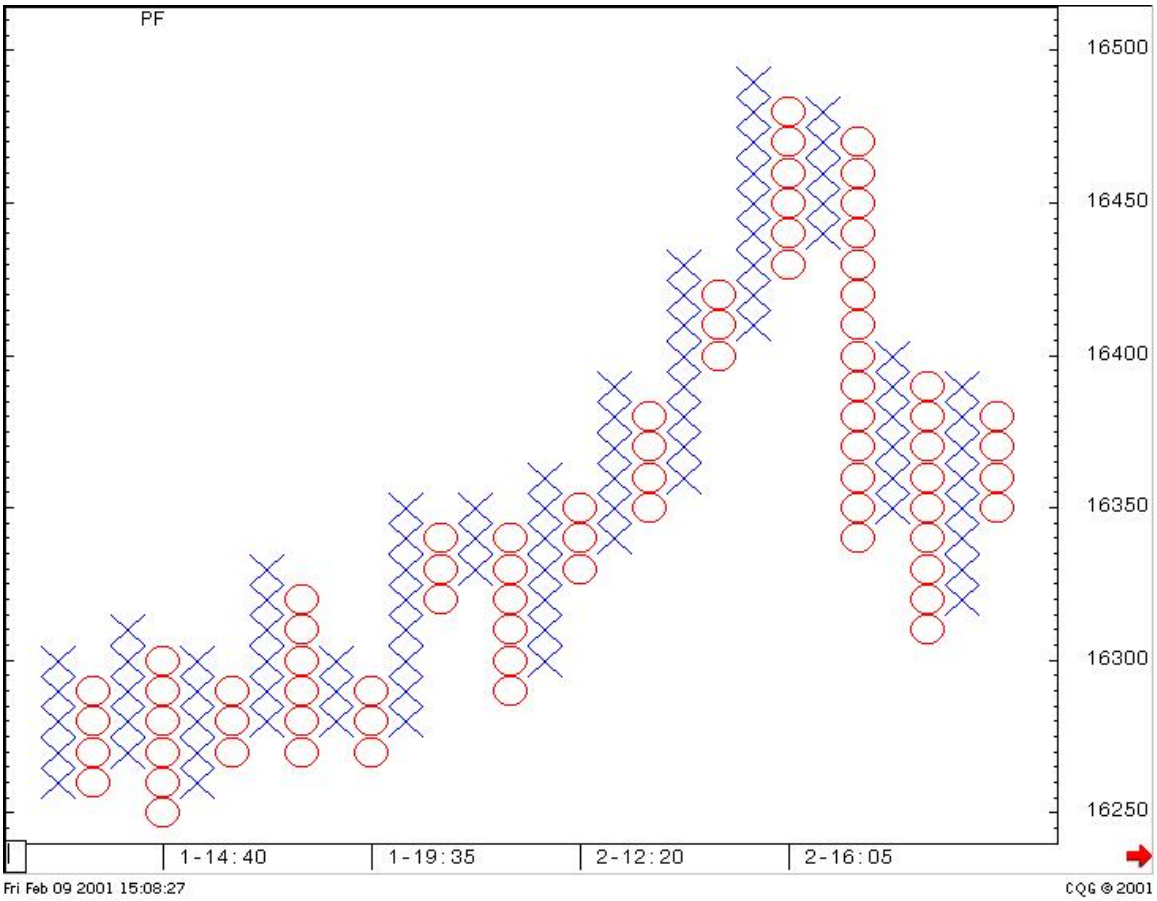
Line charts are made up of plotting the closing prices of given periods.

For example:

Date	Price
2nd Feb 02	10,864
5th Feb 02	10,965
6th Feb 02	10,957
7th Feb 02	10,946

A line chart is the simplest type of chart. A line chart's strength comes from its simplicity. It provides an uncluttered, easy to understand, view of prices.

Point & Figure Chart



A line or a bar chart is two-dimensional. The vertical spaces measure price. The horizontal spaces measure calendar time, whether hourly, daily, weekly or monthly.

A point-and-figure chart is one-dimensional. Both vertical and horizontal spaces measure price. There is no measurement of arbitrary calendar time. Each successive horizontal space on the chart represents a change of direction in the price, from up to down or from down to up.

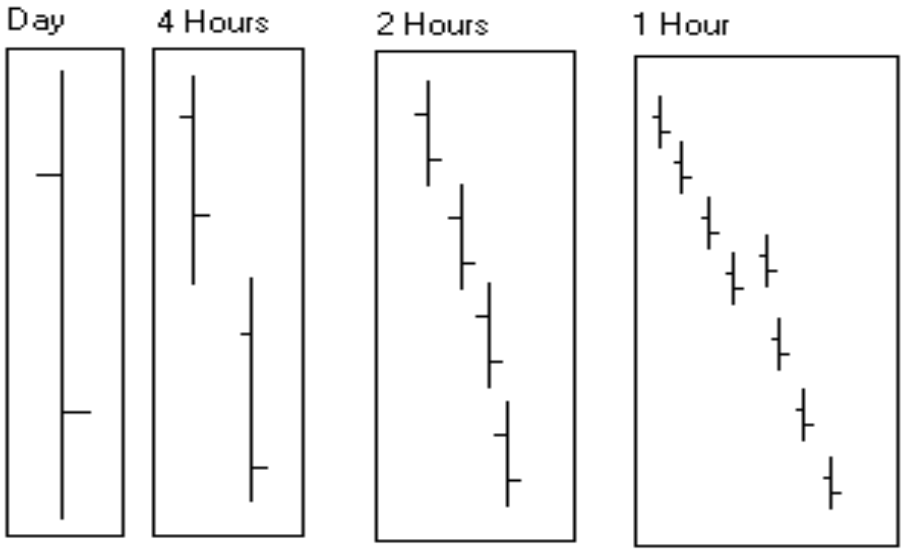
Time Periods

Very important: Know where you live!

There is no correct time period to trade, only the time period you feel comfortable in.

If you ask someone to tell you where the trend is in the S&P market, they would first have to find out what time period you were talking about. For a daily trader the trend may be up, but for an hourly trader the trend may be down.

Let's discuss this a little further. Most of the charts we will be looking at are day charts; that is to say, you are looking at one bar that encapsulates everything that happened during that day. It would have a high and low for the day, and an open and close for the day.



If you were looking at a chart made up of 4-hour bars there would be twice as many bars. Each bar would have its own open, high, low, and close (OHLC). These may be different from the day OHLC bar as the bar is measuring all the price changes inside that particular time period, in this example, 4 hours.

The same can be said for any other time period, whether it is 30 minutes or 1 minute (e.g., it would take five 1-minute bars to make up one 5-minute bar).

This is why it's impossible for someone to tell where the trend is in a particular security unless he knows what time period you are trading.

It is also why, if you were looking at a daily bar and noted that the bar closed at, let's say 500, it does not tell you what happened during the day.

If you where trading 5 -minute bars you might have watched it rise most of the day and made money, only to see it close much lower later in the day.

For the sake of simplicity, I recommend you start with daily bars only for the first few months. This will give you plenty of time to make your analysis and plan for the next days' trade.

I often see people with little or no experience trying to trade 1-minute bars, only to find the decision making process is far too much for them as they have to make decisions every minute.

Also worth noting is that there is no one time period that makes more money than another. The reason you would trade a weekly bar as opposed to a 5-minute is purely a matter of choice and circumstance.

Note:
I have purposefully left out the use of multiple time periods and time periods in relation to margin, as this should not be used when you first start trading. You can read more about multiple time periods in the Members Area: www.tradingforbeginners.com/bonusreport.htm.

One of the secrets of trading is to trade in the time period you feel comfortable in. It is also a function of time and money.

The Trend is Your Friend

The price chart of a security may appear like a random distribution, but this is not so.

About 30% of the time a security will be in a definite trend. The rest of the time prices will trade, more or less, in a sideways range. Our job is to recognize trends early, as they emerge from non-trends or as reversals of prior trends.

We then buy/sell our security early in these new trends and exit the trade profitably when the trend ends. This identification of trend, its beginning and end, is the most important thing we have to do. This is how great fortunes are made.

Trends

Trend is the easiest and the most difficult thing to understand. The difficulty arises because of the time factor. Whenever we talk of trend it has to be related to the context of time.

An intraday (relates to action on that particular day only) price chart may show a significant trend, which is contrary to a trend recognizable on a daily price chart, which may be contrary to a trend on a weekly chart.

Success depends on recognizing and trading the appropriate trend. Successful investing depends on recognizing the short, medium or long-term trend and their correction (Rallies and Dips) inside the larger trend.

We will usually be trading when, at least, the short term and intermediate term trends are in the same direction.

The ideal will be when all three trends are in unison, but this is not a prerequisite, as intermediate trends can be substantial in both time and price.

It would be too exclusive a trading strategy to ignore these opportunities and only trade when all three trends are in harmony.

A simple definition of trend is basically the general direction of price movements.

An up trend is present when prices make a series of higher highs and higher lows.

A downtrend is present when prices make a series of lower highs and lower lows.

When prices move without such a discernible series, prices are said to be trading sideways in a range or trendless.

Once a trend is discernible, then trend lines can be drawn to define the lower limits of an up trend or the upper limits of a downtrend.

It is essential that trend lines be drawn correctly. It is the recognition of the trend line and the violation of this trend line that is your key to successful trading and fortune building.

Up Trend Line

As you can see from the diagram below, the trend is moving up. To draw a trend line, draw a straight line from the lowest low of the period to the next lowest low. Make sure the line does not pass through any bars.

Up Trend

Down Trend Line

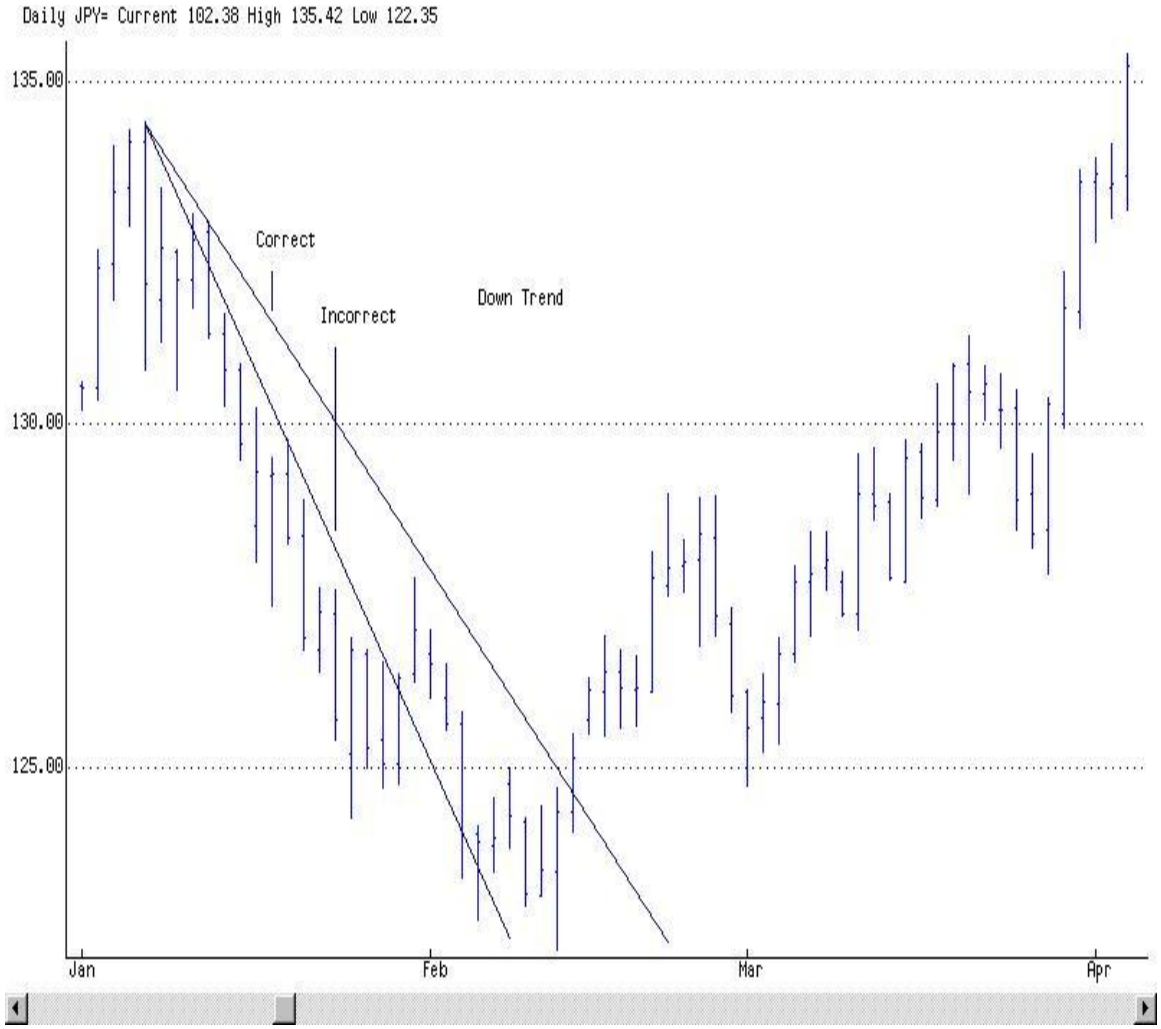
As you can see from the diagram below, the trend is moving down.

To draw a trend line, draw a straight line from the highest high of the period to the next highest high. Make sure the line does not pass through any bars

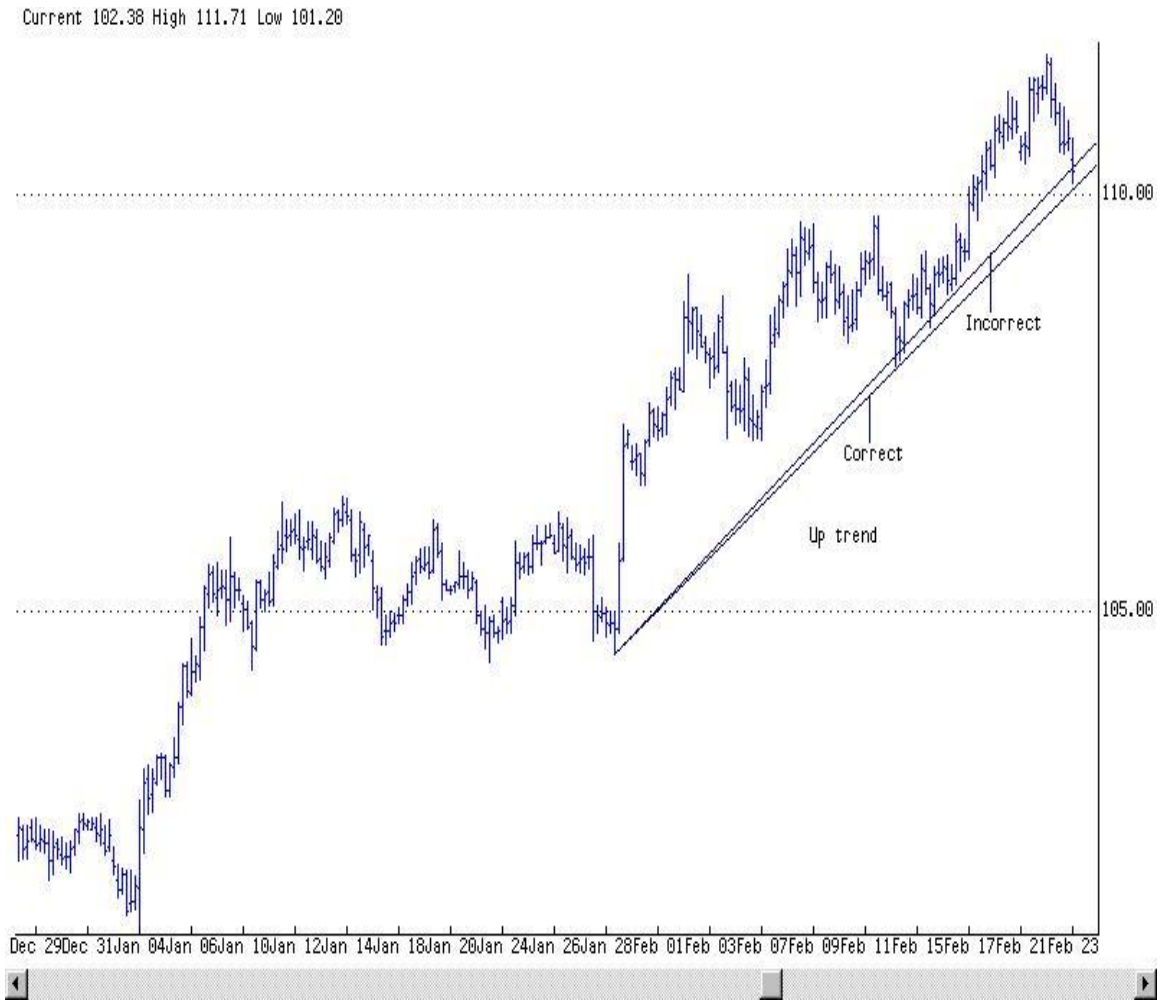
Down Trend

The following are examples of the correct way to draw a trend line:

Down Trend



Up Trend



A break in the trend line is the first indication that the market may be changing course.

Fan lines

During development of a trend, the growth of the trend proceeds at different rates at different times.

A frequent sequence is the following - a short initial explosive breakout and advance from a previous prolonged period of range trading, a much longer period of steady progression at a lower rate of change and, finally, a shorter period of noticeably slower rate of progression.

Each phase of trend advancement is followed by a period of retracement and consolidation. The initial growth phase is too rapid to be sustained and the ensuing correction is often quite deep.

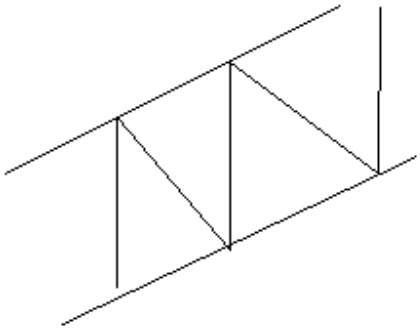
The second phase of advancement is one of steady sustainable growth and often persists for some time. Inevitably, this too ends and a period of retracement follows, but usually not as deep as the initial correction.

This second correction often takes more time than the first to complete the corrective process. When the correction is complete, the final phase of trend advancement occurs usually at the slowest rate of change for the whole progression of the trend and then this too corrects.

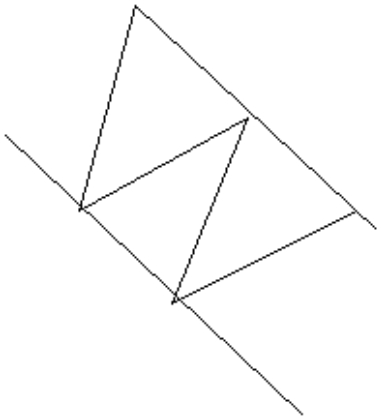
The three trend lines that can be drawn from the initial point of the trend through each of the retracement extremes are known as Fan Lines.

They illustrate the decaying rate of progress of the trend. When, finally, prices violate the third fan line it invariably means the trend so monitored has finished and a reversal of the trend is underway.

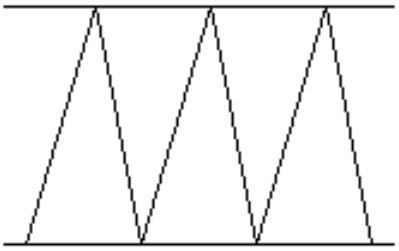
Channels



Rising Channel

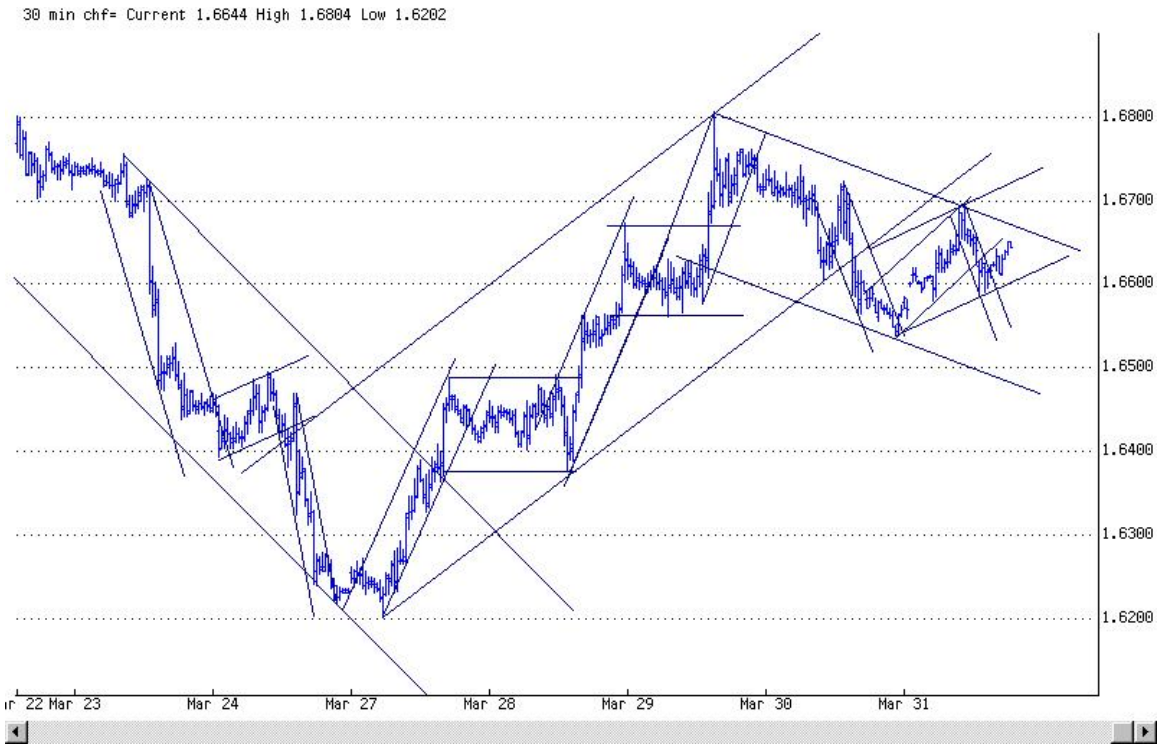


Declining Channel



Flat

Examples of Channels on Chart of the Dollar/Swiss



Channels are a good visual representation of the struggle between buyers and sellers. It is important to realize that you must know the time frame you intend to trade.

The channel on a 4-hour chart may be different from that on another time period. Once you are committed to a particular time frame we can then define trend and emphasize the importance of drawing correct trend lines within the context of the time frame.

Now we will combine these insights to maximize the efficiency of trading. This we will do by establishing channels in the particular trend we are working with.

We learned that the trend line acts as underlying support to up trend lines and overhead resistance to down trends. We also can observe that prices, once finding support or resistance, will move ahead and away from the trend line then return to the trend line.

Over time we can recognize that this movement of price to and from the trend line forms a channel, which, once identified, can be traded.

In an up trend, as prices come back to the trend line, new, increased buying comes into the market and overwhelms the sellers. These buyers are made up of previous buyers in the market adding to their positions, intending buyers who missed earlier opportunities and are now buying the dip.

The buying that stops the selling at the trend line impresses some of the previously uncommitted buyers (now convinced that the buyers have the upper hand) who will now buy. This new buying takes prices up and away from the trend line and the further it moves up, the more impressed the uncommitted become and more buyers come into the market.

The previous short sellers become frustrated and buy to cover their short positions and prices move up further. After awhile, buying becomes exhausted and is overwhelmed by selling and profit taking.

As buying is overwhelmed, more profit taking occurs and nervous, recent buyers will have their close trailing stops (to be discussed later) triggered as market orders and so price retreats to the trend line again.

This starts the whole cycle off again if the up trend is to continue. This to and fro, buying and selling in the direction of the trend plots out a recognizable channel of dynamic flux of the trend.

Recognizing the trend line and the opposing parallel channel line - channel return line - and understanding the human dynamics that account for its structure, increases the efficiency of profit making by initiating or adding to one's position at trend lines and profit taking at the channel return line.

One can, but I do not usually, trade the retracement. For those who do not wish to trade the trend so aggressively, one can use the trend line for placing and moving stops and to initiate new trades.

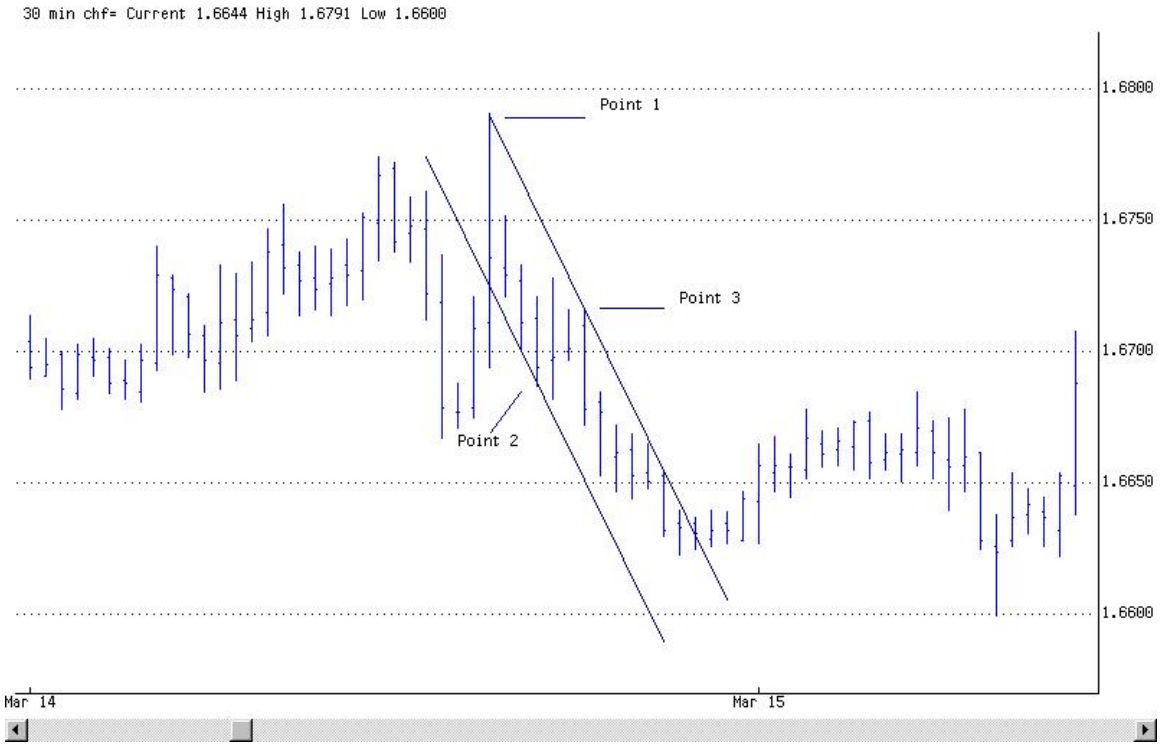
Also, when a channel is in force we can respond to trend violation by having a recognizable entry level to trade the new trend.

Also, as the trend progresses one can recognize support and resistance levels, which can also be used for further trading on the placement of stops.

As you can clearly see from the diagram, the trend line can change slope as the trend may move at different rates and it is mandatory to adjust the trend as necessary.

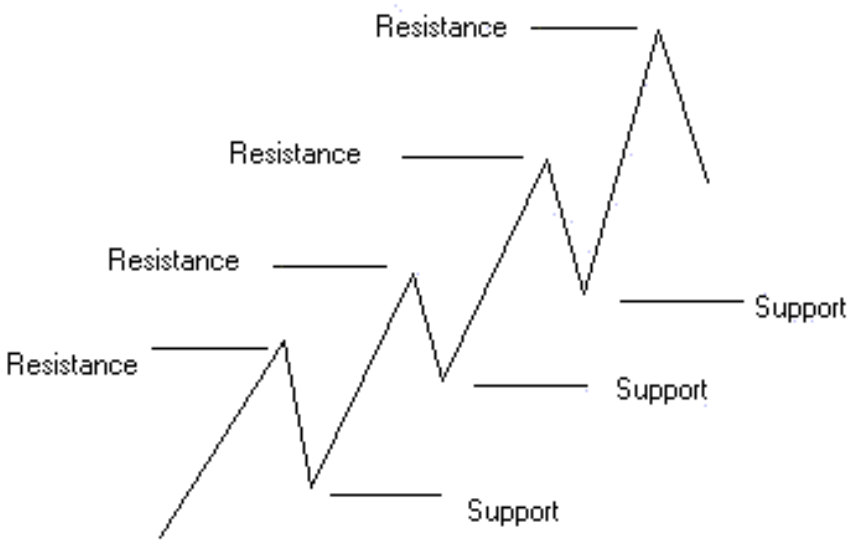
So it is with channels, as these too must be adjusted as the trend accelerates or decelerates.

Also, it can often be recognized that channels can exist within channels. These channels within channels are plotting the short, medium, and long-term trend.



When drawing your initial channel line you need three points. Point 1 is your starting point. Point 2 is the initial width of the channel. Point 3 is when it first returns to its trend line.

Support and Resistance



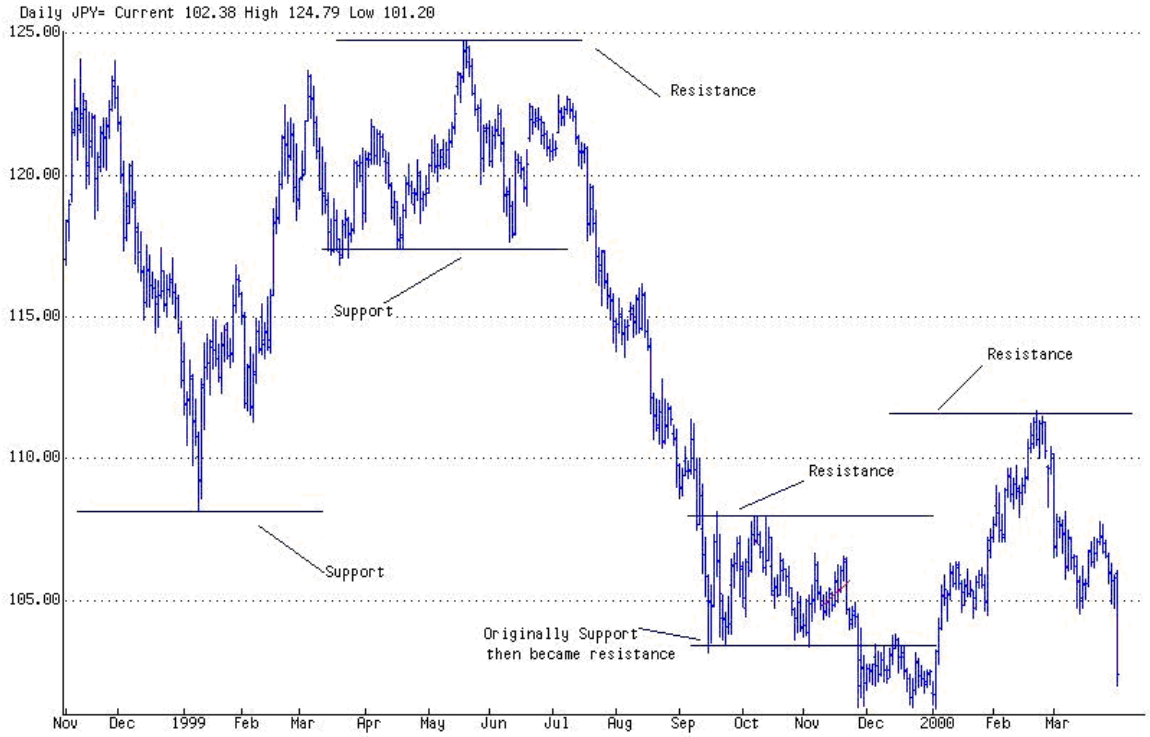
It is very important to understand the concept of support and resistance.

In up trends, every time prices drop to the up trend line and then resume their advance, the trend line has acted as support to the price up trend. Support can also be found at prices of previous support or resistance.

In down trends, every time prices rise to the down trend line and then resume their decline, the down trend line has acted as resistance to the upward move of market prices.

Resistance can also be expected at prices of previous support or resistance. Once levels of support or resistance have been violated, then, invariably, these reverse their roles, so that previous support becomes resistance and previous resistance becomes support.

Consider the following. When price action drops to a certain level, the bulls (i.e., the buyers) take control and prevent prices from falling further. Similar to support, a "resistance" level is the point at which sellers take control of prices and prevent them from rising higher.



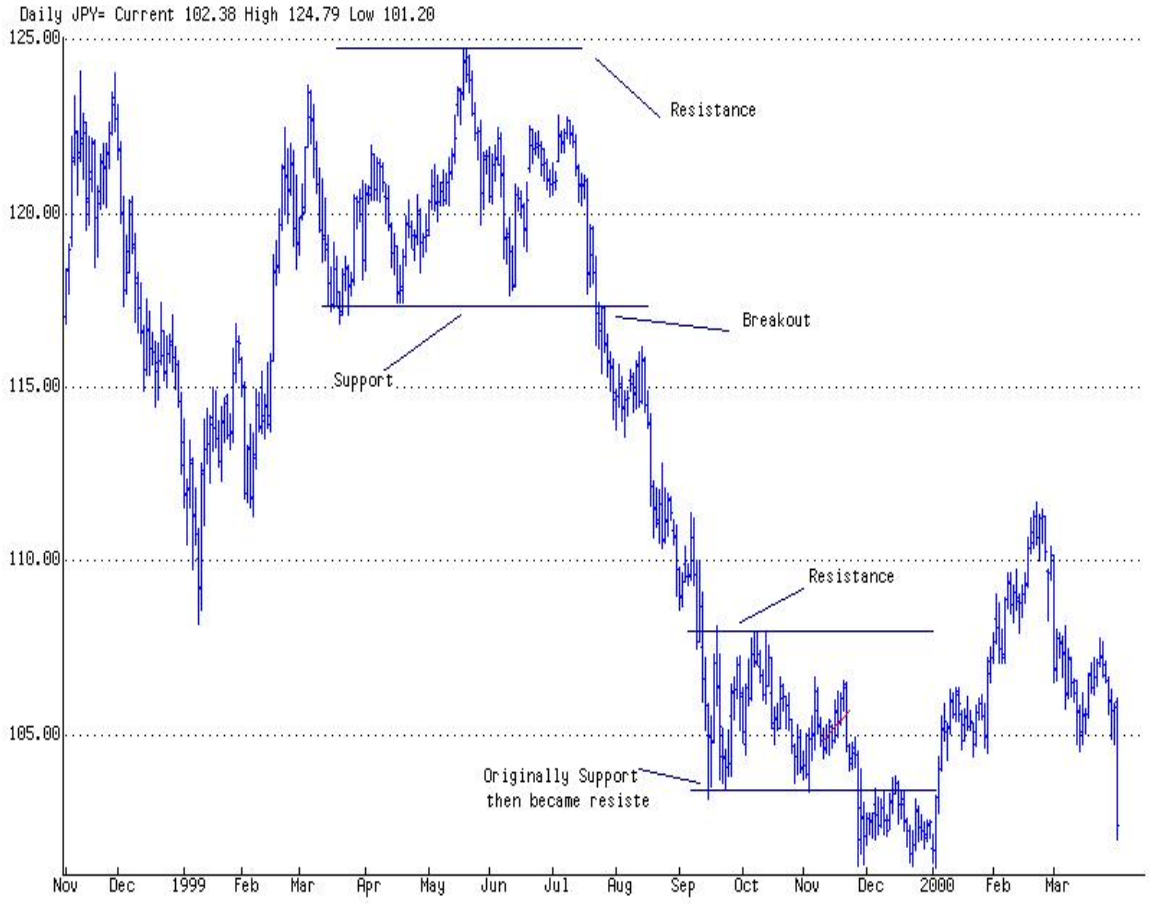
The price at which a trade takes place is the price at which a bull and bear agree to do business. It represents the consensus of their expectations. The bulls think prices will move higher and the bears think prices will move lower.

Support levels indicate the price where the majority of investors believe that prices will move higher, and resistance levels indicate the price at which a majority of investors feel prices will move lower.

When investor expectations change, they often do so abruptly. Note when prices rose above the resistance level, they did so decisively. Also similarly with support.

The development of support and resistance levels is probably the most noticeable and reoccurring event on price charts.

The penetration of support/resistance levels can be triggered by fundamental changes that are above or below investor expectations (e.g., changes in interest rates, government announcements, etc.) or by self-fulfilling prophecy (investors buy as they see prices rise). The cause is not as significant as the effect, new expectations lead to new price levels.



As you can see from the charts above, sometimes the price will just keep going through support and resistance. Sometimes it will come back to test its previous support or resistance line. This applies also to trend lines. We will be going into this in more detail in future chapters when we cover learning to trade.

It is essential to understand the concept of support and resistance.

The validity of a trend line is dependent on its duration and the number of times it has been successfully tested.

The longer the trend line has been in effect and the more times it has been successfully tested, the more important the trend line becomes. Consequently, when a trend line of long duration, which has been successfully tested many times, has been violated, then an important reversal of trend has likely occurred.

However, on no account, exit the market until definitive evidence of trend termination has occurred. Remember another trading mantra, “The trend is the trend until proven otherwise”. To ignore this dictum is to unnecessarily deny yourself profits.

Moving Averages

The changing prices of a security from tick to tick, day to day, or whatever time period you are looking at, may seem random, but there are ways to smooth out this randomness. One way traders look to make sense from this seemingly unpredictable sea is moving averages.

If you are going to trade professionally, it is vital that you can identify trading opportunities. To this end, the concept of moving averages is a very useful tool to understand.

A moving average (MA) is a way to try and eliminate or minimize the fluctuations of the numerical value of price fluctuations we are observing.

This will help us identify the underlying value. Moving averages are generally calculated using the closing price.

What, in effect, the moving average does, is to eliminate the fluctuation of price in all time periods below the number which is chosen for the average. For example, a 4-day or 9-week moving average eliminates the presence of price fluctuations for periods up to 4 days or 9 weeks, respectively.

A 200-day moving average eliminates the presence of daily price fluctuations for periods below 200 days. This smoothing effect of price change increases as you use longer and longer periods as the average.

There are four commonly used moving averages: simple, smoothed, weighted and exponential.

Simple moving averages give equal weighting to each time period’s price.

In an attempt to give more importance to more recent prices, different types of moving averages have been developed: smoothed, weighted and exponential moving averages.

I won't go into their complex mathematical derivations. Why not? Because detailed retrospective studies of their use has shown that the simple moving average statistically outperforms or equals the use of these newer, biased moving averages.

Simple Moving Average

This is the most widely used and is simply calculated by adding up a set of values and dividing the total by the number in the set.

This is the average. Movement of this average is affected by adding the next new value of the set and subtracting the first value of the set and again dividing by the same number of values in the set being studied. You repeat this simple calculation with each new piece of data.

For example, to find the 3 period average of the following sequence 5, 10, and 8, add the three numbers together which equals 23 and divide that number by 3 which equals 7.7.

The graph shows price strength is associated with a rising moving average and that weakness is denoted by a declining moving average.

The shorter the time period calculated, the more volatile the average and the shorter the lag period, but the more frequent will be costly whipsaws.

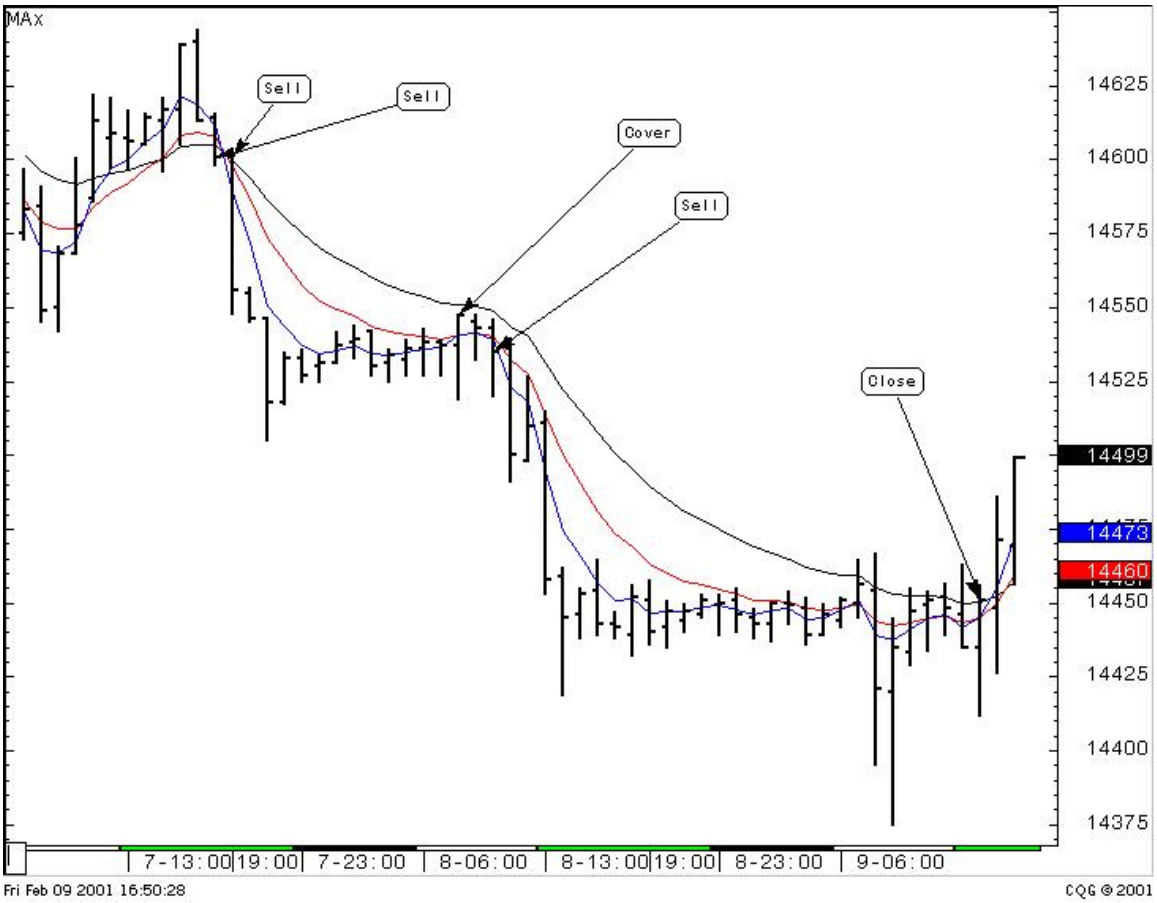
Longer time periods will be less volatile with fewer whipsaws, but the lag period will be greatly increased, substantially eroding profits.

In the next example you will see two moving averages, a 9 and an 18. This can be used as a signal to buy or sell whenever the averages cross. In the example, just like trend lines, when price returns to the average you have an opportunity to buy or sell.

In the last example we have three moving averages 4, 9, and 18.

These help represent the short, medium, and long-term trend. When the 4 and 9 period moving averages cross we have a potential buy or sell signal.

When the price returns to the faster moving average and closes above all three averages, this is a an opportunity to buy or sell.



1. The moving average is similar to a smoothed trend and, as such, often acts as an area of support or resistance.

   Retracement of prices often reverse when they reach the moving average level; i.e., in a rising trend, a falling price often finds support and in a falling market, rising stock prices often find resistance when they reach the level of the moving average.

2. The penetration or cross over of a moving average (and therefore, of a smoothed line of support or resistance) by price is frequently the signal of a trend reversal.

3. If the moving average has flattened out or has already reversed direction then its violation increases the likelihood of a reversal of the recent trend.

4. The longer the time span used to calculate the moving averages, the greater the significance of its violation by price (e.g., a 200-week moving average violation by price is of more significance than that of a 4-week moving average, which is of more significance than that of a 4-day moving average).

Which Moving Average to Use

Any time span can be considered, from minutes to years. An appropriate choice relevant to one's trading style is the most obvious.

If you are a very short term trader, then a moving average of, as little as, three days may be appropriate.

However, in a sideways moving market you can become out of sync with the trend and spend a lot of time being whipsawed.

The normal bull/bear market cycle, usually 4 years in duration, would be entirely missed by choosing a 4-year moving average. And a 2-year average would be frustratingly slow and you would be in and out of the market too late to make much, if any, profit.

Yet a short period (e.g., a 10-day moving average) would likely whipsaw you in and out the market too frequently to be very profitable.

Different markets, different market cycles, and different investor goals will determine the most appropriate time period for which to calculate the moving average. Some commonly used ones are:

- Major primary trend monitored by a 40-week (200-day) moving average
- Intermediate term trend by a 40-day moving average
- Short term trend by a 20-day moving average

Stop Losses

A stop loss is the level at which you will close a trade on the basis that it has gone too far in the "wrong" direction, and therefore, negated the reason for being in that trade.

Always use a stop loss when trading; it can be too easy for a $300 loss to become a $5000 loss. A good trader takes a small loss and goes on to the next trade.

Remember that trading capital is your business; if it burns there is no insurance. Once you have entered a trade, immediately place a stop. This safeguards you from losing your entire account.

It is also wise to talk with your broker about how they execute your stop. Some brokers execute stops differently.

Your stop loss policy can be set in a number of ways. Some use an actual figure (e.g., $100), and some a percentage figure (i.e., they do not want a position to go more than a certain percent), say 5%, against them.

Others may use technical analysis principles to set stops. This is my preferred method of trading. If I enter a trade on the short side after a signal, as in the example below, I will place my stop in the next nearest resistance.

The opposite is true for the long side. If I enter a trade from the long side I will place my stop at the next lowest support.

It's important to ensure that your stop is cancelled if you close your position. I mention this, as you would not be the first trader, which closed a position, only to forget that they still had a stop in the market, which would take you back into a position.

The most important thing, however you approach the decision, is to know where you will cut a losing position before entering the trade. Set the rules and ALWAYS follow them.

Exiting a Losing Trade

The stop loss means that if a security trades a certain amount below or above where you entered the market, an order is executed to close your position.

You may use "programmed" stops if your broker offers them. (Some brokers do not offer this.)

You can also, at anytime during the trade, close the trade by calling your broker or executing the trade on your dealing station.

If you are long a security, you will sell it in order to close it. If you are short a security, you will buy it in order to close the position. Think of it like this, when you buy something you now own it. In order to get rid of it, you must sell it.

Profitable Trades

Once you are in a profitable trade, the next challenge becomes when to take profit. Optimizing profits is the other main aim of trading, besides limiting losses.

As a trader you must determine the risk/reward level that is comfortable for you, either on your own or by discussing it with your broker.

Below are some exit strategies, but these are not exclusive; there are many trade management techniques. Take your profits as you see fit, as it is your trade and you must manage it. No one else can do it for you.

Exiting a Profitable Trade

Trailing Stop: Once a profitable position has been established, maintain a trailing stop (e.g., below the current price if you are long).

Again this can be set in actual dollar amounts, percentage terms, or using technical analysis principles.

However you approach the stop price, it is a level beyond which you are not prepared to give up profit, or where a position slips back to evens or a small loss. As the price continues to rise, your stop “trails” higher in tandem.

As an example, if you were to set a straightforward $300 trailing stop and the security moved in your favor by $1000, you could change your stop to be only $300 behind the price and lock in $700 of profit.

In this way you lock in profits and you are still in the game should the trade continue to go in your favor. You could also trail the stop until, for example, you get another signal as in a trend line breaking.

Take partial profits

Another strategy commonly used is to close, say half, your position when you are comfortable with the profit level and let the other half continue to trade. In that event also use a protective stop, either static or trailing, to prevent profit erosion on the balance of the position.

End of Day

If not stopped out by a stop loss, or a trailing stop, exit day positions before the market closes.

Holding Positions Overnight

If you are setting out expressly to trade longer-term positions, always check where the market is and if you need to close or adjust your stop.

Buy Points

Once you have decided a price at which you wish to buy, adhere to that strategy. This is particularly true if you are waiting for a certain price to trade to confirm your view. Jumping the gun can be risky. The entry level may never be reached.

Chasing a market up or down can also offer the potential for greater risk and less return (see below). Also, when a security nears its entry level, watch very carefully how it trades. Is price moving faster? How is it trading? Do we see a lot of buyers or sellers at the entry level?

All of this will help to determine if a trade is likely to be a profitable one. No one knows the future, but paying attention to how a security is trading will certainly help you make more profitable decision.

Bid/Offer

Normally when you look at your charts you only see one price and that price is the *bid* price.

Some types of charting software are capable of displaying the *offer* price but most commonly the price you see is the bid price.

This can confuse new traders as once they are all set up to go with there dealing station and place their first trade they wonder to themselves why did I get filled at a different price from what I saw on my computer screen.

This could be because the market moved between the time it took you to look at the chart and actually place the order. Or it could be that the new trader was unaware of the difference between the bid and offer.

The *bid* is the price at which other traders or institutions are prepared to buy a security and the *offer* is the price at which other traders and institutions are prepared to sell a security.

Now, if you want to buy a security you will have to pay the price at which traders are prepared to sell to you. So when you buy something, you pay the *offer* price.

On the other hand if you want to sell something then you pay the *bid* price. That is the price at which traders are prepared to buy from you.

The difference between the *bid* and *offer* is called the *spread*.

Depending on what security and how much activity there is in that market will determine the spread. In some markets the spread can be quite large and in other markets the spread can be small.

To simplify this think of it like this: when you want to go long (buy the market), you will pay the offer price and, therefore, the spread. When you close your position (sell your previous position) you get the bid price and don't pay the spread.

So, at least once during the trade, you will pay the spread. If you first enter the market long you will pay the spread on the way in, but not on the way out.

If you first enter the market short you will not pay the spread initially, but you will pay it on the way out.

There are other combinations of this, but this is the most common.

Depending on which financial newspaper you buy, you will either see the *bid/offer* price quoted separately, or if there is just one price that is normally the mid price between the *bid/offer spread*.

Most brokers are reputable nowadays, but when asking for a quote, never tell them what you intend to do. Just simply ask for a price on XYZ Company or security. That way the broker doesn't know what you want to do.

If you tell him I want to buy XYZ Company first, he knows your intention and has some advantage. If he doesn't know if you want to buy or sell, he will give the best prices he can find.

Imagine the situation you have a position in XYZ Company and call your broker and tell him that you are trying to close your position so you need a quote.

With that knowledge, he, theoretically, has an advantage because he knows you are trying to get out of a position and may accept an unrealistic price just to cut your losses.

If, on the other hand, you are simply asking for a price, the broker doesn't know if you are trying to add to the position or close it.

Even with electronic dealing station you should be able to see the *bid/offer* prices before the system knows your intention. In other words, you should not have to select an option to buy and then get the *bid/offer* price first.

Paper Trading

Over the years, I have trained many traders and I always advise that they spend, at least, three months paper trading before they go live with real money.

Now even though I advise this, I have never had a student actually do it. They all give up on paper trading after a few weeks and go live.

Why is that? They become impatient, they think they have mastered it or they think they don't need that much time.

There is a good argument for not paper trading first, as no matter how much paper trading you do, you will never get the emotional involvement that you have when you have a real live trade on.

The fact remains, however, that you need time to familiarize yourself with whatever system you are using.

Finding out you don't know how to operate your dealing system, or you don't know the correct terminology to use when speaking with your broker on the phone when trading live is a recipe for disaster.

You need time to get used to how to operate your system. Whichever system you use, you must know it inside and out. This is part of trading. It is one of your main tools and should be taken seriously.

Paper trading is simply using imaginary money with imaginary trades. In the old days you would look at the financial newspapers and write down the imaginary trades on a piece of paper, which is where the term comes from.

Virtually every broker now offers a free demo of their system and will fund your account with an imaginary amount of money (e.g., $50,000).

This will let you make trades just like you would if it were your own money in the account. The system will also calculate your profit and loss automatically.

Take this time to experiment with the system. Make mistakes. Press the wrong button. Buy when you really meant to sell and so on; it cost nothing at this stage.

One last thing on paper trading, take it seriously. If you can't make money on paper then don't even think about using real money. I know too many traders who didn't make money on paper, but for some inexplicable reason thought that, if they had real money in the account, they would.

If you are at all serious about this game, approach it professionally. If you aren't making money on paper go back to the drawing board and rethink your plan.

Homework

Remember to always do your homework. Check the charts carefully. This is your money and you are responsible for it.

Charts

You can use any reliable online charting service you want. Just make sure they provide the basic analytical tools (e.g., the capability to draw trend lines and ability to add moving averages). There are so many charting services out there that it would be hard to mention any one in particular.

Just type ‘charts’ into your favorite search engine and quite a few should pop up.

Many charting services specialize in only one security (e.g., they only provide charts on stocks).

First, decide what you are going to trade, then find a good charting service at a reasonable price. If you are going to trade intraday, you will need real time charts with no delay.

For intraday trading, you need to see every bid and offer made. These run from around $55 per month up to the top of the range at $500 per month.

If you are going to trade daily bars and up, you don’t need to see every tick of the day. You can find cheap, delayed data, or end of day services for around $20 - $100 per month. You may even want to just chart by hand with some graph paper.

Brokers

Before selecting a broker, make sure they are regulated by the financial services authority in the country you are in.

Nearly all countries regulate their brokers and require them to register. I would suggest you contact your country’s government body that regulates brokers and ask them for a list of brokers. They will be more than happy to supply this to you and you can then choose one based on personal choice or location.

Method of Trading

Nowadays, nearly every broker offers some kind of online trading. You no longer need to call your broker and ask him to place the order for you. The way that it most commonly works is your broker will ask you to download their dealing station software.

Once downloaded, you will be able to see all the information about your chosen security. It will normally have two small boxes, one for buy and one for sell. There will also be a place for you to enter the amount you wish to buy or sell.

All you need to do is decide what you want to do and select the appropriate box. That's it, it's done! Competition is so fierce for customers these days that they may also offer you free charting software or provides charts as part of your dealing station.

LEVERAGE

Stocks, or other securities financed with credit, such as those purchased on a margin account, are known as leveraged accounts.

A margined account is a leverageable account in which securities can be purchased for a combination of cash or collateral, depending what your brokers will accept.

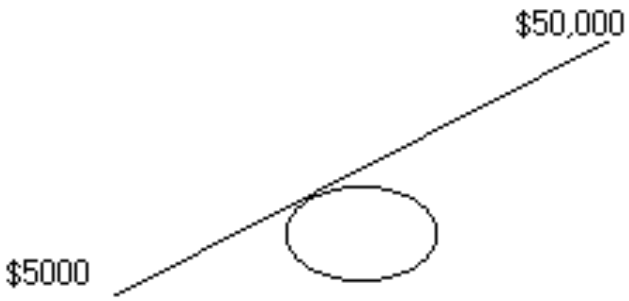
The loan in the margined account is collateralized by the security. If the value of the security drops sufficiently, the broker will ask you to, either put in more cash, or sell a portion of the security.

Margin rules may be regulated in some countries, but margin requirements and interest vary among broker/dealers.

Up until this point, you are probably wondering how a small investor can trade such large amounts of money (positions).

Some market traders are permitted to trade on highly leveraged positions (e.g., the forex market can have leverage of 1% with some brokerages).

This means you could control $100,000 with only $1,000. The amount of leverage will depend on the brokerage, the security you are trading, and your personal financial position.



Typically, the broker will have a minimum account size, also known as account margin or initial margin (e.g., $10,000). Once you have deposited your money, you will then be able to trade. The broker will also stipulate how much they require per position (lot or contract) traded.

In the example above, for every $5,000 you have, you can take a contract of $50,000. So if you have $5,000, they may allow you to trade up to $50,000 of that security.

The minimum security (margin) for each lot will very from broker to broker.

In our example above, the broker required a 10% margin. This means that for every $50,000 traded, the broker wanted $5,000 as security on the position.

Margin call is also something that you will have to be aware of. If, for any reason, the broker thinks that your position is in danger (e.g., you have a position of $50,000 with a margin of ten percent, $5,000, and your losses are approaching your margin, $5,000), he will call you and, either ask you to deposit more money, or close your position to limit your risk and his risk.

If you are going to trade on a margined account, it is imperative that you talk with your broker first to find out what the polices are on margined accounts.

PROBABILITY

Before you trade, it is very important that you have some working knowledge of probability in order to maximize your trading technique.

Let’s take a simple example. Imagine that you have in your hands a shiny new penny. The penny is brand new and has no marks or scratches on it. A statistician would call it a "fair" coin.

You decide to toss the penny into the air. It can only come down heads or tails. You know that these are the only two choices or probabilities. Since the coin is a "fair" one, it is just as likely for it to fall heads as it is tails.

In statistical language, the probabilities are equal. As you continue tossing the coin you decide to keep a record of how many times heads or tails comes up. You may not be aware of it, but if you do this, you are performing one of the basic experiments in probability.

If you toss the coin ten times, these are all the possible results:

10	heads and	0	tails
9	heads and	1	tails
8	heads and	2	tails
7	heads and	3	tails
6	heads and	4	tails
5	heads and	5	tails
4	heads and	6	tails
3	heads and	7	tails
2	heads and	8	tails
1	heads and	9	tails
0	heads and	10	tails

Is one of these combinations more probable than the others? Which is the most probable? Suppose you ask everyone in a room to toss a coin ten times and to write down the results.

What combinations would be likely to occur? If you add up all the heads and all the tails of the people in the room, would there be an equal number of each? These are questions you should start to think about when applying probability. We will soon learn how to find out.

If you toss ten coins into the air at once, instead of one coin ten times, the probability (the combination of heads and tails) are exactly the same.

The penny, as was mentioned, should be a "fair" coin. They are just as likely to fall heads as tails. Because a coin has an equal chance of falling either way, we can predict how it will fall in a great many tosses. If the coin were damaged so that it was likely to fall heads more often than tails, we could not predict how it would fall.

This may seem strange, or contradictory. But, with a damaged coin, we would first have to learn about its behavior. If we tossed it 1,000 times, we might end up with 600 heads and 400 tails. We could then say that the coin would probably fall heads 6 times out 10. But we could still not predict its behavior as accurately as we could that of a "fair" coin.

Law of Averages (Independent Trials)

Suppose that you have tossed a “fair” coin into the air ten times and each time it has fallen heads. What is the probability of getting a head on the next toss? If some friends were watching you, one of them would almost certainly say, “You’re bound to get a tail”.

The law of averages will catch up with you. The fact of the matter is that you are not “bound” to get a tail.

The chance (or probability) is exactly even that you will get another head. On any one toss, a head is as likely as a tail, no matter what has happened before. In this sense, there is no such thing as “the law of averages”.

Try to forget old ideas. Think this problem through clearly. You toss the coin into the air for the eleventh time. It has reached its high point and is about to fall.

Does the coin “remember” that it has already fallen heads ten times in a row? Of course not! Can the coin decide how it will come down? No! How it fell before has nothing to do with how it will fall now.

Statisticians often say, “The coin has no memory”.

The toss of a coin is called an independent event. Nothing outside of itself can influence the way it lands. The only way we can “predict” its fall is through the law of probability. And from these laws, we know that on each toss of a coin, the probability of a head or a tail is exactly equal, no matter what has happened before.

If the chances of heads or tails are equal, then this should be true of many tosses. If you toss a coin 100 times, you should get 50 heads and 50 tails. This is theoretically true. That is, in an ideal situation, this would be true. (Actually, as we shall see, there is seldom an equal division of heads and tails.)

However, if we accept this to be true, what happens if we start out by getting 10 heads in a row? How will the score even out?

Does it mean that we are “bound” to get 10 tails in a row to balance the 10 heads? Again we are not “bound” to get anything. We may get 10 tails in a row. But we may also never get more than 2 tails in a row.

The outstanding American probabilist, Professor William Feller, explains the evening-out process very simply. He says that the 10 heads in a row will probably be “swamped” by more tails than heads. This may be what follows the “run” of 10 heads:

Heads	10		1		1		2		1		1		1		17
Tails		1		2		3		3		2		3		2	16

Despite the “run” of heads, tails has almost drawn even. The “run” of 10 was never approached; it simply swamped.

Dependent events

Until now we have spoken of independent events, whose outcome is not influenced by what happened before. As you may have guessed, a dependent event is influenced by, or dependent upon, what you did before.

Let us imagine that you have 20 M&M’s. Of the 20, 19 are brown and one of them is red. However, it is of the same size and “feel” as all the others.

You place all 20 M&M’s into a jar. Without looking you try and pick out the red one. What is the probability? Since there are 20 in all and only one red one, the probability is 1 out of 20.

On your first try you fail. You pick a brown one. Without replacing the one you picked, you try again. What is the probability of picking the red one now? Obviously, you now have a better chance. The probability is 1 in 19.

Once you pick the red one, the game is over. But, otherwise, you proceed. The probability of picking the red one becomes higher and higher, that is, if you do not replace the brown M&M's.

Each probability is dependent upon the events that happened before. Should you fail to pick the red one on the 19^{th} consecutive attempt, what is the probability on the 20^{th} attempt? Obviously, there is no probability; there is only certainty.

And probability, as we said earlier, deals only with uncertainty. This will become clearer as we go on.

Next, we will look at how all of this effects your trading.

TRADING AND PROBABILITY

OK, so now we have a basic knowledge of probability, but how does it effect us in the trading world? Well, as a trader we are attempting to make only high probability trades. In other words, we only want to trade when we believe the odds are in our favor.

One way we attempt to find opportunities in our favor is through technical analysis. Let us first look at some things not to do. Double up and throw up!

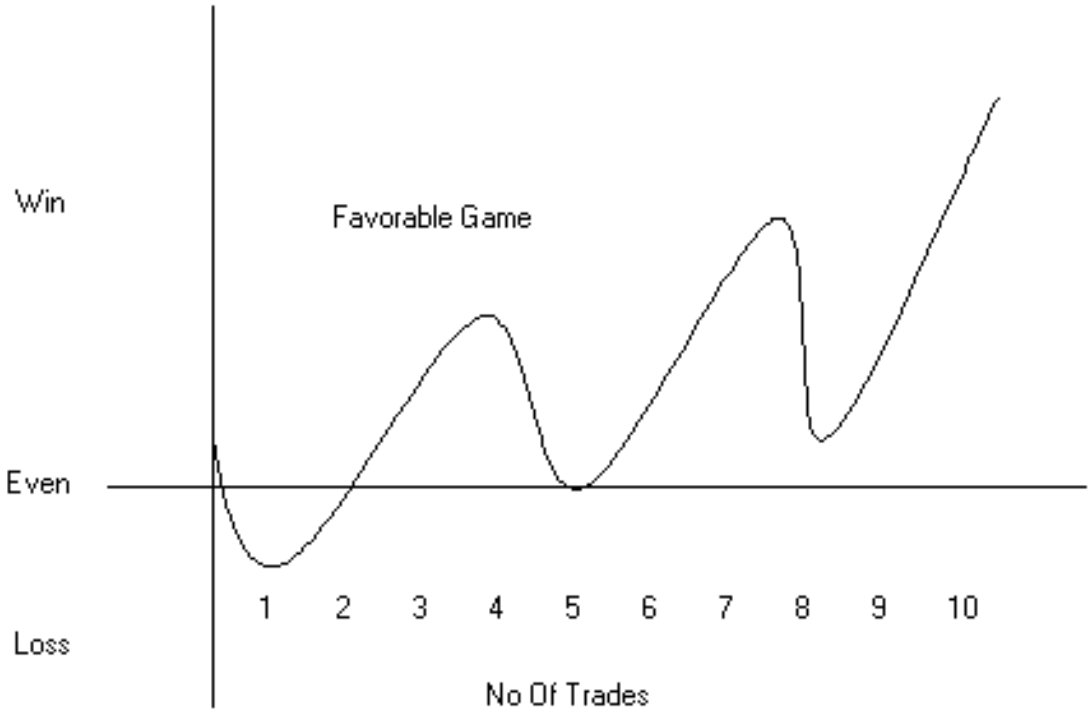
Doubling Up After Each Loss

First Trade	$	100.00
Second Trade	$	200.00
Third Trade	$	400.00
Fourth Trade	$	800.00
Fifth Trade	$	1,600.00
Sixth Trade	$	3,200.00
Seventh Trade	$	6,400.00
Eighth Trade	$	12,800.00
Ninth Trade	$	25,600.00
Tenth Trade	$	51,200.00
Total Lost	$	102,300.00

Well, as you can see from the example above, if you doubled your position after each losing trade you would need a staggering $102,300 in your account just to cover your losses.

Now you may ask me, how likely is that to happen? And that, my friend, was the point of the previous few pages. Just think back to the example with the coins, an aberrant negative run can and **will happen**.

This is why I do not recommend doubling up after each loss. If we trade in a disciplined systematic manner, when our aberrant run does occur, we will still be in the game at the end of it.



Ideal situation

No Trades	No Wins	No Losses	Total Wins
2	1	1	1
4	3	1	1
6	4	2	4
8	6	2	6
		Total Trades	14

In the above example, we made 14 out of 20 winning trades, or 70%.

Actual

No Trades	No Wins	No Losses	Total Wins
2	0	2	0
4	4	0	4
6	6	0	6
8	4	4	4
		Total Trades	14

As you can see from above, the actual may be different from the theoretical, even though we land up at the same place.

Probability is a huge subject all on its own and we could go on forever explaining the ins and outs.

The important point in all of this is to realize that, regardless of the system or method you use to trade, there will be occasions when you have losses, or even a string of losses.

When these occur, it is important to have faith in your trading plan and not to try and double up to catch up.

The final point to be made is that as we can see from the above examples, any trading system will go through times when it has more losses than wins.

This is where money management comes into play, which we shall get to soon.

Drawdown

Drawdown is a dirty word in trading but every trader will experience some drawdown. It is simply unavoidable.

Imagine that you start your trading account with $10,000 and after a few trades you lose $2,000. Your drawdown would be 20%.

Now let’s say you make more trades and gain $4,000 which brings you to $12,000 ($8,000 + $4,000 = $12,000). After this on the next trade you lose $2000. You’re draw down would be 16.7% (12,000 - $2,000). The $12,000 was your equity peak as that was the highest point in the period we looked at.

Maximum Drawdown

Maximum drawdown is the lowest point your account reaches between peaks.

If you started your account with $10,000 and the lowest amount you had in your account over a 6-month period was $5000, then you had a 50% drawdown.

You would need to make $5,000 from the lowest point in order to get back to even. This is an important point because, even though you lost 50% from your high of $10,000, you would need to make 100% on the $5,000 to get back to even.

Measuring Drawdown Recovery

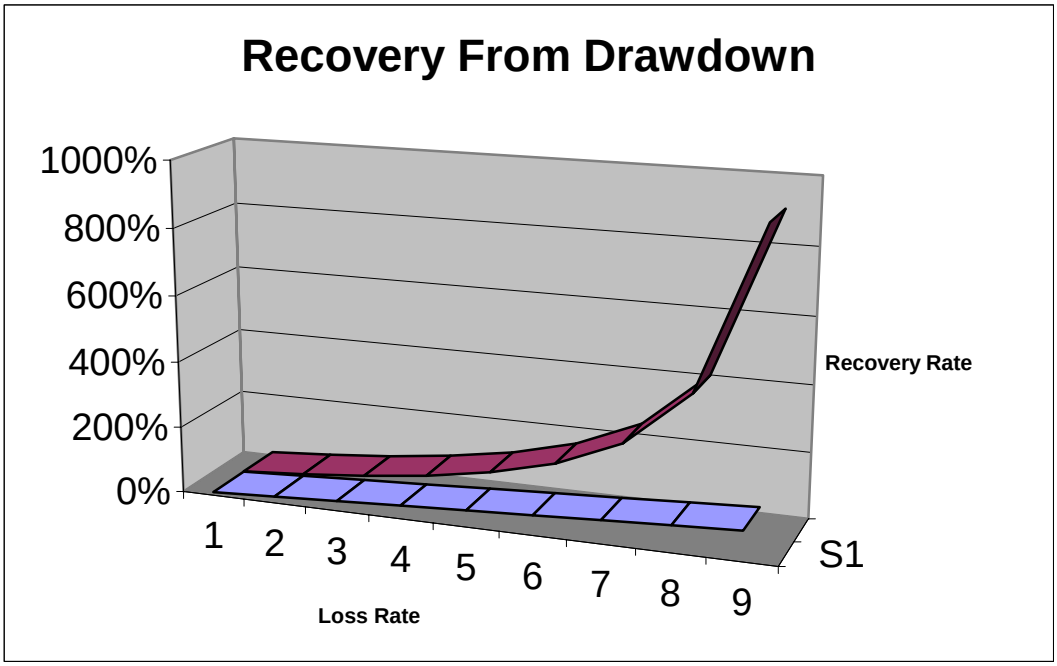
Drawdown recovery can confuse many traders. If a trader loses 20% of his account, he thinks he needs to make 20% in order to get back to even.

This is, in fact, not true. If you started with $10,000 and lost $2,000 (20%), you would need to make 25% in order to get back to even. The difference between $8,000 and $10,000 is $2,000. If you calculate the $2,000 as a percentage of $8,000 (not the original $10,000) it works out to 25%.

Loss of capital as a %	**% required to get back to break even**
10%	11.11%
20%	25%
30%	42.86%
40%	66.67%
50%	100%
60%	150%
70%	233%
80%	400%
90%	900%
100%	Blow Out/Broke

You can clearly see what's happening here. As your drawdown increases, the amount you need to make back increases faster.

I cannot emphasize this enough: You must be aware of risk! Understanding how basic probability and money management work is as important, if not more important, then any trading system.



This is the main reason I strongly advise new traders to use stop losses. If you use a stop, then you will be able to define your risk.

If, for example, you decided to risk no more than 3% in any one trade, then the chances of going broke before your destroy your bankroll are minimal.

Trade No#	Equity	3% Of Equity	Equity	20% Of Equity
1	10,000	300	10,000	2,000
2	9,700	291	8,000	1,600
3	9,409	282	6,400	1,280
4	9,127	274	5,120	1,024
5	8,853	266		
6	8,587	258		
7	8,330	250		
8	8,080	242		
9	7,837	235		
10	7,602	228		
11	7,374	221		
12	7,153	215		
13	6,938	208		
14	6,730	202		
15	6,528	196		
16	6,333	190		
17	6,143	184		
18	5,958	179		
19	5,780	173		
20	5,606	168		
21	5,438	163		
22	5,275	158		
23	5,117	153		

As you can see from the table above, if you risked 20% on each trade and had 4 consecutive losses, your drawdown would be almost 50%.

If, on the other hand, you only risked 3% on each trade, you would need 23 consecutive losses to get to the same 50% drawdown.

If you think 3% is not enough to risk on one trade, consider this. I have never met a trader who has been in this game for any extended period of time that did not have some kind of stringent money management principals.

In fact, the majority of traders who have been trading for a prolonged period would argue that 3% is too much. They would feel much more comfortable risking only 1%.

I also want you to note that if you are trading more than one market or have more than one trade in a given sector, then the total amount you are at risk should be no more then 3%.

Let's say you are following three markets and have one trade on in each market. You should add up the total amount that you are at risk if all three trades lost.

For example, if you had a starting account of $10,000 and you had three trades on each with a $300 stop loss, then your risk is actually 9%. As each of your trades has the potential to lose $300, the total amount at risk is $900, which is 9% not 3%.

Risk Reward Ratio

Risk reward ratio is simply the amount you risk, as compared to the amount you expect to make.

If you have a stop in place which limits your risk to $1,000, but when your trade is successful, you expect to make $3,000, then your risk to reward ratio is 3:1.

10 Trades	*Loss*	*Win*
1	$1,000.00	
2		$3,000.00
3	$1,000.00	
4		$3,000.00
5	$1,000.00	
6		$3,000.00
7	$1,000.00	
8		$3,000.00
9	$1,000.00	
10		$3,000.00
Sub Total	$5,000.00	$15,000.00

From the table above, you can see that if you only selected trades where you thought you had a 3:1 risk reward ratio, then even if you were right only 50% of the time you would still make a profit

Conclusion

Only risk a small portion of your trading capital in any one trade.

THREE DIFFERENT TRADING METHODS

In this section of the course I want to introduce you to three simple trading tactics.

The Trend Following Method

A simple trend following method is to use a 9-period simple moving average of the closing prices and an 18-period moving average of the closing prices.

When the 9-period moving average crosses the 18-period moving average this is the set up.

Because we don't know if this is going to develop into a trend, I like to see the price first return back to the 9-period moving average and then monitor what happens next.

If the price then closes back below the 9-period moving average, then a sell signal is generated. Obviously, it would need to close back above the 9-period moving average in an up trend.

My stop loss would be placed above the most recent high in a down trend and below the most recent low in an up trend.

The exit could be when we have a closing above the 18-period moving average.

As we mentioned previously, a period of time can be anything that you want it to be. Each bar or candle could be a 5-minute period or a monthly period.

The Breakout Method

A very common method of trading is called the breakout method.

First, we will normally see a period of inactivity or consolidation. Next, we will see a sudden burst from this range; this is the breakout.

For markets that have volume I would expect to see a sudden increase in volume to help confirm the breakout.

At this stage, aggressive traders may think about taking a position, but I like to wait a little longer and see if I get confirmation of the breakout.

I have put a 20-period moving average of the closes just as a visual guide and reference point. You can see that the market progressed to R1 and then retraced to S1, this is the setup.

Here's where it gets interesting. If, at S1, the market continues back down to the breakout area, then I do nothing. If I get a close above R1, that's when I enter the market and place my stop below S1.

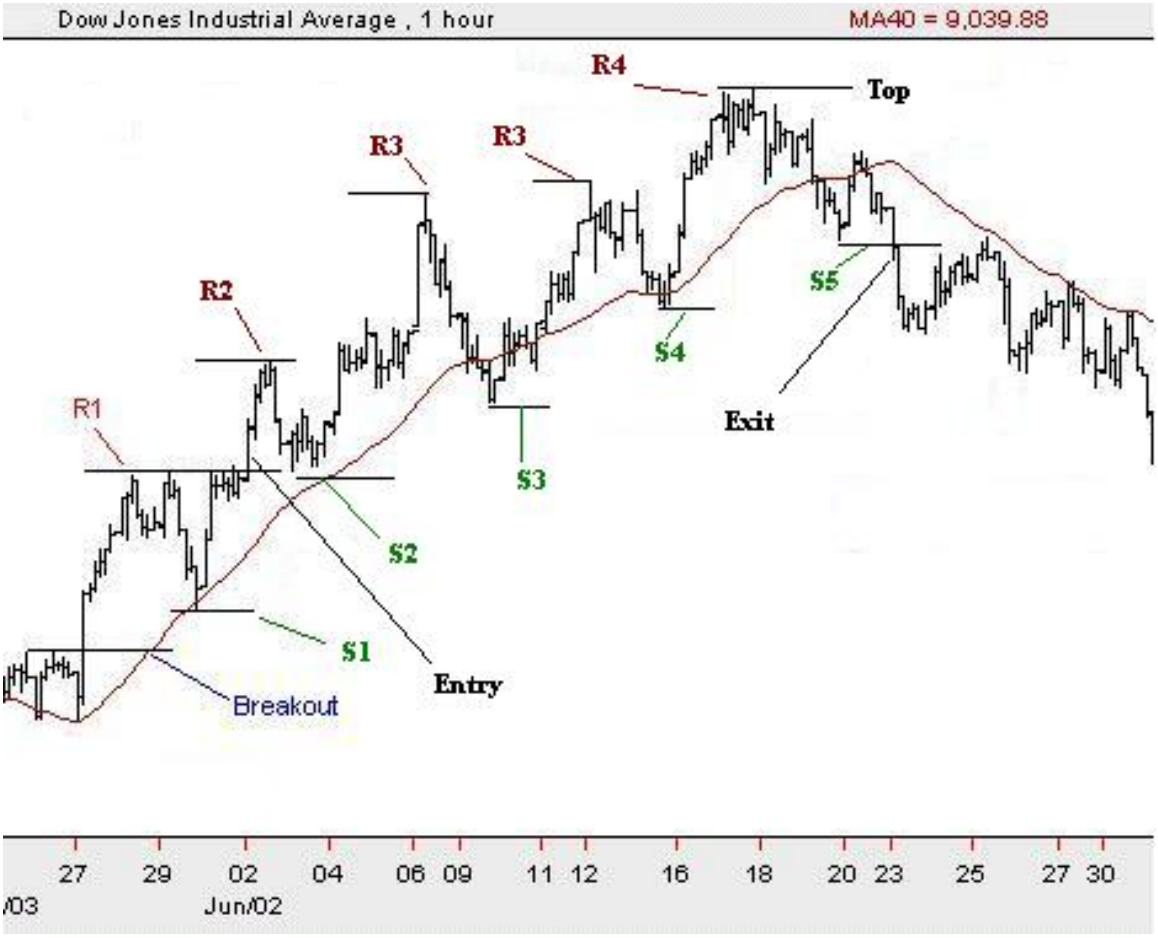
Next, the market goes to R2 and then retraces back to S2. Once the market headed north again past R2, I move my stop to S2.

The market continues its bullish move to R3 and then retraces to S3. You will notice that I have two R3's and that's because they are the same level. The market struggled to make it above R3 and retraced to S4.

Once R3 is taken, I move my stop to S4 and lock in profits.

The market finally topped at R5 and headed south to S5. Once S5 was reached, it made a little rally and came back to close below S5. This is where I would have gotten out.

S5 was the first point where the market retraced then rallied but came back to close below support.


Dow Jones Industrial Average , 1 hour
MA40 = 9,039.88
R4
Top
R3
R3
R2
R1
S5
S4
S3
S2
S1
Exit
Entry
Breakout
27
29
02
04
06
09
11
12
16
18
20
23
25
27
30
/03
Jun/02

The Reversal Method

The next method can be used as a stand-alone method or simply reversing an existing position.

First, you identify an established trend. Next, you will be anticipating a reversal of the trend as it has been in existence for some time.

In our example, I have used a 9-period moving average and an 18-period moving average on both of the closes. The first piece of evidence that this might be a top was when the 9-period moving average crossed the 18-period moving average.

Next, our established trend line was broken with a close below the line and the last piece of evidence was when we had a close below the support. This was our entry and we would place a stop loss order above the most recent high.

Our exit is the 50% retracement of the entire move. To learn about Fibonacci and retracement levels go to Lesson 27 and 28 inside the Members Area: www.tradingforbeginners.com/bonusreport.htm.

These are just three approaches to trading a particular market. There are many more practical examples of ways to trade a security inside the Members Area: www.tradingforbeginners.com/bonusreport.htm.

WHAT WILL MAKE OR BREAK YOU?

We are coming to the end of our little book now and I feel I ought to give you the heads up on what will really make or break you in this game.

Yourself

I was asked the other day what I thought was the number one reason why most traders don't make it. I didn't have to think about it much, as I already knew the answer.

I knew the answer because I went through it, and so will you. You have to be in control of yourself. You have to be disciplined.

At the beginning of the book I mentioned that trading for a living is not the measure of who you are. Whether you succeed or fail at trading will not change who you are fundamentally. But it is fundamental that you change if you are to succeed.

There is a big difference between a trader who makes a trade and has a loss, but is emotionally unaffected because he knows that it is part of the game, and a trader who has a loss because he couldn't be bothered to do his analysis or wasn't prepared for the trading day.

Trading will exploit any weaknesses you may have. If you have a tendency to gamble, or are impatient by nature, then the market will amplify this weakness.

Just as a person who is overweight knows what it would take to lose weight and doesn't do it, so does a trader. If the trader who doesn't make it really and honestly looks at himself, he will see that the main fault was his own failing.

So how can you avoid this?

Discipline!

You have to become scientific about your trading. Every time you make a mistake, either emotionally or technically, you have to write it down and analyze where you went wrong. Once you identify where you went wrong you have to have the discipline to correct it.

IMPORTANT

This is the end of the book, but not the end of your course. The bulk of the next stage is contained in the Members Area: www.tradingforbeginners.com/bonusreport.htm, where we have trading lessons in just about all the subjects you can think off.

By the time you have read this book and completed all the lessons, you will not only be as knowledgeable as the majority of traders out there, but you will have a distinct advantage.

I really hope that this book has been of some help to you. I genuinely want you to succeed.

There is nothing I hate to hear more than some trader losing their hard-earned money.

Hopefully this book and the lesson in the Members Area will have taken you a long way down the road to making better trading decisions and, at least, a more informed trader.

God Bless & Good Trading,

Mark McRae

GLOSSARY OF TERMS AND COMMONLY USED EXPRESSIONS

Account:
The bookkeeping records of a customer's transactions and credits or debits. The record usually includes confirmation of the transactions and open positions, cash and cash equivalents and beginning and ending liquidity value.

Account Balance:
The amount of money or debit in an account.

Account Executive:
The broker or clerk who is assigned to work with the client on behalf of the financial institution.

Ask:
An indication by a trader or dealer that he/she is willing to sell a market at a given price. The price at which someone is willing to accept for a tradable.

Available Balance:
The balance at the disposal of the account owner at the close of a statement period.

Base Currency:
Currency in which general ledger and P/L account is maintained.

Bid:
An indication by a trader of his/her willingness to buy a currency. The price at which a trader can sell.

Breakaway Gap:
When a security exits a range by trading at a level that leaves a price area.

Breakout:
The point when the market price moves out of the price range.

Bottom Fishing:
Buying markets whose price appears to have bottomed out or fallen to low levels.

Broker:
An individual or firm that facilitates the exchange of tradables between buyer and seller. They can sometime charges a fee or commission for executing buy and sell orders placed by other individuals or firms.

Channel:
In charting, a price channel contains prices throughout a trend.

Central Bank:
The government bank that coordinates the nation's banks and flow of payments between different banks. Can also be the central regulatory authority in a country for banks.

Client:
A client, also called a party, is a person or corporate body involved in any transaction with a financial institution.

Closing Price:
The price at which transactions took place just before the close on a given day.

Commissions:
A fee charged by a broker to a customer for performance of a specific duty, such as buying or selling a currency.

Correction:
Price reaction within the market leading to an adjustment.

Currency:
A medium of exchange that circulates in an economy. Also referred to as a country’s official unit of exchange. The currency may be represented by a currency code.

Daily Range:
The difference between the high and low price on a given day.

Dead Cat Bounce:
Rebound in the market that sees price recover and come back up somewhat.

Dip:
A slight decline in the market followed by a rise.

Divergence:
When two or more averages fail to show confirming trends.

Entry:
Point at which a trader gets into the market.

Exit:
Point at which a trader closed out of the market.

Exponential Average:
A mathematical formula where more weight is given to the most recent price.

Fill:
An executed order. Sometimes the term refers to the price at which an order is executed.

Limit Order:
An order to buy or sell when a price is fixed.

Market Order:
Instruction to a broker to immediately sell or buy at the best available bid or offer.

Moving Average:
Mathematical procedure to smooth data fluctuations and to assist in determining when to buy and sell.

Open trades:
Current trades still held open in customer's account.

Overbought:
Market price that has risen too steeply or too sharply.

Overshoot:
To pass beyond or over a specific target range.

Oversold:
Market price that has declined too steeply or too fast.

Rally tops:
Price level that concludes a short-term rally in an ongoing trend.

Retracement:
In technical analysis, price movement in the opposite direction of the prevailing trend.

Skew:
The measure of lopsidedness:

Slippage:
The difference estimated and actual transaction cost.

Stop Loss:
Risk management technique in which the trade is liquidated to halt any further decline in value.

Tick:
Minimum fluctuation of a tradable.

Trailing stop:
Stop loss order, which follows the price in a prevailing trend.

Trend:
The tendency of statistical data.

Trend channel:
Parallel probable price range centered around a price line.

Trend line:
A line that connects a series of highs or lows in a trend.

Whipsaw:
Price moves back and forth in a tight range without finding direction.

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Feel free to drop me a line if you have any question or suggestion that may improve this book.