Diary of a Professional Commodity Trader

Lessons from 21 Weeks of Real Trading

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This book is dedicated to my wife, Mona, and my children, who for more than 30 years have tolerated the ups and downs of the life of a commodity trader.

Also to some very dear folks I refer to as the Factor family, about two dozen fellow commodity traders who, since 1980, have served as a sounding board as I developed my trading plan and honed my craft.

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Acknowledgments

I owe a debt of real gratitude to my friend Dave Forbes, CEO of Petra Financial in Colorado Springs, who allowed me to use his office and staff to prepare this book.

I am also in debt to Glen Larson and his awesome team at Genesis Financial Technology, who provide me with assistance in preparing the charts for this book. I use the Genesis data and charting platform, Trade-Navigator, in my own trading and have found Glen and his team to be real partners in my market operations.

Dan Chesler, President of Chesler Analytics (a firm providing technical market research to energy traders) originally suggested that I write this book. Dan and I go back several decades as peers. If you have ever written a book, you will understand it when I say that I don't know whether to thank Dan or curse at him for encouraging me.

Finally, I want to thank Meg Freeborn and Kevin Commins of John Wiley & Sons for hanging with me during this process. I started this book in early 2009, but for health reasons I was sidetracked for nearly nine months. Meg and Kevin demonstrated great patience and guidance to get this project back on track.

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PART I

Foundations of Successful Trading

Is trading an art, or is it a science? Or is it some combination of the two? I am not sure of the answers to these questions. I am not sure it is necessary to know the answers. I view trading as a craft. A successful trader is a craftsman, applying his or her skills in the same way as a baseball pitcher who has perfected throwing a knuckleball, or a welder specializing in joining together exotic metals, or a software engineer who overcomes complex problems to design new chip technology.

All craftsmen undergo apprenticeships. An apprenticeship is not some specified period of time in a specified classroom or training grounds. Rather, an apprenticeship is a composition of personal, professional, and proprietary experiences that lead to the knowledge and skills to perform a craft.

Part I of this book relates my apprenticeship as a trader and provides context and background to all that follows in the book. Part I contains two sections:

1. An Introduction to my background and history as a trader, the reasons I decided to write this book, a road map to the book, and what I hope this book accomplishes
2. A brief overview of classical chart principles, the foundation of my trading approach

Part I lays the foundation for the architectural design of my trading plan, which is detailed in Part II.

Introduction

One of the first things I check out in a new book is the number of pages prior to Chapter 1—long book introductions put me to sleep. I will assume that most of you are like me—you want to cut to the chase. The last thing I wanted to do was write a book with a lengthy introduction, but my opinion has changed now that I'm on the author's side of the equation. It turns out introductions can be useful in providing necessary context and perspective for a book. And so, please forgive me for committing the sin I have always disliked—I think it will be worth it.

This is a book about me as a trader of commodity and forex markets and how I use price charts in my craft. I think of it as a mosaic: eventually the parts of this book will tie together in the same way that a good mosaic becomes visible only in its entirety. Piece by piece or section by section, a mosaic makes no sense. Only at a distance and in its fullness does a mosaic gain clarity and perspective. The concept of a mosaic describes how this book will unfold. First, a bit about how I got started in the business.

The Invention of a Commodity Trader

In 1972, shortly after graduating from the University of Minnesota with a degree in advertising, I moved to Chicago to work for one of the nation's largest ad agencies. A neighbor was a trader at the Chicago Board of Trade (CBOT). Through our conversations and my visits to see him on the trading floor, I became captivated by the futures markets. In commodity trading I saw the opportunity to earn a good living, work for myself, and be challenged in a very exciting field. In short, I became hooked.

Everybody started in the commodity field at the bottom. Being hired at a sizable salary was not a reality of the business. I needed a plan B if I were to quit advertising and enter the commodity field. So, I asked the president of the advertising agency if he would hire me back at a 30 percent increase in salary if I quit, tried the commodity business for a year unsuccessfully, and reapplied for my old job. He agreed to the deal.

I entered the commodity business in 1976 when I was in my 20s with the singular goal of trading my own personal account. But I needed to learn the ropes first.

When I entered the business, most traders at the CBOT (as well as the Chicago Mercantile and the New York commodity exchanges) started at or near the bottom of the pecking order. The same thing exists to this day. An "MBA fast track" has never really existed in the trading pits. The learning curve is steep—the washout rate is high.

I learned the business by working for Continental Grain Company and Conti, its futures market brokerage operation. At the time Continental Grain was the second largest grain exporter in the world next to Cargill. Continental sold its grain merchandising business to Cargill in 1999.

During my time in the advertising field I had been working on the accounts of McDonald's and Campbell's Soup Company. It became a very fortunate coincidence that both companies were huge users of agricultural products.

Processors of agricultural commodities, such as Campbell's Soup, had become accustomed to decades of oversupply conditions and stable commodity prices. But a number of events in the early 1970s, including global crop failures, led to massive bull markets in the price of agricultural products and nearly every raw material. In a matter of months the price of some commodity goods doubled. Figures I.1 and I.2 show gold and wheat prices as proxies for raw material prices.

FIGURE I.1 Spot Gold Prices, 1830–2009.

Food companies were not prepared for the price explosions taking place. Top management and purchasing executives of these companies were desperate for solutions. Few food processors had any experience with forward pricing in either the cash or futures markets.

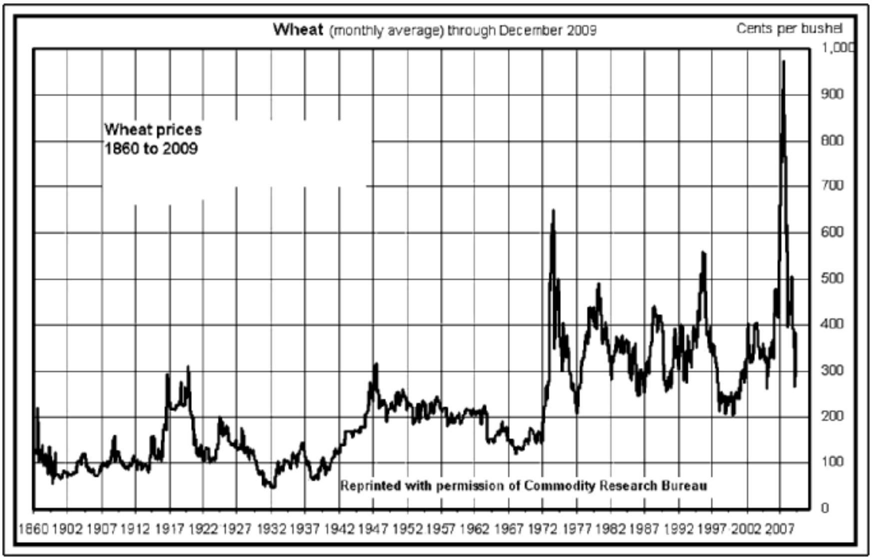

FIGURE I.2 Soft Wheat Prices, 1860–2009.

This was the environment when I switched careers from advertising to commodities.

Immediately upon joining Conti, I approached the president of Campbell's Soup Company with a proposal. I thought perhaps the futures markets could be a way for Campbell's Soup to hedge its forward purchases.

I suggested that the company appoint a senior purchasing executive to relocate to Chicago for a time to determine if commodity contracts might be a beneficial management and purchasing tool. I further proposed that the designated purchasing executive and I would then submit a formal proposal to top management—and the proposal could just as likely nix as recommend the idea of futures contracts.

In the end, we recommended that the corporation could strategically use futures contracts in cocoa (Campbell's Soup owned Godiva Chocolate at the time), corn and soybean meal (to grow chickens for its various frozen and canned products), soybean oil, iced broilers (then actively traded at the CBOT), live cattle and hogs (depending on the price relationship between the cuts of meats used by the company and the price of live animals on the hoof), and the three major wheat contracts traded in the U.S. (Campbell's Soup made noodles by the ton and owned Oroweat and Pepperidge Farms bakeries).

Campbell's Soup saw the wisdom in the use of commodity futures contracts. My consulting role with the company covered my business overhead and my family's living expenses while I learned the futures business. Had I begun trading for myself immediately, I would have likely been forced rapidly back into advertising or another career path.

After learning the ropes for a couple of years, I began trading proprietary funds around 1980, starting with less than $10,000. Initially, my personal trading was not successful, although not disastrous. I tried just about every approach I heard or read about. The traders around me at the CBOT were making money, but I just couldn't seem to find a niche that worked.

Then a friend introduced me to the book *Technical Analysis of Stock Market Trends*, written in the 1940s by John Magee and Robert Edwards. The book was—and still is—considered the bible of classical charting principles. I consumed the book in a weekend and have never looked back.

Chart trading offered me a unique combination of benefits not available with the other approaches I had attempted or considered, including:

- An indication of market direction
- A mechanism for timing
- A logical point of trade entry
- A means to determine risk
- A realistic target for taking profits
- The determination of a risk/reward relationship

I have been a chart trader ever since. More specifically, I trade breakouts of classical chart formations such as head and shoulders tops and bottoms, rectangles, channels, triangles, and the like. I focus on weekly and daily chart patterns that form over a period of four weeks to many months. Even though my focus on charts is longer term, my actual trading tends to be short term, with trades lasting anywhere from a day or two (in the case of losses) to a month or two.

Since 1981, my principle occupation has been trading proprietary funds, although off and on through the 1980s I sold trading research to other traders. In the late 1980s and early 1990s I traded some hedge funds for a couple of big money managers such as Commodities Corp. (since bought by Goldman Sachs). A number of the best hedge fund traders in the world have worked for Commodities Corp. (I do *not* pretend to be in their league.)

As a result of market burnout and an interest in nonmarket opportunities, in the early 1990s I began to distance myself from day-to-day contact with the markets and granted power of attorney over my own funds to another trader. It was not a successful experiment. From the mid-1990s through 2006 I pursued some personal non-profit interests (social causes) and did little or no trading at all. I started to employ my former trading plan again in January 2007.

In 1990, I cowrote a book with a since-deceased friend, Bruce Babcock, titled *Trading Commodity Futures with Classical Chart Patterns*, discussing in very general terms my approach to trading. That book sparked a desire to someday write a book providing much more detail on my trading operations. This book is the product of that desire.

My Proprietary Trading Record

For the active trading years of 1981–1995 (including four years when I granted power of attorney to another trader) and again starting in 2007, my average annual rate of return for proprietary funds has been 68.1 percent (annual Value Added Monthly Index [VAMI] method). I experienced one losing year during the time I was the sole trader for my proprietary funds (–4.7 percent in 1988). The numeric average of my worst annual month-ending drawdowns has been 15.4 percent. The performance capsule of my proprietary trading is shown in Figure I.3. Please read the disclaimers and discussion of my proprietary trading in the Author's Note at the end of the book. Past performance is not necessarily indicative of future results.

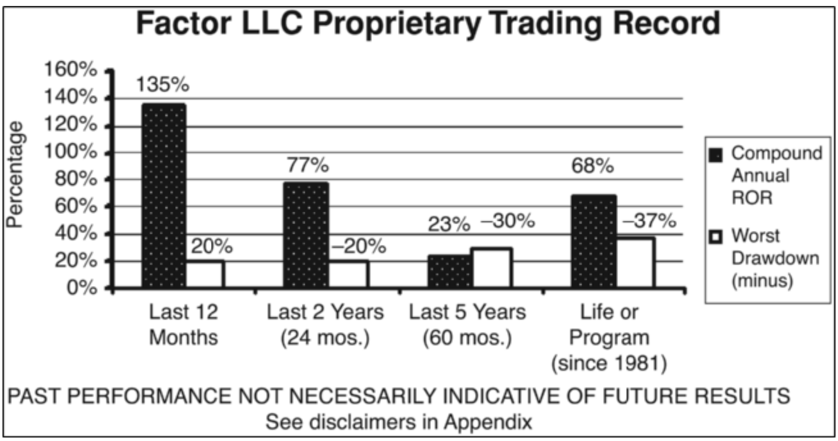

FIGURE I.3 Factor LLC Proprietary Trading Record.

Why I Wrote This Book

In the business of commodity trading books, advisory services, seminars, and computerized trading programs, there is a lot of junk being peddled. There are numerous books written each year about speculating in stocks and commodities. Does the investment world really need another book?

Given my low opinion of most trading and investment books, it is ironic that I am even writing this book. Specifically, I have had a general disdain for books approaching technical trading on a hypothetical basis. In contrast, I love the *Market Wizards* series by Jack Schwager because it presents the human side of real-life traders who use their ingenuity to make money by outsmarting the markets. If you have never read these books, then you have really missed out on some great insight into market speculation. I also loved two books by Michael Lewis, *Liar's Poker* and *The Big Short: Inside the Doomsday Machine* because both offer a real look at the real lives of smart traders.

I accepted this book challenge because John Wiley & Sons and I shared a vision for a book that would be a diary of my real-time trading operations during the course of a set time frame.

This book contains a combination of seven characteristics that I believe are unique among commodity trading books:

1. I am a real trader who trades real markets in real time with real money. I am not an academician or a person who relies on the sale of books to pay my mortgage. I am not selling a trading system or subscriptions to an advisory web site. I am just a trader trying to make money from the markets.
2. This book will catalog real-time trading signals and endeavors, not some arbitrary set of optimized rules form fit to last year's charts. This book will be a real-time diary of my trading on a day-by-day, trade-by-trade, thought-by-thought, mistake-by-mistake, victory-by-victory, and emotion-by-emotion basis. I am stepping out in faith that I will even be profitable during the next 21 weeks. But traders take risks.
3. This book will reveal trading as an upstream swim against human emotions. Consistently successful trading is a tough job. I make no pretense to the opposite. If trading were easy, everyone would be doing it for a living. Some other authors can share the glory of their constant successes. I will discuss the emotions involved to take the next trade after eight straight losing trades. Successful speculation can lead to hair-graying, sleep-losing, and dog-kicking emotions. I hope to convey the same.
4. I will attempt to show that successful speculation is mostly about managing risks. In fact, good traders view themselves first and foremost as risk managers. Just like "Texas Hold-Em," how one plays his or her cards is more important than the cards themselves. Money management has not been given the attention it deserves.
5. I will attempt to kill a really sacred cow whose death is long overdue—the idea that it is possible to be right on 70 or 80 percent of one's trades. This cow really needs to die. Perhaps I can strike a successful blow.

    Novice traders spend 90 percent of their time and money pursing methods to identify trades. In my own experience, "Trade identification" is the *least* important component of a consistently profitable trading operation. In fact, the method by which a trader identifies the markets to trade is of very little importance. I make no contention that the method I use is the best or is even above average. More to the point, how I select trades just does not matter at the end of the day. I believe that novice traders who chase systems that claim success on 80 percent of trades do so because they don't have the stomach for losing trades. But a strong stomach for losers and a miniature pride on the need for winners are necessary for consistently profitable trading operations.

6. I have absolutely no desire in this book to show how I can turn a small fortune into a large one. Books that talk about turning $10,000 into a million dollars may be good marketing, but let's get real! A person who can achieve this type of performance would possess all of the world's currency within a decade. Do the math!

   I am risk averse. My goal in 2010 is an 18 to 24 percent return. I would be in hog heaven if commodity futures and forex markets could perpetually provide for me an average two or so percent monthly return—with a minimum amount of capital volatility. I will leave it to other authors to disclose their secrets to big fortunes. If you are looking for a book on how to convert a small account into a million dollars, this book is not for you. If you want a book that details a comprehensive process for speculation aimed at exploiting an edge, then keep reading.
7. Charting has been good to me. I know it may sound a lot nobler than it really is, but I would like to share what I have learned over the years about the craft of trading chart patterns. In hindsight, it is easy to imagine how a market should have been traded. But in real time the chickens come home to roost. I believe that I can add to the body of practical knowledge on chart trading. Perhaps I can spare others the torment of the learning process.

In the end, my goal is to display the actions and emotions of a professional trader—and this involves a whole lot more than a way to identify the next trade.

This Book's Audience

I am writing this book to:

- Professional commodity and forex traders
- The general investment public (especially Baby Boomers who are now concerned about their retirement assets)

- Novice commodity "wannabe" traders who have never really gained traction in their trading

Professional Commodity/Forex Traders

You will not learn a single thing from this book, although if you are a chartist, hopefully I can add something to your body of knowledge. Nor should you be reading this book to learn anything about my approach and niche. You are successful because you know precisely what your own game plan is. But you may get a kick out of some of the anecdotes I share as I attempt to exploit my "edge" in the markets. You understand that successful speculation is primarily a human endeavor as we attempt to "swim upstream" against our emotions.

My hat is off to you. You are absolutely the best traders in the world. The global financial meltdown of 2007 and 2008 would have never taken place if professional commodity traders were in charge things of things. As a group, you can be proud that you did not contribute to the global economic woes of recent years.

As professional commodity and forex traders, you have a lot to be proud of. Table I.1 takes a look at the performance of the top 20 professional futures and forex trading operations during the past five years (measured by risk-adjusted rates of return).

TABLE I.1 Performance of the Top 20 Commodity/Forex Trading Operations from 2005 through 2009

Commodity and Forex Trading Firms	Avg. Annual ROR*	Avg. of Worst Drawdowns*	Avg. ROR During 2008 Meltdown*	% of Years Profitable in Past 5 Years (avg. of worst losing year, if applicable)*
Top 5 firms	20.5%	−8.9%	22.5%	88% (+.03%)
Firms 6–10	12.8%	−11.3%	27.0%	80% (−1.8%)
Firms 11–15	10.2%	−10.9%	20.6%	84% (−1.4%)
Firms 16–20	8.2%	−11.1%	11.7%	76% (−4.7%)
Composite* (unweighted)	12.9%	−10.5%	20.0%	82% (−1.9%)

*Commodity trading advisors managing at least $10 million with drawdowns no greater than 15% were considered for the list of the top 20 CTAs and were ranked based on average annual rate of return (ROR).
Source: Managed Account Research Inc. web site.

Of the top 20 professional commodity-trading firms during the past five years, 19 made money in 2008 as the rest of the financial world lost billions in the global meltdown. Of these top 20 firms, the average five-year compounded rate of return (ROR) was 12.9 percent. Seven did not have a single losing year in the past five years. The average worst peak-to-valley losing spell was only –10.5 percent. The average worst year among the 20 firms was –1.9 percent. Compare this to the roller-coaster ride called the stock market.

I believe that there are four principal reasons why the community of professional commodity traders is profitable year in and year out:

1. Most commodity and forex traders started trading with proprietary money. You were not just handed a multimillion-dollar pool because you had your MBA in finance or your PhD in quantum physics. In fact, you are just as likely to be a college dropout, a European history or theology major, or a former air traffic controller.
2. You understand risk because you trade leveraged markets. You know the high price to be paid for being stubborn with a losing trade. You know that small losses have a way of becoming large losses, and large losses can sink a ship. You would have never let a massive pile of worthless mortgage paper dig too deeply into your pockets.
3. You trade transparent markets that have instant and real price discovery mechanisms. The instruments you trade get marked to the market every day based on real values. You can determine the liquidation value of your portfolio to the penny at any given time—and if you need to scramble for cover, you can do so within minutes. You just laugh to yourself when you think about AIG, Lehman, and the mortgage instruments that nearly sunk the global economy. How in the world did the major financial houses put billions of dollars into instruments that could not accurately be valued at the end of every day? Imagine that some of the world's largest financial firms of their type were staking their future on financial derivative instruments they did not even understand, and when they failed, the government bailed them out. And after the government bailed them out, the executives of these firms paid themselves billions in bonuses. Nice gig if you can get it! Frankly, I think the entire bunch needs to be taken out behind the woodshed.
4. You know that a key to successful trading deals with how you handle losing trades, not in always being right. You understand that profits have a way of taking care of themselves if losses can be managed.

Average Investors

If you are like most "investors," you have experienced an "asset disappearing act" during the past several years as the value of your stocks, hedge funds, and real estate has tanked, at worst, or violently vacillated at best. Your assets have been on a wild ride.

Yet it is possible to generate consistent double-digit returns with a minimum amount of capital volatility in the commodity futures and forex markets. But you need to know that to do so is not easy work if you undertake the challenge on your own. Consistently successful trading requires diligence beyond easy description. There is not a simple golden egg.

You probably grew up hearing repeatedly that commodity markets were for speculators and that real estate and stocks were for investors. Hopefully, you now know that the traditional concept of an "investment" has no basis in reality. With the exception of T-bills, everything is speculation. Perhaps we may find out in the next few years that even U.S. government debt instruments are not a safe bet. It may even be that 30-year T-bonds will be the next bubble.

Like it or not, buy-and-hold strategies are a joke. Every decision you make in life represents a trade-off. Everything is a trade. Everything is a gamble.

You have also probably heard that commodity and foreign exchange markets represent "rags to riches" or "riches to rags" speculation because of the large leverage contained in the instruments traded.

Under the right hands, commodity futures and forex trading can be a rather conservative venture. As of March 2010, a total of $217 billion was being managed by professional commodity traders who attempt to provide their clients with consistently above-average RORs with a minimum of asset volatility.

If I sound like a cheerleader for managed futures, it is because I am. Research has shown that having a managed commodity portfolio decreases the volatility of a balanced stock and bond portfolio. Figure I.4 compares the Barclay Commodity Trading Advisor Index to the S&P 500 Index dating back to the early 1980s. You decide which roller coaster you would have rather ridden. I will allow this graph to speak for itself.

Novice "Wannabe" Traders

For you, I have some stark words! You have been duped! You have wasted your money buying expensive "black-box" trading systems, attending seminars promising you riches, thinking that the next great trading platform will solve your problems, or subscribing to the services of online trade pickers/scammers. And it is your own fault. It is your fault because you want to find an approach that overcomes your emotional inability to take trading losses in stride. Your ego and pride are too entangled with your trading.

You have had your share of profitable trades. In fact, perhaps you have even had some profitable years. But you have never become a consistently profitable performer because you spend the majority of your time, money,