

10TH
ANNIVERSARY
EDITION

Trading

IN A NUTSHELL

Planning
for consistently
profitable trading

**STUART
McPHEE**

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**INCLUDES
INTERVIEWS
WITH MARKET
EXPERTS**

Trading

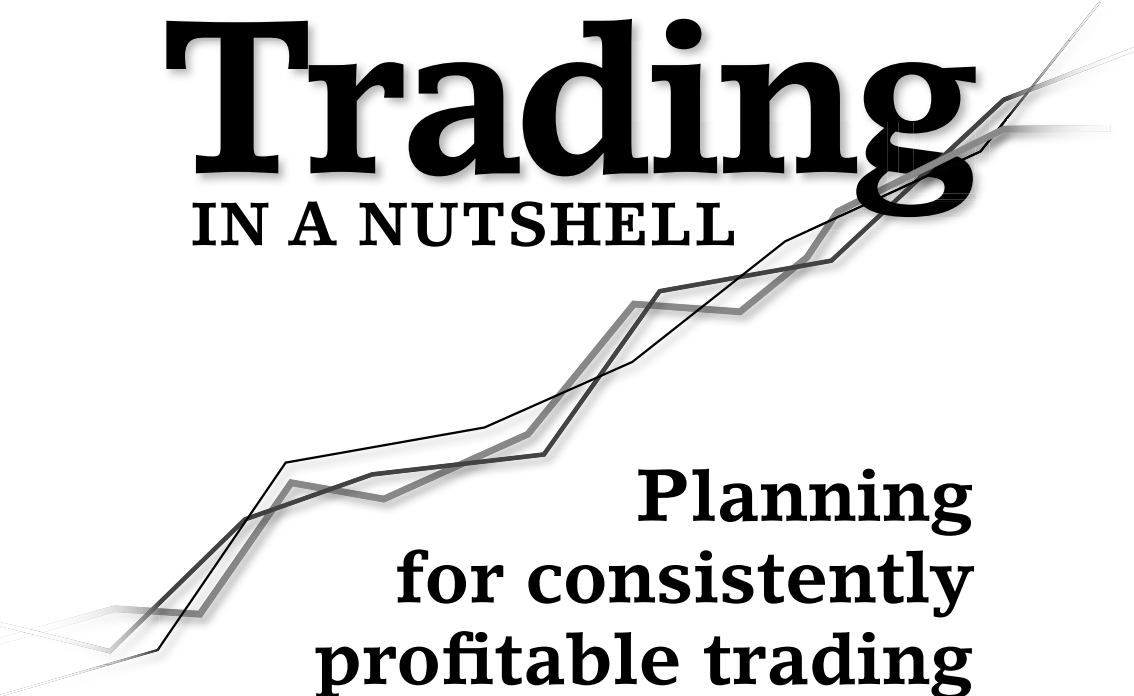
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**Planning
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**STUART
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Wrightbooks

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Preface

Let me take you back to what now seems a long time ago. I first became interested in the Australian sharemarket in 1996 and set about making some trading decisions of my own with reasonable success. Living in the US throughout 1997 and 1998 brought me closer to a major part of the financial world, New York. Here, I observed the extensive financial commentaries available on various cable TV channels, and this only served to increase my interest in our own sharemarket and the possibilities awaiting me in Australia. On my return to Australia in 1999, I set about learning more about the Australian Securities Exchange and those who were successful at trading on it. More importantly, I set about discovering what made them successful.

Through my study of successful traders and their methods, I discovered many similarities in the way they approached their craft, despite differences in their backgrounds, education and age. I found that they all placed great emphasis on certain principles and all tended to follow similar rules that have stood the test of time. A fascinating aspect of the rules is that there is no secret to them; you can read almost any trading book that has been written and discover some of them. Yet most people fail to follow them. Why?

When studying the trading careers of many successful traders, I found that most acknowledge discipline as a cornerstone of their success. More importantly, I discovered that every one of them had an individual approach to the market and a specific trading plan that was right for them.

I also found some amazing parallels between trading and my former career as an officer in the Australian Army. Obviously, discipline is instilled in all members of the Australian Defence Force through rigorous and focused training. But, somewhat remarkably, I have found that my own military background, starting at the Royal Military College, Duntroon, has given me a great grounding for trading.

When I started trading, I didn't fully appreciate how much my background would assist me. Only now do I look back and realise that learning to be disciplined, planning almost everything I did and learning to easily cope when unexpected things happen have all provided me with a great advantage in trading.

Another significant crossover between my military and trading experiences is that both demand the ability to recognise that, in most situations, there is no right or wrong answer. What you think is a good trading opportunity may not be in the opinion of other traders you know. But, at the end of the day, it doesn't matter what other people think, only what you think. This is incredibly similar to military tactics.

When faced with tactical problems on field exercises or during courses, I was always aware that there were no right or wrong answers in tackling these problems in order to develop a plan to achieve the mission. All you could be assessed on was how well you put into practice the principles applicable to that type of operation. The same could be said about making trading decisions. Follow the time-tested principles, make a decision and don't worry about what other people think.

I have been very fortunate to have travelled extensively over the last few years and to speak to traders from many countries. One thing I have realised is that traders from other countries are no different from traders anywhere else. They all face the same challenges and it seems that, generally speaking, the only difference between markets around the world is the names of the companies listed on the various exchanges.

This reinforces the belief that your education, background, language, cultural beliefs and many other factors are almost irrelevant when it comes to trading. Trading ability comes from within, with a desire to learn and develop the skills and attributes necessary for consistent, successful trading. I am confident my book will point you in the right

direction and provide guidance on developing a solid trading plan that you will execute with confidence.

Since the first edition of *Trading in a Nutshell* was published in 2001, I have coached many traders and learnt more about the problems they face. Speaking to traders from all around the world has also given me a greater appreciation of the extent to which our mindset affects our overall success as traders.

When starting out, I believe that many people view trading as easy money; however, it may be the hardest easy money there is! Trading has relatively straightforward concepts, yet it is amazing how many people make a mess of it. Once they realise that it isn't as easy as they initially thought, they try to overcomplicate their approach, believing that a complex solution is required. Unfortunately, this is often not the case and they end up travelling down the wrong path.

Over the last 10 years or so, since I wrote the first edition of this book, I have learnt so much about myself, trading and the financial markets. I am proud to say that the bulk of the content from the first edition is to be found within these pages — the new editions have simply expanded on that material with additional material I have learnt along my own journey.

During this same time, the general public has become more savvy and better educated when it comes to trading; however, the principles still remain the same. The most important part of your trading is you. One of the main reasons that people fail in the market is because they don't have a plan, or even if they do, it doesn't suit them and they don't follow it. As a simple example, they buy stocks and don't know at what point they are going to sell them. In the end, your trading success is up to you, because there is little preventing you from developing a robust trading plan that follows the rules.

Before I start, I would like to suggest an idea for you. One thing I have learnt about highly successful people in all professions is how quickly they implement new ideas. They hear something, consider it and then implement it without hesitation. The problem with most people, however, is they don't have in place a way of making this easy for themselves. Let me give you an example. You may read through this book and, as you go along, think to yourself on numerous occasions what great ideas it contains and how you can't wait to implement

them. Then as you finish the book, you forget them, drift away and focus on other things. We fail to put steps in place to implement all those ideas we just read about and were nodding our head at in agreement as we read them.

What I suggest is having a separate piece of paper to take notes relating to only those things you wish to implement in your trading straightaway. Once you have finished reading, you will have a concise task-list that will make it far easier to make changes. I am reminded of the saying, 'If you keep doing what you have always done ... you will keep getting what you have always got'.

I have included something new in this 10th anniversary edition of *Trading in a Nutshell*. I have asked several of the great people in the trading fraternity whom I have been fortunate enough to meet over the years to make a contribution to my new edition, by responding to a range of questions that I know can help you in your quest. I have included all of these responses in chapter 12 and I hope you find them valuable.

I also hope this new edition will enable you to discover yourself and then put together all the pieces of a robust plan necessary for long-term profitable trading. It is worth the effort, I can assure you.

I wish you well.

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February 2012
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1

An introduction to trading

How to succeed? Try hard enough.

Malcolm Forbes (1919–1990)

In a nutshell

- All consistently profitable traders have a trading plan that they follow.
 - There is nothing stopping you achieving trading success, except yourself.
 - Develop a passion for trading and commit yourself to it.
 - Put in the required effort and don't look back.
-

Trading

In simple terms, trading is the process whereby we regularly buy financial products, primarily in a market (more officially referred to as an exchange), and then sell them later for a higher price. This simple concept makes a lot of sense and is probably the main reason why people generally think that trading is easy money.

The financial product that we buy and sell may be stock in a company, a commodity like gold or silver, a futures contract or even a foreign currency, for example. Many people don't know that many markets offer the opportunity to take advantage of and financially benefit from a falling price as well. This is often referred to as trading 'short', as opposed to the aforementioned and more commonly known 'long' trading.

If you were to ask most people to describe their ideal or perfect job, many would suggest the following:

- Self-employment — being your own boss and reporting to no-one.
- Geographical freedom — being able to perform your necessary tasks from anywhere.
- Unlimited potential for profit — achieving financial freedom and independence.

Trading meets all of these three criteria and is why many consider it to be a great profession. It can be a very exciting and worthwhile endeavour and there are several other attractions and advantages for most people (not including ‘making money’, which is obvious).

Some of the other advantages of trading include:

- Minimal capital outlay — compare this with purchasing a franchise or establishing a new retail store in your nearest shopping complex.
- Flexibility with time — you choose when you trade and when you don’t.
- Almost anyone can do it — if you are old enough (usually 18 or 21 years of age), you can open a trading account and begin.

There are, of course, some disadvantages, which include:

- No guaranteed success — many people don’t make money trading.
- Can be stressful and emotional — when you are ‘playing’ with your own money, this is almost inevitable.
- Solitary existence — trading can be a very lonely profession.
- Takes time — like many endeavours, consistently profitable trading takes time. I list this as a disadvantage because I believe many newcomers don’t recognise this, nor do they fully appreciate what is required to develop the skills and attributes for successful trading.

I should add here that I personally have struggled at times with the solitary nature of trading. I used to work in a very large organisation and was an integral part of a team, and going from that environment to one of solitude was a significant culture shock. I think this affects people in different ways but it is certainly worth being aware of.

Another thing to consider is the contribution that traders make to society. I have been challenged on a number of occasions with the

comment that traders don't contribute anything to the orderly function of a society, whereas almost every other profession or job, including anything from being a pilot or a postie to working in a grocery store or being a teacher, does. What about traders? They are individuals who probably sit at home and use a trading plan to consistently make money from financial markets. Apart from providing some liquidity, what else do they contribute to society? What function do they perform?

This may not sit well with you.

One final thing you need to be aware of: trading has a greater potential for reward than investing, but with that extra potential for reward is greater risk. Those who trade well have been well educated and prepared. Very seldom does somebody start trading and make money from day one. Often you will hear the saying: 'Only educated traders survive'.

Develop a trading plan

If you learn only one thing from this book, I would like it to be this: if you want to trade successfully, you need to develop and then follow a written trading plan that is right for you. All consistently profitable traders have a plan that they follow, as successful traders understand the importance of having a plan to guide them in their trading actions.

I believe that many people approach the market with a sense of confidence, yet with little idea of why or how they are going to trade on it successfully. There is a well-known phrase that says: 'If you fail to plan, you are planning to fail!'

The trading plan model I always use is shown in figure 1.1 (overleaf).

Some people will use terms other than those that appear in this model (for example, Trading Psychology for Mindset, Risk or Money Management for Money, Trading System for Method); however, I like these terms as they are easier to remember — the three Ms!

Throughout this book, I will explore these three areas further. But before I do, I want to touch upon which one is most important. Most, including myself, will declare the mindset as the most important; however, there are numerous other trains of thought on this. Some would suggest that it doesn't matter how disciplined or confident you are; if you don't have a robust and simple method, you won't be successful.

Figure 1.1: trading plan model



Likewise, if you don't manage your money by cutting losses and protecting your capital, it doesn't matter how good your method is.

From this I conclude that all three are important in their own way, yet I will not change my opinion on the mindset being by far the most important ingredient in your success. Yes, you need a simple and sound method and you most definitely need to manage your money, but it is your mindset that makes it all happen and ensures you do things the right way.

By developing a written trading plan, you can clearly define and articulate the rules you will follow, your money management approach and all the various components of your trading method.

Developing a good trading plan requires commitment and discipline. Just the thought of discipline may scare a lot of potential traders. This is because many people like to break rules, even ones they set themselves. You need to realise how important it is that you demand of yourself the highest level of discipline, in order to implement the requirements of your trading plan ruthlessly. We will discuss discipline in greater detail in chapter 10 when we tackle the important character attributes.

Based on my own personal study of successful traders, I believe that you must also develop a trading plan that is right for you — that suits your personality. If you are not comfortable with the way you approach the market, then you will be more likely to drift away from your plan and fall into bad habits.

Trading is not new. Many traders have come and gone before you, and many of them have made mistakes from which you can learn. Even those who are highly successful have done some stupid things and broken rules along the way to success. Enlisting the assistance and support of a mentor can be invaluable when you are starting to trade. This can be particularly helpful in areas such as personal psychology. Some of the greatest sports people in the world have coaches to finetune and guide them in order to achieve optimum performance. Interestingly, they are the type of people you may assume would be beyond requiring assistance from a coach or mentor. Instead, they realise how valuable it is.

You should consider trading like running a business, and anyone who has run a business successfully will tell you that irrational emotions should have little place in decision-making. In essence, trading is all about decision-making—although, because our natural instincts come to the fore when dealing with money, many people cannot remove certain emotions from their trading actions sufficiently.

To develop a trading plan and then follow it requires certain character traits that lead to success in any endeavour. These include commitment, desire, discipline and patience. It takes time and a lot of introspection to trade properly. If you want to trade seriously, you must develop a plan and there is only one thing stopping you doing that: you.

Commit to it

Anybody can achieve anything they put their mind to. I'm sure you've heard this before, and I firmly believe it.

However, I also believe that not many people can set their mind to something.

Have you ever broken one of your New Year's resolutions? Why? It was because of your mind. Honestly, you were not really committed to making that particular change in your life. It is quite simple: if your mind is not set to something, then there is little chance of it actually happening.

I am sure you can think of many highly successful people that you have either known or heard about, whether they are sportspeople,

businesspeople or in some other occupation. Each person who has achieved great things in his or her life would have done so in large part by displaying passion, desire, commitment and discipline, and they would each have overcome obstacles and adversity along the way. There is no easy way for any of these people.

With regards to achieving success in life, I have several beliefs. First, I believe that anything in life that is worth achieving takes time. Trading is no exception. I believe that successful people always give 100 per cent in their ventures. Always!

I also believe that generally there are three types of people in this world. Those who make things happen, those who watch what happens, and those who wonder, 'What happened?' If you want to achieve anything in life, including being the best trader you can be, you must be a member of the first group.

Why do people think that trading should be any different from any other endeavour in life? If you want success, you will need to commit yourself, develop a plan, have discipline and develop a passion for it. Otherwise, the chances of your succeeding are fair at best.

Your own mind drives everything you do and you need to control it. If you want to trade, and therefore need to develop a trading plan and follow it, you must convince yourself that trading is something you really want to do. Once you have achieved this goal, there is nothing to stop you developing a robust plan that will, over the long run, be profitable. On the other hand, if you cannot convince yourself, then you will cut corners and fail to follow your rules or to develop a plan that is right for you. Here, chances are, you will lose money.

Markets around the world are full of people who are losing money and most are doing so because they have no plan and little discipline. The fact that you have picked up this book suggests you are keen to know more about what it takes to be successful at trading.

My story

In the preface, I provided some insight into my own personal trading story. I want to expand on this a little.

I believe most traders travel along the same trading path. We begin with the same motivations and dreams and, along the path, run into

numerous obstacles and challenges. I think that I am just further along the path than a lot of other people, but it is the same path.

I went through all the obstacles and challenges that many traders face and I sometimes think that had I not experienced significant losses and stress when the NASDAQ crashed in 2000, maybe I wouldn't be in the position that I am now. I too would still be struggling to develop a trading plan that I could implement with some confidence.

When the NASDAQ crashed, I lost a ridiculous amount of money — money I had made in the 12 months prior and then some. This really hurt! It took me many months to get over it emotionally. I was devastated.

I continued to buy things as they fell because I was so used to the market rising so sharply. This only added to the damage.

I decided to follow all the standard professional development ideas after this major setback — seeking mentors, surrounding myself with like-minded people, attending seminars and reading books on the topic. I read many trading books and started to seek out successful traders and ask them what they did that was different from what I was doing.

The biggest challenge then arose for me: accepting losing trades. This did not sit well with me at all. I think it was probably reading the book *Market Wizards* by Jack D Schwager (which I still say has had the most influence of anything on my trading life) that made me realise that even the very successful traders have all had losing trades.

Not every trade was profitable for them. So, I realised in that sense, I wasn't any different from them. The only difference was how they reacted to those losing trades.

I read other great books like *Secrets for Profiting in Bull and Bear Markets* by Stan Weinstein, *Trading in the Zone* by Mark Douglas, and many others, all of which still sit in my trading library.

I conducted extensive back-testing, which took me a long time. It was all done manually; however, I saw every chart of every trade that my testing initiated. This was very useful. I was able to gain great insight into how it all worked. I recorded the details of every trade in an Excel spreadsheet, and each page in the spreadsheet detailed the results of a different set of rules.

I started with very simple rules with a view that over time, I would add more and more conditions to build a complete picture, and make it more complicated and therefore more likely to be successful. I had already done a lot of reading and had a reasonable understanding of technical analysis, so this made developing some rules a little easier.

I was surprised at the results. You see, I had never before used the same entry conditions over and over again in my actual trading. I was always using different reasons to enter trades.

Amazingly, in the first series of back testing I did, the results were profitable. I was really encouraged by this.

From this encouragement came a little bit of confidence, which is probably what I needed to re-enter the market. All of this took time and effort. Looking back, there was no shortcut through any of this.

Put in the required effort

It's never crowded along the extra mile.

Dr Wayne Dyer

To trade successfully, arm yourself with all of the necessary tools. Consider the other market participants as adversaries and never allow them to gain an advantage over you. While you are not working on your trading plan or studying the market to remain open to new ideas, they are likely to be doing so, consequently providing themselves with the upper hand. Never think you have learnt enough about the markets. You should continually seek further knowledge. The day you believe you have nothing more to learn about trading will be the first day on your way to failure.

Seek out books and speak to those who are doing very well. Purchase a reliable laptop or personal computer and robust trading software.

The perception that trading is effortless and easy is, to a degree, true. Successful traders will tell you that trading should be effortless. A decision to enter a trade should be based on set criteria and conditions, detailed in your trading plan.

However, while the execution of a trade is relatively effortless, the preparation involved in achieving that level of systematic behaviour is extensive and takes tremendous organisation. A good analogy is that of marathon runners. When those outstanding athletes complete 42-kilometre courses in less than two hours and 10 minutes at the Olympic Games, we imagine that it is far from effortless. But, for them, those two and a bit hours are indeed effortless, when compared with their effort in getting themselves into a position to be able to run a marathon in two hours and 10 minutes.

Trading is very similar. If you are new to trading or just developing a trading plan, picture it as the beginning of your training for a marathon. Running may not be a strength of yours but, if you were to work at it, you would find running easier and, perhaps, even enjoyable. This, of course, applies in varying degrees, depending on other physical factors.

The reality is that trading success will not occur overnight. It is a journey of discovery and an adventure; however, it is an endeavour well worth pursuing. Don't be overwhelmed with what you don't know—accept it with enthusiasm and as a new challenge. I think your aim initially should be one of constant gradual improvement, as opposed to finding the entire trading plan solution immediately.

I personally look back at some of the mistakes I made and cringe. Yet at the same time, I am glad I made those mistakes and experienced the frustration and stress, as I became a better trader for the experience.

One thing a lot of new aspiring traders don't realise is how much time and effort it is going to take to reach the level of performance you need to be consistently profitable. Let's equate this to golf. If you play golf once every six months, you don't improve. If you were to play twice a week for six months, you would notice a significant improvement in your game. Trading is no different and requires a reasonable commitment from you.

There is an ancient Chinese proverb that states: 'The journey of a thousand miles begins with a single step'. If you want to trade successfully, commit yourself to trading and put in the effort. Take that first step and don't look back.

In order to help with your own personal development and ultimately develop a trading plan for you, I have planned this book so you can gain a solid understanding of the following areas:

- how markets work generally
- technical analysis and its place in your trading method
- factors to consider when deciding upon your entry conditions
- how to identify suitable trade exit levels and adhere to them
- the importance of managing your risk and, most critically, protecting your trading capital
- how to compile all this information into a formal written trading plan
- how to prepare yourself mentally and develop certain attributes for the mental rigours of trading
- the time-tested trading rules
- some useful guidance in where to get started.

Do you want to trade consistently profitably? Well, what is stopping you from developing a trading plan that will work for you?



2

Financial markets

In a nutshell

- There are numerous trading products available across many different financial markets.
 - Financial markets are a vital part of the world economy.
 - Stocks are the ideal starting point for traders.
-

What are stock exchanges?

Stock exchanges are financial markets that bring buyers and sellers of capital together in an efficient manner. They channel capital resources to those who will make the best use of them. Ultimately, resources that are used efficiently will benefit the whole community and not just the entity receiving the funds.

In a layperson's terms: if you had \$10 000 to invest in a new company, you would experience some difficulty in establishing a new business and generating a profit within a certain period of time. However, with that same \$10 000 you are able to invest in a well-established, already consistently profitable business and then benefit through capital gain and/or receiving your share of the profits.

Having access to such an efficient process of capital resource allocation, we should ideally earn the best rate of return when investing in companies listed on a stock exchange. Unfortunately, this is not always the case. On all markets, there are many listed companies that make no money at all, despite their best efforts to do

so, and thousands of people have lost all their money after investing in companies that are subsequently wound up.

The importance of stock exchanges around the world to the various economies cannot be overstated. They are a vital part of the corporate world. The largest companies in the world that are well known by the majority of people are all listed companies on their respective stock exchanges.

The most common financial product traded on stock exchanges is stocks or shares — these terms are commonly used interchangeably. Shares are equity securities, and represent the basic unit of ownership in a company. The total of all the shares in a company represents its equity capital. Equity capital is also often referred to as ‘risk capital’ as the owners have no guarantee of a return on their investment, or of recouping it. When you buy shares, you become a part-owner of the company and consequently share in its profits and losses.

One benefit of owning shares is that you may receive regular dividends — a share of the company’s profits. Another benefit of owning shares is the capital gain you may enjoy. Share prices fluctuate on a daily basis according to supply and demand and equity holders are able to benefit from a favourable move in the share price.

A distinction is often drawn between ‘traders’ and ‘investors’; traders are those who buy and sell stock more frequently, seeking relatively short- to medium-term profits, whereas investors generally tend to ‘buy and hold’. Capital gains in stock prices hold greatest appeal for traders, while a combination of long-term gains and steady dividend income tends to attract investors.

Stock exchanges around the world

Some of the largest stock exchanges in the world are worth trillions of dollars in market capitalisation and they have trillions of shares traded each and every year. Some of the world’s largest economies even have more than one stock exchange in the country, although most countries have one main central exchange.

I would like to introduce you to some of the largest exchanges in the world (in no particular order).

NYSE/Euronext

The New York Stock Exchange (NYSE) joined with Euronext in 2007 to form the world's largest group of exchanges, boasting six exchanges across five countries. The NYSE has its origins back in 1792 and is the most well-known stock exchange in the world.

NASDAQ

Presently, the NASDAQ is the US's largest electronic screen-based exchange, with around 3000 companies listed.

Toronto Stock Exchange (TSX)

The TSX is the largest equities market in Canada and one of the largest in the world. It also has a reputation for listing many mining companies and oil and gas companies from around the world.

Australian Securities Exchange (ASX)

The ASX is the main stock exchange in Australia and one of the world's top ten listed exchange groups, measured by its market capitalisation. The ASX group was created through the merger of the Australian Stock Exchange and the Sydney Futures Exchange. The ASX group now operates under the brand of Australian Securities Exchange and is a listed company in its own market. The largest companies on the ASX are mainly banks and mining companies.

Singapore Stock Exchange (SGX)

The SGX was inaugurated in late 1999 following the merger of two established and well-respected financial institutions, the Stock Exchange of Singapore and the Singapore International Monetary Exchange. The SGX too is a listed company on its own market.

Bursa Malaysia

Established in 1973, and formerly known as the Kuala Lumpur Stock Exchange, Bursa Malaysia operates the stock exchange for Malaysian listed companies and has around 1000 companies presently listed. The companies are listed on the Securities Main Board for larger companies, the Second Board for medium-sized companies, and the MESDAQ Market for high-growth and technology companies.

NZX

NZX operates a number of different markets, with the main stock exchange being called the New Zealand Stock Market (NZSX).

Tokyo Stock Exchange (TSE)

Established in 1949, although only becoming a corporation in 2001, the TSE is the second-largest stock exchange in the world. The companies are listed on the First Section for large companies, the Second Section for mid-sized companies, and the Mothers Section for high-growth start-up companies.

London Stock Exchange

The London Stock Exchange is one of the world's oldest exchanges. Companies are listed on one of two markets: the Main Market is where established companies are listed, and the AIM is the world's leading small capitalisation stocks growth market, where the majority of initial public offerings (or floats) occur in Western Europe.

Shanghai Stock Exchange (SSE)

The SSE in its present form was founded in 1990 and is a non-profit-making membership institution that is directly governed by the China Securities Regulatory Commission.

Hong Kong Stock Exchange

Despite the size of the country, the Hong Kong Stock Exchange is also one of the largest exchanges in the world and has a long history dating back to the 19th century.

Some of the largest companies listed on these various exchanges are worth many billions of dollars and it can be humbling to think that you as an individual have the ability to invest in any of these large corporations.

Companies

When companies require funds for their operations, they have two primary options. They can either borrow money (take on debt) or raise capital (issue equity), or a combination of both. The latter