The 16 Rules of Trading

Allowing the market to take away your profits by holding on to a losing trade is not a strategy – it's a tragedy!

If you were to ask someone what makes a trader successful, they would probably reply: knowledge and technology.

Having trained thousands of traders, both professional and individual, I can tell you that knowledge and technology alone do not make a successful trader. Many traders have a tremendous body of knowledge, yet they can't outperform the markets or match the trading record of someone with far less knowledge or information.

Knowledge, without emotional control, is of no advantage to a trader. In this instance, technology, instead of being used as a tool, can be used as a psychological crutch. Any technology is only as good as the trader using it.

The following 16 rules should serve you well; and they will ideally keep you from becoming a victim of market hype, bad "tips", and emotionally driven decisions. In twenty years of trading experience, I have found these guidelines to be an invaluable tool for staying out of trouble and keeping focus on the trade.

1. Trade with a plan

Set objectives before you act. Define all outcomes – not only what you will do when things goes right, but what you will do if things go wrong. Determine the amount of capital you are willing to lose, and also define when you will take profits.

Allowing the market to take away your profits by holding on to a losing trade is not a strategy – it's a tragedy! Write out a trading plan and follow it. Do not become a casualty of emotionally involved buying or selling – trade with a plan.

2. Screen your trades

To select your trades you must have a predefined method. Select a method based on price momentum and trend. Don't guess what the future is going to be – trade the current trend direction. Your method must consider your individual time frame and risk tolerance. Always address liquidity, sector rotation, and technical factors when screening stocks.

3. Always look at a chart

Never enter a trade without looking at a chart first. Look at the one-year trading range. Ascertain what that trend is, and don't trade against it. Buying and selling decisions are technical in nature. Fundamentals will never tell when to buy or sell. Always look at a chart for entry and exit timing decisions.

4. Stay with a trend

Your probabilities of success are far greater if you stay with a definable market trend. Statistically, these trends provide better profit potential with a lower amount of risk.

A good rule is to watch a 50-day exponential moving average of the close. This moving average represents the intermediate trend of a stock. A 12-day exponential moving average represents the short-term trend.

The use of these two moving averages should yield excellent results in keeping you in the trend. If you perceive the trend beginning to change, act accordingly by taking profits or placing stops to protect your capital.

5. Use money management techniques

A performance analysis software package called *Trade Equation* is excellent to use for risk management, money management, and for tracking your trading history and performance.

Cutting a loss quickly is the best money management tool you can use. Too often traders fall in love with a position and hold on to it as the market begins to move against it. Never use a hedging strategy (such as later adding options to the position) to justify holding on to a losing position.

The use of money market, bond, and stock dividend income to offset losses in your trading portfolio is an excellent technique.

Covered call options may be appropriate to generate income for your portfolio to offset losses. Be careful though – understand the nuances of this strategy before you implement it.

If the market is clearly moving against your position, liquidate it. If you are going to hold a trade overnight never risk more than 3% of your available capital. If you are going to daytrade, an excellent rule is to only risk 1% of your available capital on any one trade.

6. Buy and sell on confidence

Many times you won't feel quite right about a buy or sell decision. If this feeling persists after you have done all your research and you have followed the rules to this point, don't take the trade. Too often, individuals try to rationalise a decision. Don't try to find a good reason for making a bad decision. Your decision must be a confident one.

7. Trade liquid instruments

Stay with major markets and stocks with millions of shares in the float. Make sure the average trading volume is enough for you to liquidate your entire position on any given day. By following this rule you should be assured a reasonably good execution of your trade.

Generally speaking, trade instruments that have good trend characteristics and predictability.

8. Don't buy or sell on hot tips

More wealth has been lost on "hot tips" than is in the Tower of London. If someone tells you about an investment or trade, research the recommendation before you put your money into it.

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Most novice investors and traders fall victim to tips every day. Please don't fall for the story no matter how good it sounds. Always use technical analysis to make your buy and sell decisions, and buy and sell based on facts.

9. Do not cost average

If the timing decision for entering a position was wrong, don't make the problem worse by adding to the position as it moves against you (called "cost averaging").

The probability is that you will only compound the loss exponentially. If the reasons why you entered the trade are no longer valid, save your money and simply exit the trade with a minimal loss.

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10. No one wins 100% of the time

Many people begin trading focused only on the potential profits and do not consider the potential losses. While no one enjoys it, losing is just part of the cost of doing business. Your goal is, not to blindly put your money at risk like a buy and hold investor. You only learn how to win after you learn how to lose. How one handles loss is what distinguishes the professional from the amateur.

When professional traders lose, they don't take the loss personally, but view it like winning trades – just another part of the business of trading.

11. Always use stops

The proper use of stops will protect profits and limit your losses. When you enter a trade, you place a stop to limit the loss if the trade goes against you. When the trade becomes profitable, you use stops to attempt to lock in a profit. Anyone who would argue against risk control by advocating not using stops is an investor – not a trader. In effect, they are recommending that you put your capital at unlimited risk. Does this make any sense? Of course not – but that is exactly what buy and hold investors do all the time.

Most investors do not use stops because they have never learned how to, or they are afraid of... *being stopped out*. This is a psychological problem of not wanting to be wrong, or the inability to accept losses. It certainly isn't based on logic or strategy.

The 16 Rules of Successful Trading

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2. Screen your trades
3. Always look at a chart
4. Stay with a trend
5. Use money management techniques
6. Buy and sell on confidence
7. Trade liquid instruments
8. Don't buy or sell on hot tips
9. Do not cost average
10. No one wins 100% of the time
11. Always use stops
12. Manage your time
13. Be patient
14. Learn from mistakes
15. Know how to trade the short side
16. Follow the rules