The 10 Golden Rules of Trading

A mini eBook in the SmartTrader™ Series

By

Paul M King

This electronic book is Copyright PMKing Trading 2005. Any unauthorized distribution, copying, or reselling of this publication without written permission is strictly prohibited.

This publication is not a recommendation to enter into any equity, futures, options, or foreign currency transactions. Please consult a professional advisor before making any legal, accounting, or trading decisions.

All trading activities have a risk of loss. PMKing Trading LLC is not responsible for any losses due to any trading activity performed as a result of the contents, recommendations, or advice included in this publication.

Historical performance is not necessarily indicative of future results.

PMKing Trading LLC, 10b Seymour, Middlebury, VT 05753

public@pmkingtrading.com

802 349 9501

Version 1.0 6/1/5

Table of Contents

1	**Introduction**	**3**
2	**The Golden Rules of Trading**	**4**
2.1	Have specific goals and objectives	4
2.2	Be consistent and disciplined	5
2.3	Let profits run	5
2.4	Cut losses short	6
2.5	Never add to a losing trade	6
2.6	Don’t take too much risk	7
2.7	Only trade positive expectancy systems	7
2.8	Minimize all trading business costs	7
2.9	Be educated	8
2.10	Don’t trade scared money	8
3	**Summary**	**9**

1 Introduction

In this SmartTrader™ Series of eBooks, we will outline and explain in detail key concepts and ideas that are critical to the successful operation of a trading business. Although they include advanced trading concepts, even if you are a novice trader they can help you improve your trading and give you a focus for areas of improvement.

For experienced traders the eBooks are full of expert advice and advanced concepts that cannot be found anywhere else. All the information in the series of eBooks has been taken directly from our experience of building a successful trading business, and contains nothing that is purely academic - it is all excellent, usable, practical advice that we have used successfully in our own business.

In this introductory sample, we cover the few rules that should never be broken in trading. If you can apply these rules consistently, and with discipline, you will be well on the way to being a profitable trader.

The rules we cover are:

- **Have specific goals and objectives**
- **Be consistent and disciplined**
- **Let profits run**
- **Cut losses short**
- **Never add to a losing trade**
- **Don't take too much risk**
- **Only trade positive expectancy systems**
- **Minimize all trading business costs**
- **Be well educated**
- **Don't trade scared money**

We hope you enjoy this series of eBooks and that they improve your trading performance.

Please let us know what you think by using the 'Contact' page on our web site at www.pmkingtrading.com.

2 The Golden Rules of Trading

The following sections outline a set of rules that can significantly improve your chances of success if they are understood, practiced, and implemented consistently in your trading. These rules have been learned the hard way, by study, research, trial-and-error, and the inevitable mistakes that everyone makes when they start a trading business.

We hope that you can learn for the work we have done, and benefit from our experience. The rules will now be discussed.

2.1 Have specific goals and objectives

Few things are more important to your trading success than having set (i.e. written) goals and objectives for what you are aiming to achieve. It is amazing to me how often we hit our targets, meet our objectives, and reach our goals only when we articulate them and write them down.

For any business to be successful it must have measurable objectives that are actually achievable. In trading (obviously) the primary objective is to make money, but it is important to have other objectives that are not purely cash-related. We must always remember that reward and risk go hand-in-hand in trading and that we cannot expect to achieve high returns without planning for high risk (i.e. draw-downs).

Your objectives and goals will be very specific to you, but they must have the following characteristics to be useful:

- Be measurable (in completion and timeframe)
- Be achievable
- Be worthwhile
- Be positive

As an example, here are some of our current objectives (this is only a partial list):

- Develop 2 new positive-expectancy trading systems each year
- Make fewer errors implementing our trading systems each year
- Achieve a return to maximum draw-down ratio of 1.5:1
- Take 2 weeks vacation each year

Note that only one of them is about making money, and that has a measurable objective that is relative to draw-down, not absolute (i.e. make 100% per year). If you know what you are trying to achieve, and when you are trying to achieve it, the whole business will be focused on meeting your objectives and help guide you to only pay attention to things you really want to achieve with your limited time and resources. This will also give you a way to measure the success and progress of your trading. Generally traders with well-defined objectives will be much more successful than those that do not have pre-defined goals.

2.2 Be consistent and disciplined

In order to realize the full potential of your trading systems it is critical that you take every trading entry, adjust every stop, and close out every trade as and when your system says you should do. This takes extreme confidence in your trading systems, good robust reliable technology, and the mental discipline to stick to your trading plan whatever happens (assuming it is complete).

An underlying assumption about being consistent and disciplined is that you have a pre-defined plan for every situation you may face in your trading, so that you know how you are defining what being consistent is. Your plan needs to include at least the following items:

- All your trading rules for entering, adding to, and exiting positions
- What you will do if your trading computer, internet connection, broker, power, telephone etc. fails
- What you will do if you are unable to trade
- What you will do if you lose X% of your account
- What you will do if all the markets are closed and you can't exit your positions

Unless you write the answers down to all these issues, you cannot be consistent and disciplined in your approach to trading and if you lose money you will not know whether it is because you didn't follow your plan, because your plan is incomplete, because your systems do not work, or simply because you are going through a losing period.

2.3 Let profits run

This simple rule is the key to being a successful trader. It is three simple words that are very hard to actually implement. When we get a profitable trade our natural fear of losing the unrealized cash kicks in and we truly want to close it out now and take the money. Most trading consists of long periods of small winners and losers followed by a few huge winners that make the difference between overall profitability and simply breaking even or losing due to trading costs (commissions, spread, and slippage).

It is our ability to let the huge winners become just that - huge - that determines how we will perform overall during the year. The key to letting winners run is to have trailing stops that are outside the daily noise of the market so that they are not tight enough to get stopped out during 'normal' trading. This means being prepared to give up a significant portion of a winning trade's open profit and is the thing that makes this so hard to implement. In fact, we should be adding to a winner and widening stops rather than working out how tight our stops can be to capture maximum profit. The trade has already shown you that it intends to be a winner, and the chances are it is a low-risk idea to add to the position now rather than 'strangle it' with stops that are too tight.

It is very important that your position management rules allow for large winning trades, and that the rules are pre-defined and understood before you place the trade. This will allow you (if you have confidence in your method and discipline) to stick to your rules when you do get the big winner.

2.4 Cut losses short

This is the sister rule to the previous one, and is usually just as difficult to implement (although it is very easy to define). In the same way that profitability comes from a few large winning trades, capital preservation comes from avoiding the few large losers that the market will toss your way each year. Setting a maximum loss point before you enter the trade so you know before-hand approximately how much you are risking on this particular position is relatively straightforward. You simply need to have a exit price that says to you 'this trade is a loser and I will exit before it gets any bigger'. Due to gaps at the open, or limit moves in futures we can never be 100% certain that we can get out with our maximum loss, but simply having the rules, and always sticking to it will save us from the nasty trades that just keep on going and going against our position until we have lost more than many winning trades can make back.

If you have a losing position that is at your maximum loss point, just get out. Do not hope that it will turn around. Given that trades are either winners or losers, and this one is shouting 'Loser' at you, the chances that it will turn around and become a large winner is tiny. Why risk any more money on this losing trade, when you could simply close it out (accept the loss) and move on. This will leave you in a much better place financially and mentally, than holding the position and hoping it will go back your way. Even if it did do this, the mental energy and negative feelings from holding the losing position are not worth it. Always stick to your rules and exit a position if it hits your stop point.

2.5 Never add to a losing trade

One of the few trade management rules that we can state we never break is 'Never add to a losing trade'. Trades are split into winners and losers, and if a trade is a loser, the chances of it turning right around and becoming a winner are too small to risk more money on. If indeed it is a winner disguised as a loser, why not wait until it shows it's true colors (and becomes a winner) before you add to it.

If you do this you will notice that nearly always the trade ends up hitting your stop loss and does not look back. Sometimes the trade turns around before it hits your stop and becomes a winner and you can count yourself very fortunate. Sometimes the trade hits your stop loss and then turns around and becomes a winner and you can count yourself unlucky. Whatever the result, it is never worth adding to a loser, hoping that it will become a winner. The odds of success are just too low to risk more capital in addition to the initial risk.

2.6 Don't take too much risk

One of the most devastating mistakes any trader can make is risking too much of their capital on a single trade. One thing is certain in trading and that is if you lose all your capital you are out of the game. Why risk so much you could be prevented from continuing? There is a saying in poker than going all-in (risking all your chips) works every time but once. This is true of trading. If you risk all your account on every trade it only takes one loser to wipe you out (and no trading method is 100% accurate), so you will be out of the game at some point – it is only a question of time.

In general, we only risk 1-3% of the available capital allocated to a system on any individual trade. This is calculated using the size and, the difference between our entry price and our maximum stop price, and the amount of capital allocated to the system. With the win probability and ratio of size of winning trades to losing trades we are almost certain never to lose all of our trading capital. In fact, the chance of us hitting our maximum drawdown for the year is tiny.

All trades should be of a size that almost seems insignificant. If you are worried about the size of a trade then it is too big and you should reduce the size immediately. Remember that longevity is the key to making money by trading – slowly over a long time with minimal risk, is always preferable to rapidly with too much risk.

2.7 Only trade positive expectancy systems

If you have a positive expectancy trading system, the only factors that determine how much money you will make per year are the number of trades the system generates, how much capital you allocate to the system, and how accurately you implement the trading signals.

If you do not know whether your trading system is positive expectancy then why are you trading it? Expectancy is calculated using the profit or loss on each trade (net of trading implementation costs) divided by the initial risk (using your stop loss) and then taking the average of this number of a series of trades. Systems that have positive expectancy will make money on average and those with negative expectancy will lose money.

Successful traders only trade systems where the odds of success are in their favor (i.e. the system is positive expectancy) so they know that making money is the result of accurately implementing the system and not just pure luck.

2.8 Minimize all trading business costs

Some trading systems have only marginal profitability, and trading implementation costs (commission, spread, and slippage) can be the difference between profitability and making a loss. With the easy availability of modern electronic brokers, and fully-automated trade processing and execution, it is definitely worthwhile looking for a very low cost way to implement your trading system High commission, wide spreads, and large amount of slippage can be reduced considerably simply by carefully choosing a broker. This can be the difference between a system (especially a high frequency one) being useable or not. Paying too much for trade implementation is an avoidable way to lose money.

2.9 Be educated

In order to compete at the highest level in the trading business and be one of the few truly successful participants you must be well-educated about what you are doing. This does not mean having a degree from a well-respected university – the market doesn't care where you were educated.

Being well-educated means that you have thoroughly researched and tested your trading ideas and know why your trading system worked in the past and is continuing to work now. It means understanding all the technology and applications that your system needs to perform accurately. It means understanding your goal and objectives and how trading will achieve these. It means understanding yourself and how your personality affects your results. It means understanding the markets and instruments you trade.

In order to succeed you really need to become an expert in your own trading business to understand how it all fits together, when it is broken, and how it can be improved. As with all worthwhile endeavors, this takes commitment, hard work, dedication, and more hard work.

2.10 Don't trade scared money

Lastly, no one ever made any money trading when they had to do it to pay the mortgage at the end of the month. Having a requirement to make X dollars per month or you will be financially in trouble is the best way I know to completely mess up all trading discipline, rules, objectives, and leads quickly to disaster.

Trading is about taking a reasonable risk in order to achieve a good reward. The markets and how and when they give up their profits is not under your control. Do not trade if you need the money to pay bills. Do not trade if your business and personal expenses are not covered by another income stream or cash reserve. This will only lead to additional unmanageable stress and be very detrimental to your trading performance.

3 Summary

In this free introductory eBook we have covered the rules that we believe should never be broken in trading. Please note that the other eBooks in the series go into much more detail, and cover much more advanced subjects than this introductory example.

It is recommended that you read the entire SmartTrader™ series of eBooks to maximize your trading performance.

If you have any questions regarding this eBook, suggestions for improvement, or ideas for trading-related subjects you would like us to consider writing about, please use the 'Contact' page on our web site at www.pmkingtrading.com.

We sincerely hope this information has helped you to improve your trading performance.