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Creating a Trading System

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Why Trade a Written System?

- **Eliminates Guesswork**
- **Eliminates Confusion**
- **Eliminates Fear and Greed**

- **Provides a Road Map to Follow**
- **Provides Built-In Discipline**
- **Provides Risk-Control &
Money Management**

A Trading System

**Eliminates
Emotions**



**Building Wealth
is Always
Based on a System.**

AND

**Every System
Has Rules.**

**A System is a Set of
“Rules of Engagement”
- In Writing! -**

**If the Rules are not Written,
they are not Rules at all.**

**They are “Guidelines,”
subject to abuse.**

**System Trading is All About
Finding a Way to
Get the Odds in Your Favor
While Managing Risk
With
Stop Loss and Position Size**

**A System
Harnesses Your “Edge,”
and then
Forces You to Act
the Same Way
Every Time for
“Predictable” Results.**

Wealth-Building System # 1

**Write a Stock Market
Newsletter and
Convince 100,000 people
to send you \$150.**

\$15,000,000

If It Seems Too Good To Be True...



... It Probably Is



Wealth Building System # 2

- Live Below Your Means**
- Eliminate Debt**
- Never Buy Consumables on Credit**
- Never Pay Retail – Find the Bargain**

- Accumulate Cash w/ Disciplined Saving**
- Invest in Assets, not Liabilities**
- Take Some off the Table for a Nest Egg**
- Compound Your Profits w/ Risk Capital**

Teach Your Children How to Build Wealth

The J. Paul Getty System

- You must be in your own business**
- Have a working knowledge of the business when you start, and continue to learn**
- Save money, personally and professionally**
- Take risks with your money, and other people's**
- Learn to live with tension, and seek it out**
- Build Wealth as a by-product of your business success**
- Wait for the right time to make your moves**

**The thing that has been, shall be.
There is no new thing.
- Solomon**



Why Does a System Work?

- An Idea that Worked in the Past Will Often Work Again**
- Repetition Adds an Element of Predictability & Expectancy**
- An Expected Overall Outcome Adds Confidence When Confronted with Losses**
- Automatic Actions Increase Reaction Time and Enhances Trade Execution**

ZEN
is the Art
Of Knowing a Thing
So Well
That All Actions are
Automatic

**“The man must turn
himself into a Puppet
in the Hands of the
Unconscious”**

- Suzuki, *Zen and Japanese Culture*

“I Never Think.”



**“That’s What
Makes Me Good
at My Job.”**

**- TV Detective,
Sledge Hammer**



**A Trading
System
is Like
“Artificial Zen”**

Having a System

At All

**May be More
Important than
What Your
System Is**

Creating a Trading System

- **Start with an Idea**
- **Test the Idea**
- **Determine the Win / Loss Ratio**
- **Determine Average Draw Down**
- **Add Stops, Slippage, Costs**
- **Determine Capital per Trade**
- **Understand Your System's Expectancy**



**It's been said
the
Markets are Random
and a even a Monkey
with a
Stop-Loss
Can Make Money.**

Let's Test that Theory

The 50/50 Coin Toss System

Assumptions:

- Each Toss has 50% Probability**
- The Odds are 50% Over Time**

50/50 Coin Toss System:

- **Each Toss = 2pt**
- **20 Tosses =
10 Wins, 10 Losses**
- **Result = Break Even**

The Classic Rule:

**Let Your Winners Run
and**

Cut Your Losses Quickly

Coin Toss System : w/ Stop Loss

- **Win Toss = 2pt Gain**
- **Loss Toss = 1pt Loss**
- **20 Tosses = 50% Win Rate**
 - 10 Wins = 20pts**
 - 10 Loss = 10pts**
- **Result = 10pts Profit**

Test the Assumptions

**Toss the Coin Repeatedly
to See if “50/50” is the
Real World
Win / Loss Ratio**

Coin Toss System Results

01) TAILS	11) HEADS	COLUMN - 1
02) HEADS	12) HEADS	5 TAILS
03) TAILS	13) TAILS	5 HEADS
04) TAILS	14) TAILS	
05) TAILS	15) HEADS	COLUMN - 2
06) HEADS	16) HEADS	7 HEADS
07) HEADS	17) HEADS	3 TAILS
08) HEADS	18) HEADS	
09) TAILS	19) HEADS	HEADS – 12
10) HEADS	20) TAILS	TAILS – 8

Win / Loss Ratios

- **10 Tosses – Win / Loss = 50%**
- **10 Tosses – Win / Loss = 70%**
- **20 Tosses – Win / Loss = 60%**

**Sample Number is Critical:
Over Time, Wins Increased**

Coin Toss System w/ an Edge

If Wins are Higher Over a Large Sample, We Have an “Edge”

Each Toss = 2pt

- **20 Tosses =
12 Wins, 8 Losses**
- **Result = 8pts Profit**

Coin Toss System w/ an Edge & Stop Loss

Win Toss = 2pt

Loss Toss = 1pt

- **20 Tosses =
12 Wins, 8 Losses**
- **Result = 16pts Profit**

Profit Summary

- **50/50 Alone** **00**
- **50/50 w/ Stop Loss Alone** **10**
- **w/ an Edge Alone** **08**
- **w/ an Edge and Stop Loss** **16**

Summary

- **Manage Your Losses**
- **Find an Idea that Gives You an “Edge”**

Two Basic Types of Systems

- 1. Perpetual Position**
- 2. Opportune Entry**

**Each Type Has
Advantages & Disadvantages**

**A System can keep
you in the Market
at all Times--**

**You Never Know if a
Position will be the
“Big Move”**

“A System Keeps You in the Market for the Big Move.

“I have devised systems to ensure that I will be in for the big ride and my losses will be minimized while I wait.”

**Charlie Wright –
*Trading as a Business***

“The best traders I know, make a little, lose a little, over and over again and then have a few trades that make a lot.

“Lots of small gains and lots of small losses and a few big gains.

“This is the best way to succeed at trading.”

Larry Connors – TradingMarkets.com

OR

**Bring You In
ONLY**

**When Everything Comes
Together for the
“Right Opportunity”**

**“What beat me was not having
brains enough... to play the
market only when I was
satisfied that precedents
favored my play.**

“There is a Time for all things.”

- Jesse Livermore

**The Best Sales People Spend
the Majority of Their Time
Qualifying & Filtering
Prospective Customers.**

And Then

**Pouncing on the Most
Qualified.**

**The Less Qualified the
Prospect,
the More Likely the Result
Will Be:**

NO SALE!

Two Basic System Ideas:

**Always be in the Market for
the “Big Move”**

OR

**Only in the Market With the
Best Prospects**

**Remember:
Cash is a Position.**

**A Successful System
is Defined by
How Well it Satisfies
Your Personality
and Your Goals**

Key Questions

- **How Do You Interpret the Markets?**
- **What are Your Personal Goals?**
- **What is Your Time Frame?**
- **What is Your Risk Tolerance?**
- **How Large is Your Capital Pool?**

Interpret the Markets

- **Random Walk?**
- **Mathematical / Symmetrical?**
- **Driven by Fundamentals?**
- **Driven by News?**
- **Emotional Extremes?**

Personal Goals

- **Hobby / Dabble for Fun?**
- **Part-Time?**
- **Full-Time Occupation?**
- **Financial Target for a Specific Purpose?**
- **Supplement Your Income?**
- **Saving for Retirement?**

Time Frame

- **Scalp in 3 Minutes or Less?**
- **Hold for 15 Minutes to 2 Hours?**
- **Hold Overnight?**
- **Swing 1-5 Days?**
- **Hold for Several Weeks?**
- **Hold for Several Months?**

Risk Tolerance

- **Do You Need Many Winners in a Row?**
- **Do You Need Constant Reinforcement?**
- **Can You Handle Many Losses in a Row and Maintain Your Positive Expectancy?**

Capital Pool

- **Do You have Enough Capital to Sustain Many Losses in a Row?**
- **When the Big Win Happens, Do You Have Enough Capital Remaining for Significant Profits?**

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How Many Losses Can Your Capital Handle?

- Column 1 – 3 Losses in a Row**
- Column 2 – 2 Losses in a Row**

**You Must Have Enough Reserve
Capital to Keep You in the
Game After Repeated Losses**

Basics of a Trading System

- **Strategy for the Entry**
- **Strategy for Exposure**
- **Strategy for Profit Exits**
- **Strategy for Failure Exits**
- **Strategy for Partial Profits**
- **Strategy for Compounding**

The “Bread & Butter” System

- **Setups Put the Odds in Your Favor**
- **Setups or Targets for Profitable Exits**
- **Manage Risk with Stop-Loss Strategy**
- **Manage Risk with Position Size**

- **Draw-Down Statistics**
- **Win / Loss Ratios**
- **Risk / Reward Ratios**

**Why You Enter a Trade
is Not as Important as
Having a Definite and
Consistent Criteria
for Doing So**

**It's Best to Have an
"Idea" That Puts the
Odds
in Your Favor**

To Win the Game, You Need an “Edge”



**Your Edge is How You
Personally**

**Interpret and Comprehend
the Current Action
of the Market**

The Edge

- **Find a Setup or Reason for Entry that Shows “Promise”**
- **Test Your Premise in Various Market Environments**
- **Learn It’s “Best” and “Worst” Environmental Performance**
- **Test Profit and Loss Potential in All Environments**

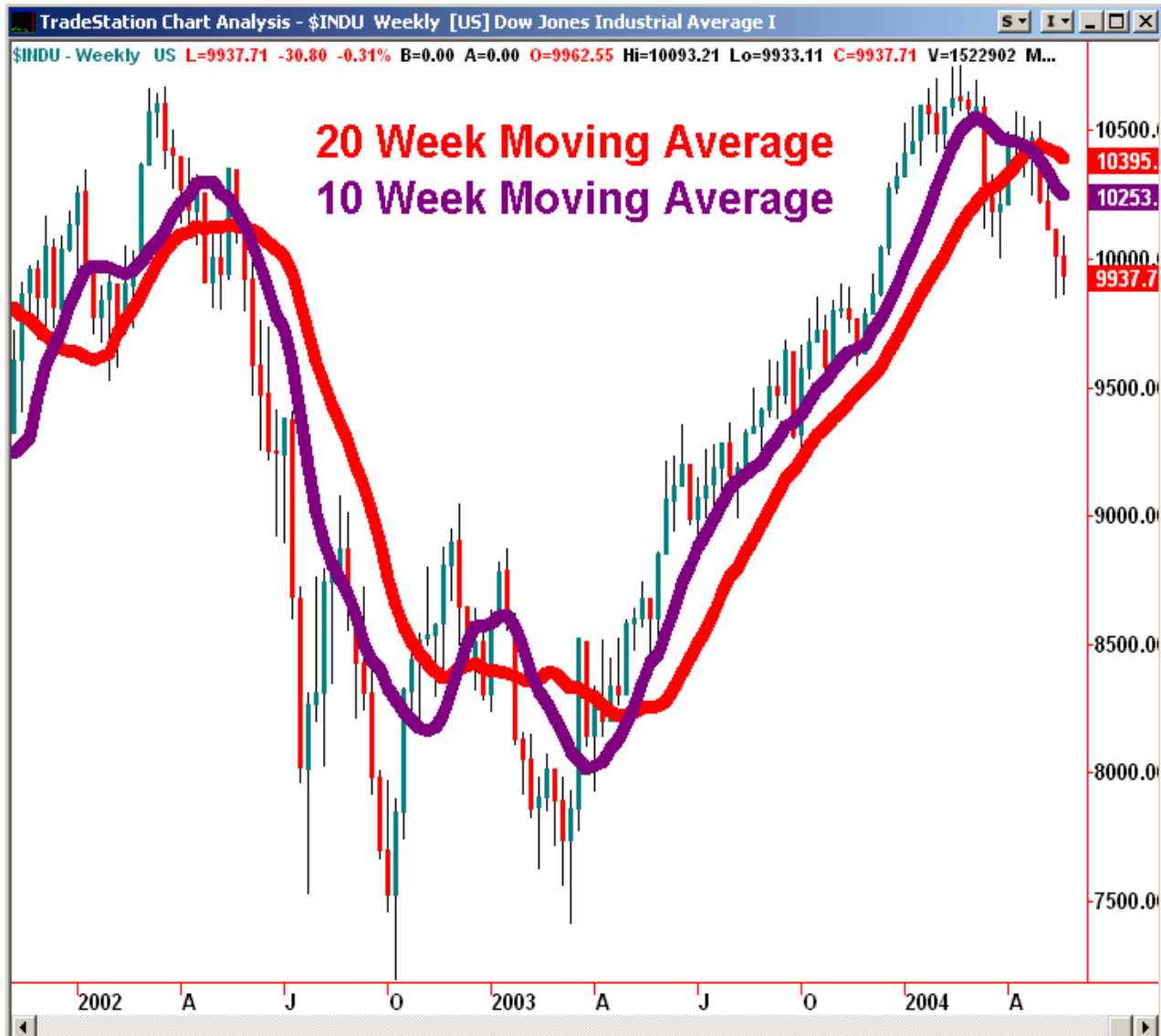
Types of Trade Entries

- **Follow the Trend**
- **Support and Resistance**
- **Fibonacci Retrace and Target**
- **Moving Average Cross**
- **Follow the News**
- **Price Patterns**

Follow the Trend



Follow the Trend



NOTE:

**When Following the Trend
Entries are Easy
But
Exits Require a
Secondary Strategy**

Support & Resistance



Support & Resistance

- **Note that the previous chart had Strong Elements, yet there was Significant “Wiggle” and False Signals**
- **When Price Breaks a Signal, What Do You Do?**

Fibonacci



Moving Average Cross



No System is Profitable In Every Market Environment



**Every System Has It's
Unique Set of Problems.
But That's OK.**

**“You don't need to know
what will happen
to make money.”**

- Mark Douglas

Strategy for Exposure

- **Use All Available Capital for One Trade, with a Reasonable Stop-Loss**
- **Use Only a Portion of Available Capital for any One Trade, Keeping a Capital Reserve**
- **Vary Exposure by Risk Ratio Criteria**

Position Size

- **Your Win / Loss Ratio is the Basis for Your Position Size for Each Trade**
- **If Your System Has Many Losses in a Row Before the “Big Win,” Stops Must Be Tight, OR, Number-of-Shares Must be Reduced**

Position Size

**If You Know You Can Easily Lose
10 Times Before the “Big Win”**

**You Must Ensure Each Trade
Preserves Enough Capital
For Trade # 11**

Strategy for Profit Exit

- **Targets Based on Direct-Opposite Signal as Entry**
- **Targets Based on Support or Resistance**
- **Targets Based on Indicators**
- **Trailing Stop-Loss**

Your Strategy for Profit Exit Does Not Need to Be the Same Type as For Your Trade Entry

Example:

**A Moving Average Cross
Entry Can Use a Support or
Resistance Profit Exit**

**At Times the Market is
Driven by Pure Emotion**

**All Targets are Broken
Until Exhaustion**

Strategy for Failure Exit

- **How Do You Know Your Trade Isn't Working?**
- **Failure Exit is the Flip Side of Profit Exit**
- **Target, Stop-Loss, or Various Other Criteria**

Trade Failure is Common

- **Get Out Immediately**
- **Never Hope, Wish, Or Ignore**
- **You Can Always Re-enter**
- **Never Allow a Small Loss to Grow Into a Huge Loss**

Stop Loss Exits

- **How Much Risk per Trade**
- **How Much Slippage?**
- **Methods for Stops**
 - **Percentage of Capital or Trade**
 - **Firm Dollar Amount**
 - **Signal**

Strategy for Partial Profits

- You Hit Your Target, but Trend is Strong**
- What is Your Secondary Target?**
- In “Most” Cases, Secondary Targets Have More Risk**
- Determine in Advance, How Much to Take Off the Table Now, and How Much to Leave on the Table for Risk**
- Keep Tighter Stop-Loss for Additional Risk**

Strategy for Compounding

- Wealth is Built by Compounding Profits**
- Security is Built by Building a Nest Egg**
- Take Money Off the Table for Savings**
- “Sweep” Your Account with Discipline**
- Resist the Urge to Risk All Your Profits**
- Use Your New “Risk” Capital with the Same Discipline You Would with “Initial Capital”**

Draw Down

- **How Many Losses in a Row?**
- **How Many Losses Can Your Capital Withstand?**
- **How Many Winners Do You Need to Replenish Your Capital?**

Win / Loss Ratio

- How Many Times Do You Win?
- How Many Times Do You Lose?
- How Many Losses Can You Sustain in a Row?

- **Winners ÷ Trades = Ratio**
5 Winners ÷ 15 Trades = .33 Win Ratio

Risk / Reward Ratio

- **Reward Should be 3 to 1:
Profit Potential 3 Times Your Risk**

Example:

- **Enter at 100**
- **Profit Target is 103**
- **Stop-Loss is 99**

System Expectancy

The Key to Confident Trading

- **Risk to Reward Ratio**
- **Win to Loss Ratio**
- **Number of Opportunities to Trade**
- **Average Life of Each Trade**
- **Average Profit per Trade**
- **Average Trades for per Time Period**

**You Can't Predict the Future
but You CAN Predict
The Probability Ratio that
Your Trades Will Be
Successful.**

**“Casino owners, experienced gamblers,
and the best traders understand:**

**“ Events that have probable outcomes
can produce consistent results,**

**“IF you can get the odds in your favor
AND there is a large enough sample size.**

**“ The best traders treat trading like a
numbers game.”**

Mark Douglas – *Trading in the Zone*

**Successful Sales People do
the Same Thing.**

**The More doors they knock,
and Prospects They See,
the Better Their Odds of
Making the Sale.**

**A System Can Keep You in the
Trades That Fit You Best, and
Manage the Bad for
Measurable Consequence.**

**Working a System Can Keep
You On Track.**



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Special Thanks

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