Developing A Plan

The Trading Journal

In order to succeed at trading, you must have an **edge**. Your edge begins with the knowledge you gain through your research and testing that a particular market behavior offers a level of predictability that provides a consistently profitable outcome over time. Without it, one is just "playing" the market in order to have something to talk about on message boards. To get it, you have to know exactly what you're looking for and what to do with it once you've found it. This process is what the journal is all about.

The journal goes through several stages depending on where you are. Once you've decided where you want to concentrate your efforts (at this level, the journal may resemble a diary), then you begin the process of developing a system (or method, strategy, procedure, whatever you want to call it). Here the journal takes on a different character. Once you've developed a tentative/preliminary system, you begin testing/trading it, and the journal adopts a still different character.

The first step is to decide what kind of trader you want to be.

- What do you want to accomplish with your trading? Is it recreational? Supplementary income? A part-time job? Do you want to make a living at it? Even the greenest of the green knows whether or not he wants to make a living at it, trade only part time, trade for recreation, trade for the action, trade to have something to talk about with other traders (for whatever reason), trade only long enough to earn money to do or buy X.

- Do you have any idea what sort of trading is most comfortable? Long or intermediate-term trading? Short-term trading? Day-trading? Trend-trading? Scalping? (Note here that a short-term trader, for example, does not become a long-term trader just because his stop was hit and he didn't sell; a long-term trader doesn't become a short-term trader because he chickened out and sold too soon. Each of these approaches is selected deliberately and for thoroughly-considered reasons.) How patient are you? How adventurous? Are you a leader or a follower (most people think they're leaders)?

The second step is to decide what you're going to trade and when you're going to trade it.

- Have you found an instrument -- futures, stocks, ETFs, bonds, options -- that provides you with the range and volatility you require but also the safety that enables you to relax and trade in an objective and rational manner?

- Have you yet found a time (5m, hourly, weekly) or tick (1t, 200t) or volume (1K, 100K) interval that gives you enough trading opportunities but also gives you enough time to think about what you're doing? If you want to limit your trading to the "morning", are you physically and psychologically prepared to trade all day? If not, can you shrug off whatever opportunities you may miss by limiting the amount of time you spend trading?

The third step is to develop your system.

A system consists of (a) a set of rules that you use to **select profitable positions** and (b) a set of rules that you use to **manage the trade** once you're in it (again, whether you call it a system, a method, a strategy, a plan, a scheme, an approach, a procedure, or a modus operandi is not as important as sitting down and doing it).

- Developing a system begins with deciding just what it is you're looking for. Therefore, begin by **studying price movement**[1] in real time (or at the end of the day through "replay", if your charting program offers it). By "study", I mean to observe it with intent, not just read about it or listen to somebody talk about it. You have to understand what you're looking **at** before you know what to look **for**. Note the conditions under which price rises, falls, drifts. Make every effort to avoid imposing your biases onto what you observe. You may see trading as a war, a competition, a game, or a puzzle. You may think you're out to kill somebody, outwit somebody, or are out only to detect the flow and slip into it, riding the waves as if you were sailing. None of this should be allowed to affect what you observe.

- Develop a set of preliminary hypotheses which exploit the profit opportunities presented by these movements, e.g. price began trending "here". Price broke out "there". Price reversed "there". What can I do to take advantage of that? What do I have to look for?

- Decide what strategy will best take advantage of what you think you've found. Are you looking to catch a **reversal** in the hopes that it will become a trend? Or are you looking to trade series of reversals within the day's or week's range? Or do you prefer to wait for a **breakout** and trade what may become a trend? Or would you rather wait for a **retracement** in what may be shaping up to be a trend? Limit yourself to only one strategy at the beginning.

- Carefully define the setup (the set of circumstances which you define which triggers an entry) which implements this strategy, preferably using old charts (attempting to define the setup by studying realtime charts is inefficient since you don't yet know what it is that you're looking for). This is called **"backtesting"**[2]. All else flows from this. Unless you know what you're looking for, you cannot test it, much less screen for it. If you have not tested it, you have no idea of the probability of its success. With no idea of the probability of success, any trades made are essentially guesses.

Therefore, focus on the setup. One setup. Determine its characteristics, find the markers of buying and selling interest, buying and selling pressure, buying and selling exhaustion. Define it so specifically and so thoroughly that you can recognize it without any doubt whatsoever in real time. Decide provisionally where best to enter, what the target ought to be, where the stop should be placed, and so on. Only after the setup is defined and tested (and it can't, ipso facto, be tested until it's been defined) can one even begin to think about trading it with real money, much less trading multiple setups. Attempting to shortcut this process merely expands the amount of time it will take to develop the necessary skills. Nothing is gained by painting the house before scraping it, cleaning it, and priming it since you'll have to do it all over again sooner rather than later.

You are free to create your own based on whatever jingles your bells. You may, for example, focus on divergence. Or higher swing lows and lower swing highs. Or candlesticks of one sort or another. Or trendline breaks. Or base breakouts. Doesn't really matter. What matters is that you keep four concepts in mind: demand/supply, support/resistance, price/volume, and trending/ranging. In this way, you can create your own setups which hundreds of thousands of other traders won't be watching along with you. You must understand, however, that what determines the success of the trade is the trader, not the setup. If you're looking for something that "works", you may as well save yourself a lot of time and stop right here. What will “work” – or won’t, as the case may be – will be you.

- Forward-test what you have so far, again using old charts, preferably replaying them (if replay is not available to you, then scroll through them, bar by bar). In other words, "pre-test" the setup. Make whatever modifications are necessary to the setup, i.e., re-examine and re-define your strategy. Address risk management, trade management, money management in further detail. Determine the ratio of winning trades to losing trades (you will, of course, have to define "winner" and "loser", which is where risk management and trade management come in). Determine the ratio of profit to loss. Determine the maximum loss. Determine the maximum number of consecutive losers.

  Note that beginners often use "win/loss" to combine two separate considerations into one, and failing to keep them separate can create problems. One is win:lose. The other is profit:loss. Between the two, the "lose" and the "loss" have two distinct meanings. Win:lose refers to the ratio of winning trades to losing trades. Profit:loss means, expectedly, the ratio of profit to loss.

  You'll read that the % of winners can be less than the % of losers as long as the winners are sufficiently profitable, one's management is superior, etc. And, yes, theoretically, one can "win" less than 50% of the time if his profits sufficiently outweigh his losses. But if your real-time real-money test begins with a string of the losses anticipated by your backtest, you'll be out of the game almost before it begins. In fact, one can be left high and dry even if his % of wins outnumber his % of losses, as mentioned above, if there is insufficient control of the amount of loss OR if the losses occur in sufficiently high numbers at the beginning of the trial.Then there are commissions and assorted trading costs to take into account, which is why traders who actually trade find that, without size (the quantity of what you’re trading), all the postulations about percentage don't mean much in practice.

- Paper-trade this plan, in a simulated environment, as a semi-final test, until you are satisfied that it performs at least as well as it did during the previous testing phase. This may take several months or more depending on how many trials you perform. If your plan is not consistently profitable, go back however many steps are necessary to arrive at a potential solution.

- Trade the plan using real money in real time, spending only what is absolutely necessary on "tools" and trading the minimum number of shares, contracts, etc., allowable. If your plan is not consistently profitable, go back however many steps are necessary to arrive at a potential solution. Recalculate your win rate and profit:loss ratio on a continuing basis.

- If your plan is consistently profitable in practice, increase your size to what is a comfortable level, maintaining a continuous loop of re-appraisal and re-evaluation. When things come unglued, back up as far as necessary to regain your footing.

Novices rarely do any of this. They borrow something from somebody or somewhere and perhaps modify it somewhat, but they rarely go through the defining and testing process themselves. Some just try whatever seems like a good idea and hope for the best.

If one has absolutely no idea where to begin, there is nothing wrong with using a canned strategy IF it is used only as a point of departure. In other words, the canned strategy, regardless of what it is or what claims are made for it, still has to be tested, which often entails taking what is unexpectedly vague to begin with and defining it to a level of specificity that enables the testing to take place (it should come as no surprise that those who do go through the process succeed and those who don't, struggle, often to the point of being driven out of the market). Examples of canned strategies that are reasonably well-defined include the Darvas Box, the Ross Hook, the Opening Range Breakout, O'Neil's Cup With Handle, Dunnigan's One-Way Formula. Some of these are more vague than others and will require considerable work on definition before they can be tested. But they serve as points of departure.

Wyckoff’s "hinge" is another setup, though not one which would be classified as "canned", requiring as it does some sensitivity to trader behavior. The hinge is a type of "springboard", in which price action firms, like Jello, another Wyckoff concept (the springboard, not the Jello), the idea being that something is getting ready to happen as a result of what bulls and bears have been doing to "discover" price. (The pattern people call it a coil or symmetrical triangle; the difference is that the hinge is the result of a particular dynamic between bulls and bears and can be expected to result in something; the triangle is technically nothing more than a pattern, and can result in nothing at all but drift.)

This particular "setup" occurs when bulls and bears are struggling over price, and it can be seen everywhere from a tick chart to a monthly chart. There is first a wide discrepancy between what one side thinks is a fair price and what the other side thinks is a fair price. Since they disagree, the range narrows (so that they can complete trades), the bars get shorter, trading activity becomes subdued, and eventually you close in on a point which is more or less a midpoint between the two extremes. From this, price will then move -- often explosively -- in one direction or the other IF the hinge is being formed in an important spot, such as a point just after the initiation of what promises to be an important trend.

> *The market always tells you what to do. It tells you: Get in. Get out. Move your stop. Close out. Stay neutral. Wait for a better chance. All these things the market is continually impressing upon you, and you must get into the frame of mind where you are in reality taking your orders from the action of the market itself — from the tape.*
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> *Your judgment will become poorer from the very time when you decide that you know more about the market than the market is telling you. From that moment your results will be unsatisfactory, for in this trading business the tape is the boss. You must learn to obey its orders, doing exactly what it tells you. When you can accomplish this, you are on the high road to success in your stock trading.*
>
> *Richard Wyckoff*

Recommended Books:

The General Semantics of Wall Street
by John Magee (see my review)

The Nature of Risk/How to Buy/When to Sell
by Justin Mamis (see my reviews)

And if you're greener than green . . .

The Wall Street Journal Complete Money and Investing Guidebook by Dave Kansas

or

Standard and Poor's Guide to Money and Investing by Morris and Morris

[1]Trading by price -- and "volume" (or trading activity) -- requires a perceptual and conceptual readjustment that many people just can't make, and many of those who can make it don't want to. But making that adjustment is somewhat like parting a veil – or taking the red pill -- in that doing so enables one to look at the market in a very different way, one might say on a different level.

One must first accept the continuous nature of the market, the continuity of price, of transactions, of the trading activity that results in those transactions. The market exists independently of you and of whatever you're using to impose a conceptual structure. It exists independently of your charts and your indicators and your bars. It couldn't care less if you use candles or bars or plot this or that line or select a 5m bar interval or 8 or 23 or weekly or monthly or even use charts at all. And while you may attach great importance to where and how a particular bar -- or candle -- closes, there is in fact no "close" during the market day, not until everybody turns out the lights and goes home.

Therefore, trading by price and volume, or at least doing it well, requires getting past all that and perceiving price movement and the balance between buying pressure and selling pressure independently of the medium used to manifest or illustrate or reveal the activity.

For example, the volume bar is a record of transactions, nothing more. The volume bar does not "mean" anything. It does not predict. It is not an indicator. Arriving at this particular destination seems to require travelling a tortuous route since so few are able to do it. But it's a large part of the perceptual and conceptual readjustment that I referred to earlier, i.e., one must see differently and one must create a different sense of what he sees, he must perceive differently and create a different structure based on those perceptions. As long as one believes, for example, that "big" volume must or at least should accompany "breakouts" and clings to this belief as ardently as he clings to his rosary beads or rabbit's foot or whatever, he will be unable to make this perceptual and conceptual shift.

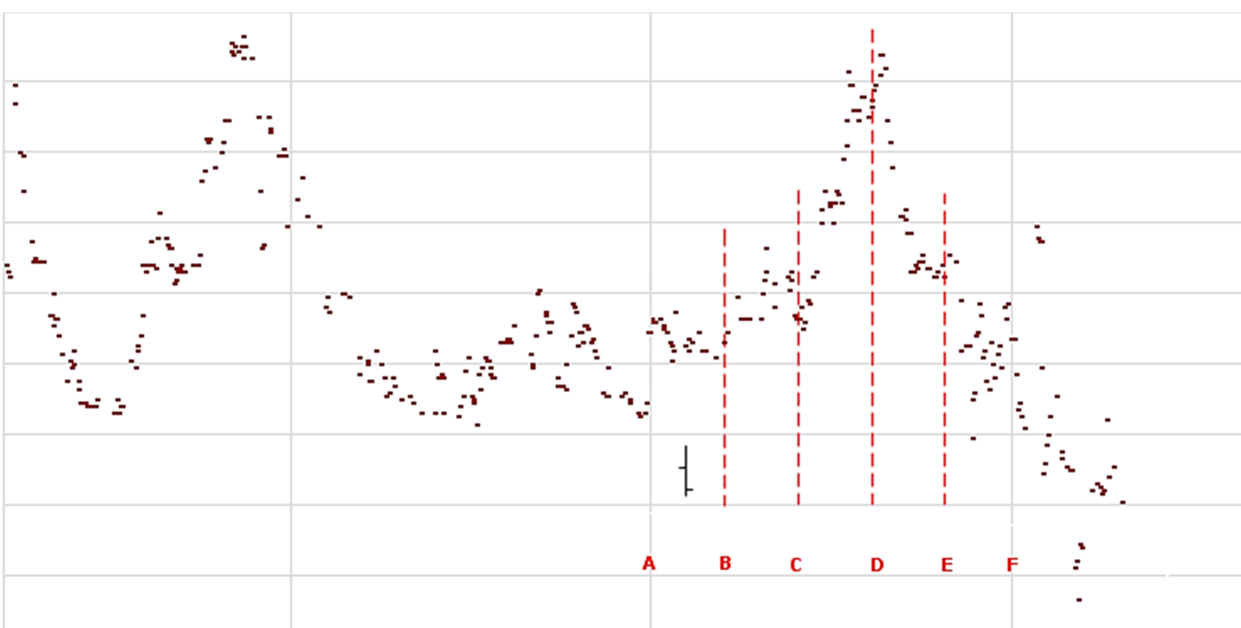
If you can work your imagination and use it to travel in time, you will have a far easier time of this than most. Imagine, for example, a brokerage office at the turn of the 20th century. All you have to go by is transaction results -- prices paid (and maybe # of shares) -- on a tape. No charts. No price bars. No volume bars. You are then in a position wherein you must decide whether to buy or sell based on price action and your judgment of whether buying or selling pressures are dominant. You have to judge this balance by what's happening with price, e.g., how long it stays at a particular level, how often price pokes higher, how long it stays there, the frequency of these pokes, their pace, at what point they take hold and signal a climb, the extent of the pokes, whether or not they fail and when and where, etc., all of which are the result of the balance between buying and selling pressures and the continuous changes in dominance and degree of dominance.

One way of doing this using modern toys and tricks is to watch a Time and Sales window and nothing else after having turned off the bid and ask. But this wouldn't do you any good unless you spent several hours at it and no one is going to do that. Another would be to plot a single bar for the day and watch it go up and down, but nobody's going to do that, either. Perhaps the least onerous exercise would be to follow a tick chart, set at one tick. Then follow it in real time. Watch how price rises and falls due to imbalances between buying pressure and selling pressure. Watch how and where these waves of buying pressure and selling pressure find support and resistance to their movements. And when I say "watch", I mean just that. Don't worry about what you're going to do about whatever it is you're looking at. Don't worry about where you'd enter or where you'd exit or how much money you'd make or whether you'd have been right or wrong to do whatever. Just watch. Like fish in an aquarium. If that seems only slightly less exciting than watching concrete harden, or it's just not possible for you to watch this movement in real time, then collect the data and replay it later at five or ten times normal speed. You can do an entire day in little more than half an hour (though you won't get any sense of real-time pace). Granted this means a lot of screen time, even in replay, and only a handful of people are going to do it. But those few people are going to part that veil and understand the machinery at a very different level than most traders.

Time	Price	Volume
17:06:22	4711.0	1
17:06:20	4711.0	20
17:06:17	4712.0	3
17:06:16	4711.5	10
17:06:16	4712.0	5
17:06:16	4712.5	24
17:06:15	4713.0	5
17:06:13	4713.5	42
17:06:12	4713.5	4
17:06:10	4712.0	9
17:06:10	4712.0	1
17:06:08	4713.5	2
17:06:07	4713.0	1
17:06:05	4713.0	5
17:05:59	4713.0	1
17:05:58	4713.0	3
17:05:57	4713.0	18
17:05:56	4712.5	1
17:05:56	4712.5	2
17:05:54	4713.0	1
17:05:54	4712.5	1
17:05:53	4712.5	1
17:05:51	4712.5	1
17:05:49	4712.5	1
17:05:48	4713.0	1
17:05:48	4712.5	1
17:05:47	4712.5	1
17:05:46	4712.5	7
17:05:46	4712.0	36
17:05:45	4711.5	2
17:05:44	4712.0	1
17:05:42	4711.5	7
17:05:41	4711.0	31
17:05:41	4711.0	3
17:05:40	4711.0	3
17:05:39	4711.5	3
17:05:38	4711.5	1
17:05:37	4711.0	1

Once the continuous nature of these movements is understood, and this may take no more than an hour, the idea of wondering -- much less worrying -- about what a particular volume bar "means" is clearly ludicrous, as is the "meaning" of a particular price bar or "candle" (including where it "opens" and "closes" and what its high is and so forth), and eventually the trader may come to the realization that all those people who've been insisting that these bars have some cosmic meaning have been trying to sell him something, i.e., DVDs and courses and software and seminars (box lunch included) and so forth that explain what these meanings allegedly are.

For example, here is a tick chart:



Note that the third pane has been subdivided into 1m blocks, i.e, A to B spans 1m of time. Now look at all those ticks – transactions – that are printed during that 1m span. If one were to consolidate all those ticks into a bar, he'd end up with the bar shown below the ticks in the first interval: the "opening" tick, the high and low ticks, and the "closing" tick. What is more informative? The character of the array of the ticks? Or the bar? And what about the array of trades/ticks in the second interval, B-C? And the third? Is it worth knowing that price retraced a little after printing the highest tick? Is it worth knowing that the ticks in the D-E interval printed with little to no buying pressure and finished only a couple of ticks off the "low"?

If the continuous nature of these movements is not understood, then the trader spends and wastes a great deal of time over "okay so this bar is higher than that bar but lower than this other bar, and price is going up (or down or nowhere), so . . .".

2 *So, when your recommend backtesting, do you actually mean applying your system manually on historic charts or do you use some coding to test your ideas?*

No coding, no algorithms, no computerized backtesting at all. It's all done manually.

The manual way will be tough, since one needs to create a large sample, right?

Depends on how long it takes for you to get it. If you have a lot of experience with coding and indicators, it will likely take you far longer to get it than it would someone who's starting fresh for you are more likely to view price as something independent of the efforts made by buyers and sellers to arrive at that price.

Take support, for example. A lot of traders view support as a mathematically determined level or point that one reaches by calculating Fib or Pivots or plotting MAs or whatever. But support is none of that. Support is that level or zone where buyers decide for whatever reason that they are going to stop the decline of price and turn it around. This entails a different way of looking at price and price movement. Price is the product of an activity. To trade by price, one must understand the nature of that activity and not define price solely as prints on a page or tape.

You may, therefore, be able to distinguish between trend and trading range by looking at only a handful of charts. Or it may take dozens. Or more. Or you may never be able to do it (and don't feel bad; there are plenty of vendor/pundits who can't tell up from down and consequently make one losing countertrend trade after another).

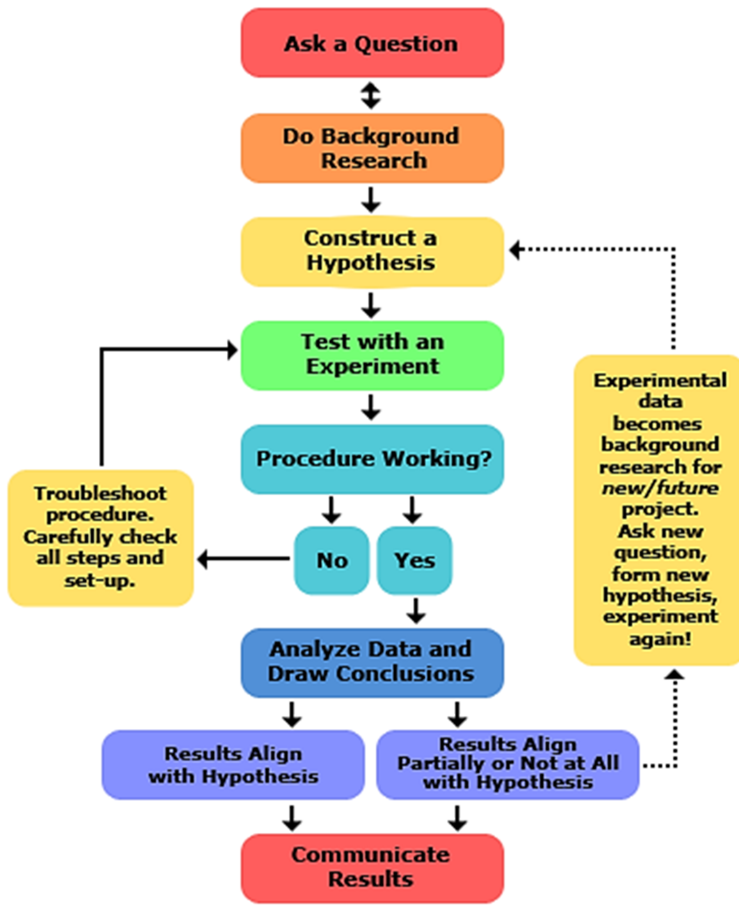
A thorough backtest, of course, ought to cover at least a year (though with replay it needn't take a year; you can cover a year in a few months, or even a few weeks). The comfort level that a trader attains by having backtested all market conditions is impossible to reach any other way. August does not trade like November does not trade like March does not trade like June. A couple of weeks, needless to say, just doesn't cut it. Those who try to get away with the minimum end up changing their trading plans to accommodate every curve ball that the market throws their way. In a few months, they have a real mess on their hands, so many rules that they wind up unable to act at all.

A thoroughly-backtested trading plan will cover the vast majority of contingencies. The market can and will come up with completely unexpected behaviors, but the trader who has backtested a year's worth of contingencies will recognize the unexpected for what it is and either stand aside or try to make the best of it. He will not alter his trading plan to accommodate something that may never reoccur.

There is also the forwardtest, which too many beginners skip, thinking that real-time trading is pretty much the same thing and will accomplish the same objective. It isn't and it doesn't. Those who skip it will experience far more failures in real-time trading and end up having to rewrite their plans again and again, which they will likely do rather than go through the backtesting again, which is what they ought to do instead.

How do you distinguish between backtesting and walk-forward testing, when both are on historic charts?

When you backtest, you're surveying or scanning from some point backward, right to left. You see the result and you want to figure out how that result was obtained. For example, if you find a trend day, where and how did the trend start? How was the activity different before and at the turning point from what it was during the preceding downturn/upturn or trading range? Once you've found what you think are the key elements that determined or at least affected the turnaround, you choose charts at random, and you either replay them in simulated real time or you cover them up and disclose the price points only one at a time, reading from left to right. Look for those elements which are part of your hypothesis. When you find them, see if they offer the desired result. If they do, keep going until you find another of your patterns. If they don't, determine where you went wrong in your hypothesis and try again. Once you have this, you'll be able to determine support and resistance and trend and trading ranges in real time. You will then be at a point where you can look at how to take advantage of this knowledge with minimum risk and make some money.


Ask a Question
Do Background Research
Construct a Hypothesis
Test with an Experiment
Procedure Working?
No
Yes
Troubleshoot procedure. Carefully check all steps and set-up.
Analyze Data and Draw Conclusions
Results Align with Hypothesis
Results Align Partially or Not at All with Hypothesis
Experimental data becomes background research for *new/future* project. Ask new question, form new hypothesis, experiment again!
Communicate Results

The most common error traders make when learning this approach is to try to determine where they should enter and where they should exit in order to make the most money with the least risk rather than determine what's going on with the traders involved in the trading activity that's occurring in front of them. Since they don't understand what's happening in front of them, i.e., they don't know what they're looking **at**, they don't know what to look **for**. So they guess. But whether the guess works out or not is irrelevant to their ultimate success -- or failure -- because there is no structure to their trading, no thoroughly-tested underpinning (e.g., they think price is in an uptrend, so they go long). However, they figure that as long as they keep making these guesses in more or less the same way, they are being "disciplined" and will eventually meet their objectives. Of course, it's always possible. Monkeys at typewriters. But it will take years, and they will more likely go broke before the light ever dawns. How much more efficient , and profitable, to do the testing in the first place.

If you can anticipate where price is most likely to break trend and move sideways or reverse and what it will do thereafter, you will be far more likely to profit from that anticipation than if you have no idea why traders are doing what they're doing and view all of this as a random sequence of events. For instance, one of the more important things you'll learn as a result of testing is that entering trades inside a trading range is riskier and less profitable than entering trades at the limits of that trading range. But this is something that you have to prove to yourself through testing, which is both risk-free and at-your-own-pace. If you decide instead to skip the testing and treat it as some sort of principle, you won't internalize it, and you'll violate it repeatedly, involving yourself in losing trades again and again.

Explaining all of this to someone who's in a hurry is much like talking to a post. If you yourself are in a hurry, the best I can do is to urge you to hurry as slowly as possible. Open up some old charts and see how much sense they make to you without guidance. If you're used to using bars and candles as indicators, convert the display to a line chart. Once you're able to understand the continuous flow of and interaction between trading activity and price movement, your chances of success will be much greater.

The Trading Log

As part of your journal, a trading log should be more than just bought here, sold there, made this, lost that. It should contribute to the record of your journey (“journey” -- ”journal”). If done correctly, a log will reveal **patterns**. Patterns of what you're doing right and what you're doing wrong and when and how often and under what circumstances. Patterns of the behaviors of those who are trading your stock (bond, fund, option, whatever). Patterns of the market you're trading, of its cycles, of its stages, of what works at some stages and in some cycles and not in others. It will reveal much regarding your trading. It will also reveal much regarding your “self”.

Addressing the questions asked in **The Trading Journal** and defining and testing the setup are only the preliminaries. Eventually, one starts trading, if only on paper, and that is where the log and journal can make the difference between success and failure.

A log is not just a record. It is also a plan. Before the first trade is ever made, even if only on paper, prepare for the day. Note any events that you should be aware of (reports, press releases, meetings, speeches, testimony, nuclear explosions, approaching meteors, etc). Write down reminders of any elements of the trading plan that you're having trouble with and what you intend to do about them, e.g., “don’t take any trades anywhere but at support or resistance” or “be wary of wide-range bars” (this may be necessary as early as the afternoon of the first day).

Above all, record your justification for each and every trade. Record your thoughts before, during, and after the trade, written in real time (your perception of what looks to you like a potential setup will change substantially after the “setup” resolves itself, and when you ask, later, “what the hell was I thinking?”, your record of your thoughts -- your "self-talk" -- will tell you, so that the next time, in real time, you’ll have a deeper and more rational perspective). This is more than just the reason for the trade (“It looked like it was going to go up”). It is more than the rationalization (“It was time for it to go up”). It is more than the mystic prompt ("I felt it was going to go up"). It’s the justification for it, the explanation that one would provide to one’s boss or client if he were trading for someone else. If everyone wrote down the reasons behind and justifications for every trade, their learning curves would be accelerated dramatically. And if writing all this down proves to be too much of a distraction from the screen, pick up a digital voice recorder from eBay for a few bucks.

At the end of the day, review your decisions, if necessary by "replaying" the day, a feature available in several charting programs. Did you make good trading decisions, i.e., did you follow your rules or not? If you followed your rules but made one or more losing trades anyway, do any of your rules need to be re-examined? If you didn’t follow one or more rules, which do you most often fail to follow? What’s the problem? What did you say to yourself at the time? What do you need to work on the following day? Always, what could you have done differently to improve the outcome? Can it be tested to find out if it's only an occasional anomaly or worth incorporating into the system?

And then you write down your detailed plan for the next day . . .