How to Implement the Trading Process

By Stuart McPhee

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Introduction

“Action is the foundational key to all success.”

Pablo Picasso (1881–1973)

I think it is really important that I set the scene right from the start. This ebook is not designed to teach you everything about trading. It is designed to help you pull all the pieces together into a workable solution that you can implement with some confidence.

My experience over the years is been that so many people have done extensive work in learning about trading related topics but really struggle to put the pieces together into a workable and robust trading plan.

The purpose of this ebook is to run you through what I believe is a very effective trading process. It provides you a framework for you to work with – some structure to your trading.

I believe trading is best done when it is considered as a process – a rules based activity.

So I still need you to put the pieces together but hopefully in accordance with my step by step process.

Having a Trading Plan

If you want to trade successfully, you need to develop and then follow a written trading plan that suits your personality.

All consistently profitable traders have a plan they follow, as successful traders understand the importance of having a plan to guide them in their trading actions.

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.

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.

Unfortunately, for a lot of people who start trading, success will be difficult to achieve. One wonders what the minority are doing right that gives them the advantage over the vast majority who leave the market with less money than what they had when they started trading.

Sadly, a lot of those who fail walk away with very little of what they had originally.

So, what is it that separates the successful from those who fail? If you ask anybody who has studied trading for any period of time, they will answer ‘psychology’. They will add that ‘your psychology’ is what will make or break you as a trader.

Essentially, your mental ability to manage losses and profits, the good times and the bad, your capacity for risk management, and the self-discipline necessary to avoid becoming too greedy are all subsumed beneath the heading of ‘trading psychology’, along with many other similar skills and abilities.

If we are naturally inclined to break all the time-tested trading rules, how can we overcome those natural tendencies and therefore control our mindset?

One of the biggest reasons that our mindset is such a determinant of our trading success is that our emotions influence our actions. Irrational emotions have little place in our trading; however, removing our emotions from our decision making is easier said than done.

It is our emotions that cause us to break the trading rules that have been proven to work over hundreds of years.

Your Trading Plan

Having a trading plan facilitates your decision making by helping to remove some of your emotions from the equation and, therefore, will make you trade more effectively. The best way to ensure you get the most from your trading plan is to write everything down.

I believe your trading plan should take into account three broad areas, as follows:

- your trading mindset (or psychology)
- your money management (position size, pyramid strategies, selecting exits etc)
- your trading method (requirements for trade initiation, filtering processes, daily routine and so on).

One thing I have experienced over the years is many people accept that a trading plan is an essential requirement to trading well, yet they don’t know where to start to put one together. I accept that it can be overwhelming at first to tackle this issue.

So, let me simplify this for you. There are three key decisions you need to make when trading and if we think in these terms and your trading plan answers each question, then you may have the makings of a simple yet robust trading plan.

Despite what I listed previously as the three broad areas in your plan, your trading boils down to the following three questions:

- Under what circumstances will you enter a trade?
- How much money will you commit to the trade?
- Under what circumstances will you close the trade?

Never picture your trading plan as a detailed document containing pages and pages of information because then it will overwhelm you and may deter you from compiling one in the first place. Think in the simple terms above and, once you have answered these questions, then you can add some detail to it as time goes by.

First, under what circumstances will you enter a trade? Let me provide a slightly alternative view to what our trading plan is designed to do. Many would agree that your trading plan and the method listed therein are designed to get you into the market.

My view is counter-intuitive as I believe my trading plan is designed to keep me out of the market.

There are theoretically an infinite number of trading opportunities every day. The vast majority of these do not fit our trading style and therefore our trading plan is constantly telling us not to initiate a trade.

If a currency pair or commodity makes it through your selection criterion, then it has done so for very good reason.

Next, is your position sizing. Remember, protecting your trading capital is the most important thing you can do. Determine your risk amount, your maximum limit for each trade and then determine how you will calculate how much money to commit to each trade.

Finally, the most critical part — and that is when to exit. Notwithstanding the importance of mindset and cutting losses, etc., from a technical standpoint, this would be the most common problem inexperienced traders have. The problem is not that traders don’t set initial stop losses, etc., but where they place them.

Developing your Trading Plan

“Give me six hours to chop down a tree and I will spend the first four sharpening the axe.”

Abraham Lincoln (1809–65)

In order to develop a trading plan that is right for you and suits your personality, a journey of self-discovery and introspection is required. As a starting point, you could conduct a self-assessment to determine the following:

- your own mindset and whether or not you are seriously committed to trading and to developing a sound trading plan
- your own goals and objectives in entering the market
- your own personal strengths and weaknesses (think about these attributes for starters: humble, motivated, commitment, in control, passionate, persistent, focused, flexible / agile, decisive, conservative and honest)
- your tolerance of risk
- your patience
- the amount of time you are prepared to commit to trading and the amount you can afford to commit
- your level of self-confidence
- your discipline
- whether it is possible to reduce the effects of distractions in the place where you make your trading decisions
- your ability to quickly accept losing trades and move on
- whether or not you can cope with an extended losing streak.

Following closely behind your mindset or psychology, the next crucial factor for your trading success is money management.

Ensure you have answered all of these questions thoroughly:

- What is your trading capital?
- What is your risk amount?
- How will you determine your position size?

- What is the maximum amount of your trading capital you are prepared to commit to a single position?
- What will be your maximum risk exposure at any one time?
- How will you determine your initial stop loss level?
- How will you determine your trailing exit level / take profit level?
- When and how will you pyramid into positions?
- After losing what percentage of your capital will you cease trading?

A few comments on managing your money. An important reason why many people fail in the markets is that they do not employ sound money management methods. This is for a whole host of reasons and often because they get too emotionally involved.

The bottom line is that money management will make or break you as a trader. This is a widely accepted fact. Proper money management rules have been proven over long periods of time and are not secrets to anyone.

The rules of 'keeping your trades small' and 'never averaging down' (adding more money to a losing trade), for example, have worked for hundreds of years, yet most people ignore them!

No matter what aims you may identify when first determining what you are setting out to achieve with your trading, all aims are secondary to your primary goal — preserving your capital. This is by far the most important aspect of successful trading. Simply stated, you need capital to trade.

'Trading to survive' is another way of expressing this primary goal. If you can survive, you can keep trading, and the longer you keep trading, the greater chance you have of success.

Most people don't realise how important it is that you protect your capital and, again, many people are not inclined to think about protecting it.

Finally, some questions regarding your methodology:

- What financial products will you trade on what market?
- Over what time frame will you trade and how will you identify trends?
- What technical and/or fundamental conditions will use to determine a trade entry?
- Will you trade 'at market' or 'at limit'?

Your decision to enter a trade is one of the first decisions you make when trading. However, it is also one of the least important. There are far more important issues, such as determining how large your trade will be (position size) and what your exit plan is.

Many people believe that if they spend most of their time determining an appropriate entry signal and making the decision to buy or sell, they increase their chances of having a profitable trade. This seems to make sense to new traders.

The two biggest problems people have with their entry signal is a lack of consistency and it being too complicated.

Unfortunately, many beginners undertake a ruthless search, even subconsciously, for the Holy Grail — the method that will guarantee unbelievable success and/or perfect trades every time.

At the very least, they will develop such a complex trading methodology, that even the trader who thought up the approach, will likely lose their place a few times should they describe it to you, with the belief that ‘more complicated must be better’.

Some of the most effective trading methods have very simple trading rules and entry criteria, and winning traders often use very simple techniques. Invariably they use either a modified version of an existing methodology or else they have developed their own.

It could be argued that the simplest of trading methodologies is easier to implement than complex techniques.

Winning traders will often use simple approaches and they will use them consistently. It could be argued that a poor plan, with solid risk management rules, used consistently is going to outperform an approach where you are constantly jumping from one method to another.

The Trading Process

Once you have all those items attended to, one of your final steps should be the compilation of all of your rules and conditions into a written trading plan. To facilitate the adherence to your trading plan, develop a routine (aka trading process) that will guide you through all the necessary steps and that will stop you being distracted by other matters.

I can assure you that your trading plan and routine will provide you with an edge over most market participants.

Your routine will be a logical progression from your written trading plan, and it will help you to adhere to your trading plan. You should aim to develop a routine that will guide you through all the necessary steps.

If necessary, you could write down your routine in the form of a list, in a logical sequence, and tick/check off every item as you complete it. This way you can be guaranteed to complete everything that you should.

The 7 step process I teach fellow traders is below. It is a logical step by step process that traders work through. This trading process provides traders some structure and a framework to work with. It has them focusing on what they need to be focused on.

Decision making heavily influences your trading success. Anything that can help you focus on the important decisions that need to be made should be considered. Again your written routine or checklist can assist greatly.

Another advantage of developing a routine is to assist with information management. An individual trader can easily be overwhelmed by the amount of information available, so your routine should reduce the likelihood of accessing information that is not relevant to your trading plan.

As an example, many reputable internet sites that offer market, economic and company news give you similar information. Why would you waste your time browsing all of them when there is no need?

Here it is … the Trading Process:

Step 1: Monitor and assess existing trades / adjust stops or exit where necessary

Step 2: Scan for potential trading opportunities

Step 3: Obtain shortlist from Step 2 and select trades

Step 4: Determine initial stop loss

Step 5: Calculate the trade / position size

Step 6: Execute the trades

Step 7: Do something else and let your trades run their course.

The Trading Process Explored Further

Step 1 – Monitor and assess existing trades

The amount of work required here will depend on your trading style. Some use complete automation with their trading once the trade is entered and therefore are content to allow trades to run their course.

This has actually provided traders a tremendous advantage over their predecessors from around 15 years ago when orders triggered automatically for you were not so commonplace.

Prior to these trade execution tools being available, you would have to manually close the trade, which opened the door for you to deviate from your plan. These tools can be quite advantageous as they can remove the emotional input you may otherwise have.

I don't use automation, and perhaps it comes from my conservative nature. I always wish to check how my trades are going – not every second, but in accordance with the usual implementation of this 7 step process.

Therefore whilst I am all for allowing trades to run their course and not interfere with them, I just want to check that all is OK – the trading platform is doing its job correctly and my stops are roughly where they should be.

This shouldn't take too long at all, if you even attend to this in the first place.

Step 2 - Scan for potential trading opportunities

This is obviously when you begin the process of looking for new trades.

Let me first talk about an important part of good trading, especially in selecting trades – consistency.

"Insanity: doing the same thing over and over again and expecting different results."

Albert Einstein

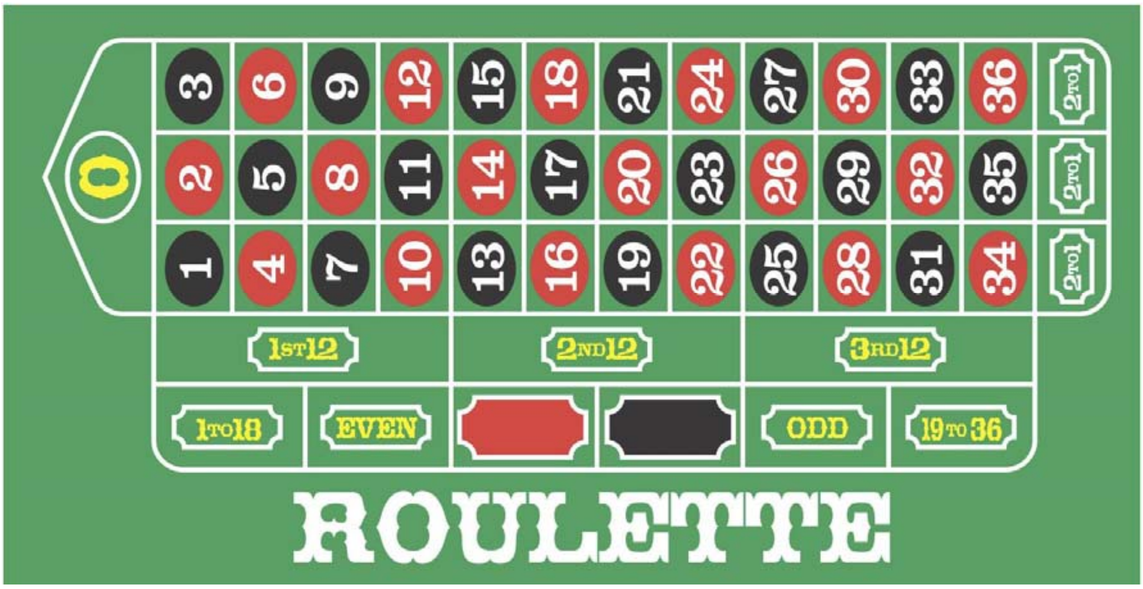
I always talk to people about my three C words with trading: consistency, comfort and confidence. Comfort in the level of risk you take with trades, confidence in yourself, your own ability and your trading plan, and consistency in your whole approach.

When I look at a chart, I could tell you within a second whether it is a likely opportunity or not. Why is that?

I know exactly what my strategy is and why I will enter a trade. I know exactly what it looks like on a chart, because I have seen it thousands of times.

What I want you to do is commit to mastering one trading setup and then executing it with great discipline and consistency. Take a mental picture of what your perfect setup looks like and burn that template into your mind. This will ensure that when you see a chart that doesn't match your template, you are able to eliminate it quickly.

I don't like to compare trading to gambling, although many people think that trading is exactly that; however, let me talk about consistency from a casino's point of view. Let's use the example of a roulette wheel.



As the roulette wheel and table include a zero and in some cases also a double zero (00), the odds are slightly tipped in their favour. The presence of the green squares on the roulette wheel and on the table are technically the only house edge; however, that is all they need.

The casino has an edge and they apply that edge with absolute consistency over an extended period of time.

For example, if you place a bet on one of the numbers, your payout is 35 to 1, i.e. 35 times your bet. However, the odds of you winning are 1 in 37 (assuming no double zero). Outside bets (i.e. if you place a bet on 1 to 18, 19 to 36, red or black, even or odd) will always lose when a zero comes up.

Do they make money every time the white ball is released onto the spinning roulette wheel? Of course not. However, over time, do they make money? Absolutely they do.

They have a set of rules which they know work and gives them an edge, and they apply those rules with absolute consistency – no exceptions! Casinos are the greatest exponent of consistency and we all know how well they do.

You need to strive for the same level of consistency where you place the odds in your favour. Trading randomly and using a variety of different entry setups does not come close to achieving this. You will end up on a never-ending journey of moving from one strategy to another to the next and so forth.

Being consistent means that when you see a potential trading opportunity that no longer meets your entry rules, you don't trade it. It doesn't matter if it is a classic break higher from an ascending triangle or the perfect moving average crossover that you read about on the weekend.

If it doesn't meet your entry conditions, move on.

I am not ashamed to admit that my trading style is a little boring, mainly due to this level of consistency; however, I am very comfortable with that tag. I have always said that trading won't deliver a great rush of excitement for the majority.

If you want to feel exhilarated, jump out of a plane. I don't think trading will provide it to you.

I know for a lot of people who start out and want to trade stocks, they struggle with identifying potential trading opportunities. They consider that there may be thousands of stocks listed on the stock exchange and don't know where to start. This can be a daunting experience.

One thing that greatly assists me with consistency with my stock trading is using software to filter out all those stocks that don't meet my criteria, leaving me with a small list to manually scan through.

This is a great time saver for me but it also greatly assists with the consistency, as I don't even look at a chart unless it has met my conditions.

I think this is one of the most valuable things a piece of software can provide. Many online trading services offer basic charting functionality, but one of the tools that separates dedicated trading software from many online services is the ability to scan through thousands of securities very quickly, therefore providing you with a small list rather than thousands.

This is why I have used MetaStock since 1999 – metastockaustralia.com – because of its ability to quickly sort the wheat from the chaff.

Having said that, some traders don't need such a tool if they are focussing on only a few items to trade. For example, forex traders may trade less than 10 currency pairs and therefore they don't necessarily need the ability to sort through all that data, they can easily look at 10 charts within minutes and identify any trading opportunities.

So with practice, this step won't take very long but it is obviously a critical part in delivering a group of high probability and high quality entry signals.

With regards to your trading universe – what is it and what should be in it?

Your trading universe is that group of financial products that you will routinely look for trading opportunities in.

One of my concerns with trading platforms available to the retail trader is the plethora of financial products available on the platform. These can easily number in excess of 10,000.

A trader with limited experience all excited about the new trading platform can easily be overwhelmed with the range of financial products available but also feel that any strategy will equally apply across any product. I don't believe this at all.

Just because you have a strategy that works well for gold, doesn't mean it will work well for sugar or cotton or the EUR/USD.

This can be a massive trap – it is too easy to be excited what products are available to you and it won't make much sense if I come in and tell you to ignore 95% or more of them.

What should be in your trading universe? It is obviously completely up to you. Will it be stocks, currencies, indices, commodities or a combination of all of these? If you are trading stocks, will you use a leveraged product to do so or just trade the stocks themselves?

If you use leverage for any product, what leverage amount will you use? Does your trading platform allow you to alter this? Should you have conditions in your trading plan that force you to make changes to your leverage amount?

What have I seen?

I have seen people who will trade anything out of 1000+ stocks, down to someone who only trades 1 index. Some will just trade currencies and similarly will only trade 1 currency pair. Most FX traders I know will have a small group they look at, perhaps 8-10 currency pairs.

Once you have clearly identified your trading universe and your trading strategy you will use to identify your high probability trading opportunities, you can then work your way through the universe looking for opportunities that meet your criterion.

If you find a trading opportunity on your first chart, you don't stop and trade it. You keep going through the entire universe looking for anything that meets your criterion. Once you have worked your way through your universe, you will hopefully have a short list to work with.

Every financial product on the short list should meet your criterion – how strict you are with the criterion is up to you, but I know what I prefer.

Obviously it is difficult to manually look through 500 – 1000 charts so obviously the best option in this situation is to use some software like MetaStock. Having only a handful of indices or currency pairs to look through, you may not need it.

Depending on your trading style, you may routinely work through step 2 and not find any opportunities. This is par for the course as far as I am concerned, as this has been my experience over and over again.

If you yearn for excitement and activity in your trading, then you are likely to develop a strategy more likely to deliver opportunities on a more regular basis – whether that be a good thing or not.

I would like to provide a little more information of how to develop your trading strategy in the first place, in relation to time frame. Choosing your trading style / time frame is very important and yet often misunderstood.

Trading Style and Time Frame

With all of that in mind, it comes to the crunch where you will need to decide on your trading style. This is very important and is definitely a problem new traders have. If you don't decide on a particular trading style, it will be difficult to create specific trading rules and commit to them.

It will also be difficult to be consistent and you will find yourself making up your rules as you go along.

Even though it isn't obvious, one of the first things you need to assess is how much time you have available to commit to your trading. This is critical and would be one of the most overlooked factors when people begin devising their trading style.

Can you spend several hours every day digesting trading data or only a limited time during weekday evenings and some time on the weekends?

For example, if you have only a little time during the week to trade, then you will find it almost impossible to trade diligently using very short-term trends, due to the amount of time this would demand of you.

Generally speaking, the potential for returns in short-term trading is greater than those with medium- or long-term trading approaches especially when derivatives are included in the trading, hence the attraction to this style of trading.

As people are generally infatuated with money, they are naturally drawn to short-term trading because of the very real possibility of achieving good returns quickly.

If you cannot afford the time, however, you will find yourself cutting corners and not following your plan adequately. In this scenario, unfortunately, the chances are that you are on the road to failure, as you have not developed an approach that is right for you.

Short-term trading by its very nature demands constant attention and a reasonable amount of your time during the trading week in order to monitor open positions, adjust stops, conduct analysis and make your trading decisions.

Furthermore, new traders who begin trading short term often do not have sufficient capital to make it worth their while. They cannot tolerate losing months and the capital drawdown, and the high number of transactions results in a lot of commissions being paid, which can affect the bottom line considerably.

In short-term trading, derivatives may be used to counter the lack of equity; however, the degree of skill, discipline and risk management to trade these successfully is far greater, further reducing the chances of long-term success for beginner traders.

The derivatives enable you to benefit from the price movements over such a short period of time, as well as allowing you to trade in both directions, i.e. trade long and short.

You can also assess your patience. This will also have an influence over the time frame you select for your trades. If you are an impatient person then you will find it hard to wait for medium-term trends to develop before entering a position.

You will be wondering why you didn’t get into the stock two weeks earlier, when you knew it was starting to head up, rather than waiting for the level of confirmation that most medium-term traders require.

Assuming you have considered those couple of factors, looking at Table 1 below and using the right hand column, you need to decide on what your ideal or typical duration of a profitable would be. From that, you can categorise that time frame as a particular trading style.

Trading Style	Average Profitable Trade Duration
Very Very Short Term	Minutes to Hours
Very Short Term	Hours to days
Short Term	Days to weeks
Medium Term	Weeks to months / years

Table 1 – Trading Styles

It is important to identify your trading style as many decisions stem from this. For example, this may determine the periodicity of the charts you use. Refer to Table 2 as a guide.

Trading Style	Chart Periodicity
Very Very Short Term	1 min, 5 mins, or 15 mins
Very Short Term	1 hour, 2 hours, or 4 hours
Short Term	1 hour and / or daily
Medium Term	Daily and / or weekly

Table 2 – Chart Periodicity

Furthermore, the way you identify trends and how you set your stops will also be determined by your trading style. Regardless of your trading style, you should still follow the time tested trading rules – the way you apply the rules will slightly differ with each style.

Trading Strategy Structure

Within your plan, you will have to write down the specific rules which present you with a trading opportunity. When defining these requirements for trade initiation, traders use terms like signals/triggers and conditions/filters.

A signal (or trigger) will be a single event that generates a trading opportunity signal for you. Simple examples of this include two moving averages crossing over, a break higher from an ascending triangle, a significant candlestick pattern, or indicators crossing through relevant reference lines.

This list is theoretically infinite.

However, not all signals present us with high-probability opportunities; therefore, you don't trade every single signal. We need a process of methodically removing all the poor signals, and we do that by using conditions (or filters).

Conditions are another part of your entry decision. Your conditions will generally be trend-based, because you want to ensure you only trade with the trend.

You may get several signals when looking at a stock; however, a signal is not valid unless it is accompanied by your underlying conditions being present as well.

Simple examples of a condition could be that the price must be trading above its 30-day simple moving average and must have been doing so for at least the last five trading days, or you require a certain level of liquidity or volatility.

The combination of a signal and all filters results in a valid trading opportunity, commonly referred to as a valid trading setup. Traders only ever enter the market once a signal has been validated.

So when you develop your own trading strategy, think in terms of your signal and underlying conditions, and write them down in your trading plan accordingly.

I firmly believe in keeping the entry requirements simple. I have seen people with the sort of elaborate entry criteria that I would not even be able to dream up, let alone comprehend. Whatever your entry requirements, document them in your trading plan. Speaking of which …

Keep it simple!

"Simplicity is the ultimate sophistication."

Leonardo da Vinci

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 strategies, believing that a complex solution is required. Unfortunately, this is often not the case and they end up travelling down the wrong path.

Unfortunately, some beginners then undertake a ruthless search, even subconsciously, for the Holy Grail — the method that will guarantee unbelievable success and/or perfect trades every time.

Furthermore, many traders will dismiss simple entry strategies, because they are convinced that trading is difficult. Consequently, a simple approach can't possibly work.

I have had clients take more than 10 minutes to explain their entry signal to me. After two minutes, I am already starting to shake my head inside. I believe that we like to complicate things and our entry signal is no exception.

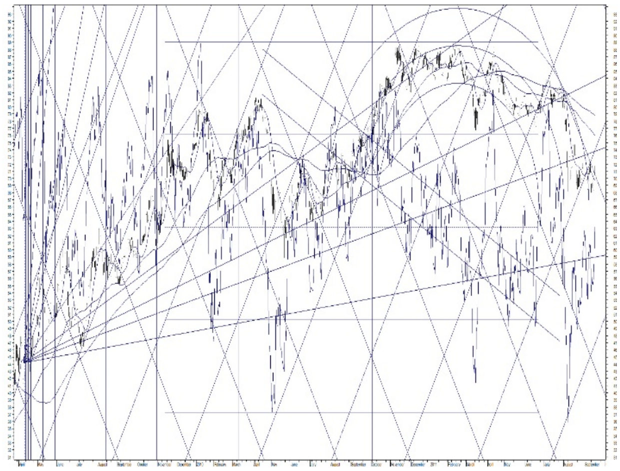
Examples I have heard involve numerous indicators crossing each other at various angles and changing colours and all sorts of trivial conditions.

If I were to take these clients' notes away from them, they wouldn't be able repeat 20 per cent of their entry signals. This is a concern.

I firmly believe in keeping the entry requirements simple. I have seen people with the sort of elaborate entry criteria that I would not even be able to dream up, let alone comprehend.

There is definitely a natural tendency to complicate things in trading. Indicators are perfect for that as you can place so many on a chart and have lines go in every direction, that you lose sight of the price.

I have seen too many people have charts open which resemble the chart below. In my opinion, this isn't trading or technical analysis, it is playing with software.



Some of the most effective trading methods have very simple trading rules and entry criteria, and winning traders often use very simple techniques; however, they will use them consistently.

It could be argued that a poor plan, with solid risk management rules and used consistently, is going to outperform a trading approach where you are constantly jumping from one strategy to another.

So, if you don't take on board anything else that I have suggested, whatever you do, please keep your entry signal simple. Your entry signal is one of the least important decisions you make, yet people have a natural tendency to make it unnecessarily complicated.

Generally, two big problems that traders face are not having a trading plan or, if they do have one, not following it. There is no need to complicate things beyond simple comprehension. One thing I have learned about trading plans is that the easier they are to understand, the more likely you are to follow them.

My entry signal is very simple and it works for me. One thing I gain a great deal of confidence from is that my exit signals and position sizing are robust and solid and ensure the more important ingredients of my trading success are well managed.

There are different types of financial instruments available for us to trade, including stocks, foreign exchange, indices and commodities, and derivatives of them. All these markets have their own characteristics and best ways of trading them.

Variations in your strategy to trade these other products could include the periodicity you use to chart prices and identify trends, or the chart patterns that you may find effective, for example.

The reality is that there are theoretically an infinite number of possible entry signals or trading strategies. There are many strategies widely available through books and websites.

You could massage them a little to make some changes or to include other analytical approaches like using chart patterns, indicators, or considering support and resistance. These topics have equally been well covered over the years.

Step 3: Obtain shortlist from Step 2 and select trades

Following on from step 2 is to choose the best candidates from your shortlist. Remember your shortlist may have no trading opportunities – zero. Which of course means you are done. 'NFA' – aka, no further action.

You may routinely only have 1 trading opportunity presented to you, which makes this step redundant. Or you may have more opportunities presented to you than your risk management rules allow you to take.

In this case, we need to select the best trading opportunities.

This is hard to do and really just comes down to you making a decision on what is an important factor in your entry strategy and ranking the candidates on that. This may change over time as you learn more about your trading strategy.

The reality is you will often choose a candidate and yet other potential opportunities will end up moving far better – this is going to happen whether you like it or not.

Step 4: Determine initial stop loss

I believe one of the things that separates successful traders from the rest of the market is that they have a clearly defined plan for getting out of a trade, whether it be at a loss or a profit. The planning and execution of exits is far more important than the planning and execution of entries.

While trading routinely involves decision making, there is no more important decision you have to make than when to exit or close a trade. Many traders often overlook this part of trading or underestimate how important it is.

It is closing trades that determines whether or not you make any money trading. Entering the trade is simply a means of putting yourself in a position to make money trading.

Hopefully, one of the things that will separate you from the majority of market participants is that you will have a detailed plan that will guide you as to when to exit. This is essential.

A couple of major points I want to pass on:

- Closing trades to cut our losses is critical
- we can easily be influenced to make the wrong decisions by our irrational emotions

A 'stop loss' is a predefined level at which you will exit a trading position, when it is obvious that the price is not heading in the direction you had anticipated. Setting stops and then adhering to them is absolutely essential to your survival as a trader.

One thing that people like is certainty — in fact, we yearn for it on a regular basis in life. However, there is never any certainty about how our trades are going to turn out. We need to prepare ourselves for a losing trade and ensure we do everything we can to protect our capital — we do this by minimising our losses.

There are a number of different ways of calculating stop loss levels and they all have their own inherent advantages. A number of factors will influence the type of stop you use. These include:

- your tolerance to risk
- your trading objectives
- your trading style / time frame over which you trade

Whilst I don't formally mention it in the trading process, at some stage here you will need to determine your exit strategy in the event of a profitable trade.

Traders are often divided here – do they use trailing exits or profit targets? I personally use both but I also know when which one is most effective.

Generally speaking I believe that trailing exits are used well with stocks and a combination of both for everything else. Many will disagree with that but that is what I believe.

The term 'trailing exit' refers to an exit level trailing the price by a set amount as the price moves. If the price reverses, the trailing exit locks in and is in a position to 'catch' the price should it fall down to the exit level. If this happens, take it as a signal to close the position.

If the price does not move to the exit but continues upwards again, the trailing exit also continues to follow behind the price.

Of course it is the opposite for a short trade.

It is imperative that there are steps in place to ensure you maximise your profits. You should not take profits too early. The notion that 'you'll never go broke taking a profit' is wrong.

In fact, this is exactly the reason why a lot of traders do go broke: they take their profits too early and don't let them run so that they can sufficiently offset their previous losses.

Successful traders want to give price room to move, in order to see how far it can take them, whereas many traders are too quick to grab a profit in fear of losing it all.

However many traders use profit targets with particular financial products which are more conducive to using them. A profit target is a predetermined point at which a trader will exit a trade in a profitable position.

It is a variation on the trailing exit method as it doesn't wait for a level to be reached and then catch the price on the way back towards your entry.

Opponents of profit targets will argue that you are not quite following the time-tested trading rule of 'letting your profits run'. You are limiting the profit by cutting the trade short.

A common method for determining a profit target level is to use a multiple of your initial stop loss distance. The letter 'R' is often used to explain this concept as well as reward to risk ratios.

For example if your stop loss distance is 50 points, you may set a profit target at either 75 or 100 points (i.e. 1.5 or 2 multiplied by the initial stop loss distance).

This is when your trading becomes a mathematical game as you explore average loss versus average profit and winning / losing trade percentages.

The reality is exiting trades appropriately is critical to long term success. Poorly planned and executed exits are frequently identified as one of the main reasons why so many traders fail.

It is often suggested that it is not your entries that determine whether you make money or not, it is your exits. Your exit signals must be clearly defined to make it easy for you to act on them.

As far as I am concerned, there is no trading rule more important than 'cut your losses'. If you have a firm exit plan in place and implement this rule, following through confidently, decisively and without hesitation, you will be well on your way to trading successfully.

Step 5: Calculate the trade / position size

Practically everyone knows the old saying about not putting all your eggs into one basket. This rule definitely applies to trading.

One of the best ways to manage your risk in your trading is to limit or set a cap on the amount of money you put into a single position. This is to guard against the possibility of adverse events.

This limit could be expressed as a percentage of your capital or a set amount and once set, it should not be broken, regardless of how confident you are about a particular trade.

Before you start trading, you will need to determine your 'risk amount'. This is the amount you are prepared to lose every time you open a position. This decision is an essential part of risk management. Your risk amount forms the basis of your position sizing, which is to be explained shortly.

A commonly presented view is to not risk more than 2% of your capital on any position. What this means is that every time you open a position, you are prepared to lose 2% of your trading capital and no more. Some present a view of a higher percentage for trading styles that may only have one trade open at a time.

'Position size' is the amount of money you commit to a single position or trade, and the process of determining what this amount will be is known as position sizing.

Your position sizing will ensure that, regardless of how far your initial stop is from your entry, you should never lose any more than your risk amount in any position. Remember, preserving your capital is the primary aim of trading and, if you do not manage risk, you will fail.

A further precaution you could take to manage your risk in the markets is to ensure that you have only a certain percentage of capital at risk at any one time across all open positions.

For example, this limit may be set at 6 per cent. In this case, if you have three positions open simultaneously (2 per cent risk in each), where the initial risk amount is still at risk (that is, you have not moved your stops up to protect an unrealised profit), then you should not open a fourth position until one of the others has closed or moved into a profit.

There are a number of different ways of determining position size, most of which take into account your risk amount. A simple way of doing this is to divide your trading capital into equal amounts and commit that amount to every trade.

This is known as the equal portion method and does not consider the risk associated with each individual trade.

I use a very simply yet robust position sizing model which basically uses the risk amount and the distance to stop, incorporating my currency exposure per pip / point.

You need to use something and stick with it. Again, having software to calculate this for you clinically and objectively is advantageous.

<< The Altitude Trading System within my official MetaStock 'Trade Launch Systems' add-on has position sizing calculations within the Expert Advisor >>

Step 6: Execute the trades

Generally, your orders will be placed either 'at market' or 'at limit'. If you are a buyer (or going long), the order 'at market' implies that you are prepared to pay the market price as listed on the trading screen; if you are a seller (or going short), it implies you are prepared to receive the market price for the product you are trading.

Normally, an 'at market' order ensures that your order will be completed, whereas with an 'at limit' order there is no guarantee that your order is going to be completed either in part or full.

This is especially the case if you place your order a couple of levels above or below the current market price and it moves away from you.

With this in mind, those who are exiting a position at a loss may be better served by placing their order 'at market' to ensure the order is completed straightaway.

Numerous trading platforms may have their own type of orders you can use like profit targets and 'on stop' or 'buy stop' orders; however, they are all variations on either at market or limit orders. It is best to investigate the use of each of these orders with the respective trading platform provider.

A thorough comprehension of the manner in which your own broker / trading platform handles all buying and selling orders is important, and will ensure confidence when placing orders.

The system really is quite simple; however, I am amazed at the number of people I meet who do not fully understand how the trading system works or how ‘at limit’ and ‘at market’ orders are processed.

I have known people who have lost money simply because they were ignorant of how their order was going to be processed. For example, they placed a trade to exit a position at a loss and assumed that the entire parcel was being sold.

However, due to insufficient liquidity at the market price, only half the position was sold as the sell order was processed, with the balance remaining waiting to be sold at the market price.

The price then continued to move lower, leaving the remainder of the parcel sitting there unsold as the price moved further away, resulting in a greater loss.

The advantage of dealing only in a regulated exchange is having confidence that your orders will be handled the same way every time, with full transparency. Yet, some people don’t take the time to learn how the trading system works.

Don’t let this lack of knowledge cost you money with any of your trades. Traders who don’t know precisely how their order will be handled may lose money as a result of this ignorance.

Step 7: Do something else and let your trades run their course

I still remember taking my very first trades. I was fixated on the price for the immediate future. I would press ‘F5’ on my keyboard so often to refresh the price in my browser so I could keep on top of the price and my trade.

I wanted to make sure I had made the right decision with my trade entry.

In the first 10 seconds, I swear I would have pressed ‘F5’ 15 times - how silly!

However I thought that’s what trading was – watching your trades and being ready to spring into action and respond to changes in the market.

If I was long and the price ticked down, I would immediately slump and feel down.

If it ticked up, I was excited but then quickly disappointed that I didn’t have a larger trade on.

I would go on this rollercoaster of emotions in my trade – all within the first five minutes!

What is my point?

Leave your trade alone – you are the weakest link. Please don’t interfere.

Allow your trades to run their course and for the rules to do what they are supposed to do – protect you from making silly decisions.

I will concede that this becomes far easier with more experience. I know that the last thing you feel like doing in your early trading days is completely ignore your trade – you will always want to sneak a peek.

Implementing this Process

Hopefully the Trading Process is able to provide you some structure to your trading activities. The final important question is how often do you run through it and how long will it take?

If you think back to the tables I provided on what periodicity your charts should be, I think that gives you a great guide as to how often you would work your way through the process.

If you trade daily charts, go through the Trading Process once per day. I don't see the need to run through your process any more often that the time frame / periodicity of your charts.

You may also schedule some actions that you perform weekly and monthly; for example, a systematic review of past trades, accounting etc.

Why do we need a process to work through? For consistency and efficiency.

The first time you work your way through the Trading Process, it will take you a long time. The next time you work through it, it will take you a long time minus five minutes. Next time? A long time minus ten minutes.

You get the idea?

The more you work through it, the easier and more efficient it becomes. You are working you way through a methodical process / system to trade well.

This is what good traders do – they don't trade randomly and indiscriminately.

Guidance for new traders

- Be humble — you are not going to get every trade right. In fact, you will be proven wrong very often.
- Be committed — trading is not easy and any half-hearted attempts will get you nowhere.

- Educate yourself — there is so much to learn and while you can learn from actually trading, you can save yourself a lot of money and stress by learning from someone else who has come before you.

- Take it slowly/be patient — trading success is not going to happen overnight. For most people, this is a life-long endeavour, so it doesn't really matter if it takes you a few years to start trading profitably.

- Keep it simple — people have a tendency to overcomplicate matters and develop intricate and complex solutions to problems. When we accept that trading is not easy, we think only a complex solution (trading plan) will work. In trading, simple does work. It also makes it much easier for us to follow the plan when it is simple.

- Be realistic — having high expectations of yourself is a good thing; however, having unrealistic expectations is not. Many traders when presented with the wonderful opportunities that the market offers can be very easily led to setting unrealistic goals for their trading. This can be devastating. It is vital to set yourself goals with your trading but it is equally vital to ensure that those goals are measurable, and realistic.

- Focus on the right things — don't focus too much on your entry signal, as most people do. Keep it simple and then move on to the more important areas such as position sizing, setting exits and preparing your mind for successful, disciplined trading.

- Whatever you do, protect your capital — it goes without saying that if you have no money left, you can't make money. This is an important issue because any new trader is not focused on protecting their money: they are focused solely on making money!

Conclusion

I would like to finish off by providing some final words of wisdom and guidance on where to go from here.

I have had some amazing experiences over the last 10 years travelling around the world to trading events, especially throughout South-East Asia. One of the images that sticks in my mind is seeing the Petronas Twin Towers in Kuala Lumpur, Malaysia, all lit up at night — they are simply spectacular!

They rise eighty-eight storeys and for a few years held the title of the tallest buildings in the world. The walk on the skybridge on the forty-first floor is amazing, as it provides stunning views. By looking upwards, you can really gain an appreciation of how tall the buildings are.

Take that thought to Dubai which I visited on my way back from speaking at an expo in London, and the Burj Khalifa – I have never seen anything like it.

What do they have to do with trading? Despite the visual stimuli they provide, the most important part of those buildings is never talked about and never seen.

Furthermore, when the planners began the massive task of planning and building the towers, what do you think would have been one of the first things they dealt with?

Of course, I am talking about the foundations. We never think about them because we never see them.

Any flaw with the foundations may have serious consequences above ground. The same can be said about our trading.

A rarely considered part of trading is laying the right foundations. Stocks are and always will be the easiest product to trade; therefore, they provide the ideal starting point for new traders.

Yet, it is amazing how many people switch to a more difficult product after finding they can't trade stocks profitably. 'Well I can't trade stocks, so I will try something else', is a common thought.

The reality is that if you cannot trade stocks well, then you have less chance of trading more difficult products profitably.

Other leveraged products that seem to attract people are things such as futures, options, contracts for difference (CFDs) and more recently foreign exchange (FX). What isn't helping this is how easy it is to trade these products.

Ten years ago, very few individual traders traded FX, yet now it is very easy to establish an account and then execute trades from anywhere.

While these leveraged products all offer greater potential for reward, with this comes the certainty of far greater risk, and therefore the possibility of you losing your money. My experience is that not only do people lose their money switching from stocks prematurely, but they lose more of it and more quickly.

It is a natural step to tackle leveraged products at some stage in your trading career, but I believe the best way to approach this is to lay the foundations first.

Develop your trading plan for stocks, execute that plan with confidence and along the way develop the essential personal attributes, such as decisiveness and discipline, and hone your technical skills.

Once you have done this for an extended period, only then should you consider expanding your repertoire, and moving onto more difficult products that provide you with a greater potential for profit.

If you wish to trade consistently well for the next ten, twenty, thirty years or more, spending three years at the beginning laying the solid groundwork isn’t a great deal of time, in my opinion.

My message to you here is quite simple ... please lay the foundations first before you consider trading products that offer greater potential for profit, but equally higher risk. Reward is only potential while the risk is certain.

Finally, it is critical for you to convince yourself of the importance of having a trading plan. If you don’t, you have already severely reduced your chances of trading success.

All consistently successful traders have a plan — how anyone could possibly think otherwise is beyond me.

Accept that not only having a trading plan is a key but also that executing that plan with discipline is a cornerstone of trading success. If you know you lack discipline and want to trade, identify this as a weakness and work on it.

I am convinced that I will never stop learning about the markets, trading and the way I react to certain situations in the market. Learn constantly and always seek new ideas.

Remember, your mind is like a parachute — it is only good when it is open!

When reviewing your trades, if you find that you have followed all your rules, then feel proud of yourself, because that is exactly the right thing to be doing. If you lose money in a trade after following all your rules, then feel prouder because, in the long term, this is the right thing to do.

If you find yourself breaking your own rules, seriously ask yourself why you are doing so. The rules should underpin your trading and keep you on the right track to profitability by protecting you.

Finally, have confidence in yourself and don’t listen to tips. Remember the saying, ‘Think you can or think you can’t — either way, you are right!’ Follow the rules, develop a plan that is right for you and stick with it!

I hope you have enjoyed my ebook.

Please feel free to send me a message through stuartmcphee.com

About Stuart McPhee

Author of the best selling book ‘Trading in a Nutshell, 4th Edition’ (John Wiley), Stuart has personally coached high net worth traders from all over the world.

Stuart regularly appears on Sky Business in Australia and Channel News Asia in Singapore providing commentary on the currency market.

His practical, time-saving strategies have been distilled into his exclusive new MetaStock add-on ‘Trade Launch Systems’. This versatile new add-on includes the Altitude and Ignition Trading Systems, as well as 20 indicators.

Please visit stuartmcphee.com