Commodity Futures Trading for Beginners

Contents

Introduction

Commodity Trading As An Investment Vehicle

The Risks of Trading

The History of Trading

The Trading Process

Making A Trade

The Truth About the Commodity Markets

Separating the Winners and Losers

Learning To Trade Correctly

Elements of a Successful Trading Plan--Getting Started

Elements of a Successful Trading Plan--Trade With The Trend

Elements of a Successful Trading Plan--Cut Losses Short

Elements of a Successful Trading Plan--Let Profits Run

Elements of a Successful Trading Plan--The Markets You Trade

Elements of a Successful Trading Plan- Manage Risk

Psychological Pitfalls

Introduction

Many people have become very rich in the commodity markets. It is one of a few investment areas where an individual with limited capital can make extraordinary profits in a relatively short period of time. For example, Richard Dennis borrowed $1,600 and turned it into a $200 million fortune in about ten years.

Nevertheless, because most people lose money, commodity trading has a bad reputation as being too risky for the average individual. The truth is that commodity trading is only as risky as you want to make it.

Those who treat trading as a get-rich-quick scheme are likely to lose because they have to take big risks. If you act prudently, treat your trading like a business instead of a giant gambling casino and are willing to settle for a reasonable return, the risks are acceptable. The probability of success is excellent.

The process of trading commodities is also known as futures trading. Unlike other kinds of investments, such as stocks and bonds, when you trade futures, you do not actually buy anything or own anything. You are speculating on the future direction of the price in the commodity you are trading. This is like a bet on future price direction. The terms "buy" and "sell" merely indicate the direction you expect future prices will take.

If, for instance, you were speculating in corn, you would buy a futures contract if you thought the price would be going up in the future. You would sell a futures contract if you thought the price would go down. For every trade, there is always a buyer and a seller. Neither person has to own any corn to participate. He must only deposit sufficient capital with a brokerage firm to insure that he will be able to pay the losses if his trades lose money.

In addition to speculators, both the commodity's commercial producers and commercial consumers also participate. The principal economic purpose of the futures markets is for these commercial participants to eliminate their risk from changing prices.

On one side of a transaction may be a producer like a farmer. He has a field full of corn growing on his farm. It won't be ready for harvest for another three months. If he is worried about the price going down during that time, he can sell futures contracts equivalent to the size of his crop and deliver his corn to fulfill his obligation under the contract. Regardless of how the price of corn changes in the three months until his crop will be ready for delivery, he is guaranteed to be paid the current price.

On the other side of the transaction might be a producer such as a cereal manufacturer who needs to buy lots of corn. The manufacturer, such as Kellogg, may be concerned that in the next three months the price of corn will go up, and it will have to pay more than the current price. To protect against this, Kellogg can buy futures contracts at the current price. In three months Kellogg can fulfill its obligation under the contracts by taking delivery of the corn. This guarantees that regardless of how the price moves in the next three months, Kellogg will pay no more than the current price for its corn.

In addition to agricultural commodities, there are futures for financial instruments and intangibles such as currencies, bonds and stock market indexes. Each futures market has producers and consumers who need to hedge their risk from future price changes. The speculators, who do not actually deal in the physical commodities, are there to provide liquidity. This maintains an orderly market where price changes from one trade to the next are small.

Rather than taking delivery or making delivery, the speculator merely offsets his position at some time before the date set for future delivery. If price has moved in the right direction, he will profit. If not, he will lose.

In his book *The Futures Game*, Professor Richard Teweles explains the functions of the futures markets: "In addition to reducing the costs of production, marketing and processing, futures markets provide continuous, accurate, well-publicized price information and continuous liquid markets. Futures trading is [thus] beneficial to the public which ultimately consumes the goods traded in the futures markets. Without the speculator futures markets could not function."

Since speculators perform the valuable functions of providing liquidity and assuming the risk of price fluctuation, they can earn substantial returns. The potentially large profits are available precisely because there is also a risk of substantial loss.

top

Commodity Trading As An Investment Vehicle

There are many inherent advantages of commodity futures as an investment vehicle over other investment alternatives such as savings accounts, stocks, bonds, options, real estate and collectibles.

The primary attraction, of course, is the potential for large profits in a short period of time. The reason that futures trading can be so profitable isleverage.

For instance, if you had a $10,000 futures trading account, you could trade one S&P 500 stock index futures contract. If you were going to buy the equivalent amount of common stocks, you would currently need about $350,000, thirty-five times as much.

Let's say you decided that the stock market was going to go up. You could invest $350,000 and buy individual stocks equivalent to the S&P index, or you could buy one S&P futures contract. Buying a futures contract is the same as betting that the S&P index will go up.

If you had made your move on the first trading day of September, 1996 and held your position for two weeks, your common stock position would have been worth about $20,000 more than when you bought it, a gain of about six percent. Not bad for only two weeks. If you had taken the futures route, however, you would have made the same $20,000, which would have been a 200 percent gain on the $10,000 margin required in your futures trading account.

That is an actual example of the tremendous returns you can earn in a short period of time trading futures. Of course, you can lose money just as fast if you trade in the wrong direction. Suppose you had thought the stock market was about to go down and you had sold a futures contract instead of buying one. If you had valiantly held it for two weeks, you would have lost $20,000. That's a good example of why you must exit your trades quickly if they start to move against you.

Another advantage of futures trading is much lower relative commissions. Your commission on that $20,000 futures trading profit would have been only about $30 to $50. Commissions on individual stocks are typically as much as one percent for both buying and selling. That could have been $7,000 to buy and sell a basket of stocks worth $350,000.

While profits can be large in commodity trading, it is not easy to make consistently correct decisions about what and when to buy and sell.

Commodity speculation offers an important advantage over such illiquid vehicles as real estate and collectibles. The balance in your account is always available. If you maintain sufficient margin, you can even spend your current profit on a trade without closing out the position. With stocks, bonds and real estate, you can't spend your gains until you actually sell the investment.

As you will see, commodity trading is not particularly complicated. Unlike the stock market where there are over ten thousand potential stocks and mutual funds, there are only about forty viable futures markets to trade. Those markets cover the gamut of market sectors, however, so you can diversify throughout all important segments of the world economy.

In futures trading, it is as easy to sell (also referred to as going short) as it is to buy (also referred to as going long). By choosing correctly, you can make money whether prices go up or down. Therefore, trading a diversified portfolio of futures markets offers the opportunity to profit from any potential economic scenario. Regardless of whether we have inflation or deflation, boom or depression, hurricanes, droughts, famines or freezes, there is always the potential for profit trading commodities.

There are even tax advantages to making your money from futures trading. Regardless of the actual holding period, commodity profits are automatically taxed as sixty percent long-term capital gains and forty percent short-term capital gains. The current maximum capital gains rate is thirty-three percent, somewhat less than the maximum rate for ordinary income. To the extent that capital gains tax rates are reduced in the future, commodity traders will benefit. If a distinction is re-established so that taxes on long-term gains are lower than on short-term gains, commodity traders will benefit.

top

The Risks of Trading

Before becoming too excited about the substantial returns possible from commodity trading, it is a good idea to take a long, sober look at the risks. Reward and risk are always related. It is unrealistic to expect to be able to earn above-average investment returns without taking above-average risks as well.

Most people are naturally risk averse. They don't like to take big risks, especially financial risks. Perhaps you can relate to the point of view of humorist Will Rogers: "I am not as concerned about the return on my money as I am about the return of my money."

Commodity trading has the reputation of being a highly risky endeavor. It is true that a high percentage of traders eventually lose money. Many people have lost substantial sums. There is a famous old line about the best way to make a small fortune trading commodities . . . start with a big one.

However, commodity trading's reputation as a highly risky activity is somewhat undeserved. Think of yourself walking into a gambling casino in Las Vegas or Atlantic City. You decide to play roulette. The table has a $5 minimum bet and a $5,000 limit, which happens to be your total bankroll. If you place a $5,000 bet on red, you should not be surprised if you immediately lost your $5,000. On the other hand, if you made only $5 bets, you could play for a long time and probably not lose very much at all.

Commodity trading is the same in the sense that the individual is the one who decides how he wants to operate. He can make large bets or small ones. One can trade commodities carefully and risk as little as $100 or $200 on a trade. You could trade a long time this way and only lose a few thousand dollars. However, most people are not that patient. The unfortunates who lose big are those who can't control themselves. They take big risks in an attempt to get rich quick. Another way to lose big is blindly to turn your money over to others to trade such as brokers or money managers.

One of my favorite quotes about trading comes from trading psychology expert Mark Douglas. As he points out, most of us are not as willing to take financial risks as we think: "Most people like to think of themselves as risk takers, but what they really want is a guaranteed outcome with some momentary suspense to make them feel as if the outcome had been in doubt. The momentary suspense adds the thrill factor necessary to keep our lives from getting too boring."

Anyone who is going to try speculation should be fully aware of and be comfortable with the risks involved. Managing the risks of trading is a very important part of any trader's success. Although the risks can be managed, they can never be eliminated. Remember that the high returns successful speculators can earn are available only because the speculator is being paid to take risk away from others.

When a commodity trader buys a futures contract, he will lose if the price declines. His risk is theoretically limited only by the price of the commodity going to zero. If he sells, he will lose if the price goes up. The risk is theoretically unlimited because there is no absolute ceiling on how high the price of the commodity can go.

In practice, however, the trader can offset his position when the trade is going against him to limit his loss. While a prudent trader always has a plan to limit his losses when trades don't work, it is not possible to guarantee a particular loss limit amount. As a practical matter, however, you can usually limit losses to within a few hundred dollars of an intended amount. Very often losses are within $100 of the amount you project. Only when very unusual things happen suddenly can losses balloon to thousands of dollars more than you expected.

A good example of this was what happened to many traders in stock index futures just before the Gulf War started in 1991. In *The New Market Wizards* by Jack Schwager, respected money manager Monroe Trout describes his ordeal: "January 9, 1991 was the day that Secretary of State James Baker met with the Iraqi ambassador in an effort to avert the Gulf War. At the time there was a reasonable degree of optimism going in to the meeting. Addressing the press after the meeting, Baker began his statement with the word 'Regrettably.' A wave of selling hit the stock and bond markets. I lost about $9,500,000, most of it in about ten seconds." Trout was holding 700 S&P futures contracts at the time.

One of the trading systems I was using during that period was a day trading system for the S&P. Although on most days that system didn't trade at all, it was unlucky enough to be in a long position that morning. I remember watching Baker's news conference and the S&P price action at the same time in my office. Even though I had a $500 stop-loss in the market, my system lost $5,500 per contract on that day's trade because the market's liquidity evaporated so rapidly.

The S&P stock index is the most expensive market to trade, and those with accounts less than $25,000 should probably not be trading it at all. Therefore, this once in-a-decade event would have cost about twenty percent or less of a reasonably capitalized account.

Other kinds of surprise situations that can cause unpredicted losses are freezes, floods, droughts, government currency interventions and crop reports. With attention and foresight a trader can sidestep these risky situations. The best way to control unpredictable risks is to trade conservatively so larger-than-expected losses are still only a small percentage of the total account.

Another thing to understand about risk in trading is that you cannot avoid losses by careful planning or brilliant strategy. Numerous losses are part of the process. In *The Elements of Successful Trading*, Robert Rotella puts it this way: "Trading is a business of making and losing money. Any trade, no matter how well thought out, has a chance of becoming a loser. Many people think the best traders don't lose any money and have only winning trades. This is absolutely not true. The best traders lose a lot of money, but they eventually make even more over time."

There is no point trading commodities if you cannot handle the psychological discomfort of making losing trades. While people tend to take losses personally as a sign of failure, good traders shrug them off. The best trading plans result in many losses. Because of the amount of randomness in market price action, such losses are inevitable.

If I haven't scared you away so far, let's take a closer look at what successful commodity trading is all about.

top

The History of Trading

Although the first recorded instance of futures trading occurred with rice in 17th Century Japan, there is some evidence that there may also have been rice futures traded in China as long as 6,000 years ago.

Futures trading is a natural outgrowth of the problems of maintaining a year-round supply of seasonal products like agricultural crops. In Japan, merchants stored rice in warehouses for future use. In order to raise cash, warehouse holders sold receipts against the stored rice. These were known as "rice tickets." Eventually, such rice tickets became accepted as a kind of general commercial currency. Rules came into being to standardize the trading in rice tickets. These rules were similar to the current rules of American futures trading.

In the United States, futures trading started in the grain markets in the middleof the 19th Century. The Chicago Board of Trade was established in 1848. In the 1870s and 1880s the New York Coffee, Cotton and Produce Exchanges were born. Today there are ten commodity exchanges in the United States. The largest are the Chicago Board of Trade, The Chicago Mercantile Exchange, the New York Mercantile Exchange, the New York Commodity Exchange and the New York Coffee, Sugar and Cocoa Exchange.
Worldwide there are major futures trading exchanges in over twenty countries including Canada, England, France, Singapore, Japan, Australia and New Zealand. The products traded range from agricultural staples like Corn and Wheat to Red Beans and Rubber traded in Japan.

The biggest increase in futures trading activity occurred in the 1970s when futures on financial instruments started trading in Chicago. Foreign currencies such as the Swiss Franc and the Japanese Yen were first. Also popular were interest rate instruments such as United States Treasury Bonds and T-Bills. In the 1980s futures began trading on stock market indexes such as the S&P 500.

The various exchanges are constantly looking for new products on which to trade futures. Very few of the new markets they try survive and grow into viable trading vehicles. Some examples of less than successful markets attempted in recent years are Tiger Shrimp and Cheddar Cheese.

Futures trading is regulated by an agency of the Department of Agriculture called the Commodity Futures Trading Commission. It regulates the futures exchanges, brokerage firms, money managers and commodity advisors.

top

The Trading Process

Here are some typical steps in the process of making a commodity trade including the trader's decision-making process and the procedures involved in actually placing the trade.

In order to make decisions about when to trade commodity futures, you must have a source of price data. Many daily newspapers carry some commodity prices in their financial sections. The *Wall Street Journal* has comprehensive commodity price listings. *Investor's Business Daily* has both price tables and numerous price charts

All experienced commodity traders prefer to look at price activity on a chart rather than trying to interpret tables of numbers. In financial analysis, charts are indispensable for quickly grasping the essence of historical and recent price action.

The typical commodity chart depicts daily price action as a thin vertical bar which indicates the day's high and low by the top and bottom of the bar. The opening and closing prices are shown as tiny dots attached to the left and right side of the bar. A typical daily price chart can show up to six months of price action this way.

It is easy to change the bar's time frame from days to weeks or months and thus show from two to twenty years of historical price action in the same format. For short-term trading you can change the bar's time frame to hours or even minutes.

Looking at such bar charts enables a trader to see the recent trend of prices--whether up, down or sideways--in whatever time frame he chooses. Following the current trend of prices is a cornerstone of successful trading.

There are a number of ways to obtain the price charts a trader needs to analyze the markets. You can make your own using graph paper. This sounds rather primitive, but some experts recommend it as a good way to put yourself in close touch with price activity and monitor risk.

Another source of charts is the printed chart service. There are about half a dozen of these. They typically mail a booklet of numerous charts covering all the tradeable markets after the markets close on Friday. There is space on the charts to update them daily during the following week until next chart book arrives. These printed chart books normally have a number of indicators plotted along with the price action and contain a wealth of additional information.

For computer owners there are many software programs that create fancy charts on the computer screen. You can input the price data manually or, via telephone modem, download comprehensive data after the markets close for the day. Those with larger budgets can install a small satellite dish and watch price changes in all the markets nearly instantaneously as they occur. The software creates charts dynamically on the computer screen as each trade takes place on the exchanges. You can put many different charts on the screen and thus watch numerous markets all around the world in real time. The cost can range from a few hundred to $1,000 a month depending on the software and the number of exchanges you subscribe to.

It is easy to believe that computers can make a big difference in trading success. Vendors of expensive software will tell you that since other traders, who are your competition, have expensive computer setups, you need one too. This isn't really true.

Those who can't trade profitably without a computer probably won't be helped too much by using a computer. It may actually be detrimental by causing an increase in trading frequency. While a computer will not make a bad trader into good one, they are fun to use, and they do make a trader's life easier.

There are two primary analytic methods for deciding when to take a futures position: fundamental analysis and technical analysis. Fundamental analysis involves using economic data relating to supply and demand to forecast likely future price action. Technical analysis involves analyzing past price action of the market itself to forecast the likely future price action.

While there are differences of opinion about the relative merits of the two approaches, almost all successful traders emphasize technical analysis. There are a number of reasons for this. First and foremost is the difficulty of obtaining accurate fundamental data. While various governments and private companies publish statistics concerning crop sizes and demand levels, these numbers are gross estimates at best. With the current global marketplace, even if you could obtain accurate current information, it would still be impossible to predict future supply and demand with enough accuracy to make commodity trading

decisions.

Technical analysts argue that since the most knowledgeable commercial participants are actively trading in the markets, the current price trend is the most accurate assessment of future supply and demand. If someone is correct that for fundamental reasons, prices will likely move up strongly in the future, the commercial participants who have the greatest knowledge and influence on the markets should certainly be moving the price upward right now. If price instead is moving down, a lot of very knowledgeable people must think price in the future will likely be down, not up.

For this reason, almost all successful speculators learn to follow price action and not try futilely to predict turning points in advance. They seek to trade in tune with the large participants who move the markets.

In his classic book, *Technical Analysis of the Futures Markets*, famous analyst John Murphy summarizes the rationale for technical analysis: "The technician believes that anything that can possibly affect the market price of a commodity futures contract--fundamental, political, psychological or otherwise--is actually reflected in the price of that commodity. It follows, therefore, that a study of price action is all that is required. By studying price charts and supporting technical indicators, the technician lets the market tell him which way it is most likely to go. The chartist knows there are reasons why markets go up and down. He just doesn't believe that knowing what those reasons are is necessary."

top

Making A Trade

Assuming the trader has consulted his price charts, applied his trading plan's decision-making criteria and decided to make a trade, how does this actually take place? He will have a trading account open with a broker. Believing, for example, that the price of Silver will be going up in the near future, he calls his broker's trading desk, and the following conversation might occur.

> "XYZ Discount Brokerage.
>
> "This is Bruce Babcock. For account number 22656,
> buy one December Silver at the market."
>
> "Buying one December Silver at the market. Please hold."

The broker may enter the order into a computer or she may call the exchange floor directly. In either case, the order goes to the exchange trading floor in New York City. Once at the broker's desk on the edge of the trading floor, a runner may take the order to the trading pit to be filled or a clerk may transmit it to the pit by hand signals. In the trading pit, a floor broker executes the order with his fellow floor traders by a combination of shouting and hand signals. The process is then reversed as the trade price is communicated back to the customer.

> "Hello. You bought one December Silver at 550."
>
> "I would like to enter my stop order. Good 'til cancelled,
> sell one December Silver at 540 stop."
>
> “For account number 22656, selling one December Silver
> at 540 stop. Good 'til cancelled."
>
> "Thank you."

The second sell order was an instruction to the broker to automatically offset the trade if Silver declined in price by $500. This was a prudent step to limit the loss in case price did not go up as the trader expected. Placing the order with the broker means that the trader will not have to monitor the market constantly to be sure the loss does not get too big if price goes down instead of up. The trader is not guaranteed to limit his loss to exactly $500, but he will usually be able offset his position fairly close to

the requested price.

The trader can offset his position any time before the Silver contract expires in December. To the extent Silver's price is more than $5.50 an ounce when he offsets, the trader will profit by $50 for each cent. To the extent Silver's price is less than $5.50 when he offsets, the trader will lose $50 for each cent.

To do the same trade with less dollar risk, the trader could have instructed the broker to place the orders at the Mid America Exchange, where the Silver futures contract is only one-fifth the size of the regular New York contract. That would have yielded profits and losses of $10 for each cent rather than $50.

top

The Truth About the Commodity Markets

In order to be a successful trader, you must understand the true realities of the markets. You must learn how the professionals make money and what is possible. Most traders come into commodity trading, lose a substantial portion of their capital and then leave trading without ever having a correct perception of what good trading is all about.

For many years college professors have argued that the markets are both random and highly efficient. If this were true, it would be impossible to gain an edge on other investors by having superior knowledge or a superior approach.

Professional traders, who make their living trading rather than studying the markets from afar, have always laughed at these ivory tower theories. A good example is George Soros, who has made billions of dollars from trading and is perhaps the greatest trader of all time. Here is how he responds to these ivory tower academics: "The [random walk] theory is manifestly false--I have disproved it by consistently outperforming the averages over a period of twelve years. Institutions may be well advised to invest in index funds rather than making specific investment decisions, but the reason is to be found in their substandard performance, not in the impossibility of outperforming the averages."

Mathematicians have conclusively shown the financial markets to be what are called non-linear, dynamic systems. Chaos theory is the mathematics of analyzing such non-linear, dynamic systems. The commodity markets are chaotic systems. Such systems can produce random-looking results that are not truly random. Chaos research has proved that the markets are not efficient, and they are not forecastable. Commodity market price movement is highly random with a small trend component.

Most beginning traders assume that the way to make money is to learn how to predict where market prices are going next. As chaos theory suggests, the truth is that the markets are not predictable except in the most general way.

In his book, *Methods of a Wall Street Master*, famous trader Vic Sperandeo, whose nickname is "Trader Vic," warns: "Many people make the mistake of thinking that market behavior is truly predictable. Nonsense. Trading in the markets is an odds game, and the object is always keep the odds in your favor."

Luckily, as Trader Vic suggests, successful trading does not require effective prediction mechanisms. Good trading involves following trends in a time frame where you can be profitable.

The trend is your edge. If you follow trends with proper risk management methods and good market selection, you will make money in the long run. Good market selection refers to trading in good trending markets generally rather than selecting a particular situation likely to result in an immediate trend.

There are three related hurdles for traders. The first is finding a trading method that actually has a statistical edge. Second is following it with consistency. Third is consistently following the method long enough for the edge to manifest itself on the bottom line.

This statistical edge is what separates speculating from gambling. In fact, effective trading is actually like the gambling casino rather than the gambling customer. Professional trader Peter Brandt explains successful trading in just this way: "A successful commodity trading program must be based on the simple premise that no one really knows what the markets are going to do.

We can guess, but we don't know. The best a commodity trader can hope for is an approach which provides a slight edge. Like a gambling casino, the trader must earn his profits by exploiting that edge over an extended series of trades. But on any given trade, like an individual casino bet, the edge is pretty meaningless."

Unsuccessful and frustrated commodity traders want to believe there is an order to the markets. They think prices move in systematic ways that are highly disguised. They hope they can somehow acquire the "secret" to the price system that will give them an advantage. They think successful trading will result from highly effective methods of predicting future price direction. These deluded souls have been falling for crackpot methods and systems since the markets started trading.

Prolific futures trading author Jake Bernstein describes how these desperate traders are victimized: "Futures trading is ultimately very simple. Any attempt to make trading complex is a smokescreen. Yet for self-serving reasons an army of greed-motivated promoters try to make things complicated. Too many market professionals consider it their mission in life to obfuscate. Why? Because in so doing they give the appearance that their efforts are scholarly and important. They create a need for more information, and then they fill it!"

Books on how to trade commodities are famous for showing a few well-chosen examples where a described prediction method previously worked. They never show what would have happened if you had applied the method religiously for many years in numerous markets. Those who have tested these methods have found that in the long run almost all of them don't work. Be wary of any trading method unless you see a detailed demonstration showing that it has worked for at least five to ten years in a variety of different markets using exactly the same rules.

The job of the person who wants to trade commodities rationally and prudently is to ignore the promises of those promoting pie-in-the-sky prediction mechanisms and concentrate on finding and implementing a proven, integrated methodology that follows market trends.

top

Separating the Winners and Losers

A very high percentage of those who try commodity trading eventually lose money. The ratio of losers could be as high as ninety-five percent. However, this does not necessarily mean that your chance of failure is that high. If, before you begin, you identify correctly the reasons most people lose, you can improve your odds significantly.

There is a small percentage of full-time professionals and highly skilled part-time traders who have learned how to trade correctly and generate consistent profits year after year. It is not impossible to determine what separates these people from the crowd.

Because trading well is not easy, you must approach the task very seriously. This is not something to treat as a hobby. Perhaps, first and foremost, this is what separates professionals from amateurs. Professionals look at their trading as a business. There are substantial profits to be made, and they will not just fall into your lap.

Another crucial difference between successful and unsuccessful traders is that the successful ones have a plan and they follow it. Considering the amount of money involved and the potential risks, it is remarkable how few traders actually have any kind of plan for their trading. They go from trade to trade applying various ideas they have learned without any consistency and without any testing. They make decisions based on hot tips, something they read, today's news. They are acting from emotion rather than using a proven methodology. While they may not want to admit it, they are really gambling in the futures markets rather than trading intelligently.

Trading by emotion in an unstructured way certainly adds fun and entertainment to the enterprise. Taking positions on instinct is exciting, especially when they work out . . . as they often do. But in the end, this kind of trading will lose money.

Good trading is boring because you've thought out your strategy and tactics in advance. You trade according to a carefully tested system or method, not from what moves you emotionally that day.

Two psychological traits that separate winners from losers are patience and discipline. It is not enough to have a carefully tested trading plan. You must also be able to follow it religiously. This is not as easy as you may think.
Every experienced trader knows how great the temptation is to stray from the plan. There is always what seems to be a good reason. The true professional can resist this temptation and stick to his plan. He has the patience to wait for his method to signal a trade and not take trades he may be emotionally attracted to that are outside his plan. He has the discipline to follow his plan and take all the trades that it signals even when there appear to be strong reasons to make an exception.

This may sound easy, but when real money is on the line--your money--nothing is more difficult. The kind of trading that really works is emotionally demanding.

It is hard work to create a winning trading plan. It is hard psychologically to follow the plan after you create it. This is why so many people fail. Perhaps you have what it takes to be an exception.

top

Learning To Trade Correctly

One way to learn how to trade correctly is to find a successful trader and have him or her teach you exactly how they do it. However, even if you could find such a person and even if they would be willing to spend the time with you, it would not necessarily make you a successful trader. You might not have the capital necessary to trade the way they do. You would definitely not have the years of experience they had developing their successful approach. You might not have the personality profile necessary to execute their style of trading.

Another way to learn is by trial and error. This is the method of choice for most people although they probably don't realize it. The trouble with trial and error in futures trading is that you don't always take a loss when you trade incorrectly and you don't always make a profit when you trade correctly. Some of the best methods generate losses more than half the time. You can take many losses in row applying a very effective system. On the other hand, if you are lucky, you can makes tons of money trading quite stupidly. Psychologists call this random reinforcement, and it makes good trading impossible to learn through trial and error.

The most obvious and practical way to learn how to trade correctly is to read books. Find the best books by the most respected authors and the best traders and learn from them. While this may work in other areas of life, it is more problematic in commodity trading.

One of the few real secrets in commodity trading is that most of what you read in books about how to trade does not work in the real world. Even books by respected authors are full of trading methods that lose money when put to the test. You may find this shocking, but almost no commodity authors demonstrate the effectiveness of the methods they advocate. The best you can hope for are some well-chosen examples or a few cursory tests.

Learning to trade is a combination of being exposed to ideas plus practical experience watching the markets on a day-to-day basis. This is not something that can happen in only a few weeks. On the other hand, you can become a great trader even with only average intelligence. Professional trader and money manager Russell Sands describes the makeup of a successful trader: "Intelligence alone does not make a great trader. Success is equal parts of intellect, applied psychology, practice, discipline, bankroll, self-understanding and emotional control."

Furthermore, to be successful you don't have to invent some complex approach that only a nuclear physicist could understand. In fact, successful trading plans tend to be simple. They follow the general principles of correct trading in a more or less unique way.

top

Elements of a Successful Trading Plan--Getting Started

The first element of any trading plan is the amount of capital you intend to invest. This is up to you, but you should understand that there is a direct relationship between the amount of capital you commit and your probability of success. The more you invest, the greater is the likelihood that you will make money.

What is the minimum advisable amount to start with? Most professionals agree that it takes a minimum of $10,000. If you try to trade with anything less, what happens to you will be luck. You won't have the capital necessary to apply proper risk management principles.

An important thing to keep in mind when deciding how much to commit initially to commodity trading is that the amount you invest must be "risk capital." Risk capital is defined as money you can afford to lose without affecting your standard of living. It should also be money that you feel comfortable risking. Think of your commodity account as an investment in a business. Many businesses fail. That's life. Make sure you won't be so afraid of losing money that it will affect your ability to make correct trading decisions.

The next part of your trading plan involves how you will make your actual buying and selling decisions. Under what conditions will you enter trades? When will you exit your trades? What markets will you trade?

There are four cardinal principles which should be part of every trading strategy. They are: 1) Trade with the trend, 2) Cut losses short, 3) Let profits run, and 4) Manage risk. These building blocks are so basic and important that I have written a whole book about them. You should make sure your strategy includes each of these requirements for success.

top

Elements of a Successful Trading Plan--Trade With The Trend

Trading with the trend is hard to do because a logical give-up exit point will be farther away, potentially causing a larger loss if you are wrong. This is a good example of why so few traders are successful. They can't bring themselves to trade in a psychologically difficult way.

You can define the concept of trend only in relation to a particular time frame. When you determine the trend, it must be, for example, the two-week trend or the six-month trend or the hourly trend. So an important part of a trading plan is deciding what time frame to use for making these decisions.

Do you want to be a long-term trader, also called a position trader? They hold positions for weeks or months. Do you want to be a short-term trader who holds positions only for a few days? There are even very short-term traders called day traders. They watch the markets during the day and always enter and exit their positions on the same day.

While it is perhaps easier psychologically to keep the time frame short, the best results come from longer-term trading. The longer you hold a trade, the greater your profit can be.

Day trading has great attraction because you can start each day fresh and sleep comfortably every night with no open positions. However, it is the most difficult kind of trading there is. Here's how legendary trader Larry Williams describes it: "Day trading is so stressful. You're going to end up frying your brain. All the day traders I talk with are losing money. Besides, it's really hard to come up with profitable day trading systems."

For the greatest chance of success, your time frame to measure trends should be at least four weeks. Thus, you should only enter trades in the direction of the price trend for the last four weeks or more. A good example of a trend-following entry rule would be to buy whenever today's closing price is higher than the closing price of 25 market days ago, and sell whenever today's closing price is lower than the closing price of 25 market days ago.

When you trade in the direction of this long a trend, you are truly following the markets rather than predicting them. Most unsuccessful traders spend their entire careers looking for better ways to predict the markets.

top

Elements of a Successful Trading Plan--Cut Losses Short

If you are following market trends rather than trying to anticipate them, the next important part of the plan is how to exit trades that don't work out. Here is where the second cardinal principle comes in. It is Cut Losses Short.

This is another sensible-sounding concept that is much easier to acknowledge than actually to execute when real money is on the line. No one wants to exit a trade with a loss. They don't want to lose money. More importantly, they don't want to admit they were wrong. You can always think of many reasons to hold on to a losing trade. You can hope that the market will suddenly turn around and give you a profit instead of a loss.

This is another example where successful traders have learned to do the hard thing. If there is one thing consistent in the stories of how good traders turned themselves around from being bad traders, it is their attitude about losses. Professional traders accept that losses are part of the game. Since the markets are mostly random, the best trading methods will always have numerous losses. Professionals do not equate losses with being wrong.

It is precisely because correct trading methods invariably generate many losses that it is important to keep the individual losses small in relation to the overall size of the account. In order to keep trading, you must preserve your capital. If you can keep trading in the direction of the trend, the big profits will come. However, if you take too many large losses, your capital will be wiped out before you can enjoy the big profitable trades.

The laws of probability insure that regardless of your approach, you will inevitably suffer some long strings of consecutive losses. If you are risking too high a percentage of your account on each trade, before long one of these unavoidable losing streaks will blow you away. Keeping losses to about one percent of your account size is optimal. With smaller accounts, the percentage will have to be larger. Five percent on one trade is probably the highest prudent level of risk.

Because of the randomness in commodity price action, you must allow the market a certain amount of leeway before giving up on a trade. In general, you must be willing to risk between $500 and $1,000 to trade most markets. For smaller accounts, the Mid America Exchange offers trading with smaller sized contracts that allow you to trade with lower risk.

While there are more sophisticated ways to decide when to exit a losing trade, getting out after a loss of a predetermined dollar amount is as good a way as any. The important thing is to respect your plan. You can place a stop-loss order with your broker that instructs him in advance to exit a trade if the market hits your loss limit. You should always do this to guard against inattention or changing your mind at the crucial moment.

top

Elements of a Successful Trading Plan--Let Profits Run

The next part of the plan involves a more pleasant alternative: when to exit a trade that is profitable. The cardinal principle involved is Let Profits Run. In other words, stay with your profitable trades as long as possible because the trend is likely to continue and make your profits even larger.

Again, this is easy to understand but not so easy to do when real money is involved. The difficulty is that although your profit may become much larger if you stay with a trade, it may also decrease and even disappear. Human nature is such that it values a sure profit much more highly than the probability of a much higher profit. Thus, traders are inclined to take their profits too soon. This can be fatal to long-term success because big profits are necessary to overcome the inevitable collection of small losses.

There is a good way to let profits run while still guarding against the possibility that prices will turn around and take away much of your accumulated profits before the trend actually reverses. It is called a trailing stop. You include in your plan a method for moving an exit point along some distance behind your trade. As long as the trend keeps moving in your favor, you stay in the

trade. If the market reverses direction by the amount of your trailing stop, you exit the trade at that point. You would also offset your trade and reverse position if the trend reversed.

One way to set a trailing stop is to protect a certain percentage of the accumulated profit. That will always insure that you keep some profit on a good trade.

top

Elements of a Successful Trading Plan--The Markets You Trade

Another trading plan consideration is the markets you trade. There are about forty futures markets with sufficient liquidity to allow prudent speculation. However, it is important to select a good universe of markets that are appropriate for your account size, risk level and trading style.

It also important that your market universe be diversified. There are always a number of big market moves every year, but no one knows in advance where they will be. If you trade a diversified portfolio, there is a greater chance that you will catch some of the truly big moves that make for successful trading.

Another consideration in choosing a market to trade is its historical propensity to have more big trending moves. Since the trend is your edge in trading, you can maximize your edge by selecting the most trendy markets. The following are some of the best trending markets in various trading sectors.
The currencies are the best trending sector. The currencies to trade are the Swiss Franc, the German Mark, the Japanese Yen and the British Pound.

Interest rate futures are also good trending markets. T-Bonds represent long-term interest rates and Eurodollars are for short-term interest rates.

In the energy complex, Crude Oil, Heating Oil and Natural Gas are good trading vehicles.

In the food sector, Coffee, Orange Juice and Sugar are recommended.

In metals, you can trade Gold, Silver and Copper.

In agriculturals, Corn, Oats, Soybeans and Cotton are the best.

Now you have the outline of an overall plan to trade commodities. The key to success is to test whatever strategy you intend to apply before you trade with it. Remember that the conventional wisdom that you read in books is mostly ineffective. When applied consistently, most trading methods don't work.

You can't test your plan unless it is specific. The rules must be precise and objective. Having a thoroughly tested plan is crucial to maintaining the confidence necessary to keep trading the plan through the inevitable losing periods that every good system and every good trader must endure.

The reliability of non-computerized testing is highly suspect. Using computer software that tests a particular approach or a variety of approaches is preferred. You must learn the correct way to test and evaluate trading approaches.

top

Elements of a Successful Trading Plan--Manage Risk

The final cardinal principle of trading overlays all the rest. It is Manage Risk. This is as crucial as the others because it is by managing risk that you limit losses and preserve your capital.

The most important element of managing risk is keeping losses small, which is already part of your trading plan. Never give in to fear or hope when it comes to keeping losses small. Preventing large individual losses is one of the easiest things a trader can do to maximize his chance of long-term success.

Another element of risk is the market you trade. Some markets are more volatile and more risky than others. Some markets are comparatively tame. If you have a small account, don't trade big-money, wild-swinging contracts like the S&P 500 stock index. Don't be above using the smaller-sized Mid-America contracts to keep risk in proportion to your capital. Don't feel you have to trade any market that might make a move. Emphasize risk control over achieving big profits.

The biggest risks to commodity traders come from surprise events that move the markets too quickly to exit at their pre-determined give-up point. While you can never eliminate these risks entirely, you can guard against them by advance planning. Pay attention to the risk of surprise events such as crop reports, freezes, floods, currency interventions and wars. Most of the time there is some manifestation of the potential. Don't overtrade in markets where these kinds of events are possible.

Trade in correct proportion to your capital. Have realistic expectations. Don't overtrade your account. One of the most pernicious roadblocks to success is greed. Commodity trading is attractive precisely because it is possible to make big money in a short period of time. Paradoxically, the more you try to fulfill that expectation, the less likely you are to achieve anything.

The pervasive hype that permeates the industry leads people to believe that they can achieve spectacular returns if only they try hard enough. However, risk is always commensurate with reward. The bigger the return you pursue, the bigger the risk you must take. Even assuming you are using a method that gives you a statistical edge, which almost nobody is, you must still suffer through agonizing equity drawdowns on your way to eventual success.

It is better to shoot for smaller returns to begin with until you get the hang of staying with your system through the tough periods that everyone encounters. Professional money managers are generally satisfied with consistent annual returns of twenty percent. If talented professionals should be satisfied with that, what should you be satisfied with? Surprisingly, disciplined individuals can do better. It is realistic for a good mechanical system diversified in the best markets to expect annual returns in the twenty-five to fifty percent range.
One last thing about creating a trading plan. Don't be enticed into trading options as a less risky alternative to futures. While the dollar risk of buying puts and calls may appear lower and more certain, the probability of long-term success is remote.

Experienced professional traders, such as Larry Williams, agree: "Options are a very difficult game because you have to do two things: You have to beat the market and beat the clock. Perhaps some sophisticated people can trade options. I've been trading stocks and commodities successfully for over thirty years, but I don't trade options because it's too tough."

The best way to trade options is to sell them to small speculators. That's what options professionals do. However, selling options has more risk and is more difficult than trading futures. Unless you are well-capitalized and committed to a full-time career as a professional options player, stick to futures.

Although the commodity markets appear complex from the outside, making money trading is quite simple. You use an historically proven plan that trades with the trend, cuts losses short and lets profits run. You trade your system in a carefully-selected group of markets. You start with sufficient capital and pay close attention to managing risk. Richard Dennis made his $200 million following precisely this kind of trading approach.

top

Psychological Pitfalls

Here are some additional psychological pitfalls to avoid. Be wary of depending on others for your success. Most of the people you are likely to trust are probably not effective traders. For instance: brokers, gurus, advisors, friends. There are exceptions, but not many. Depend on others only for clerical help or to support your own decision-making process.

You may acquire trading methods or systems from others or from books, but be sure to test them carefully yourself before

trading. Good systems that you can buy come with computer software that allows comprehensive historical testing.

Don't blame others for your failures. This is an easy trap to fall into. No matter what happens, you put yourself into the situation. Therefore, you are responsible for the ultimate result. Until you accept responsibility for everything, you will not be able to change your incorrect behaviors.

Stay long-term oriented. Don't adjust your approach based solely on short-term performance. Through luck, any horrible system can look great, even for relatively long periods of time. Conversely, the best systems have frequent losing periods. If you judge a system by short-term performance, you are likely to reject the best systems that exist.

Most traders have such an ego investment in their trading that they cannot handle losses. Several losses in a row are devastating. This causes them to evaluate trading methods and systems based on very-short-term performance. Don't start trading a system based on only a few trades, and don't lose confidence in one after only a few losses. Evaluate performance based on many trades and multi-year results.

Don't underestimate the psychological difficulty of successful trading. Robert Rotella describes the trauma in *The Elements of Successful Trading*: "Trading is one of the most stressful endeavors imaginable. Taking losses day after day with a strategy that, just a short while ago was working well, can be a terrible experience. Trading performance can be consistently volatile with good and bad times highly magnified. The market can batter your psyche and gnaw at your soul. These bad experiences will never end as long as you trade. The more successful you are as a trader, the more money you will lose."

Keep trading in correct perspective and as part of a balanced life. Trading is emotionally intensive no matter whether you are doing well or going in the tank. It is easy to let the emotions of the moment lead you into strategic and tactical blunders.

Don't become too elated during successful periods. One of the biggest mistakes traders make is to increase their trading after an especially successful period. This is the worst thing you can do because good periods are invariably followed by awful periods. If you increase your trading just before the awful periods, you will lose money twice as fast as you made it.

Knowing how to increase trading in a growing account is perhaps the most difficult problem for successful traders. Be cautious in adding to your trading. The best times to add are after losses or equity drawdowns.

Don't become too depressed during drawdowns. Trading is a lot like golf. All golfers, regardless of their ability, have cycles of good play and poor play. When a golfer is playing well, he assumes he has found some secret in his swing and will never play poorly again. When he is hitting the ball sideways, he despairs that he will never come out of his slump.

Trading is much the same. When you are making money, you are thinking about how wonderful trading is and how to expand your trading to achieve immense wealth. When you are losing, you often think about giving up trading completely. With a little practice, you can control both emotional extremes. You'll probably never control them completely, but at least don't let elation and despair cause you to make unwarranted changes in your approach.

Other common themes of good traders are self-understanding, balance and self-control. If you can master yourself, you can master the futures markets.

I wish you good trading.