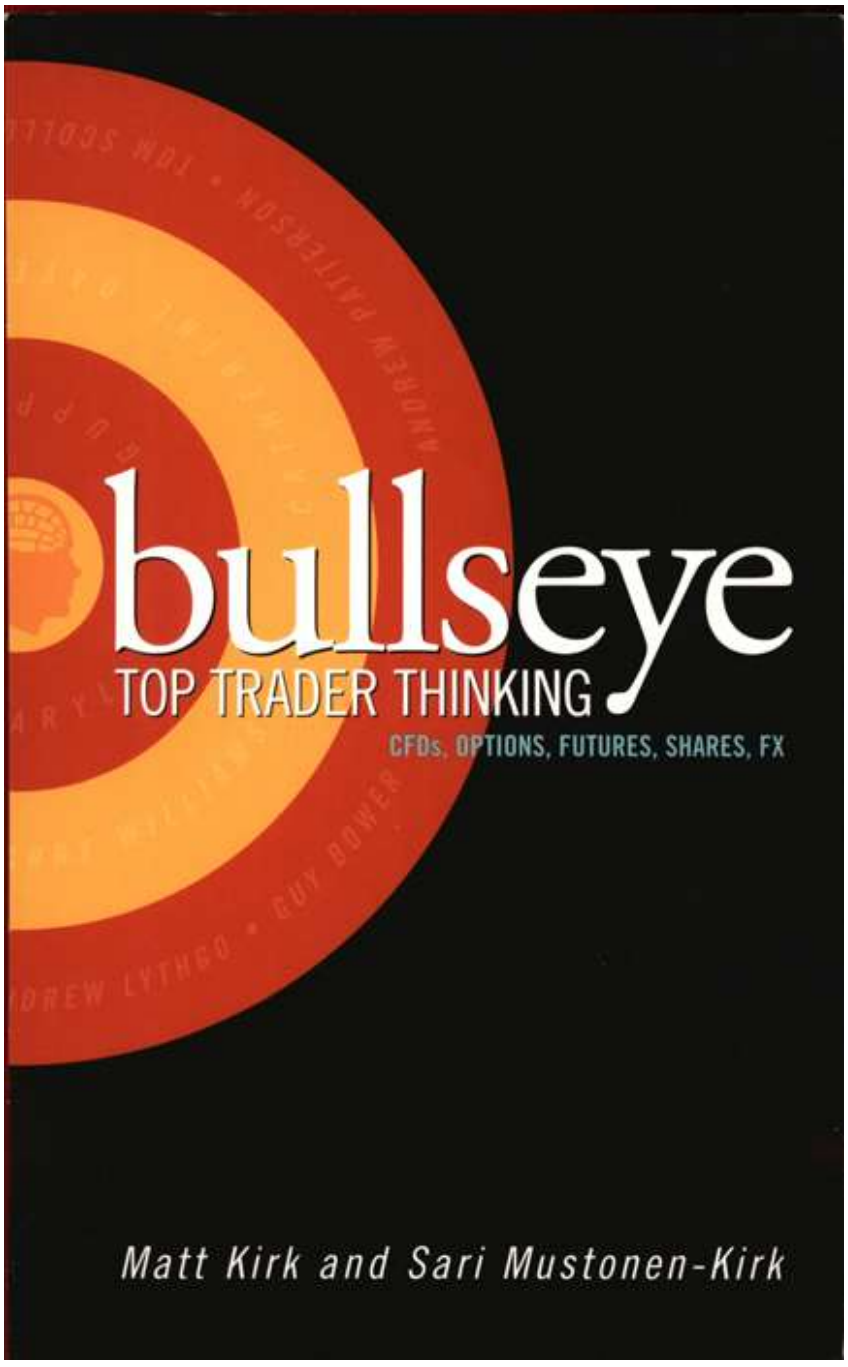
bullseye
TOP TRADER THINKING
CFDs, OPTIONS, FUTURES, SHARES, FX
Matt Kirk and Sari Mustonen-Kirk

This is an excerpt from the book Bullseye: Top Trading Thinking. For the complete book visit:

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bullseye

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Matt Kirk and Sari Mustonen-Kirk

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Chapter 3

Trader's inventory — realistic beginnings

There's a very positive relationship between people's ability to accomplish any task and the time they're willing to spend on it.

Joyce Brothers — psychologist

Fundamental to the success of any commercial venture is having the requisite amounts of time and money — firstly to get the idea off the ground, and then to stay in the game long enough to turn it into a viable proposition for the longer term. For example, if you want to generate $50000 a year from your investing activities, there are a couple of different ways you can do it, depending on your time/money ratio.

If you're money-rich but time-poor, you could source a professional to make the decisions for you. You can authorise someone to tailor a complete trading program and even trade it for you, or you can take the more traditional route and select a managed fund. If you're time-rich but money-poor, you could start with a smaller amount of capital and spend your time researching and educating yourself.

Assuming you've decided to trade for yourself, the time/money ratio will also play a part in determining the right fit for you. When it comes to trading, both the available time you have to dedicate to trading (including your research time, order placement and money management activities) and your starting capital (your account size) will help you decide on the most appropriate trading style to adopt. The more passive your role in the achievement of the end result (generation of profits), the greater the amount of initial capital required.

Just a word of caution here: if you are time-poor and money-poor, and you see an opportunity that promises huge returns in a short space of time for a tiny outlay, stop and think. Every deal must be rich in something, and if it's not time-rich or money-rich then it

must be risk-rich. Going for the risk-rich opportunities does sometimes pay off big but the message we're trying to get across is one of sustainability, and staying in the game long enough to create an income from your activities.

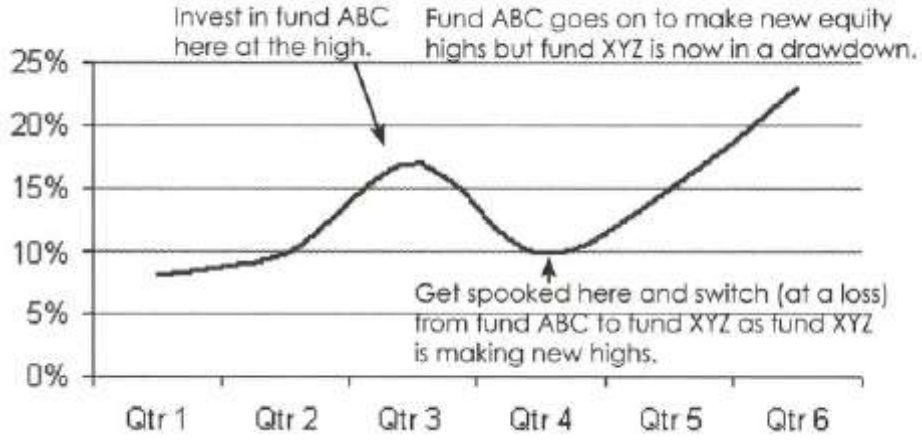
Time and money are dynamically linked and you should be seeking to strike and maintain the right time/money balance to develop an approach that works for you at various stages of your trading or investing career.

Money

By allocating a starting capital, regardless of the type of financial instruments you trade, you are putting in place a framework to accurately track your true profit and loss. This brings us to a key difference between traders and property or fund investors or small businesspeople. Traders are so close to their results that they can rapidly lose faith in a carefully considered strategy. This is because they know, down to the last cent, whether their capital is in front or behind, on a daily basis. Fund managers generally report their results quarterly for this reason. Sure, they quote unit prices daily, weekly or even monthly but most investors don't check these performance tables very often, if at all. Professionals know that short-term volatility is a very difficult thing for most people to cope with, and spooked investors will invariably pull out their funds at exactly the wrong time.

Visually represented, the rocky and frustrating journey of some investors can look a little like figure 3.1.

Figure 3.1 Journey of frustration - Murphy's Law of switching funds.



From the 'journey of frustration' above, you can see that without a time and money perspective you can end up investing at the highs, pulling out at the short-term lows with a loss and investing in another fund, only to suffer the inevitable drawdown of the new hotly

marketed fund. It's no wonder investors who do this feel that managed funds are lacking something.

Let's now return to our discussion of how the money component affects style. We'll use a futures trading account as an example. The generally accepted minimum initial commitment to trade futures through a broker in Australia is A$ 10 000. This is rarely sufficient, however, unless you plan on trading just one contract with a highly disciplined methodology using tight stop losses. The standard $10 000 figure is the industry's benchmark and seems to be the price point that newcomers to the markets will bear without too much trouble. As in any business, however, the greater the starting capital (and the margin to equity ratio, which we'll discuss later) the greater the chances for success, both in tangible profit terms and the more intangible psychological effects.

If you're trading with much less than $10000 you're basically trading on the hope you'll hit a home run straight up to increase your capital base to trade properly. Based on our observations of successful traders, we'd suggest the realistic minimum starting account balance is closer to A$50000. This doesn't preclude those with smaller accounts from making reasonable profits but you need to keep the targets aligned with the realities of the capital base. It's all about staying in the ball game financially and emotionally.

If you sell yourself short by being too impatient to start trading before you have adequate capital and are sufficiently prepared, you'll find it almost impossible to hit the target even if you're brimming with confidence in your abilities and trading system. Perhaps the best way to think about how much capital is required is to ask yourself, 'How much do I want to earn annually from my personal trading fund?' Going one step further, ask yourself, 'What percentage return do I want to achieve from my trading?' And finally, to put it in a business context, 'What level of return on investment (ROI) or return on capital (ROC) is required to make it a sensible use of my capital and time resources?' While asking yourself these questions, don't forget to factor in the inherent levels of risk that trading holds.

Based on the minimum $10000 account, ending the year with a 30 per cent return, or $3000 profit, is hardly going to press any buttons for you. Let's assume you have a full-time source of income, and you start with a more realistic account size of $30000. At the end of the first year a 30 per cent return on $30 000 will turn your account balance into $39000 and will begin to make your venture look like something more worthwhile. While it's not a life-changing amount of profit, in three years your $30000 capital at 30 per cent compounded per year would grow to $65910. At this rate by the end of your fifth year, you would have $ 111387 and at the end of the tenth year your trading account would be a healthy $413 575.

The effect of compounding is well known and unless you have a longer term focus on trading, or any business for that matter, your chances of success are severely diminished — or in most cases, nil. This is not a business where newcomers make lots of money quickly and hang onto it. We've seen countless traders turn $50000 into $10000 inside of a year and only a few who have turned $50 000 into $250 000, kept it, and put it to good use. Hero to zero happens all too often in trading. This is not the quick road to riches some marketers would have you believe — it's about consistency and building a trading business for the long term.

Imagine opening the doors of a restaurant without enough start-up capital. Things might go well initially but when it comes to the inevitable quiet periods you need cash reserves to keep the doors open and perhaps even spend on advertising to attract new clientele. If your business has been running on the smell of an oily rag, any disruption to cash flow can sound the death knell for your beloved enterprise.

Successful businesses are those that set aside cash buffers for when times are slow or, in trading terms, when you're in a drawdown. If you rely on the income from your trading alone to feed and house you and your family, you absolutely must have cash reserves set aside. Imagine if you were trading several different markets and some of your positions moved against you. Don't put yourself in the situation of having to liquidate positions at the worst possible time because you need to pay the rent or mortgage. If there's one thing you can almost guarantee, the trade you don't take, or can't take due to too little capital, will end up being one of the most profitable. It could even be the trade that would compensate for the run of losing trades you've experienced, and perhaps put you in front again. If the next trade you can afford to take turns out to be another loser then the effect this will have on your decision-making ability and emotional stability could be crushing. Top trader thinking advocates giving your trading fund the best chance of succeeding over the longer term, by being adequately capitalised from the outset.

The grim statistics of small business failure, running as high as 80 per cent in the first few years, are there for all to see. Trading is no different. Ask any broker what the common reasons are for traders dropping out of the game and you'll often hear one or both of the following:

- a mismatch between the size of the trading account relative to the strategy employed
- a strategy that worked beautifully in certain market conditions — for example — sideways markets, but performed dismally when markets changed.

Money inventory

So how much money are you starting (or already trading) with? What are your expectations? Answer the questions below before moving on to how time will affect your choices.

My overall investment capital is	$
(excluding home and personal possessions)	
The amount I'm comfortable allocating to my trading is	$
Based on my total capital my trading represents	%
My annual income requirements for this year are	$
The total amount I aim to earn from trading this year is	$
Other sources of income this year will be (net)	$
I am comfortable to risk a maximum on any one trade of	$
Based on my account size my annual return equates to	%

Time

The next important element is time. Just as the amount of starting capital will dictate your strategy and subsequent results, so will the amount of time you have available. Countless people enter the markets every day sold on the idea of sitting by a palm tree and trading on a laptop. If this is your vision then you'll need to be full-time. Please don't be naive enough to believe that any kind of success can flow from just a couple of minutes of effort a day. If you're working a full-time job then forget about intraday trading of Australian resource shares or the S&P 500 in the US at night-time. Whether you're in Australia or in the opposing time zone of the US you'll either be sacked from your day job for watching your pager, and secretly calling your broker to place orders, or you'll be reprimanded for sleeping at your desk because you've been up all night trading. This is like expecting to win a race every time without running shoes — you may win once or twice but when the soles of your feet wear out you'll be limping at best.

You'll find there are only a certain number of markets and time frames you'll be able to trade when you take into consideration your day job, family, socialising, community and rest. The more time you have the more markets you can look at and the more active your style can be but there is a limit. Work within the time you feasibly have available to study the markets, execute your decisions and manage the profits and losses. Don't try to be a superhero by feeling the need to trade everything, everywhere, in all different time frames. Even if your full-time business is trading you're not going to be profitable by trading 24 hours around the clock.

One trader we worked with thought he could trade equity indices intra-day in the Asian time zone, then move on to Europe when Asia closed. Amazingly, he tried to top it off by trading the complete US shift with the S&P 500 and the Dow Jones. That's roughly 18 consecutive hours with overlapping time zones. If there was something to trade on a Sunday he would have tried that too — you can imagine what his performance was like. It just doesn't work like that. Even if in the rare event that all of this wild trading was generating substantial returns, the strategy is ultimately flawed and unsustainable. If every spare minute is engaged

watching the markets and trading to get a result, you will soon find your records in a shambles with no transparency of the risk relative to the return.

Let's look at some of the more common types of trading and how they relate to the time/money discussions so far.

Day trading

A day trader's aim is to profit from intra-day price fluctuations by opening and closing trades within the same trading session. Day traders have no open positions at the end of the session and therefore their bottom line is always transparent. Closing out all positions at the end of each day means day traders don't carry any overnight risk. Although they'll be busy trading all day, theoretically they should be able to sleep well at night.

Day trading is a full-time job, as you need to be in constant touch with market action for the whole session. It requires high levels of discipline and you have to be able to cut any losing positions quickly. You'll need to set up your own trading room, which means that the associated data and technology costs are often higher than with other forms of trading. Generally you're trading one market, but some day traders may trade up to three markets. Over time, you'll become familiar with the individual characteristics and nuances of the markets you trade and this should serve you well. The flip side is falling in love or becoming addicted to a market (or a company share) where the rewards are not commensurate with the time and effort you invest.

Short-term trading

Short-term traders take positions and hold them for anywhere between a day and up to three or four weeks. They attempt to profit from shortterm fluctuations but are willing to hold positions overnight to capture larger moves. Short-term trading could also be considered a full-time job but is less onerous than day trading, as you don't necessarily need to be glued to your screen all day as in intra-day trading. Working hours could be more erratic than with day trading depending on the time zones of the markets followed.

Long-term trading

Long-term traders look to capture large moves by trading well-defined trends, usually holding positions for longer than a month. Long-term traders spend less time monitoring price action and more time analysing the bigger picture. Some long-term traders follow a wider range of markets and products provided they have the time to properly analyse them. If you decide to trade over the long term, look for markets that tend to trend for well-defined periods and design a trading strategy or set up a computer scan to search for markets that fit your criteria for long-term profit opportunities. Naturally you can set up computer scans for the other forms of trading too. Long-term traders make less time-sensitive decisions so it's a

more suitable activity for those who have other commitments or for those who simply don't wish to dedicate their days to watching price action.

Multi-strategy trading

You won't necessarily fit neatly into any one of the above boxes. In fact, you might decide to employ a multi-strategy trading plan whereby you employ a combination of all three types. You might have orders working throughout the day with a few positions held short term in other markets and maybe one or two more long-term positions. Many professional traders known as commodity trading advisers (CTAs) employ exactly this approach, where they have a blended strategy of short to medium-term positions to take advantage purely of fluctuations in price and a few long-term positions in markets on which they have a specific view.

Time inventory

As we did before with the money component, it's your turn to stop and think again for a moment. Be realistic — how much time do you have to dedicate to trading or investing? Perhaps an even better question is how much time do you want to dedicate? How do you see your trading activities taking place?

How many days per week are you available to trade?

_____

How many hours per day can you spend on trading?

_____

How many hours per week can you dedicate to trading?

_____

How many hours per week do you want to dedicate?

_____

What is the most conducive time of the day for your trading?

_____

The time—money fit

We asked our panel members to share what works for them and there's room below for you to consider the same.

Sari: What trading or investment time frame do you prefer — short, medium, long or a combination? Why does this work for you?

Larry: Most of my trading is one to three days. I do very little day trading.

Andrew L: Short. As a floor trader everything was about the moment and the edge. Technology has taken that edge away.

Guy: Between one and five weeks. This time frame is just more suited to the style of spreading that I do.

Catherine: If I'm wrong on a CFD trade I can be out in a matter of hours. If I hold a position for a day and it's drifting between my entry and my stop loss, but doesn't get stopped out, I will often just scratch the trade at the end of the day. Because Australian stocks have a certain risk factor due to overseas and especially US events, there can be some hefty gaps on the open. Therefore it's often not worth running the risk of a gap open in the wrong direction. It also means I occasionally exit a stock that then opens on a gap the next day in my favour. For a winning trade I could hold for a few days or up to a week. Also if I'm right I am always adding to the position. This enables me to grow my rate of return the more right I am.

Andrew P: Short, but occasionally medium. I like to stay in stocks with good momentum.

Tom: Medium to long term usually as this fits with my lifestyle and other business interests and allows me time. I also trade CFDs for short-term plays for a few days/weeks when I have the time. I do it for the sport as it also keeps me sharp.

Daryl: This depends on the market conditions. In some markets I switch to short-term, three-to five-day trades, or intra-day trades. In nervous markets time becomes a significant risk factor. Most of my trades are open for an average of 30 days. This is position trading. I look for high probability trades based on a small selection of chart patterns. I also use longer term trend trades, which may last for many weeks or months. Analysis of the strength of the underlying trend is the key factor in this type of trade. What we plan to do and what we actually do in response to market conditions are two different things. I may plan to be a position trader, but that does not mean that all my positions will remain open for a set amount of time.

It seems, then, that just as there is a money strategy that fits with every trader so there is a time frame that makes all the difference between trading being a chore or an activity that forms part of a good-fit lifestyle.

What trading time frame appeals to you?

_____

_____

_____

What trading time frame seems like a good fit considering your current obligations elsewhere in your life?

_____

_____

_____

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