CHAPTER 1

Everyone Needs a Plan

A new wide-eyed, aspiring trader asks a learned, wealthy, successful trader, "How can I end up with a million dollars in the stock market?" The old trader scratches his head and after some thought says, "Start with $2 million."

I was having trouble figuring out how to start this chapter and therefore this book, until I was listening to a New York Mets game in my car last week. During a rain delay the announcer, Steve Somers, was talking about Pedro Martinez, a three time Cy Young award winner, and for those non-baseball people, that means he was the best pitcher in baseball for the year. Somers was talking about how good a pitcher Pedro is and how he has been able to adjust due to injuries and age, as well as how he can adjust to batters in a game. He was saying Pedro has many different game plans, and he can easily switch them once he is in a game. This ability to know what is and isn't working is what makes him one of the most dominant pitchers in baseball.

THE HANGING CURVEBALL

And I was thinking, "Hey, this is a great analogy for what I'm trying to say." So here is how I would describe it. Pedro Martinez has a main plan (which is like a trader's trading plan); that plan is to do everything possible to win. It includes mastering his pitches, knowing the opposition, and staying healthy by eating right, resting, and working out. He has worked hard to develop his pitch selection arsenal, his pinpoint control, and his ability to throw from different arm angles and speeds. These are all things that were done prior to his pitching on any given day. Part of his main (trading) plan is to know when he is getting tired and when to come out of a game. His main plan doesn't change often, but he will be constantly reevaluating it to make sure it is working and for ways to improve it. For example, in recent years he's added a cut fastball to his regular fastball and his speed has dropped from the low 90s to the mid to upper 80s, though he can reach back and still throw a little faster when needed. Once he is happy with his main plan it pretty much stays the same until the next evaluation.

However, each individual game and situation brings something new to the plate, and Pedro has different game plans he will use depending on the situation. As part of the game plan he will study opposing batters to learn what does or doesn't work. He will have an overall game plan for the game as well as adjustable plans for each batter. He doesn't just rely on throwing a fastball for strikes. He knows there are times he can rest his arm and try to get groundball outs instead. Some items in this game plan could be, if the curve is working, keep throwing it. If Barry Bonds is swinging at pitches in the dirt, keep throwing them there. If another batter is not going for them then throw it closer to the strike zone for him. If the count is 0–2 throw a changeup or a curve, unless Jeter is batting and keeps hitting those. If his fastball up and inside is not working, throw it low and away. If so and so hitter has been hitting curves away lately, pitch him inside. When something is not working, he figures out what it is and fixes it. A lot of this mental work is done between innings and with the help of a coach, not in between pitches, when his emotions could get the best of him.

With injuries and age slowing down his fastball in the last few years, Pedro relies more on control these days and he is able to adjust in a game. What makes him an outstanding pitcher is his ability to adjust. Similarly, a trader needs to review his game plan and adjust his positions all the time. The best pitchers will do this, while the poor ones keep throwing hanging curves and never learn to adjust. They get sent back to minors and then end up selling used cars a couple of years later.

Sorry to those readers who haven't a clue what I just wrote. I'm sure someone in France is saying, "Merde, what eez zeez 'hanging curve?' Zeelly Americaans wizz zeer zeelly games. Now futbol—zat eez a game."

So to clarify, a hanging curve is a bad pitch that often leads to a home run. A curveball is a pitch that is slower then a fastball and is supposed to curve away from the batter, making it hard to hit. However, a hanging curveball fails to curve and just hangs like a big fat grapefruit, making it quite easy to hit. A pitcher who does this often will not be a pro very long.

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A TYPICAL BAD TRADER

So how does this relate to trading? Let's say John, the really bad trader, has been long crude oil for two days now, and is up $2.00 on the trade. He got long because all he hears about on TV is how crude is going to the moon and because he just paid $3.00 a gallon at the pump last week. Now two days later, it opens 20 cents lower and sells off a bit, and he fears the worst and sells it at the market. By the end of the day however, it has rallied up a dollar and a few days later it's up four bucks from there with barely a down move. Not only did he never get back in, in fact he shorted it, because he thought it would retrace a bit giving him a chance to get back in on the long side. By the end of the week he's lost $4,000 on a trade that should have made him $4,000.

Why? Because he never had a trading plan for the trade or a game plan for what to do with it after he got in. He threw a bad pitch because he didn't do his homework and then threw a few more as he wasn't prepared and let his emotions get the better of him. His reasons for getting into the trade were not thought out. High gas prices alone are not a good reason to buy oil impetuously. You need to thoroughly think out a trade before jumping in. And then, once in the trade, John had no idea what he wanted out of it. You cannot trade this way and expect to make money. You should always have a plan for your trades if you want to make it as a trader, as trading on impulses will not get you very far.

A TYPICAL GOOD TRADER PREPARED WITH A PLAN

On the other hand, a good trader will make a thorough analysis of the situation before jumping in. He might take a look to see where crude oil is on a chart, considering: Is it overbought? How much risk is involved? How much can he hope to make on the trade, and so on? After meeting any criteria he may have, he will next look to time an entry if he has decided to get in. One of the things that make this trader better is that after deciding to buy, but before getting in, he will start to make an exit strategy for the trade. After getting in he will evaluate the trade on a regular basis.

Basically, he would have a both a plan of attack and a defensive strategy for the trade, or more precisely he would have a game plan for the trade from start to finish.

If you look at Figure 1.1, you can see the situation where these scenarios could have happened. Crude oil was in the news a lot these days as

FIGURE 1.1 Crude Oil
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gas prices were at record highs, and it looked like the market was going for another record high after being in a congestion stage for a short while in the strong uptrend. Though a prudent trader wouldn't jump into a trade based on it being in the news, let's just say Harry, from here on in,the good trader, looked at the chart the day of the shaded circle A, drew a couple of trend lines and said, "You know what, this looks like a good situation. It meets all my criteria [his trading plan]: It's in a major uptrend [not seen in its entirety in this chart but shown with Trend Line A]. It is fairly close to the trend line; it just broke out of a small congestion area at $70, retraced a bit and now has broken out again; it is near all-time highs; and the risk measured by Trend Line B is acceptable, given the potential for it to take off. A good place to have a stop would be just below that trend line so the risk is about two points. The stochastics are high, but not yet crossing over, and the upward trend line in them is a bullish signal. Should the stochastics turn below the overbought area I'll get out, as if the market breaks the trend line."

Now Harry has made a trade that fits his trading style and the criteria set out in his trading plan. Plus, he has made a game plan as to what to do with it. He doesn't get shaken out two days later at circle B like John does, but instead holds for another week and sells at circle C when both the trend line C is broken and the stochastics cross below the overbought territory. Harry likes to draw trend lines and since the market got pretty steep, he adjusted the angle to come up with trend line C. The bottom line is that Harry, having a game plan, makes close to $4,000 per contract while John, the yo-yo, lost $4,000 on the same trade.

By the way, I'm editing the book now and wrote the above more than a year ago. Crude oil has since hit $135 dollars a barrel. Good thing I didn't start shorting when I thought it was overpriced at $70. And Pedro Martinez since has torn his calf muscle, spent most of last year on the disabled list with a torn rotator cuff, and followed that up at the beginning of this year with a strained hamstring; so much for that staying-healthy theory I had earlier. It just goes to show how things can change.

THE TRADING PLAN AND THE GAME PLAN

What this book is all about is how to reduce the gambling aspect of trading. Many people perceive trading as nothing more than a gamble. And to many traders it is. But there are many traders, who year after year and month after month make money trading. They have learned how to separate gambling from trading and their results show that it is possible to do. I believe anyone can do it as well if they are willing to do the work it takes. For me, that hard work is developing and trading with a plan. There is probably no greater tool you can have then a proper, well thought out plan.

When I talk about plans I refer to two types, the trading plan and the game plan. Though they work together, they are two different creatures that rely on each other to work. A good trading plan with no game plan won't work. That's like Pedro having the best fastball and curveball in world but not knowing when to throw them or who to throw them at. On the other hand, without a trading plan, a game plan is not nearly as strong. It's like Pedro deciding he needs to throw a knuckleball in a tough situation, but realizing too late he never learned how to throw one. But once he gets both of these plans working together, he can win a lot of games and be the superb pitcher he is.

This holds for traders as well. The main reasons for having these plans are to ensure you make smart trading decisions all the time, to help you exit a trade and to make sure you know what you are risking and how much you stand to gain prior to making a trade. Without the aide of plans, you are starting behind the eight ball. Your chances of succeeding are so much smaller if you are trading haphazardly, as opposed to when you have a proper plan to guide you. Throughout this book you will see just how important a trading and game plan will be in making you a better trader. I've traded with and without a trading and game plan, and I know for sure, my results are exponentially better when I have the guidance of a proper plan behind me.

If you have read my first book, *High Probability Trading*, you will know that I stress that having a plan is a very important ingredient in becoming a top trader. In that book, I had a chapter devoted to trading and game plans. And it is from there that I got the idea for this book.

The Trading Plan

The trading plan comes first, and it is the board based trading strategy each trader should have. It should reflect a trader's trading style, trading strategies, and risk aversion. A trading plan doesn't have to have a system set in stone, but it can have known-to-work strategies like "buy dips in an uptrend and don't risk more then 5 percent of equity on any given trade." A trading plan won't change much from day to day, as it consists of a trader's systems and money management plans. It does need to be reviewed on a regular basis, but overall it usually stays the same. Though this book is not about how to make a trading plan, I'll expand on the basics of doing so in the next chapter.

The Game Plan

Once a trading plan is in place, a trader needs a plan to be able to attack the markets on a day-to-day basis. This will be the game plan and it will change constantly as it reflects new market conditions. Markets have something new to offer all the time and a well-prepared trader can take advantage of this by preparing how to react in advance. This may include moving stops, knowing what you will do after an unemployment number is released, or waiting for a market to reach a trend line before getting in. The game plan will include finding trades, timing, knowing how much to trade, where to exit, and how to adjust risk. You should reevaluate your positions on a regular basis and come up with new scenarios so that you can alter your game plan as the market changes. This book will focus more than anything on how to use a game plan to your advantage. And if you learn how to make and use one, you will become a trader who leaves very little to gambling.

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A DISCLOSURE OR TWO BEFORE WE CONTINUE

Now, before I continue, I just want to make it clear that these are just my ideas and should not be taken as gospel or the holy grail of what a trading and game plan are. These are just outlines on which you should expand. This book is not for the lazy trader. You will not find any get-rich-quick strategies or systems to make you a million dollars. This book will make you a better, more alert trader, but you will have to work to improve your trading. Hopefully though, after reading it you will have a couple more tools in your arsenal that will lead you in the right direction. I know you are trying to be a better trader because you bought this book and that's a start. If you are glancing through this book in a bookstore, just take the plunge and buy it. Anyway, I hope I can help you.