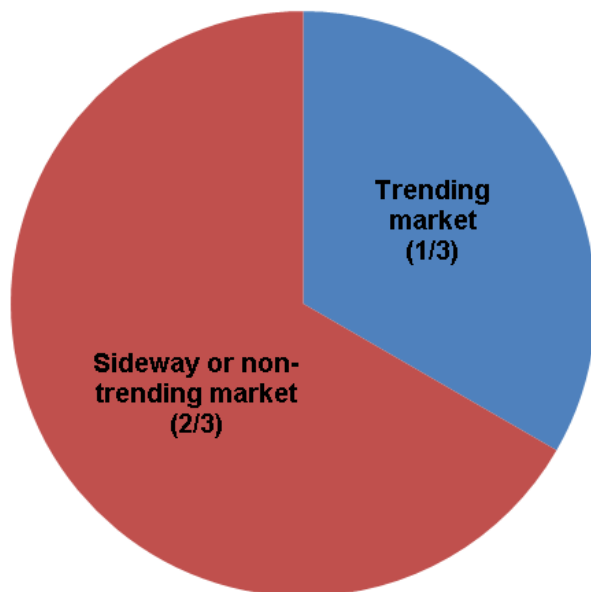


How Profits and Losses unfold in the real world...

Most amateur traders have simply no idea how the markets work in the real world and, therefore, have no idea how their profits and losses are anticipated to unfold. There are many software packages that allow you to develop and back-test a multitude of strategies, enabling you to generate trading reports. However, because these are just a simple statistical analysis of trading results, they can often be misleading - especially when you see them in the context of a bare analysis of just a set of numbers...without any understanding of how the markets really unfold.

So, in this chapter I want to look at how the markets unfold and show you how profits and losses fit into the real world scheme of things.

Over time, markets can unfold in three basic ways: they can go up; they can go down; they can move sideways. Most of us are familiar with rising markets and falling markets but in reality a sideways market is far more common. Typically, markets will spend about 2/3 of their time moving sideways and about 1/3 of their time in a trend (moving either strongly up or down). Most trading strategies rely on a market actually moving - either in an uptrend or a downtrend - to make money. Therefore, typically, you should anticipate making profits only about 1/3 of the time.

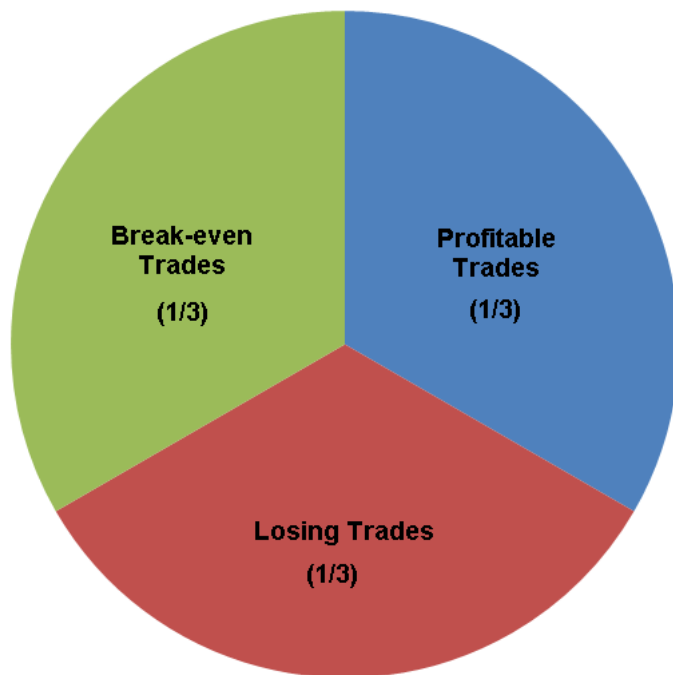


However, most trading strategies or statistics about profits and losses, do not take into account the observation that the markets are in a position where profits can be made only about 1/3 of the time. This makes profit and loss statistics very misleading, particularly when the amateur trader starts trading for real.

So what should you really anticipate as far as profits and losses are concerned?

Well, over the last 20 years that I have been involved in the markets and from seeing hundreds of different trading systems, I have seen that profits and losses and breakeven (no profit or loss) trades tend to unfold in approximately equal 1/3 segments. Put another way, about 1/3 of the time you will be making losses, about 1/3 of the time you will be making breakeven trades and about 1/3 of the time you will be making profits.

Let's take a look at this concept in a picture:

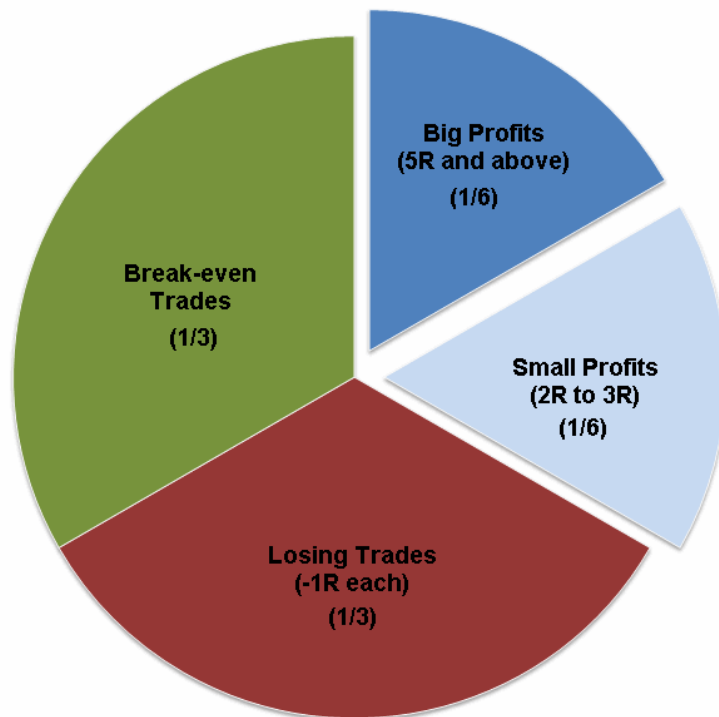


Hopefully, you can see that how you treat your breakeven trades has a huge effect on how you report the percentage of winners. For example, if the breakeven trades are counted as losing trades, you could have a system that is 66.6% losses and only 33.3% winners. In other words, your profitability could quite easily be reported as 30-40% winning trades. On the surface, this does not look good and will deter amateur traders.

However, if the breakeven trades are counted as winners (for example, if each breakeven trade was actually just a \$1 winner), the system in the last paragraph is turned on its head. Suddenly, the system has 66.6% winners and 33.3% losers. Not surprisingly, this system is far more appealing to most traders...

As you see, this is where statistics can be very misleading - you need to look into them in far greater detail.

Again, trading typically seems to unfold in equal 1/3 segments where 1/3 of the time you will have losing trades, 1/3 of the time you will have breakeven trades and the remaining 1/3 will be profitable trades. But is that where the story ends? Well, not quite...because in reality the profitable 1/3 splits down often into 1/2 where your profitable trades are small profits (such as +2R or +3R) and 1/2 where your large profits (+5R and above) fall. What this actually means is that you tend to make your largest profits only about 1/6 (1/2 of your profitable 1/3) of the time! This is precisely where most amateur traders fall down.

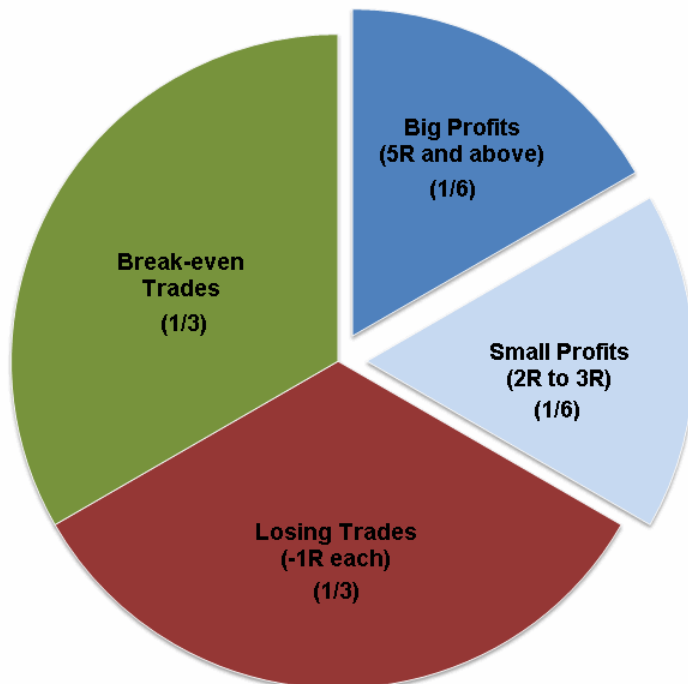


In reality, then, you will spend 2/3 of the time either making losses (albeit small) and breakeven trades and only about 1/6 of the time will you be making the big profits. Most amateur traders find it very difficult to deal with this psychologically because most amateur traders - this is basic human nature - want to be right all the time and have big profits all of the time. So, what happens in practice is that the amateur trader will have 2, 3 or 4 losing or breakeven trades... then, as soon as they get one winner, they will exit that winner too early. By not managing it correctly, they cut one of their big profitable winners into a small winner. This can have a devastating impact on their profitability because the big winners are necessary to make the money overall. I am sure that you can understand that by not allowing these big winners to develop, and banking profits too early, you miss out on the big winners.

It is quite strange that becoming a successful trader sometimes has more to do with dealing with yourself on a psychological level - mainly by allowing your winning trades to run further - rather than actually learning how to trade. I imagine this is why 97% of amateur traders end up losing and only 3% end up becoming successful, profitable professional traders.

This is why you need to understand how markets unfold in the real world...so you can understand why it is so important to let your big winners run. And also, to understand that to be a successful profitable trader actually means trading water (small losses and breakeven trades) most of the time, waiting for the few big winners to come through. In reality, you will not have that many big winners but they are vital to your overall success as a trader.

So let's summarise by looking at what a successful professional trader should anticipate in terms of profits and losses:



As you can see, typically you should anticipate about 1/3 of the time you will be making losses (but keeping them small at just -1R); 1/3 of the time making breakeven trades; the remaining 1/3 profitable, with the profitable 1/3 splitting into 1/2 of the time small profits and 1/2 the time large profits. You should anticipate having large profitable trades only about 1/6th (16-17%) of the time.

If you are going to become a successful professional trader, understanding this gives you a far better chance of being able to manage your trades and letting the big profitable trades run - which is vital for your overall trading success.

Amateur traders expect to be right all the time and make big money all the time. In real life nothing is further from the truth. As we have seen, on the surface you can have a 66% profitable system (profits and break-even trades), but in reality the big profits unfold only about 16-17% of the time.