Top 10 Forex Trading Rules

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Introduction

Why Trade in Currencies?
There are 10 major reasons why the currency market is a great place to trade:

1. You can trade to any style - strategies can be built on five-minute charts, hourly charts ,daily charts or even weekly charts.
2. There is a massive amount of information - charts, real-time news, top level research - all available for free.
3. All key information is public and disseminated instantly.
4. You can collect interest on trades on a daily or even hourly basis.
5. Lot sizes can be customized, meaning that you can trade with as little as $500 dollars at nearly the same execution costs as accounts that trade $500 million.
6. Customizable leverage allows you to be as conservative or as aggressive as you like (cash on cash or 100:1 margin).
7. No commission means that every win or loss is cleanly accounted for in the

P&L.
8. You can trade 24 hours a day with ample liquidity ($20 million up)
9. There is no discrimination between going short or long (no uptick rule).
10. You can't lose more capital than you put in (automatic margin call)

Fair Warning
This tutorial is designed to help you develop a logical, intelligent approach to currency trading base on 10 key rules. The systems and ideas presented here stem from years of observation of price action in this market and provide high probability approaches to trading both trend and countertrend setups, but they are by no means a surefire guarantee of success. No trade setup is ever 100% accurate. That is why we show you failures as well as successes - so that you may learn and understand the profit possibilities, as well as the potential pitfalls of each idea that we present.

The 10 Rules
1. Never Let a Winner Turn Into a Loser
2. Logic Wins, Impulse Kills
3. Never Risk More Than 2% per Trade
4. Trigger Fundamentally, Enter and Exit Technically
5. Always Pair Strong With Weak
6. Being Right but Being Early Simply Means That You Are Wrong
7. Know the Difference Between Scaling In and Adding to a Loser
8. What is Mathematically Optimal Is Psychologically Impossible
9. Risk Can Be Predetermined, but Reward Is Unpredictable
10. No Excuses, Ever

Trading is an art rather than a science. Therefore, no rule in trading is ever absolute (except the one about always using stops!) Nevertheless, these 10 rules work well across a variety of market environments, and will help to keep you grounded - and out of harm's way. (If you have questions about currency trading you might want to check out, *Common Questions About Currency Trading*.)

Never Let A Winner Turn Into A Loser

Repeat: Protect your profits. Protect your profits. Protect your profits. There is nothing worse than watching your trade be up 30 points one minute, only to see it completely reverse a short while later and take out your stop 40 points lower. If you haven't already experienced this feeling firsthand, consider yourself lucky - it's a woe most traders face more often than you can imagine and is a perfect example of poor money management.

Managing Your Capital

The FX markets can move fast, with gains turning into losses in a matter of minutes, making it critical to properly manage your capital. One of the cardinal rules of trading is to protect your profits - even if it means banking only 15 pips at a time. To some, 15 pips may seem like chump change; but if you take 10 trades 15 pips at a time, that adds up to a respectable 150 points of profits. Sure, this approach may seem like trading like penny-pinching grandmothers, but the main point of trading is to minimize your losses and, along with that, to make money as often as possible.

The bottom line is that this is your money. Even if it is money that you are willing to lose, commonly referred to as risk capital, you need to look at it as "you versus the market". Like a soldier on the battlefield, you need to protect yourself first and foremost.

There are two easy ways to never let a winner turn into a loser. The first method is to trail your stop. The second is a derivative of the first, which is to trade more than one lot.

Trailing Your Stops

Trailing stops requires work but is probably one of the best ways to lock in profits. The key to trailing stops is to set a near-term profit target. For example, if your "near-term target" is 15 pips, then as soon as you are 15 pips in the money, move your stop to breakeven. If it moves lower and takes out your stop, that is fine, since you can consider your trade a scratch and you end up with no profits or losses. If it moves higher, with each 5-pip increment you boost up your stop from breakeven by 5 pips, slowly cashing in gains. Just imagine it like a blackjack game, where every time you take in $100, you move $25 to your "do not touch" pile. (For more on this, see *Trailing Stop Techniques*.)

Trading In Lots

The second method of locking in gains involves trading more than one lot. If you trade two lots, for example, you can have two separate profit targets. The first target would be placed at a more conservative level, closer to your entry price, say 15 or 20 pips, while the second lot is much further away, through which you are looking to bank a much larger reward-to-risk ratio. Once the first target level is reached, you would move your stop to breakeven, which in essence embodies the first rule: "Never let a winner turn into a loser".

Of course, 15 pips is hardly a rule written in stone. How much profit you bank and by how much you trail the stop is dependent upon your trading style and the time frame in which you choose to trade. Longer term traders may want to use a wider first target such as 50 or 100 pips , while shorter term traders may prefer to use the 15-pip target. Managing each individual trade is always more art than science. However, trading in general still requires putting your money at risk, so we encourage you to think in terms of protecting profits first and swinging for the fences second. Successful trading is simply the art of accumulating more winners than stops.

Logic Wins; Impulse Kills

More money has been lost by trading impulsively than by any other means. Ask a novice why he went long on a currency pair and you will frequently hear the answer, "Because it has gone down enough - so it's bound to bounce back." We always roll our eyes at that type of response because it is not based on reason - it's nothing more than wishful thinking.

We never cease to be amazed how hard-boiled, highly intelligent, ruthless businesspeople behave in Las Vegas. Men and women who would never pay even one dollar more than the negotiated price for any product in their business will think nothing of losing $10,000 in 10 minutes on a roulette wheel. The glitz, the noise of the pits and the excitement of the crowd turn these sober, rational businesspeople into wild-eyed gamblers. The currency market, with its round-the-clock flashing quotes, constant stream of news and the most liberal leverage in the financial world tends to have the same impact on novice traders.

Trading Impulsively Is Simply Gambling
It can be a huge rush when a trader is on a winning streak, but just one bad loss can make the same trader give all of the profits and trading capital back to the market. Just like every Vegas story ends in heartbreak, so does every tale of impulse trading. In trading, logic wins and impulse kills. The reason why this maxim is true isn't because logical trading is always more precise than impulsive trading. In fact, the opposite is frequently the case. Impulsive traders can go on stunningly accurate winning streaks, while traders using logical setups can be mired in a string of losses. Reason always trumps impulse because logically focused traders will know how to limit their losses, while impulsive traders are never more than one trade away from total bankruptcy. Let's take a look at how each trader may operate in the market. (To get a better understanding of traders, check out *Understanding Investor Behavior*.)

The Impulsive Trader
Trader A is an impulsive trader. He "feels" price action and responds accordingly. Now imagine that prices in the EUR/USD move sharply higher. The impulsive trader "feels" that he has gone too far and decides to short the pair. The pair rallies higher and the trader is convinced, now more than ever, that it is overbought and sells more EUR/USD, building onto the current short position. Prices stall, but do not retrace. The impulsive trader, who is certain that they are very near the top, decides to triple up his position and watches in horror as the

pair spikes higher, forcing a margin call on his account. A few hours later, the EUR/USD does top out and collapses, causing Trader A to pound his fists in fury as he watches the pair sell off without him. He was right on the direction but picked a top impulsively, not logically.

The Analyzer
On the other hand, Trader B uses both technical and fundamental analysis to calibrate his risk and time his entries. He also thinks that the EUR/USD is overvalued, but instead of prematurely picking a turn at will, he waits patiently for a clear technical signal - like a red candle on an upper Bollinger band or a move in the relative strength index (RSI) below the 70 level - before he initiates the trade. Furthermore, Trader B uses the swing high of the move as his logical stop to precisely quantify his risk. He is also smart enough to size his position so that he does not lose more than 2% of his account should the trade fail. Even if he is wrong like Trader A, the logical, Trader B's methodical approach preserves his capital, so that he may trade another day, while the reckless, impulsive actions of Trader A lead to a margin call liquidation. (To read more on technical and fundamental analysis, see *Technical Analysis: Fundamental Vs. Technical Analysis*.)

Conclusion
The point is that trends in the FX market can last for a very long time, so even though picking the very top may bring bragging rights, the risk of being premature may outweigh the warm feeling that comes with gloating. Instead, there is nothing wrong with waiting for a reversal signal to reveal itself first before initiating the trade. You may have missed the very top, but profiting from up to 80% of the move is good enough in our book. Although many novice traders may find impulsive trading to be far more exciting, seasoned pros know that logical trading is what puts bread on the table.

Never Risk More Than 2% Per Trade

Never risk more than 2% per trade. This is the most common - and yet also the most violated - rule in trading and goes a long way toward explaining why most traders lose money. Trading books are littered with stories of traders losing one, two, even five years' worth of profits in a single trade gone terribly wrong. This is the primary reason why the 2% stop-loss rule can never be violated. No matter how certain the trader may be about a particular outcome, the market, as the well known economist John Maynard Keynes, said, "can stay irrational far longer that you can remain solvent." (For more on "stop-loss" read the article *The Stop Loss Order - Make Sure You Use It*.)

Swinging for the Fences

Most traders begin their trading careers, whether consciously or subconsciously, by visualizing "The Big One" - the one trade that will make them millions and allow them to retire young and live carefree for the rest of their lives. In FX, this fantasy is further reinforced by the folklore of the markets. Who can forget the time that George Soros "broke the Bank of England" by shorting the pound and walked away with a cool $1 billion profit in a single day! But the cold hard truth of the markets is that instead of winning "The Big One", most traders fall victim to a single catastrophic loss that knocks them out of the game forever. (To learn more about George Soros and other great investors, read the *Greatest Investors Tutorial*.)

Large losses, as the following table demonstrates, are extremely difficult to overcome.

Amount of Equity Loss	Amount of Return Necessary to Restore to Original
25%	33%
50%	100%
75%	400%
90%	1000%

Just imagine that you started trading with $1,000 and lost 50%, or $500. It now takes a 100% gain, or a profit of $500, to bring you back to breakeven. A loss of 75% of your equity demands a 400% return - an almost impossible feat - just to bring your account back to its initial level. Getting into this kind of trouble as a trader means that, most likely, you have reached the point of no return and are at risk for blowing your account.

Why the 2% Rule?
The best way to avoid such a fate is to never suffer a large loss. That is why the 2% rule is so important in trading. Losing only 2% per trade means that you would have to sustain 10 consecutive losing trades in a row to lose 20% of your account. Even if you sustained 20 consecutive losses - and you would have to trade extraordinarily badly to hit such a long losing streak - the total drawdown would still leave you with 60% of your capital intact. While that is certainly not a pleasant position to find yourself in, it means that you need to earn 80% to get back to breakeven - a tough goal but far better than the 400% target for the trader who lost 75% of his capital. (to get a better understanding check out *Limiting Losses*.)

The art of trading is not about winning as much as it is about not losing. By controlling your losses, much like a business that contains its costs, you can withstand the tough market environment and will be ready and able to take advantage of profitable opportunities once they appear. That's why the 2% rule is the one of the most important rules of trading.

Trigger Fundamentally, Enter and Exit Technically

Should you trade based upon fundamentals or technicals? This is the $64 million question that traders have debated for decades and will probably continue to debate for decades to come.

Technical Analysis Vs. Fundamental Analysis
Technicals are based on forecasting the future using past price movements, also known as price action. Fundamentals, on the other hand, incorporate economic and political news to determine the future value of the currency pair.(For more, check out our *Technical Analysis Tutorial* and our *Fundamental Analysis Tutorial*.)

The question of which is better is far more difficult to answer. We have often seen fundamental factors rapidly shift the technical outlook, or technical factors explain a price move that fundamentals cannot. So the answer to the question is to use both. Both methods are important and have a hand in impacting price action. The real key, however, is to understand the benefit of each style and to know when to use each discipline. Fundamentals are good at dictating the broad themes in the market, while technicals are useful for identifying specific entry and exit levels. Fundamentals do not change in the blink of an eye: in the currency markets, fundamental themes can last for weeks, months and even years.

Using Both to Make a Move
For example, one of the biggest stories of 2005 was the U.S. Federal Reserve's aggressive interest rate tightening cycle. In the middle of 2004, the Federal Reserve began increasing interest rates by quarter-point increments. The Fed let the market know very early on that it was going to be engaging in a long period of tightening and, as promised, it increased interest rates by 200 basis points in 2005. This policy created an extremely dollar-bullish environment in the market that lasted for the entire year.

Against the Japanese yen, whose central bank held rates steady at zero throughout 2005, the dollar appreciated 19% from its lowest to highest levels. USD/JPY was in a very strong uptrend throughout the year, but even so, there were plenty of retraces along the way. These pullbacks were perfect opportunities for traders to combine technicals with fundamentals to enter the trade at an opportune moment.

Fundamentally, it was clear that the market was a very dollar-positive environment; therefore, technically, we looked for opportunities to buy on dips rather than sell on rallies. A perfect example was the rally from 101.70 to 113.70. The retracement paused right at the 38.2% Fibonacci support, which would have been a great entry point and a clear example of a trade that was based on fundamentals but looked for entry and exit points based on technicals. (To find out more on Fibonacci numbers look at *Fibonacci And The Golden Ratio*.)

In the USD/JPY trade, trying to pick tops or bottoms during that time would have been difficult. However, with the bull trend so dominant, the far easier and smarter trade was to look for technical opportunities to go with the fundamental theme and trade with the market trend rather than to trying to fade it.

Always Pair Strong With Weak

Every baseball fan has a favorite team. The true fan knows who the team can easily beat, who they will probably lose against and who poses a big challenge. Placing a gentleman's bet on the game, the baseball fan knows the best chance for success occurs against a much weaker opponent. Although we are talking about baseball, the logic holds true for any contest. When a strong army is positioned against a weak army, the odds are heavily skewed toward the strong army winning. This is the way you should approach trading.

Matching Up Currency Pairs
When we trade currencies, we are always dealing in pairs - every trade involves buying one currency and shorting another. So, the implicit bet is that one currency will beat out the other. If this is the way the FX market is structured, then the highest probability trade will be to pair a strong currency with a weak currency. Fortunately, in the currency market, we deal with countries whose economic outlooks do not change instantaneously. Economic data from the most actively traded currencies are released every single day, which acts as a scorecard for each country. The more positive the reports, the better or stronger a country is doing; on the flip side, the more negative the reports, the weaker the country's performance. (To get a better idea of the available economic data, look at *Economic Indicators*.)

Pairing a strong currency with a weak currency has much deeper ramifications than just the data itself. Each strong report gives a better reason for the central bank to increase interest rates, which increases the currency's yield. In contrast, the weaker the economic data, the less flexibility a country's central bank has in raising interest rates, and in some instances, if the data comes in extremely weak, the central bank may even consider lowering interest rates. The future path of interest rates is one of the biggest drivers of the currency market because it increases the yield and attractiveness of a country's currency. (For more insight, see *Get To Know The Major Central Banks*.)

Using Interest Rates
In addition to looking at how data is stacking up, an easier way to pair strong with weak may be to compare the current interest rate trajectory for a currency. For example, EUR/GBP (which is traditionally a very range-bound currency pair) broke out in the first quarter of 2006. The breakout occurred to the upside because Europe was just beginning to raise interest rates as economic growth improved.

The sharp contrasts in what each country was doing with interest rates forced the EUR/GBP materially higher and even turned the traditionally range-bound EUR/GBP into a mildly trending currency pair for a few months. The shift was easily anticipated, making EUR/GBP a clear trade based on pairing a strong currency with a weak currency. Because strength and weakness can last for some time as economic trends evolve, pairing the strong with the weak currency is one of the best ways for traders to gain an edge in the currency market. (To find out more, see *Forces Behind Exchange Rates*.)

Being Right but Being Early Simply Means That You Are Wrong

There is a great Richard Prior routine in which the comic lectures the audience about how the only way to respond when your spouse catches you cheating red-handed is by calmly stating, "Who are you going to believe? Me? Or your lying eyes?" While this line always gets a huge laugh from the crowd, unfortunately, many traders take this advice to heart. The fact of the matter is that eyes do not lie. If a trader is short a currency pair and the price action moves against him, relentlessly rising higher, the trader is wrong and needs to admit that fact - preferably sooner rather than later.

Analysis of the EUR/USD 2004-2005
In FX, trends can last far longer than seem reasonable. For example, in 2004 the EUR/USD kept rallying - rising from a low of 1.2000 all the way to 1.3600 over a period of just two months. Traders looking at the fundamentals of the two currencies could not understand the reasons behind the move because all signs pointed to dollar strength.

True enough, the U.S. was running a record trade deficit, but it was also attracting capital from Asia to offset the shortfall. In addition, U.S. economic growth was blazing in comparison to the Eurozone. U.S. gross domestic product (GDP) was growing at a better than 3.5% annual rate compared to barely 1% in the Eurozone. The Fed had even started to raise rates, equalizing the interest rate differential between the euro and the greenback. Furthermore, the extremely high exchange rate of the euro was strangling European exports - the one sector of the Eurozone economy critical to economic growth. As a result, U.S. unemployment rates kept falling, from 5.7-5.2%, while German unemployment was reaching post-World War II highs, climbing into the double digits.

What If You Took a Short Position and Exited Early?
In this scenario, dollar bulls had many good reasons to sell the EUR/USD, yet the currency pair kept rallying. Eventually, the EUR/USD did turn around, retracing the whole 2004 rally to reach a low of 1.1730 in late 2005. But imagine a trader shorting the pair at 1.3000. Could he or she have withstood the pressure of having a 600-point move against a position? Worse yet, imagine someone who was short at 1.2500 in the fall of 2004. Could that trader have taken the pain of being 1,100 points in drawdown?

The irony of the matter is that both of those traders would have profited in the end. They were right but they were early. Unfortunately, in currency markets, close is not good enough. The FX market is highly leveraged, with default margins set at 100:1. Even if the two traders above used far more conservative leverage of 10:1, the drawdown to their accounts would have been 46% and 88%, respectively.(Learn more about forex leverage with, *Forex Leverage: A Double Edged Sword*.)

Right Place, Right Time
In FX, successful directional trades not only need to be right in analysis, but they also need to be right in timing as well.. That's why believing "your lying eyes" is crucial to successful trading. If the price action moves against you, even if the reasons for your trade remain valid, trust your eyes, respect the market and take a modest stop. In the currency market, being right and being early is the same as being wrong.

Know the Difference Between Scaling In and Adding to a Loser

One of the biggest mistakes that traders make is to keep adding to a losing position, desperately hoping for a reversal. As traders increase their exposure while price travels in the wrong direction, their losses mount to a point where they are forced to close out their positions at a major loss or wait numbly for the inevitable margin call to automatically do it for them. Typically in these scenarios, the initial reasoning for the trade has disappeared, and a smart trader would have closed out the position and moved on. (For related reading, see *The Art Of Selling A Losing Position*.)

However, some traders find themselves adding into the position long after the reason for the trade has changed, hoping that by magic or chance things will eventually turn their way.

We liken this to driving in a car late at night and not being sure whether you are on the right road. When this happens, you are faced with two choices:

1. To keep on going down the road blindly and hope that you will find your destination before ending up in another state
2. To turn the car around and go back the way you came, until you reach a point from where you can actually find the way home.

This is the difference between stubbornly proceeding in the wrong direction and cutting your losses short before it is too late. Admittedly, you might eventually find your way home by stumbling along back roads - much like a trader could salvage a bad position by catching an unexpected turnaround. However, before that time comes, the driver could very well have run out of gas, much like the trader can run out of capital.

Do Not Make a Bad Position Worse
Adding to a losing position that has gone beyond the point of your original risk is the wrong way to trade.There are, however, times when adding to a losing position is the right way to trade. This type of strategy is known as scaling in. (To learn more about scaling in, see *Tales From The Trenches: Trading Divergences In FX*.)

Plan Your Entry and Exit and Stick To It
The difference between adding to a loser and scaling in is your initial intent *before* you place the trade.

If your intention is to ultimately buy a total of one regular 100,000 lot and you choose to establish a position in clips of 10,000 lots to get a better average price (instead of the full amount at the same time) this is called scaling in. This is a popular strategy for traders who are buying into a retracement of a broader trend and are not sure how deep the retracement will be; therefore, the trader will scale down into the position in order to get a better average price. The key is that the reasoning for this approach is established before the trade is placed and so is the "ultimate stop" on the entire position. In this case, intent is the main difference between adding to a loser and scaling in.

What Is Mathematically Optimal Is Psychologically Impossible

Novice traders who first approach the markets will often design very elegant, very profitable strategies that appear to generate millions of dollars on a computer backtest. The majority of such strategies have extremely impressive win-loss and profit ratios, often demonstrating $3 of wins for just $1 of losses. Armed with such stellar research, these newbies fund their FX trading accounts and promptly proceed to lose all of their money. Why? Because trading is not logical but psychological in nature, and emotion will always overwhelm the intellect in the end, typically forcing the worst possible move out of the trader at the wrong time.

Trading Is More Art Than Science
As E. Derman, head of quantitative strategies at Goldman Sachs, a leading investment banking firm, once noted, "In physics you are playing against God, who does not change his mind very often. In finance, you are playing against God's creatures, whose feelings are ephemeral, at best unstable, and the news on which they are based keeps streaming in."

This is the fundamental flaw of most beginning traders. They believe that they can "engineer" a solution to trading and set in motion a machine that will harvest profits out of the market. But trading is less of a science than it is an art; and the sooner traders realize that they must compensate for their own humanity, the sooner they will begin to master the intricacies of trading.

Textbook Vs. Real World
Here is one example of why in trading what is mathematically optimal is often psychologically impossible.

The conventional wisdom in the markets is that traders should always trade with a 2:1 reward-to-risk ratio. On the surface this appears to be a good idea. After all, if the trader is only correct 50% of the time, over the long run she or he will be enormously successful with such odds. In fact, with a 2:1 reward-to-risk ratio, the trader can be wrong 6.5 times out of 10 and still make money. In practice this is quite difficult to achieve. (for related readings, see *Using Pivot Points In FX*.)

Imagine the following scenario: You place a trade in GBP/USD. Let's say you decide to short the pair at 1.7500 with a 1.7600 stop and a target of 1.7300. At first, the trade is doing well. The price moves in your direction, as GBP/USD first drops to 1.7400, then to 1.7360 and begins to approach 1.7300. At 1.7320, the GBP/USD decline slows and starts to turn back up. Price is now 1.7340, then 1.7360, then 1.7370. But you remain calm. You are seeking a 2:1 reward to risk. Unfortunately, the turn in the GBP/USD has picked up steam; before you know it, the pair not only climbs back to your entry level but then swiftly rises higher and stops you at 1.7600.

You just let a 180-point profit turn into a 100-point loss. In effect, you created a -280-point swing in your account. This is trading in the real world, not the idealized version presented in textbooks. This is why many professional traders will often scale out of their positions, taking partial profits far sooner than two times risk, a practice that often reduces their reward-to-risk ratio to 1.5 or even lower. Clearly that's a mathematically inferior strategy, but in trading, what's mathematically optimal is not necessarily psychologically possible.

Risk Can Be Predetermined, but Reward Is Unpredictable

If there is one inviolable rule in trading, it must be "stick to your stops". Before entering every trade, you must know your pain threshold. This is the best way to make sure that your losses are controlled and that you do not become too emotional with your trading.

Trading is hard; there are more unsuccessful traders than there are successful ones. But more often than not, traders fail not because their ideas are wrong, but because they became too emotional in the process. This failure stems from the fact that they closed out their trades too early, or they let their losses run too extensively. Risk MUST be predetermined. The most rational time to consider risk is before you place the trade - when your mind is unclouded and your decisions are unbiased by price action. On the other hand, if you have a trade on, you want to stick it out until it becomes a winner, but unfortunately that does not always happen. You need to figure out what the worst-case scenario is for the trade, and place your stop based on a monetary or technical level. Once again, we stress that risk MUST be predetermined before you enter into the trade and you MUST stick to its parameters. Do not let your emotions force you to change your stop prematurely. (To learn more on why you need a plan, see *The Importance Of A Profit/Loss Plan*.)

The Risk

Every trade, no matter how certain you are of its outcome, is simply an educated guess. Nothing is certain in trading. There are too many external factors that can shift the movement in a currency. Sometimes fundamentals can shift the trading environment, and other times you simply have unaccountable factors, such as option barriers, the daily exchange rate fixing, central bank buying etc. Make sure you are prepared for these uncertainties by setting your stop early on.

The Reward

Reward, on the other hand, is unknown. When a currency moves, the move can be huge or small. Money management becomes extremely important in this case. Referencing our rule of "never let a winner turn into a loser", we advocate trading multiple lots. This can be done on a more manageable basis using mini-accounts. This way, you can lock in gains on the first lot and move your stop to breakeven on the second lot - making sure that you are only playing with the house's money - and ride the rest of the move using the second lot.

Make the Trend Your Friend
The FX market is a trending market. Trends can last for days, weeks or even months. This is a primary reason why most black boxes in the FX market focus exclusively on trends. They believe that any trend moves they catch can offset any whipsaw losses made in range-trading markets. Although we believe that range trading can also yield good profits, we recognize the reason why most large money is focused on looking for trends. Therefore, if we are in a range-bound market, we bank our gain using the first lot and get stopped out at breakeven on the second, still yielding profits. However, if a trend does emerge, we keep holding the second lot into what could potentially become a big winner. (To learn more, check out *Trading Trend Or Range?*)

Half of trading is about strategy, the other half is undoubtedly about money management. Even if you have losing trades, you need to understand them and learn from your mistakes. No strategy is foolproof and works 100% of the time. However, if the failure is in line with a strategy that has worked more often than it has failed for you in the past, then accept that loss and move on. The key is to make your overall trading approach meaningful but to make any individual trade meaningless. Once you have mastered this skill, your emotions should not get the best of you, regardless of whether you are trading $1,000 or $100,000. Remember: In trading, winning is frequently a question of luck, but losing is always a matter of skill.

No Excuses, Ever

Our boss once invited us into his office to discuss a trading program that he wanted to set up. "I have one rule only," he noted. Looking us straight in the eye, he said, "no excuses."

Instantly we understood what he meant. Our boss wasn't concerned about traders booking losses. Losses are a given part of trading and anyone who engages in this enterprise understands and accepts that fact. What our boss wanted to avoid were the mistakes made by traders who deviated from their trading plans. It was perfectly acceptable to sustain a drawdown of 10% if it was the result of five consecutive losing trades that were stopped out at a 2% loss each. However, it was inexcusable to lose 10% on one trade because the trader refused to cut his losses, or worse yet, added to a position beyond his risk limits.

Our boss knew that the first scenario was just a regular part of business, while the second one could ultimately blow up of the entire account.

The Need For Rationalization

In the quintessential '80s movie, "The Big Chill", Jeff Goldblum's character tells Kevin Kline's that "rationalization is the most powerful thing on earth. As human beings we can go for a long time without food or water, but we can't go a day without a rationalization."

This quote has strikes a chord with us because it captures the ethos behind the "no excuses" rule. As traders, we must take responsibility for our mistakes. In a business where you either adapt or die, the refusal to acknowledge and correct your shortcomings will ultimately lead to disaster.

Case In Point

Markets can and will do anything. Witness the blowup of Long Term Capital Management (LTCM). At one time, it was one of the most prestigious hedge funds in the world, whose partners included several Nobel Prize winners. In 1998, LTCM went bankrupt, nearly bringing the global financial markets to its knees when a series of complicated interest rate plays generated billions of dollars worth of losses in a matter of days. Instead of accepting the fact that they were wrong, LTCM traders continued to double up on their positions, believing that the markets would eventually turn their way.

It took the Federal Reserve Bank of New York and a series of top-tier investment banks to step in and stem the tide of losses until the portfolio positions could be unwound without further damage. In post-debacle interviews, most LTCM traders refused to acknowledge their mistakes, stating that the LTCM blowup was the result of extremely unusual circumstances unlikely to ever happen again. LTCM traders never learned the "no excuses" rule, and it cost them their capital. (To find out more, see *Massive Hedge Fund Failures*.)

No Excuses

The "no excuses" rule is most applicable to those times when the trader does not understand the price action of the markets. If, for example, you are short a currency because you anticipate negative fundamental news and that news occurs, but the currency rallies instead, you must get out right away. If you do not understand what is going on in the market, it is always better to step aside and not trade. That way, you will not have to come up with excuses for why you blew up your account. No excuses. Ever. That's the rule professional traders live by.