TRADE YOUR WAY TO FINANCIAL FREEDOM

SECONDE DITION

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This book is dedicated to my wife, Kalavathi Tharp.
Kala provides a very special spark in my life.
Without that spark and her tremendous love,
this book would not be possible.

CONTENTS

FOREWORD

Let me start by saying that *Trade Your Way to Financial Freedom* is required reading for all of my new traders. Of all of Dr. Van Tharp's published books, this one gives the essence of his teachings from his workshops and home study courses. My name is Chuck Whitman, and I am the CEO of Infinium Capital Management, a proprietary trading firm located in the Chicago Board of Trade. We currently have 90 employees, trade on 15 different exchanges, and trade underlying instruments and options on all asset classes. I have personally purchased many copies of this book, but before I get in that, let me tell you about my experiences with Van Tharp.

I first became aware of Van's teachings in 1998, when one of my mentors, Bruce, obtained two of Van's home study courses, the *Peak Performance Course for Traders and Investors* and the *Developing a Winning System That Fits You* Course. Later, Bruce also attended one of Van's System seminars, and he came back telling me how impressed he was with the material and the quality of students that had attended the seminar.

At that time, I was in the midst of one of the most difficult periods of trading of my career. Ironically, 1997 was one of my most successful trading years, and in 1998 I had decided to commit myself to becoming absolutely the best trader I could be. However, the only approach I knew was to "do more" so I could hit my new revenue goal, and needless to say, I was overtrading and battling huge profit and loss swings in my account. In the fall of 1998, I put on a large trade that conceptually was a great trade. However, I mismanaged the trade, and it quickly spiraled into one of the largest losses of my career. Looking back at it now, I'd made many mistakes, and this is according to Van's definition of a mistake which is "not following my rules." I had not done any scenario planning befo the trade, and I found myself in a position with a terrible reward-to-risk ratio. Furthermore, as I battled the loss, I responded emotionally and did everything I could to prevent it. It's what Van calls the "loss trap." Instead of just taking a small loss, I struggled with it, trying to avoid it. And the more I struggled with the loss, the worse it became. And the bigger it got, the more I wanted to avoid it an not take it. Eventually, the loss became too painful and I liquidated the trade. The moment I was out of the trade, I made a vow that I was going to learn from what I had been through and make sure I would never repeat it. It turned out to be a major turning point in my trading career.

I started on my evaluation of myself to discover what I could do to improve as a trader. As a resul I decided to borrow the first book of the *Peak Performance Course* from Bruce, and I found a chapte in there on the "loss trap." I could see myself in the story and how I had responded to that difficult trade. All the mistakes I had made on that trade and how I approached my trading in general were described in that chapter. I was hooked. I immediately ordered myself a personal copy of the course.

In January 1999, I had knee surgery, and I was required to be off my feet for 10 weeks. At the tim I was a floor trader, so I was planning to test some of my "off-the-floor" trading ideas. I also started working through the *Peak Performance Course*, and I quickly decided that the best use of my time would be to clear my head from the markets and focus on my trading psychology. Early in the course Dr. Tharp had said that the exercises you didn't want to do were probably the ones you needed to do the most. As a result, I committed to doing every single exercise in the course, working at it every da for four to six hours for 10 weeks. And, in my opinion, I emerged from that process a trader with a totally different psychology that has served as the foundation of my trading ever since.

At that same time, I decided to attend one of Dr. Tharp's workshops. It was given by Van and

Robert Kiyosaki of *Rich Dad, Poor Dad* fame. That seminar changed my beliefs about wealth and wealth creation as radically as the *Peak Performance Course* had changed my psychology. I'm really glad to see that Dr. Tharp has incorporated a little of that material into this new edition of *Trade You Way to Financial Freedom* by defining *financial freedom* in the preface. I learned that wealth was an idea, not a finite resource as was taught in my economics classes. I realized that I was the biggest factor in my success and that time was more valuable than money. From that point on, I started to ac on faith, and I made decisions that revolved around increasing my productivity and learning. If I cou spend money to improve my productivity and give me more time to learn, I would do it. Shortly afte that workshop, I returned to trading with a new perspective on trading and wealth. I made more mone in the next four months than I had made in my entire career.

After that period, I backed off my trading, doing it instead on more of a part-time basis, and I started to work on a lifelong dream that I had, which was to build my own trading firm and become a upstairs speculator. I spent the next two years learning, researching, and building the plan of how I wanted to trade. As I built this plan, I used many of Van's principles as the foundation. I read this book and his other published book at the time, *Financial Freedom through Electronic Day Trading*. I took several more of Van's workshops, and I adopted five key principles around which I built my firm. Four of those principles I learned from Van. I have kept the principles consistent and in the order Van teaches them as well. Here they are:

1. *Psychology*. You could have the best opportunities and resources in the world but if your psychology is flawed, you won't make it. We operate on the belief that we create and manifest our own realities. If we think the world has problems, then we manifest those beliefs in what we see. But if we think the world is abundant, then we find lots of evidence to show that it is. We place the most amount of focus in this area from how we hire new employees to how we teach them and how we grow. And in this new edition of *Trade Your Way to Financial Freedom*, you'll find that principle throughout the book. You are responsible for the results you get, which means that you are in charge of your trading. When you get results that you don't like, you made a mistake in some way, and you can fix that mistake.

2. *Position sizing*. You could have the best trading plan, information, and execution systems, but if you bet too big, you'll blow out. As Van points out in this new edition, a low-risk idea is an idea that's traded at a risk level that allows you to survive the worst-case contingencies in the long term, so that you can achieve the long-term expectancy of the system. This is one of the real keys to trading success, and you should read this book, several times, just to make sure that you understand this point. You are going to have losses, and it's important to limit the damage of those losses to achieve optimal compounded returns. Position sizing is one of the most important aspects of trading yet so few people teach it. It's that part of your system that helps you achieve your objectives. Make sure you really let that sink in as you read this book.

3. *Market selection*. This principle is my addition, although it's part of Dr. Tharp's model given in Chapter 4. The market you trade is far more important than how you trade. I've seen this principle operating throughout my trading career. In the late 1990s, early 2000s there were stock options guys making enormous amounts of money, yet they had no idea what they were doing. A few short years later, some of these same traders were approaching me for jobs as clerks with our firm. In contrast, I saw some great traders make a solid living

slugging it out in bad markets. If they were in some of the busy markets, they would have ~~been legends. This confirmed my belief. Find the busiest, most volatile markets and focus~~ on those. As John Paul Getty used to say, “Go where the oil is!” I’m really glad to see that Dr. Tharp has added a chapter to this new edition on assessing the big picture, and then finding markets and strategies that fit the big picture.

4. *Exits*. The key to making money in the markets is in how you exit the market. You must limit your losses by knowing when you are wrong and pulling the trigger on your bad trades. This is discussed extensively in Chapter 10. You must also know how to manage a winner and let it optimally run. This is discussed extensively in Chapter 11. Some of the greatest traders I know and have watched were masters at admitting they were wrong, exiting the position without ego, and doing it in a way that no one even knew they were getting out of the market.

5. *Entries*. In Chapter 9, you learn that you can enter the market randomly and still make money. Dr. Tharp even talks about his random entry system and shows you how to make money with it. If you have a sound psychology that allows you to trade without ego; a positive expectancy system, which is produced by making sure that your losses are kept to a minimum (Van calls this “making sure your losses are 1*R* or less”), and trading for excellent reward-to-risk ratios (which Van calls “having your winners be large multiples of your initial risk”); and trade in the best market, using position sizing to meet your objectives, then your entry just isn’t that important. These principles are discussed throughout this new edition of *Trade Your Way to Financial Freedom.*

These principles are the core of my business, and I teach them to all new recruits and to the employees of my firm. These principles are in sharp contrast to the following beliefs that are held by most of the general trading public:

- You have to pick the right stock. If you haven’t made any money, you probably picked the wron stock. Contrast this belief with Principle 5 above.
- You should be fully invested at all times, and diversification is involved in controlled risk. Contrast this belief with Principle 2.
- When you lose money in the market, it is probably because you are a victim of the market or your broker or advisor. Contrast this with Principle 1.

As a result, the general trading public is primarily focused on picking the right stocks at the right time and they ignore what’s really important for success. That’s why this book is so important.

In Chapter 2 you’ll learn why success is so elusive to so many people—it’s because of all the biases they have in their decision making. Dr. Tharp calls these “judgmental heuristics.” And, ironically, the people who know about them use them to try to predict the market. In contrast, we’ve adopted Van’s idea that most people lose because they are inefficient decision makers, so why not make ourselves more efficient.

As I mentioned earlier, *Trade Your Way to Financial Freedom* is required reading for my new traders. It gives insight into all of Van’s other work that I have found so valuable. This book will hel you learn how to develop a trading system that fits your beliefs and helps you to achieve your objectives. If you read it again and again, you’ll gain even more insight into the five key principles I use to run my company.

I would not have had the success and blessings I have had or had the opportunity to share them with so many others in the building of my firm if it had not been for the philosophies that Dr. Tharp taught me. I believe it was God’s plan that I ran into Dr. Tharp and had the chance to learn from him have seen these philosophies put to the test over and over again as I have built my firm. They are the principal reason my firm has become extremely successful.

I hope you too learn the wonderful lessons from this book and use them to trade more profitably and to live your life more purposefully.

Chuck Whitma
Chief Executive Offic
Infinium Capital Manageme
Chicago, Illino

PREFACE TO THE SECOND EDITION

BECOMING FINANCIALLY FREE THROUGH THIS BOOK

First, I'd like to comment on the title, which includes the words "financial freedom" in it. Many people thought that the words "financial freedom" made the title a bit too commercial. Jack Schwage even wrote a comment on the first edition that said, "While I can't promise you financial freedom, I can promise you a book filled with sound trading advice and lots of ideas you can use to develop you *own* trading methodology. And, if you don't think that's enough, then you really need this book."

So what is financial freedom? The first section of my book *Safe Strategies for Financial Freedom* is devoted to this topic. I won't repeat that discussion here, but I will summarize it.

Financial freedom is really a new way to think about money. Most people think they win the money game by having the most money and the most toys. This rule has been set up by other people to mislead you. If you follow it, someone else besides you will win the money game. The reason is that only one person in the world can have the most money, and even if you think billionaire status qualifies, it still means that your chances of winning the game are very slim.

If you think having the most toys wins the game, then you'll probably end up in debt because, afte all, you can buy any toy now if the down payment and the monthly payments are low enough. However, doing this ultimately relegates you to a world of huge consumer debt and a life of financia slavery in which financial freedom (as I mean it) continues to move farther and farther away.

Financial freedom, to me, means adopting a different set of money rules to win the game of money. And if you follow those rules, become committed to the goal, and learn from your mistakes, then I can promise you financial freedom through this book. Financial freedom means that your money working for you makes more money than you need to meet your monthly expenses. For example, if your expenses are $5,000 per month, and your money working for you makes you $5,000 or more each month, then you are financially free.

Trading and investing make up one of the many ways that you can have your money working for you. I believe if you can develop a methodology through this book that doesn't require a lot of work maintain (that is, it doesn't require more than a few hours each day) and that can generate enough money to meet your monthly expenses, then you are financially free. For example, if you have a $300,000 account and you make $60,000 (that is, 20 percent) each year trading that account and it takes you only a few hours each day to do that, then you are financially free. That doesn't mean that you won't spend hundreds, or even thousands, of hours building the foundation for your financial freedom. It also doesn't mean that you can avoid working on yourself yet continue to maintain that level of return. It does mean, however, that financial freedom is possible once you lay that foundatio

YOU TRADE ONLY YOUR BELIEFS

This book was originally published in 1999. Since then, numerous people have told me that it totally changed their thinking about trading, investing, and approaching the markets.

My understanding has always been that you cannot trade the markets. Instead, you trade your *beliefs* about the market. For example, if you believe that the market is going to go up (or generally that it goes up in the long run) and you believe that trend following works, then you might adopt a trend-following approach to buy stocks that are going up. However, if you believe that the market is overvalued and likely to go down, then you might have trouble buying stocks that are going up because doing so conflicts with your beliefs.

Everything that I said in the first edition of this book reflected my beliefs about the markets and what was necessary for trading success at the time that I wrote the book. However, beliefs are not reality. Instead, they are your filters to reality. I’ve acknowledged that for a long time, and I’ve continually said that what I teach reflects the most useful beliefs that I now have about the market an trading success.

Over the years, I occasionally run across beliefs that seem to help people even more. And in the seven years that have elapsed since the first edition of this book was published, I’ve adopted many new, more useful beliefs. As a result, even though most of the core concepts have *not* changed from the first edition, enough things have changed that I can help people even further with this new editio of the book.

Here are a few of the major changes that reflect my current beliefs:

- I believe that all trading systems should reflect the big picture. In 1999, we were nearly at the end of a great secular bull market that had begun in 1982. In 1999, you could buy any high-tech stock and hang on to it for six months and perhaps double your money. However, secular bull markets are followed by secular bear markets such as the one that began in 2000. These tend to last for as long as 20 years, so people need strategies that take advantage of these macro tendencies to make good profits. The bear market isn’t bad news. It just requires a different focus to make money in it.
- My model for developing a trading system that fits you has evolved slightly over the last six years, and I’ve included the changes in this book.
- Although most of the concepts in the first edition are timeless, my perspective on them is not. A a result, I’ve changed my emphasis in this second edition to what I believe works best now.
- My explanation of expectancy in the first edition of this book was slightly misleading and definitely confusing. I changed it in my other books, *Financial Freedom through Electronic Da Trading* and *Safe Strategies for Financial Freedom*, and I’ve also made sure that it is crystal clear in this book as well.
- I now strongly believe that systems can be thought of as distributions of *R* multiples that they generate, which you’ll understand better as you read the book. When you understand this, your perspective on trading systems will totally change.
- Because systems can be thought of as distributions of *R* multiples, it’s also possible to use those distributions to simulate what your future results might be like. And even more importantly, such simulations will tell you how to position size your system to meet your objectives. I’ve placed a strong emphasis on this topic in this new edition.

In addition, there are many small but significant changes in this edition that will help you become a much better trader or investor. I hope you benefit as much from the second edition as many people have claimed to have benefited from the first.

Van K. Tharp, Ph.I
August 20

PREFACE TO THE FIRSTE DITION

A number of my clients have asked me not to include certain sections in this book with the admonishment of “You’re giving away too much.” Yet my job is to coach traders and investors to achieve peak performance. Every available tool is important in attempting to do that because so much misinformation exists in the literature that the average person will constantly be led astray.

Most of the misinformation is not deliberate. People want to be led astray. They constantly ask the wrong questions. For example,

- What’s the market going to do now?
- What should I buy now?
- I own XYZ stock. Do you think it’s going to go up? (If you say no, then they’ll ask someone else until they find a person who agrees with their opinion.)
- Tell me how I can get into the market and be “right” most of the time.

And those selling information get rewarded by giving them the answers they want.

In April 1997, I did a two-day seminar in Germany. Toward the end of the seminar, I gave the participants the choice between doing an exercise dealing with self-sabotage (which all of them needed) and asking me questions. Although I believe that working on yourself is the most important thing you can do, they voted to ask questions. Guess what the first question asked of me was: “Dr. Tharp, what’s your opinion about what the U.S. stock market will do for the rest of 1997?” This was despite my best efforts over the past two days to explain to them why such questions were unimportant. And hopefully, by the time you finish this book, you’ll understand why.

When people move beyond questions on what to buy to questions about “how?” they still ask the wrong questions. Now the question becomes something like this:

What criteria should I use to enter the market in order to be right most of the time?

There is a large industry available to give you the answer to such questions. Hot investment books are filled with entry strategies that the author claims to be 80 percent reliable or to have the promise of big gains. A picture tends to be worth a thousand words, so each strategy is accompanied by a graph in which the market just took off. Such “best-case” pictures can sway a lot of people and sell a lot of books. They also sell a lot of newsletters and a lot of trading systems. Unfortunately, they don’t help that many people.

At an investment conference in 1995, a well-known speaker on the futures markets talked about his high-probability entry signals. The room was packed as he carefully explained what to do. Toward the end of the talk, one person raised his hand and asked, “How do you exit the market?” His response, albeit facetiously, was, “You want to know all my secrets, don’t you?”

At another conference about a year later, the keynote speaker gave an hour talk before 600 people on high-probability entry techniques. Everyone listened eagerly to every word. Nothing was said about exits except that one should keep a tight stop and pay close attention to money management. After the talk, this particular speaker sold $10,000 worth of books in about a half-hour period becaus people were so excited that such high-probability entry techniques were the answer.

At the same conference, I spoke about position sizing—the key factor in determining one's profits. Thirty people listened to the talk, and about four of them purchased a book having to do with that particular topic. People gravitate toward the things that don't work. It's human nature.

Such stories could be repeated in conference after conference. Everyone will flock to a talk on high-probability entry signals or the software that they believe will tell them what to buy right now. And fewer than 1 percent will learn anything significant. However, talks featuring the most important keys to making real money, those on position sizing and your personal psychology, will have few people in attendance.

Even the software programs dealing with the markets have the same biases built into them. These products typically are loaded with indicators that can help you perfectly understand why markets did what they did in the past. Why wouldn't they? Those indicators are formed from that past data about which they are predicting prices. If you could do that with futures prices, the software would be wonderful. However, the reality is that you cannot predict prices in this manner. But it does sell a lot of software. And the software does answer the question that most people have: "What should I buy now?"

I might be leaning on a lot of sacred cows before I finish this book. The reason is that you can learn the real secrets to the market only if you pay attention to what really works. If your attention is elsewhere, you are not likely to find any secrets. However, this book simply contains my beliefs and opinions. It is filled with the kind of information that will help you really improve your performance as a trader or investor. Search it out and you will take a giant leap forward in your ability to make money consistently.

Van K. Tharp, Ph.D.
June 199

ACKNOWLEDGMENTS

This book is a product of 25 years of thinking about markets, studying hundreds of great traders and investors, and coaching many more to greatness by helping them apply some of the principles you'll find in this book. The first edition has been an inspiration to thousands of traders. And if this new edition helps thousands more, even those I have never met, it will have been worth the effort.

During the 25 years I've spent in this field, numerous people have helped shape the thinking that has gone into this book. I can acknowledge only a few of those people by name. However, everyone who contributed in any way has my deepest thanks and appreciation.

Tom Basso has been a great contributor to my thinking and my life. Tom was a guest speaker at more than a dozen of my seminars and several of our professional trader schools. Tom has also contributed several sections to this book.

Ray Kelly was one of my earliest clients. I watched him evolve from a tough, Irish floor trader whose favorite saying used to be "My way or the highway!" into someone who would freely give his time to inner-city high school kids just to convince them to start to take responsibility for their lives, and who later ran a spiritual retreat in California. Ray was one of the best traders I've known and a great teacher as well. He presented at many of our seminars and wrote the arbitrage section of this book. Ray passed away since the first edition of this book was published. He was special and I miss him greatly.

I'd like to thank Chuck Whitman for writing the foreword to this book. Chuck's been part of my Super Trader program, and I used to consult with him regularly on the phone regarding system ideas. Chuck's not only been one of my best clients, he's also evolved into a model trader.

Chuck LeBeau helped me make the link from the famous traders' axiom "Cut your losses short an let your profits run" to the importance of exits. Think about it: Cutting losses short is all about aborting losses, exits. Letting profits run is all about exits as well. The entire axiom is about exits. Chuck's persistence in driving home this point has been very valuable to me. Chuck is frequently a guest speaker at our advanced systems seminar.

I'd also like to thank D. R. Barton. Over the last 15 years, I've watched D.R. transform himself from an engineer into a trader-teacher and a great contributor to our workshops. D.R. wrote the band trading section in the concepts chapter and thus has the honor of having contributed to all three of the books I've published through McGraw-Hill.

Kevin Thomas, Jerry Toepke, and Louis Mendelsohn all contributed great sections to the concepts chapter. Their work is very insightful and helpful. I deeply appreciate their contributions. Kevin was the first person to join my Super Trader program, and he now trains traders in London.

I'd also like to acknowledge Chuck Branscomb. When Chuck first came to our workshops, he thought he had a great system, when he really had no system at all—just some entry signals. Over the years, I watched him evolve into a very knowledgeable systems trader. He is also a great example of how solid "intuition" about the market evolves out of solid systems trading. Chuck is a former editor of our newsletter, and in that capacity he helped me coin such concepts as *R* multiples that have been included in this book.

Both Frank Gallucci and Chris Anderson helped me develop software that has shown me the importance of using simulation to determine the appropriate position-sizing algorithm to meet one's objectives in trading. In addition, I’d also like to acknowledge John Humphreys who incorporated all of ~~my suggestions about position sizing and enabled me to see the millions of possibilities that~~ now exist for various algorithms.

I’d like to thank my staff at IITM for their support in completing this book. Cathy Hasty was a great help in laying out the book in its original format with the graphics. Becky McKay helped me tremendously with the second edition of this book with proofreading and chapter editing. I had only a few months to get the second edition done, and I couldn’t have done it without you, Becky. I am also grateful to Ana Walle and Tamika Williams, who assisted and supported me in a variety of different ways on this project. And I want to especially thank Melita Hunt for inspiring me to write this second edition of the book. Melita spearheaded the project and played the most critical role in handling details with my publisher, McGraw-Hill, which made this second edition possible.

I’d like to thank my editors at McGraw-Hill who made this second edition possible. They include Jeanne Glasser, the acquisition editor, and Jane Palmieri, the editing manager. In addition, I’d like to thank Marci Nugent who caught many of the errors that always creep into the manuscript.

To the best of my knowledge, *position sizing* was never used as a trading term prior to the first edition of this book. Since the publication of the first edition, it has virtually replaced *money management* as the word that best describes the most critical aspect of your trading system—the topi of “how much.” To all of you who have adopted the term, whether you credited this book or not, I extend my thanks because by doing so you have taken much of the confusion out of this most important aspect of trading.

I’d also like to acknowledge all of the great traders I’ve had the privilege to work with over these many years. Many of you have made millions of dollars in profits in your trading career following th concepts contained in this book. Whether you helped me understand the concepts better or helped me prove to others that these concepts work, I extend to you my deepest gratitude.

Last, I’d like to thank the three people I love most—my wife Kalavathi, my son Robert, and my niece Nanthini. You are all my inspiration. Thank you for being there.

PART ONE
The Most Important Factor in Your Success: You!

The objectives of this book are twofold:

1. To help you in your search for the secrets of the Holy Grail and at the same time,
2. To help you in your search for a winning trading system that's right for you.

There is a critical assumption in both of these objectives: that you are the most important factor in your performance. Jack Schwager, after writing two books for which he interviewed some of the world's top traders, concluded that the most important factor in their success was that they each had trading system that was right for them. I'd like to take that assumption one step further. You cannot design a system that is right for you unless you know something about yourself.

As a result, the first part of this book is about self-discovery and moving yourself to a point from which it's possible for you to do market research. I've included a chapter on the psychological essence of successful trading (what the Holy Grail is really all about), a chapter on judgmental heuristics, and a chapter on setting your personal objectives.

CHAPTER 1
The Legend of the Holy Grail

> We have only to follow the hero's path, and where we had thought to find an abomination, we shall find a god. And where we had thought to slay another, we shall slay ourselves. Where we had thought to travel outward, we will come to the center of our own existence. And where we had thought to be done, we will be with all the world.
>
> *Joseph Campbe*
> The Power of Myth (page 5

Let me tell you a secret about the market. You can make big money by buying breakouts that go beyond a normal day's range of price movement. These are called *volatility breakouts*. One trader is famous for making millions with volatility breakouts. You can do it too! You can make a bundle! Here's how you do it.

First, you take yesterday's price range. If there's a gap between yesterday and the day before, then add the gap into the range. That's called the *true range*. Now, take 40 percent of yesterday's true range, and bracket today's opening price by that amount. The upper value is your buy signal, and the lower value is your sell signal (that is, for selling short). If either value is hit, get into the market, an you'll have an 80 percent chance of making money. And over the long run, you'll make big money.

Did that particular pitch sound interesting to you? Well, it has attracted thousands of speculators and investors alike. And while there's some truth to the pitch—it can be a basis for making big mone in the market—it's certainly not a magic secret to success. Many people could go broke following th advice because it's only part of a sound methodology. For example, it does not tell you

- How to protect your capital if the market goes against you
- How or when to take your profits
- How much to buy or sell when you get a signal
- What markets the method is designed for and if it works in all markets
- When the method works and when it fails miserably

Most importantly, you must ask yourself, when you put all of those pieces together, does the method fit you? Is it something you'd be able to trade? Does it fit your investment objectives? Does it fit you personality? Can you tolerate the drawdowns or the losing streaks it might generate? Does the systen meet your criteria for feeling comfortable trading it, and what are those criteria?

This book is intended to help traders and investors make more money by learning more about themselves and then designing a methodology to fit their own personality and objectives. It is intended for both traders and investors because both of them attempt to make money in the markets. The trader tends to have a more neutral approach—being willing to both buy and sell short. The investor, in contrast, is looking for an investment that can be purchased and held over a longer perioc of time. Both of them are looking for a magic system to guide their decision making—the so-called Holy Grail system.

The journey into finding the profits available in the markets usually starts another way. In fact, th typical investor or trader, in preparing to trade, goes through an evolutionary process. At first he gets hooked on the idea of making a lot of money. Perhaps some broker gives him a pitch about how muc ~~money he can make playing the market. I've heard a radio advertisement in North Carolina that~~ goes something like this:

> Do you know where real money is made year after year? It's all in the agricultural sector—people have to eat. And when you consider the weather we've been having lately, there's likely to be a shortage. And that means higher prices. And for just a small investment of $5,000, you can control a lot of grain. You'll make a small fortune if grain moves just a few pennies in your favor. Of course, there are risks in this sort of recommendation. People can and do lose money. But if I'm right about what I'm saying, just think how much money you can make![1]

(I've heard similar pitches for various other commodities and, these days, even for currency trading.)

Once the trader has committed his initial $5,000, he's hooked. Even if he loses it all—and in mos cases he will—he'll still retain the belief that he can make big money playing the markets. "Didn't Hillary Clinton turn $1,000 into $100,000? If she can do it, then I certainly can do it."[2] As a result, o investor will spend a great deal of time trying to find someone to tell him what to buy and sell in his quest to determine the hot prospect.

I don't know many people who have made money consistently following other people's advice. There are exceptions, but they are very rare. In time, the people who have followed other people's advice and have consequently lost their capital get discouraged and drop out of the picture.

Another pitch that really seems to get people is the newsletter pitch. That typically goes somethin like this: "If you had followed our guru's advice, you would have made 320 percent on XYZ, 220 percent on GEF, and 93 percent on DEC. And it's not too late. You can get our guru's picks for each of the next 12 months for only $1,000." As you'll learn from both the expectancy chapter and the position sizing chapter, one could easily have gone broke following such a guru's advice because we know nothing about his or her downside or even the expectancy of his or her system.

I once heard this pitch from an options trading guru: "If you had followed my advice on every trac last year, you would have turned $10,000 into $40,000." Now does that sound impressive? It does to most people, but what he really meant was if you had risked $10,000 on every trade recommendation made, then at the end of the year, you would have been up by $40,000. In other words, if your risk pe trade was 1*R* (where *R* is short for risk), then you would have been up by 4*R* at the end of the year. Believe me when I say that 99 percent of the trading systems you'll probably develop will give you better performance than this one. Nevertheless, people fork out the $1,000 for the guru's advice because the pitch suggests a 400 percent return rather than a 4*R* return. That is, they do until they decide that perhaps they should ask a better question.

A few people miraculously move onto the next phase, which is "Tell me how to do it." Suddenly, they go on a wild search for the magic methodology that will make them a lot of money. This is wha some people call the "search for the Holy Grail." During the search, our trader is looking for anythin that will provide her with the secrets to unlocking the universe of untold riches. Typically, people in this phase go to lots of seminars in which they learn about various methods such as this one:

> Now this is my chair pattern. It consists of at least six bars in a congestion range followed by a seventh bar that seems to break out of the congestion. Notice how it looks like a chair facing to the left? See what happens on this chart after a chair pattern occurred—the market just zoomed up. And here's another example. It's that easy. And here's a chart showing how much profit I

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