Chapter 1

The Problem with Non-Mechanical Trading

You can't go broke taking a profit.

Let your profits run.

Dr. Discretionary

Chances are you've encountered the adage that markets aren't right or wrong—they just "are" and that if you're losing, you're somehow arguing with them rather than heeding what they're telling you. As a mechanical trading advocate, I have come to appreciate the precariousness of that position. I've seen traders drive themselves crazy day after excruciating day, trying to retrofit reasons for their failure. "I thought I was buying the start of a fifth Elliot wave, but it was really a reaction in an extended fourth." "I thought I was selling away from the value area, but I should have seen that it was setting up a new higher value area."

Their new "insights" never seem to move them forward. Why?

The answer primarily lies in the nature of the playing field itself. Markets are overwhelmingly random noise with a small trend component. The latter is what mechanical traders largely hang their hopes on, but it's not perceivable on an individual trade basis. You need many trials to expose biases the same way Vegas needs many bets to exemplify the fact that their long term edges are ultimately insurmountable.

Follow your convictions.

Don't get married to an idea.

Dr. Discretionary

The trade in progress is the only focus of the gut trader. "How do I turn this winner into a loser? How do I maximize this profit and where do I decide that it's given all it's going to?"

Since the trend component can't be exploited over one trial in a small trading horizon, gut traders are almost by definition attuned to the noise. Despite the rare gifted individual who grows prosperous as the exception to the rule, most of us can't hear what the market is saying any more than we can perceive sub-sonic reverberations. We aren't hearing because the markets ain't talking.

What we are inputting, however, is random intermittent feedback, which is not necessarily a good thing. Researchers have scientifically demonstrated that the hardest behavior to break or modify is that which is rewarded in an arbitrary fashion. A lab rat that only occasionally receives food, a drug rush, etc. when he pushes a lever will continue to hit it until its paw is raw. This is the phenomenon behind compulsive gambling. Note the robotic behavior of people hooked on slot machines--the spell stays unbroken until the last coin is gone.

Furthermore, there's the problem of what is actually being reinforced. In nearly every other life situation, repeated experience results in learning. Trading doesn't conform because good ideas (whatever they are) won't necessarily produce winning trades any more than bad decisions will become losses. People get frustrated trying to form rules around an overload of information, and the result is like trying to see the forest for the trees. The other hand ("I should have been short, not long") is omnipresent and could always be theoretically argued in hindsight. Something clearly compels us to continue making such trades, but the hoped-for underlying revelations never seem to materialize.

Stay long unless the 8500 support level is taken out.

Why did you get out?! It was only penetrated by a tick!

Dr. Discretionary

There's a weird Deja vu that runs through the discretionary world. We remember soybeans hanging on a bottom for months just before exploding into a weather market—let's buy them! Did we forget that even when the charts played out almost exactly according to plan, there were periods where the heat was too much for us and we got stopped out prematurely? How about the times we were just flat out wrong and the market almost immediate plunged through the support? And how we held on too long? Or we kept chopping ourselves up—frantically exiting and then re-entering?

There's always a sense of "this time I'm right—this is a trade I can't afford to miss." It's a powerful feeling that seems to have an intrinsic logic. Why, after all, would we take a trade we didn't strongly feel was going to work? But again, more often than not, such impulses are wrong.

Some of the most accurate clichés in the industry apply to the chances of our success or failure. Ninety to ninety-five percent of traders lose money to the remaining minority. Let's review the resulting walk-thorough:

1. Most people are neither systematic nor mechanical.
2. Most people trade according to whatever whim strikes their fancy at the moment.
3. Most people lose.
4. It therefore stands to reason that you do not want to do that which is psychologically gratifying if you don't want to be part of the big loser pool.

Probably every mechanical trader (and most traders in general) will affirm that the trades we
fear the most are the ones that tend to be the greatest windfalls. This accounts for the timeless phenomenon of mechanical traders jumping ship on a system after a harrowing series of losses—only to watch from the sidelines as an over-the-top paper rebound occurs. It's a sickening feeling, one in which many traders affirm is worse than actually losing money. The other side, obviously, is that our comfortable trades tend to be our trouble spots.

This all makes a weird kind of sense when you think about it. If everyone were in synch and markets behaved in an intuitive manner, we'd all be making money—but of course, that can't be. Who, then, would be losing? Who would be providing the grist for our mill?

You have to be out of synch with the everyday trader to profit. It's incredibly difficult to maintain that position on a discretionary basis. Sooner or later, you'll start fooling yourself about what you really think is the incorrect pathway of the masses, and what is really the prudent contrarian alternative—and then all hell will break loose like it always does. A mechanical system solves that problem by churning out signals completely independently of emotion.

Don't you have any market sense at all?

Dr. Discretionary

You can advise people over and over about the discretionary dead end. They can even repeatedly experience the negative reinforcement (read losses) directly without an inkling that something has to change. It seems so right to do what's wrong, regardless of how many times you've been down the road.

To paraphrase trading legend Richard Dennis, successful trading depends on "doing the hard thing." Effective mechanical system trading is cut and dried, perfectly laid out, and readily fortifying. It's a series of mandates stemming from historic summaries. It involves no attempt to forecast the next market direction. Besides sufficient capital, your only requirement is that you maintain faith and determination.

This, of course, can be easier said than done. You have to follow your program all the time, 100 percent exactly as stipulated. Even one detour can completely skew your performance, which happens more often than one might imagine. Violations tend to occur the most during the worst pressure periods. Such times are often followed by the most unimagined turnaround windfalls.

You'd think our confirmed results would be enough to let us intellectually overcome our destructive impulses. You'd think a clear pathway would be more comforting than the nebulous, contradictory world of the rudderless impulse trader.

You'd think, but you'd be wrong. We're only human, after all, and that random intermittent response mechanism is tough to overcome.

Tough, but luckily, not impossible.