The Anatomy of Winning

By Roger Felton

I once watched two professional traders in Chicago take totally random market entries in the S&P 500 Emini. They didn't win big, but they did make money 9 out of 10 trading days and had a decent net profit considering that the "system" they used was the worst one ever devised. The exercise didn't prove that solid robust systems weren't important, but it clearly demonstrated the power that acquired trading skill had on even the weakest of systems. The problem with trying to replicate what those two guys did is that it took them nearly 20 years to learn and was so intuitive in nature that it was virtually unteachable. But it was darn sure fun to watch.

Our focus in this discussion is on the short-term, mostly intraday trader. Long-term traders are classified as investors and beyond the scope of this article. Also, we won't be spending much time trying to figure out why systems fail their traders because it's much more beneficial to understand why traders fail their systems. If your efforts have been focused on finding a winning trading system, then it's a pretty safe bet that you're a struggling trader with a dim future until the mindset changes. It's vital that every trader understands that no trading system on the planet is any better than the trader behind it pushing the buttons. But, in the hands of a trained trader who's done their homework, some systems can be vastly superior in their profit potential and the likelihood of staying that way.

With that in mind, later we'll have fun as we build a trading system designed to achieve greater accuracy and more consistent long-term profitability yet be simple enough to learn fairly quickly. When you apply the right set of acquired skills to any solid system, your confidence level naturally skyrockets. Personally, I believe that the main reason traders can't follow their rules and fail is rooted in a lack of extreme, rock-solid confidence in their system or method. None of the negative human emotions that sabotage traders can exist in the presence of unshakable confidence. To reach that level, there are several things traders must understand that have nothing to do with any particular trading system.

It's no surprise to anyone that most traders fail. But what is surprising is how few traders ever spend much time trying to figure out why. In trading, being in the majority isn't a good thing and traders invest years and fortunes trying to get to that small elite group known as the "Top 10%". Most never come close. Many that do finally manage to migrate from the big group to the small one fail to stay there. Like buying a horse to get to the moon, traders dream of their destination but invest time and money in the wrong things to get there.

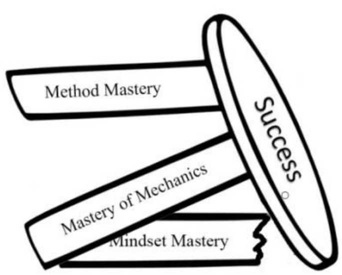
Traders come to me because they are struggling. They are desperate for direction and often running out of time, money or both. Most of them truly believe they've tried everything. The first thing any unsuccessful trader must do is to fully understand the reasons that consistent success has eluded them no matter what system they tried or how hard they worked at it. I use the word “reasons” because there’s no single answer to the trading puzzle. There is a solution but before you can have a winning system, you must begin with a winning trader.

A good place to start is to clearly understand, by definition, what trading is: ***Professional trading is an acquired skillset strategically applied to a specific method governed by a set of inalienable rules applied to a specific market condition.*** Yeah, that’s a mouthful. So let’s examine that definition in detail because it’s very important that you fully understand exactly what it means and the depth of what it involves.

You’d be surprised at the number of traders I meet who think successful trading is all a matter of finding a “winning system”. They comb the Internet and attend every webinar they can find. These traders are easy prey for unscrupulous vendors with big hype and empty promises. Occasionally these system seekers actually do find a fairly decent system but they quickly abandon it once they realize that its success will require some study and effort.

A system’s function could be very basic and only serve to help the trader understand market dynamics by simple visualization via oscillators, volume bars, support & resistance lines, etc. Or, a system can be quite sophisticated and perform all of the time-consuming, tedious measuring, figuring, anticipating, data crunching, filtering, back testing, etc. thereby freeing the trader to do the fun part of trading that humans do best.

Trading tools simply provide the data traders need to make consistently accurate trading decisions. Like a set of clubs to a pro golfer, they are a tool albeit an important one. But you never saw a tournament trophy presented to a bag of clubs. So, real lasting trading success is rooted in an <u>acquired set of skills</u> rather than in an acquired tool such as our trading system. Over time, our skills continually improve and the tools we use evolve, also, as better, easier and more effective ones are discovered. So, how do we find and develop the right skillset?



I visually think of these essential skills in the old three-legged stool analogy. All 3 legs are critical. Remove even one leg and it will topple and become useless. Same principal applies in trading. I call these essential skills the “3M’s” of trading. Sharing equal importance, they are: Mastery of the Market **M**echanics, Mastery of the **M**ethod and Mastery of the **M**ind.

Before any trader can ever hope to succeed, they must establish a good comprehensive understanding of market fundamentals (including the science of market behavior) plus a thorough understanding of charts, trading platforms, etc. and a good working knowledge of Technical Analysis helps, too. Traders must master the mechanics of trading.

Having a terrific trading system or method is useless if you don’t understand how to fully harness its power and utilize its capabilities to consistently pull profits from the markets you trade. You must know every aspect of your system because it’s your trading “partner” and "advisor" and you are, in effect, married to it for as long as the relationship is working. And, like choosing a spouse, the selection must be done carefully and only after much due diligence. You must learn, practice and master your method (or system) so well you could trade it in your sleep. Ok, not really, but you get the idea.

All systems and mechanical methods have rules. Applying rules to a system is a mechanical exercise but following those rules (discipline) is just one of several mental skills that all too many traders never master. To master the mind is to master yourself. Many traders say it's the toughest part of trading but I believe it's the most important. Now, total mental mastery is nearly impossible. After all, none of us are Mr. Spock. But all we need is "sufficient control" to the point where we will still experience our natural human emotions but not allow them to influence our trading decisions. Harnessing the destructive effects of negative human emotions is essential or you'll constantly be standing in your own way, blocking your path and sabotaging your success more thoroughly than if you did it on purpose.

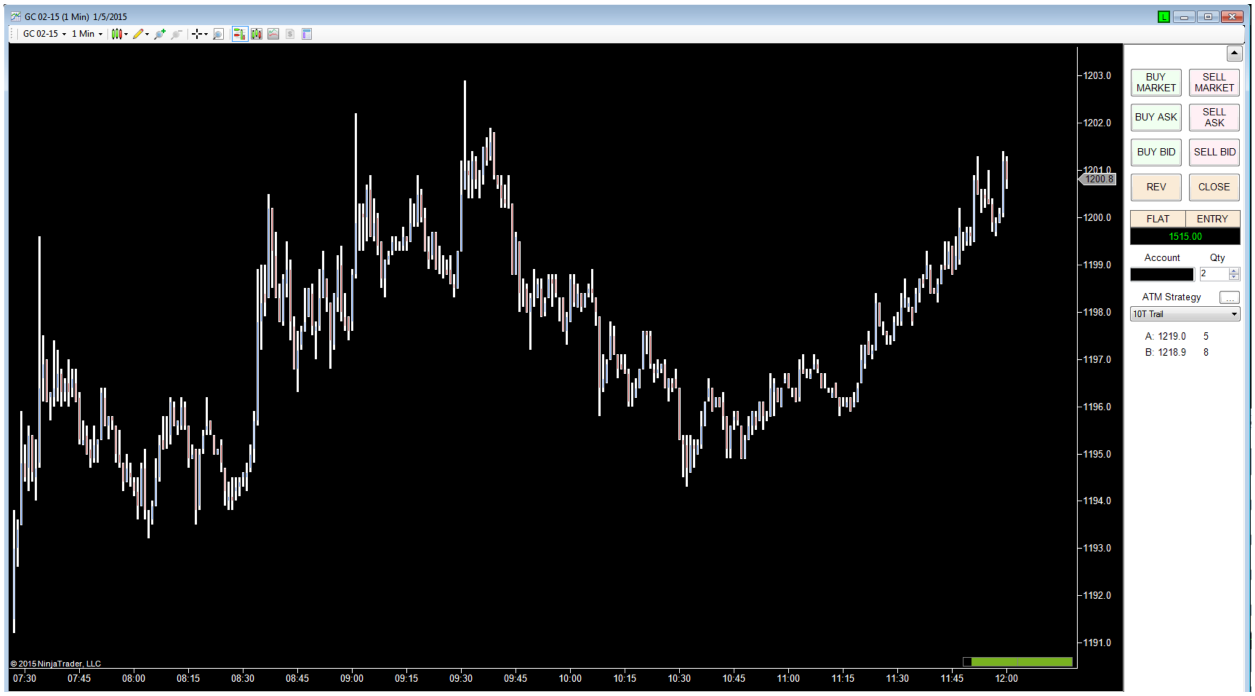
Many books and articles have been written on each of the "3 M's". Each one is critical and don't look for a crash course or shortcut around them because there isn't one. Most of you probably already have at least a good start in some or all of these areas. If you're not where you want to be as a professional trader, then there's more work to be done. Note that you should add a considerable amount of time, years in fact, if you are attempting to learn entirely on your own. Having a really good mentor is invaluable.

I hope by now that every trader truly understands that the "anatomy of winning" isn't just a bunch of indicators slapped on a chart waiting for some magical alignment of conditions to occur. The "winning" totally depends on what happens between your ears, not what's happening on your charts. Trades are won or lost before you ever pull the trigger when they are born of knowledge, training, practice and experience.

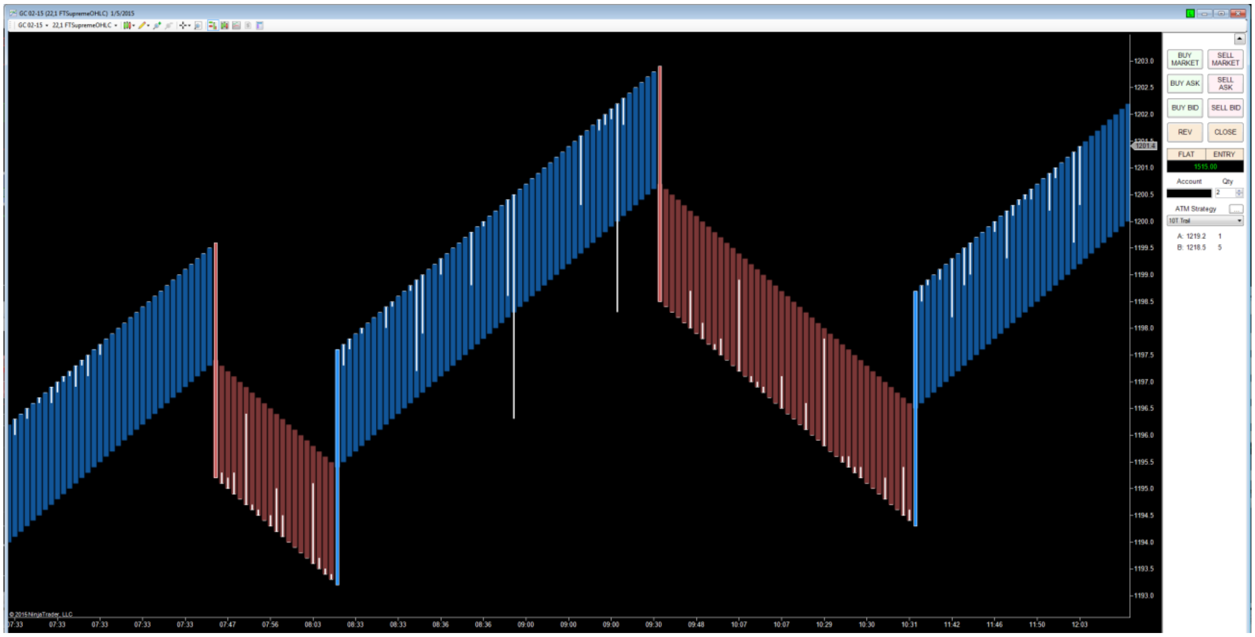
Also, before we go any farther, we must all understand and candidly admit that not everyone is cut out to be a trader. Usually it's due to a lack of passion or the inability to master the psychological side of trading. If you find that you lack the patience, discipline or passion to trade, don't despair. I was too thin to be a Sumo wrestler and too short for the NBA. We all find our niche in life. But, assuming that consistent trading success is your dream and burning desire, then let's have some fun and build a trading system you can learn quickly and have fun with. Who knows, it might just change the way you approach trading from now on.

These days, practically every trader uses some form of Technical Analysis and that means they use charts of one bar type or another. Many traders use several bar types and each one might have several different timeframes. Charts are how traders peer into any moving market in an effort to determine where it's going over some given time period in the future. So, if we think of charts as our "eyes", then the bar type we use can be thought of as our "glasses". You wouldn't use reading glasses to study the moons of Saturn or binoculars to read a book. As chartists, it will help you immensely to learn which bar types are the most effective for what you need them to do. As we shall see, the charts you use will matter greatly both in how clearly you can see what a market is actually doing and how accurately you can predict where that market is going next. So, let me introduce you to the charts I use and see why I find them to be so superior.

Below is a typical image of a 1-minute chart of gold futures (symbol GC) on 1-05-15 for the time period 7:30am to 12:00n CST.



It doesn’t matter what market or what time period you choose, the result is the same as we now observe gold (GC) on a modified Renko chart:



It’s the same instrument (GC), same day, same time period! Yet they look like two totally different markets. For smooth predictable cycling volatility, which chart would you rather use. The decision took me about 5 seconds and it cut the time it took for me to reach my daily goal in half simply by switching to a bar type that naturally filtered market “noise”. By the way, you won’t get this degree of angular, geometric form from other bar types such as Heiken Ashi or Range Bars. Plus, these also let you “peek into” each bullish and bearish bar to see what Price actually did with those white “skeleton bars”. That’s imperative info especially for back testing your strategies.

I mentioned that these were modified Renko bars because traditional ones just couldn’t do what I needed. I’ve been using them for nearly 4 years and I’m now starting to see system and platform vendors producing their own similar versions so the word is out and the trading world is catching on to the versatility and superiority of this bar type. You can probably find a suitable version online in trading forums or contact Felton Trading and we can get you set up.

As I started to study this amazing bar type, I found that they opened up a whole new world of opportunity with entirely new signals, entries, filters, targets and they really took the guesswork out of stop placement, too.

Their versatility is virtually endless. Notice in the upper left-hand corner it says, “22,1 FT SupremeOHLC”. What do those two numbers represent? The 22 tells you the size of the red and blue colored bars in ticks. So, in this case, the colored part of each bar is 22 ticks tall but does not include the “tails” where price poked out of a Renko but was unable to pull back far enough to change the Renko bar to the opposite color. To do that, Price would have had to reverse direction an amount approximately double which, in this case, would be about 44 ticks.

When Price fails to retrace far enough to change the bars color, then eventually they will close out in the current trend direction (and bar color) leaving that telltale "shadow". I call those bars "bottle rockets" because of the physical resemblance and they often pack a powerful punch due to their inherent momentum.

So, if 22 is the bar's tick size, what's the significance of the "1"? We call that the "step size". It's simply the difference between the close of one bar and the close of the next…in this case, it would be a 1 tick differential. You have an infinite number of combination choices, and depending on the ones you select such as 4,2 or 10,5 or 25,13, you can set your chart timeframe to maintain a risk/reward ratio perfectly tailored to the size of your trading account. Just remember, the first number you choose is the bar size and the second number is the step size and both are measured in ticks.

Now we're ready to learn a signal or two using our new Renko bars. For the past 17 years I've always utilized the power and accuracy of divergence. It's simple to learn and it's always there every day in every market that moves. If you aren't familiar with divergence signals, you can go online and be up to speed in a jiffy. Basically, it's when Price forms a double bottom (for longs) or a double top (for shorts) while a corresponding oscillator forms a higher low (left to right) or a lower high (left to right). They are one of the least complicated price patterns in charting.

The problem many traders have with divergence trading is that they are considered a counter-trend signal. Fighting trends can be risky business and many traders have been tossed into the wood chipper trying to trade that way. But our trusty Renkos make trading divergence a snap. This is mainly due to the fact that when the bars change color on these bars, it's an actual change in market direction rather than just noise. Their natural noise filtering characteristic is one of the first things I noticed.

Let's go find a divergence signal (they're all over the place) by observing the following 22,11 chart of the Nasdaq (NQ) and we'll learn the characteristics of a really good divergence for a short signal.

The first thing you notice about Price in a divergence short is it looks like a giant multi-colored letter M. I like to place Price in a channel with multi-colored borders as it lets me see Price action more clearly and it shows me strong turning points. But it's not necessary for this study in Renko divergence.

In my trading, the second "peak" of the "M" can be higher, equal to or slightly lower than the first peak. In this example, the peak is a higher high. The oscillator I use is a stochastic and is not shown here since my software finds the signal for me but there are a multitude of other choices you can use and parameters aren't critical. On my stoch, my settings are 6 for the %D, 5 for the %K (I don't use it) and 3 for the smoothing. You would want to see the second peak of the oscillator you use to be <u>lower</u> than the first, not equal or higher. Research divergence formation and you'll catch on quickly if you aren't already familiar with it.

Your entry will be one tick beyond the closing price of your "trigger bar" which is the first red bar to form after the 3rd "leg" of the M completes its double top requirement. It's identified and labeled with the yellow BD (Basic Divergence) and the red arrow pointing downward aligned with the entry (trigger) bar. The strength of this signal comes from the initial bullish uptrend that ran for 165+ ticks before rolling over and firing the BD short. With that much volatility, you will rarely see one of these fizzle. I call them "Stretched M's" because that's what they look like with those long "legs".

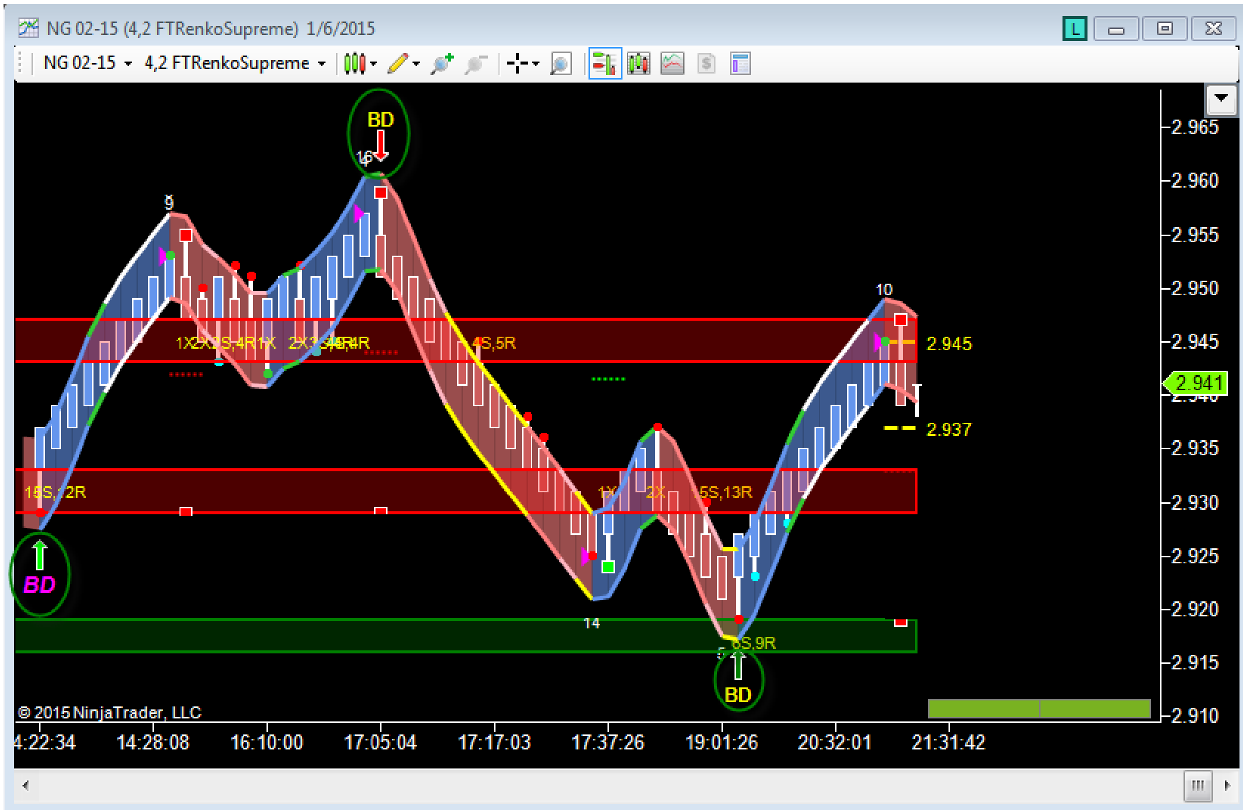
For my stop, I use the range of the entry bar. That is, I place the stop at the top of the bar's tail (shadow). There will always be one. If you notice on every turn, if you entered every one of them, a stop placed at the tail's end doesn't get hit unless the trade is just flat not going to work. This virtually eliminates those pesky times when you enter a trade, your stop gets knocked in the weeds and then Price goes on to what would have been a nice profitable trade.

The advantage here is that you will know way in advance what price you will enter the trade and precisely where your stop will go. This is where you can calculate your risk and, if it's too steep, then you are trading on too large of a timeframe. Another advantage here is knowing exactly where to exit your trade. For purposes of this lesson, let's assume that you are not a trade management whiz and tend to exit much too early or maybe overstay your welcome and exit too late. You want black and white and knowing way ahead of time your entry price, stop price and exit price is all any trader needs as long as their trades sustain a strong winning average.

So, where do we exit? I have found that the simplest and most accurate no-brainer target is 50% of the volatility of the first "leg" of the formation. In this example, it's that first run of blue bars on the left side of the chart. Accomplished Fibonacci traders can likely milk more out of these BD's but becoming proficient at Fibonacci usually takes years of study and practice and most Fib traders I know are still struggling with it. A 50% target is simple and it's accurate. Every day I see Price retrace to 50% and then bounce away like a beach ball on a trampoline. I'm talking "to the tick". Plus, 50% can be a really lucrative target.

Using this technique in the example above, the BD short would have picked up around 65 ticks. Trading just 2 contracts that would put about $650 in the poke and that's just one trade! In the example above, there was a larger formation we call an Extended Divergence (ED) signal that, going long would have put another 50+ ticks on the board for a cool $500. And that's trading the Nasdaq in a historically lousy time of day. That's nearly $1200 on 2 trades trading just 2 contracts each. If you need more then take more trades, increase your number of contracts or some traders might consider lowering their lifestyle.

Taking what you've learned, observe the following chart of Natural Gas (NG) on a 4,2 Renko Supreme. Remember, the bars are 4 ticks tall and the step size is 2 ticks in this example. Notice also that we're not cherry-picking here; this is what's happening right now, as of this moment of this writing and certainly not in an ideal time period. Understand that what you've learned so far happens all day and all night in any moving market. But using any other bar type, you'll likely be oblivious.



There are three (3) Basic Divergence (BD) signals identified here in green ovals. The middle short and the final BD long are the "Stretched" divergence formations that resemble the "M" for short and the "W" for long trades. Observing the last two stretched versions, were they successful in achieving their 50% retrace targets? Where will Price go from here?

In the screen cap above, I've shown a little more of the "tools" I use as I've included my Support and Resistance indicator. Notice how nicely they nail those turning points. There are several S&R indicators available in most platform studies and in trading forums. Don't be timid about incorporating the indicators you are already using and I think you will be amazed at how much more clearly and efficiently they do their job and blend seamlessly with most other systems.

Anyone wishing to learn more about this or any of the other signals, techniques or indicators that I use, there are no secrets so please feel free to contact me anytime. Email: Questions@FeltonTrading.com. Or to register for our full one week free trial of our trading room, go to www.feltontrading.com and click on the Free Trial button.