Introduction

Do you have what it takes?

A floor broker who is a friend of mine once told me the following story; he swears it's true.

In the 1960s, there was a corn speculator who traded in "the pit" at the Chicago Board of Trade. He was known for **plunging**, or taking big positions.

Early one summer, he put on a large, short corn position for his own account (a position that makes money if prices fall but is costly if prices rise). Soon after, the weather began to heat up in the midwestern United States, where the corn is grown. The corn crop needed rain, and prices began to rise.

Day after day, the sun shone, not a cloud in the sky, and the corn crop was burning up. The market continued to rally against this guy. He knew if this continued, he'd go broke.

Late one trading session, the big trader started a rumor in the corn pit. His rumor was that it was going to rain the next morning at 10:30 A.M.; however, the next morning, the sun shone with not a cloud in the sky, and the market opened higher. Then, almost miraculously, at precisely 10:30 A.M., rain started pouring down the windows that looked onto the grain trading room. (The old grain room was located on the fourth floor of the Chicago Board of Trade Building, which had tall windows you could see from La Salle Street.) Inside in the corn pit, a selling panic developed as the traders scrambled to sell out their corn futures. The market went down the limit! The speculator covered his entire short position on this break and was saved from bankruptcy.

How did the trader know it would rain at 10:30 that morning? It seems he was owed a favor from his drinking buddy, the Chief of the Chicago Fire Department. The Chief brought out the hook and ladders and decided it was a good day to wash those tall windows that looked out on La Salle Street!

So you're thinking of trading, but you don't know the chief?

Let's assume you've just finished reading a private newsletter hot off the presses, a firsthand report of how the witch's tail disease is devastating the cocoa crop in the Ivory Coast. Cocoa sounds like a moneymaker, but you have no way of knowing for

sure how true all of this is. You do like chocolate, but you didn't know it all starts with a bean called the cocoa bean. (You thought it came out of a can.) Hey, you don't even know where the Ivory Coast is, and you're thinking of trading this bean against the likes of Hershey and Nestlé and whoever else really does know what's going on. Why would you do something like this? To make money, of course!

You do know one thing, however; the cocoa market is moving up, and it's moving fast. Although you aren't exactly losing money by doing nothing, it's starting to feel that way. Do you have the guts to act? Do you have the money? Is now the time?

You assume the **shorts** (those betting on lower cocoa prices) are beginning to experience financial pain. The **longs** (those betting on higher cocoa prices) are experiencing the opposite emotions—elation and the satisfaction that comes from being right. The accounts of the longs are growing bigger. Money from nothing. The shorts are watching their money evaporate.

Let's stop this commentary for a moment, because it's time for your first lesson: *Trading is a human game*.

As a result, emotions affect price as much, perhaps more, than the news. You will learn that price movements themselves are a fundamental and, in turn, they affect future price movements. It's all a function of who is being hurt and who is benefiting. It's a function of which side of the market is being "sponsored" by the "strong hands." Shorts and longs act differently based on price movements, which affect their emotions as much as their pocketbooks.

Your job as a trader is to identify what happens next. To do that, I want you to start thinking about how others feel, because feelings affect actions. People who are generally right tend to do certain things (on balance). People who are generally wrong tend to act differently. The majority acts a certain way, but be warned, the majority is usually wrong at major turning points (although it can be right at times).

So, back to our scenario. Find out whether the majority is now long or short cocoa. The shorts are in pain, the longs are not; but then again, this can change just as fast as the market's tone changes.

Here's lesson number two: On balance, when talking about futures trading, the uninformed majority will not win.

Because the profitable minority acts in a completely different manner, you must learn what makes these people tick and how to act like them. One fact is certain, and this is that people make markets, and generally people tend to act the way they did in the past. With certain stimuli, they could act opposite of how they generally act, but you are playing the odds here. You need to identify what manner of move the market is in now. Is it a "normal" move in which the market acts in a normal way, or is it extraordinary? (At times, the market acts in an extraordinary manner, and these can be the best times to play.) If you, as a trader, are able to accurately predict what the next pattern will be, your rewards will be substantial.

In this book, I present various methods designed to identify profitable market patterns. No method is foolproof, so the best I can do is try to put the odds in your favor. My goal is to teach you to approach commodity futures and options trading

like a business. This is not a casino. In a casino, risk is artificially manufactured for risk's sake, and the odds are engineered in favor of the house. In the commodity futures and options markets, you are dealing with natural risks associated with the production and consumption of the materials that make life possible and worthwhile—food, metals, financials, and energy products. You cannot bend these risks to your will, but you do have tools to manage them. Unlike a casino, I believe you can move the odds to your side of the table. To do this, you must be disciplined.

You will need patience, and you will need guts. I cannot force these qualities upon you, but I can describe how the successful trader acts. It will then be up to you to act the right way. To profit in the commodity futures and options, you will need a *systematic* approach, a well-thought-out strategy. I will present you with some good ideas, but it's up to you to implement them systematically. After all, a strategy is just a consistent approach to trading.

Do you have what it takes?

So you've decided to risk some of your hard-earned cash, go for the big bucks, and trade commodities. This is a **zero sum game**, meaning that for every dollar someone makes, someone else loses it. Some of the money goes to your commodity broker in the form of commissions, and a small amount goes to the Exchanges for their fee. Then, if you are lucky or skillful enough to win, you owe the taxman some of your profits. When you lose on any particular trade, most of your loss is transferred electronically to someone else's account (and you still pay that commission). You will never see this person on the other side of your trade, but he (or she, or it if a corporation) is out there somewhere.

You will be pitted against some of the best financial minds in the world. Professionals on the Exchange floor, professional traders who are Exchange members off the floor, CTAs (Commodity Trading Advisors) and CPOs (Commodity Pool Operators) hedge fund managers, commercial firms that use and other commercial firms that produce commodities. Then there are those other individuals with more experience than you have. Can you hope to compete? The answer is, emphatically, yes! But I didn't say it would be easy, did I? You will need to develop a sensible trading plan and a feel for the markets. This book will help you. You must develop certain human qualities too, which nobody can give to you.

More than 50 years ago, the legendary speculator W.D. Gann discussed the four qualities essential for trading success. His observations are just as valid today, and trust me, you must have these (if you don't, then develop them) if you ever hope to compete and win.

Patience

According to Gann, patience is the number one essential quality for trading success. A good trader possesses the patience to wait for the right opportunity. He will not be over-anxious, because over-anxiousness consumes capital, and over time it will

tap you out. When you are fortunate enough to catch a good trade, you need the patience to hold it when it starts to move your way. Perhaps the primary failing of the amateur is to close out a profitable position too soon. In other words, patience is required for both opening and closing a position. Hope and fear need to be eliminated. If you are in a profitable position, instead of fearing the profit will turn into a loss, hope it becomes more profitable. You have a cushion to work with in this case. When you are in a losing position, instead of hoping it will turn around, fear it will get worse. If you see no definitive change in trend, use your essential quality of patience and just wait.

Knowledge

There is no on-the-job training program here. The stakes are too high, and the competition too intense. You need a well-thought-out and thoroughly researched trading plan before you begin, and you need to do your homework.

Your plan should always have a mechanism to cut the losses on the bad trades and to maximize profits aggressively on the good ones. You must be organized and remain focused at all times. If the plan is a good one, you need the consistency to stick with it during down periods.

My personal goal is to make money daily, but when that is not possible, I try not to lose too much. It is a constant trial to maintain the vigilance necessary so as not to let good judgment lapse. If you are a novice, it makes sense to "paper trade" before you trade for real. If you are trading currently, you should keep a logbook. Log your triumphs and your failures. You want to avoid making the same mistakes again, but I must warn you, all traders repeat this same mistake. At the very least, learn not to make the mistake so often. By keeping a record of what you do right and what you do wrong, you can identify areas of weakness and areas of strength. If you are not totally prepared on any given day, don't trade. You can't "wing it" in this business, because the competition will eat you up. Over time, you will develop what I call a "trader's sense." You will know when a trade doesn't feel right, and when this happens, the prudent thing to do is step aside. You cannot ignore the danger signals, and when it's time to act, you must do so without hesitation.

To recap, you must have a game plan and stick to it, but the paradox here is that you also need to be flexible. At times, it is best to do nothing, and you need to fight the urge to play for every pot. And, as I said before, stay focused. At times, I've been distracted by day trades and missed the big moves, because I missed the big picture. By the time I finally saw the light, it was too late.

The legendary trader of the 1920s, Jesse Livermore, once shared one of his secrets, which is that he attempts to buy as close to the danger point as he can and then he places his stop loss. In this way, his risk per trade is low. This makes sense, but how do you know where that danger point is? In normal markets, you need to take normal profits, but on those rare occasions when you have the chance to make, a windfall, you must go for it. But how can you tell when a market is normal as opposed to extraordinary? It takes experience, and it takes knowledge, an essential quality for success. Knowledge takes study and hard work. This book is a good first step.

Guts

Call it nerve, courage, bravado, or heart; I call it guts, and this one quality is as essential as patience and knowledge. Some people have too much guts, and this isn't good because they are too hopeful and tend to overtrade. Some lack the guts to act (either to enter a position when the time is right or to cut a loss when it isn't). This is a catastrophic fault and must be overcome. You need guts to pyramid positions, which is not easy, but it's where the big money is made.

In this book, I am going to teach you to trade without hope, without fear, and with just the right amount of guts. I will instruct you to enter positions on what I believe is the proper basis, and then urge you to remember at all times that you could be wrong. You will need a defensive plan to cut the losses when you are wrong. I've been a student in the School of Hard Knocks too many times, but I've never lost my guts. At times, I know I've had too much and have overtraded, but then there are some people I know who have an inability to pull the trigger, and this is just as deadly. Looking back only brings regrets, so you need to face the future with optimism, knowledge, patience, and guts.

Health and rest

This is the fourth essential quality for trading success. If you don't feel right, you won't trade right, and this is the time to be on the sidelines. When you stick with something too long, your judgment becomes warped. Traders who are continually in the market without a rest get too caught up in the day-to-day fluctuations and eventually get tapped out. At least twice a year, it makes sense to close out all your trades, get entirely out of the market, and go on a vacation. When you return, recharged, your trading will improve.

So there you have it: Gann's four essential human qualities required for success. You need them. Very soon this book delves into specifics that I believe will help you travel this rocky road to trading success. Some of the most important lessons I've learned over the past 25 years are in the pages to come, and they should help you make money. However, if you don't have patience, guts, knowledge, and good health, all the rules in the world are just so many words.

So, with that said, let's get into the meat of the matter. I'm not trying to be all things to all people, but I do believe this book will appeal to the novice and veteran trader alike. We begin at the beginning. If you are new to this game, you need to know how the game is played, what the rules are, and how the money works. I will strive to be as complete as possible, and if I do this right, at times it might actually appear simple. If it were that simple, however, most people wouldn't lose, and the nature of the futures markets is to punish the majority. Let's begin our journey to join the minority, because it is the minority who reap the rewards!