THE 12 CARDINAL MISTAKES OF COMMODITY TRADING, AND HOW TO OVERCOME THEM - by Walter Bressert

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1. Lack of a Game Plan.

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12. Lack of Patience (Or Trading for the Excitement, Not for Profit) May not be reproduced without written permission.

INTRODUCTION:

Tremendous amounts of money can be made in commodities markets. While profits are there for the making, this is not a book to tell you how to make money, but how to avoid losing money. In the decade I have been trading commodities, I have made every possible mistake at least three times. The most common mistakes are what I call the 12 CARDINAL MISTAKES OF TRADING COMMODITIES. Each is listed in this booklet with solutions to help you avoid repeating these mistakes time and time again. Walter Bressert

SELF-DISCIPLINE:

It has been my experience in trading commodities that the most significant cause of loss is lack of self-discipline--lack of self-discipline to follow your game plan; lack of self-discipline to be patient; lack of self-discipline to take a loss or profit, lack of discipline to follow proven money management concepts. The list can go on and on.

FEAR AND GREED:

With the tremendous leverage commodities offer, you as a commodity trader, are frequently exposed to the underlying emotions of fear and greed. At certain times in your trading career, these emotions can make you entirely and irrational, oblivious to what is happening. It can make you rely on hope; hope that the market will do what you want it to do because it must! Otherwise, you will lose all of your risk capital and sometimes much more.

DANGER OF SUCCESS:

Each time I made one of these 12 CARDINAL MISTAKES, I promised myself that I would not repeat the same mistake, but as I was once again victorious, as I made money. You are most likely to make these same mistakes when you are making money, not losing it. After several losses, you naturally tighten your discipline and become more conservative, or lose all of your risk capital. Following several loses, you are likely to lose the least amount of money on a trade.

OVERCONFIDENCE:

It is following a string of profitable trades that you are most likely to lose large amounts of money. If you began trading with $30,000 and limited yourself to 10% risk, you could lose a maximum of $3000 per trade. With profits increasing your account to $100,000, you can now lose $10,000 per trade. Worse yet, flushed with success you are more prone to break your rules and “wait a day”, when you should have been stopped out.

Reviewing my records, I found that some of my largest losses have come from my smallest positions. After making large profits, I let these small positions run into extremely large losses because I was overconfident.

BALANCE:

Trading commodities is a game of psychology. It is a game of balance. Emotional extremes create an imbalance. In your delight at being successful, you will make mistakes of greed. In your reluctance to take a loss, you will make mistakes of fear. The great emotional release I had felt when I finally closed out a significant losing position was unusual. Fighting the market, yet knowing it was going to go against me, but wanting it to go in my direction — pushing it, hoping for it, worrying about it. After a few days or a few weeks of that, it felt as though the weight of the world was taken off my shoulders when I finally took the loss.

HOPE:

You know when you find yourself hoping, that you are wrong, and should immediately get out of the market, but it takes an unusual amount of self-discipline to make that substantial loss.

TAKE PROFITS:

Tremendous amounts of money can and are being made in the commodities markets. Profits are there for the making, but the real key to trading commodities is not making money; it is keeping it. It is not basking in the happiness of success; it is taking your profits and looking over your shoulder.

PROFIT/LOSS CYCLE:

Every experienced commodity trader has a profit/loss cycle. I know, mine, and most other professionals realize theirs. Without exception, every futures trader I know experiences a cycle of success, of, over-commitment, of over-confidence, followed by loses and a feeling of failure. I have made and lost many millions of dollars and know that these 12 CARDINAL MISTAKES can be overcome through strict, unbending self-discipline, and mechanical rules that cannot be broken. Once aware of these mistakes, by following the rules and guidelines outlined in this booklet, your odds of making money will be significantly increased.

1. LACK OF A GAME PLAN:

I have published several advisory services over the past eight years (1981). I have had thousands of contacts with the trading public. I never fail to be amazed that year after year, trade after trade, that their approach is the same. A trader who thinks a market is about to start up will usually say something like – "I think Gold is going up to$600. Where do you think I should buy it?" My response is usually something like, "Well, where are you going to get out if you are wrong?" Often there is silence, or perhaps a puzzled "Huh?" They never thought about being wrong; they never thought about where to put their stop. My next question -- "Well, if it does go up, how and where are you going to get out?" -- often receives the same response.

Better than 90% of the commodities traders that I have come in contact with having no game plan. That means they do not know what to do if they are wrong, and they do not know what to do if they are right. The significant paper profit they made often turns into a substantial loss because they did not know where to get out.

One of the most important moves a futures trader can make is to develop a game plan consisting of these basic guidelines.

- Know-how and where you are going to enter a market.
- Know how much money you are going to risk on every trade.
- Know-how and where you are going to get out if you are wrong.
- Know-how and where you are going to take profits if you are right.
- Know how much money you are going to make if you are right.
- Have a Safety Stop in case the market does the unexpected.
- Have an approximate idea of when a market should meet your objectives; when it should begin to make a move, and if it has not done so, get out!

2. LACK OF MONEY MANAGEMENT:

I am continually amazed at how few commodity traders and commodity brokers have no concept of money management. Money management is controlling your risk through the use of stops while balancing your potential for loss against your potential for profit.

Let me give you just one example of poor money management. Many commodity traders refer to a trade that might lose them $500 if they are wrong and make them $1500 if they are right as a three-to-one risk/reward ratio – a “decent” trade.

That is wrong because the most crucial aspect of a trade is not how much you are going to lose if you are wrong, or how much you are going to make if you are right, but what are the odds of making money, of being right. What are your odds of losing money, of being wrong?

Proper money management means you know your profit objective and the odds of being right or wrong and control your risk with stops. You are better off with a trade where you might lose $1000 if you are wrong, or make $1000 if you are right, that would work eight times out of ten, than to take a trade where you would make $1500 if you are right and lose only $500 if you are wrong, but works only one time out of three.

This mistake can be overcome only by developing and testing money management concepts. An entire book could be written on money management, but some of the necessary money management concepts that I have followed and found to be very successful over the past years are contained in an article that appeared in the July 1981 issue of Commodities magazine, which is available on our web site.

3. FAILURE TO USE PROTECTIVE STOP/LOSS ORDERS:

This fits right in with a game plan and money management. It is the failure to use stop/loss orders once you enter a market — not mental stops, but real stops that cannot be removed. All too often commodity traders use mental stops because in the past they have been stopped out and then watched the market move in their direction. This does not invalidate the use of stops, and it means their stop was in the wrong place —they did not have an excellent technical stop.

When a stop/loss order that was determined before you entered the market is hit, it means your analysis was wrong, your game plan was wrong. With a mental stop, as soon as the market has gone through your stop price, you no longer act like a rational human being. You are more likely to make mistakes because you are now operating on fear and hope.

How many times have you had a mental stop and instructed your broker to call you when the price goes through it? By the time he could call you, the market had run an extra $500 against you. You invariably decide to hold onto the trade, hoping that you can get out on a retracement to your previous stop price. Unfortunately, it never touches that price again, and you take a significant loss. Or you make the mistake of holding the trade overnight because you hoped it would go higher the next day. But the next day it is lower yet, and by then your loss is so significant you can't "afford" to get out —and what should have been a small loss turned into a disaster.

There is an old saying that the first loss is the lowest. It is also the easiest to take, even though it may seem hard at the time.

The only way to overcome this mistake is to have an unbreakable rule (and the discipline to follow it!) that stop/loss orders must be placed every time the market is entered. I have found the easiest way to take a loss is to have the stop order waiting before the open or immediately after entering the market. Do your homework when the market is closed and place your order before the open. Another rule to follow; under no circumstances should an initial protective stop/loss order be changed to increase your risk, only to reduce it.

4. TAKING SMALL PROFITS AND LETTING YOUR LOSSES RUN:

A prevalent mistake among futures traders is taking small profits, and letting losses run. This is often the result of no game plan. After one or two losing trades, you are very likely to take a small profit on the next trade even though that trade could have turned into a large profit-maker that would offset all your losses. Letting your losses run often happens to new futures traders and are not uncommon among professional futures traders. After entering a market, you don't know where to get out. Once you start losing money, you tend to let your loss get larger and larger as you hope that the market will retrace to make you break even — which of course, it seldom does.

This mistake is overcome by using predetermined stop/loss orders to prevent your losses from running and following your game plan to take profits at your profit.

5. OVERSTAYING YOUR POSITION:

One of the most common mistakes of trading futures is overstaying your position, or merely failing to take profits at a predetermined level. There seems to be a natural law that the market is only going to allow one individual so much money before it starts to take it back. It is when you have these profits, mainly paper profits in your account, that you often try to get the last nickel out of the trade.

If the market meets your price objective and you are still in the market without a close stop/loss order, you are overstaying your position. All too often the market breaks sharply through your "mental stop" and from that price level, you watch your paper profits disappear before your eyes. Then you decide to hold on for a small rally, and then market never rallies enough. It drops back to break-even, and now you began hoping. Next thing you know you have a loss. Be aware that a substantial profit can turn into even more significant damage.

This mistake can be overcome by the use of trailing stops raised closer to the markets. Your price objective is approached or automatically taking profits at your price objectives.

6. AVERAGING A LOSS:

This is usually a holdover from trading stocks. In futures, with five or ten percent margin, averaging a loss can be disastrous. A typical approach is that after you have bought a future and it drops lower, you might figure that since it was a good buy then, it is a better buy now. You can also justify averaging down by thinking you will have a lower average entry price and require a smaller move to break even. Unfortunately, you will lose twice as much if the market continues against you, as it almost always does.

Some approaches will allow you to buy a market at one price level, add on at a lower level and add on again at even a lower level, as long as this was your predetermined game plan before you bought the first contract. You must also have an unmovable stop/loss order that takes you out of all contracts.

This mistake is easily overcome by having a strict rule that you never average a loss unless your predetermined game plan called for buying the market at lower levels with an unmovable stop/loss order to take you out of all contracts if it is hit.

7. MEETING MARGIN CALLS:

Most often, meeting a margin call will only increase your loss. A margin call means you are wrong in the market, and your position should be closed out. Margin calls are met because people do not want to admit being wrong and take a loss; because they hope the market will eventually go in their direction. Margin calls are the result of making one or more of the 12 CARDINAL MISTAKES such as not having a game plan, not using stop/loss orders, overtrading or weak money management. You should never have a margin call, much less have to meet one using the rules to overcome the12 CARDINAL MISTAKES.

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8. INCREASING YOUR COMMITMENT WITH SUCCESS:

One of the most dangerous mistakes you can make in trading commodities is to increase your exposure, as you become more successful. Just by being successful, you will risk more dollars per trade because you have more money. But, because you have more money (and confidence) when successful, you are also likely to take more considerable percentage risks. Not surprisingly, this ruins more futures traders than a series of small losses.

You can overcome this mistake by not allowing your percentage commitment to increase as you realize profits and by maintaining your stop/loss discipline.

9. OVERTRADING YOUR ACCOUNT:

......Or risking too large a percentage of equity on any single trade, either with too substantial a dollar risk per contract or by trading too many contracts for any single trade or by trading too many commodities.

This also happens after a period of success when you “know” that the market is going to do something. You are so confident that this is going to be a massive move that you risk much more than the maximum 10% of your equity. Already emotionally out of balance, all it takes is a couple of limit moves against you, and you are bust. To prevent this mistake from occurring, you must have a hard and fast rule that you can risk no more than a certain percentage of your equity on any trade regardless of how good the trade looks.

10. FAILURE TO REMOVE PROFITS FROM YOUR ACCOUNT:

It is almost a natural law that the commodities markets over a given period of time will allow you to make only so much money, and then you are going to have to start giving some back. Yet, probably no more than 1% of all commodities traders I know have the rule to take profits out of their account. (But they never fail to put money into their accounts as they meet margin calls.) Almost always, they leave profits in their accounts and go for the “big trade” — the one that will give them a real “killing” —and usually kills their profits.

This can be overcome by predetermining an equity level at which you remove profits from your account.

When you make profits in the commodities markets, take some money out and put it somewhere else. The commodities markets are not a cornucopia. You, as all commodity traders, will move in cycles. You will make some, lose some, make some, lose some. By taking money out of your account when you are profitable, you will not make the mistake of losing more significant amounts of money when your down cycle begins.

11. CHANGING YOUR STRATEGY DURING MARKET HOURS:

During market hours, you are subject to emotional reactions of fear and greed much more than you are when the market is closed.

Have you ever noticed that when you sit down in the quiet of the night before the trading day, you can very calmly figure out what you want to do the next day; yet, shortly after the market opens you do precisely the opposite of what you had planned.

With rare exception, the best approach is not to change your trading strategy during market hours unless there is an unexpected news event or market reaction. Overcome this mistake by developing your trading strategy before the market opens and having the discipline not to change your game plan during the day.

12. LACK OF PATIENCE:

...Or trading for the excitement, not the profit. The average life of a commodity trader is somewhere between five minutes and nine months. Not all commodity traders trade because they want to make money. Many trades because they want the action. Think about it -- must you have a trade a day, or can you patiently wait for the high probability trades, even if it means standing aside for a week or two?

For those of you who wish to learn how to make money in the commodities markets, rest assured you can. However, do not expect to make money in every trade. If you concentrate on not breaking the 12 CARDINAL MISTAKES of commodities trading, you have a higher probability of making money over a period of time. Indeed, you will have losing trades. Yes, the market will do the unexpected, and at times you will lose more than you expected; but if you steadfastly avoid making these mistakes, you must make money.

By studying the history of a market, you can isolate high probability trades and situations that offer huge profits relative to the dollar risk. You must evaluate your trading and determine whether you trade to make money, or for the action and excitement. To overcome this mistake, you must develop patience, do your homework, and research markets for high probability trades.