THE NETPICKS INFORMER

Savvy strategies for profitable traders.

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LETTER FROM THE DEVELOPER

How would you like to boost your chance of successful trading 10x?

That's a pretty big claim, right? I get asked all the time what is the difference between a successful active trader, and someone who simply does not make it.

I can confidently state that the individual who puts in the work, and then continually re-educates themselves can easily have 10x the odds of success.

Almost without fail, the individual who ends up unsuccessful is someone who is in too much of a rush, does not want to put in the work, and has not interest in continuing education.

The successful trader? Realizes this is a bit of a journey, filled with some amazing highs, but also some challenging lows. Ultimately though many more of the former. And, the successful trader continues to educate themselves and realize that they are not winning 100% of the time so why not make every effort to add incremental improvements to their trading - which goes directly to the bottom-line.

The best place to start? Instead of just glancing through the NetPicks Informer take this issue and whether on your computer, laptop, or tablet read it through. Then, go back and look at the most recent back-issues and start to read those through.

You'll be amazed how just adding to your knowledge-base will start to make you a better trader. Sure, not everything will directly apply to you but it is the collective education and experiences we're sharing in these pages that you can directly benefit from.

We've already gone through the school of hard knocks for you — and save you a lot of grief and frustration. However, it does take some time and it certainly takes a commitment.

Commit here and now to working at this. To constantly being open to absorbing new ideas and education. Watch the most recent videos we release, read the trading blog (www.netpicks.com/trading-tips), attend our webinars.

I know just going through these actions will likely make you better off than 98% of everyone out there flailing their way to failure.

Troy (It's Just a Numbers Game), Shane (Emotions and Mechanical Trading Systems), Will (Out of Sample Testing) and Mike (How to Grind Out Profits in a Slow Market) share much in these pages.

Now, it's up to you.

Mark Soberman

Great Trading!
Mark Soberman
NetPicks.com

EMOTIONS AND MECHANICAL TRADING SYSTEMS

by Shane Daly

We hear it all the time as traders: **Emotions will kill your chances of trading success.**

Anybody whose been in a trade and allowed emotions to dictate their course of action understand this to be true.

- Maybe it's moving the stop further from oncoming price because you can't emotionally handle another trading loss.
- Maybe it's seeing some quick moves in your favor and you cash out because the amount will cover your previous losers.
- Perhaps it's buying the highs after a big run up or selling lows after a decline because you can't miss a move.

Whatever thing you have done in the name of emotions know it was the absolute wrong thing to do.

Emotions in trading will seriously impede the progress of a trader.

Mechanical Trading Systems Keep You Honest

Nobody wants to miss the boat and not cash in on the large moves but having a scarcity mentality is the path to ruin.

There will always be another trade but whether you take the trade or not depends on many things.

One reason people may not pull the trigger on the next trade is due to having a string of losses piling up.

But pulling the trigger on an entry from a trading system you have tested is exactly what you must do.

If you are trading, you must have a trade plan. This trade plan will be your lifeline and ensure that you are staying inside the parameters of the trading system you are using.

What happens though if your trade plan has many discretionary aspects?

The more you put human input into your trading decisions, the more you have emotions lurking in the background ready to make you do something stupid.

This is where mechanical systems have their strength if you adhere to the trade plans.

The system will always fire of a trade setup and you must commit to taking each one the fits the plan.

Let's take a look at some variables that are worth thinking about if mechanical trading is something you have considered.

In the picture above you can see that entries, stops and targets are laid out on the chart leaving you with no discretionary aspects except moving them around key and structural levels.

The trade plans and instruction will tell you exactly what has occurred that makes that a setup. You are not flying blind and if the mechanical trading system you are considering doesn't explain the entries, pass on the system.

The trade plan will tell you when to move your stop, where to move your stop (outlined on the chart), where to take your profits and in this example, where to have a runner for bigger profits.

What are the benefits of having the setups printed?

1. No guesswork is involved
2. Knowing at a glance if entries, targets and stops are near any concerning price structure
3. Allows precise trade management when price meets certain targets

Since the setups are printed, it also allows you to easily back test as far back in history that you have data for.

What are the benefits of targets?

1. You know exactly where to get out when price reaches the area
2. The feelings of greed can be overcome as you place your order to exit a head of time
3. You don't have to watch the charts every minute of every trading session

Back testing Your Trading Systems

What other way is there to test the validity of the system historically than through back testing? You can certainly forward test (something you should do anyhow) but can you imagine forward testing for 5 years…the same amount of time you can back test during the course of a week?

Once you get an idea of the success of the system, it can aid you in being disciplined in following the rules. Having confidence with the method you use when interacting with your trading charts will go miles towards you implementing according to the trade plan you have set out.

Think of a GPS.

If you are venturing out on a driving journey using a GPS, you put your trust in traveling the unknown path to a guidance system. There may be variables such as accidents or road closures that impede you however you will still probably reach your destination by following the guidance system.

In trading, that guidance system is the trading plan for the method you are trading.

When trading, the outcome on each individual trade is unknown but if following a properly tested system, you will probably reach the destination of more $ wins than losses.

Discipline can be an important by-product of diligent back and forward testing. Without discipline, your chances of trading survival are almost none.

Downfalls of back testing

Back testing will give you an idea of the validity of the trading system.

But it will just be an "idea" of the validity.

Depending on how you back test, you have the benefit of hindsight that may alter how you take each trade.

It also won't take into account slippage that may have occurred during the trade entry or exit.

You don't have to worry about emotions taking over like you do during live trading. Emotional trading where you ignore the trading rules can take a profitable system and turn it into a losing system.

It also won't cover slippage and no-fills that can occur in real time trading.

You should account for those variables when considering the results.

The most difficult part of following mechanical rules is having the ability to push the button when required. Like any habit, this can only become ingrained if you are consistently taking action according to the trade plan.

Mechanical trading systems and rules are not simply "enter here, exit here". In the system shown in the above graphic, the Counterpunch Trader, there are mechanical adjustments around key levels and market structure. These can put you above or below any roadblocks that may impede the progress of the trade.

The secret is, once again, to be disciplined in execution. Without that discipline, it makes no difference what method you are trading. You will fail as the many who have gone before you.

IT'S JUST A NUMBERS GAME

by TJ Noonan

There is a simple concept to successful trading that typically gets overlooked and discarded as soon as the everyday average 'would-be winning' trader encounters a few losing trades. They might have a very effective and profitable strategy but after a few losing trades, that strategy gets tossed out the window and the search for the next best strategy begins. This is called 'chasing performance' and is a trap that normally leads to more losses. The way it works is that the would-be winning trader waits until the market is 'trading well,' winning trades have just occurred in other words, and then decides to start trading. The moment he does, his trades lose and the feelings of betrayal and conspiracy come rushing in. As the losses continue to mount, there comes a time when our would-be winning trader takes more pain than he can handle and quits. Of course the next series of trades are all winners which hurts even more. Sound familiar? If you're reading this, chances are you are nodding your head in agreement and can identify with this unpleasant and all too common scenario. Most of us have been there and done that many times.

Another typical behavior that a would-be winning trader will do is to 'fix' the losing trades by tweaking or changing the rules so that the losses would have been winners. This is very common and usually proves to be a bad idea as well. Any rule that a trader comes up with is bound to have incidents where it just isn't going to work. Perfection in trading, that is, figuring out how to get nothing but winning trades just doesn't exist. Do you think governments are going to allow our would-be winning trader to just mint money whenever he pleases without there being any risk involved? If you believe that, I've got an igloo building company I'd like to sell you. More likely we'll be paying you a visit while you're breaking rocks in Leavenworth! It is illegal to mint your own money. Trading has inherent risk which means there will be losses to go along with any winners you could ever hope to enjoy as a trader. By the way this type of thing, fixing losing trades after the fact with changes to your rules is called 'curve fitting' and that never ends well either because market conditions are constantly changing. As soon as you change the rule, you will lose again while the original rule would have won. Does that sound familiar too?

The typical healthy growing equity curve will go two steps forward, one step back, two steps forward, one step back. Losses occur as part of a winning tradeplan. The performance chaser above waits until he has just seen the two steps forward occur and begins to trade at the exact wrong time. Then, at the end of the one step back, right about the moment he has taken on far more pain than he can handle, he quits. He is constantly on the wrong side of the curve. The only result will be continued losses, frustration and potential financial ruin. Sadly, this is completely avoidable and yet it still happens more often than imaginable. It is far too common and doesn't need to be like that.

To discover the simple concept that all too often gets cast aside and that would set our would-be winning trader on the road to becoming an actual winning trade can be found by modeling what the casinos do (or, you can simply re-read the title of this article). The casino creates a statistical advantage and then they just go about doing their business, giving the power of the 'odds' the time it needs to work in their favor. Think about it. The secret to success is so simple that it defies logic how easily it is ignored, overlooked, cast aside, underutilized or flat out forgotten when a few losing trades occur.

What good is having the best strategy in the world, one that would make you money from now until forever, if you never learn how to get to the money and instead toss it aside as soon as some losing trades happen? The best strategies will still lose money and do serious damage in the hands of the ill-equipped (lousy) trader. Usually it will be because of the hard to control 'need' to either curve fit or chase performance in the quest for eliminating losing trades. What does that have to do with making money and being a winning trader thought? Nothing at all and in fact it ironically just propagates the cycle of continued losses.

You have to become a great trader to make money even with a great strategy because as I said above, nothing is perfect in trading. But what does that mean? Does it mean being able to execute trades perfectly? That's part of it but remember, some trades are going to lose. Losing trades DO exist within a winning tradeplan and trade strategy. Great traders understand this and have learned to surrender to this idea, accept it, and then begin to focus on what it really takes to become a winning trader. They focus on being the casino and letting the house odds work in their favor, over time.

In the end, like any business, trading is a numbers game.

If you can learn how to stack the odds in your favor and survive long enough so that the odds swing back around to do the heavy lifting and grow equity, you can be like the casino and succeed. The secret to successful trading is not a secret at all. It's just good 'ole common sense. Establish a statistical advantage, an EDGE in the market, and then go about your business taking the trades that over time, will allow that advantage to grow your equity.

Wins and losses will come at a random distribution, that's just the reality of trading, no matter how good you and your strategy are. Losing traders focus on avoiding losing trades. That never works. The difference maker is that the winning trader understands and accepts this, establishes a statistical advantage (edge) in the market and then goes about his business focusing on smart risk and money management, giving him the ability can stay in the game through the random losses, so that he can take the next trade per his tradeplan enough times to let the odds work in his favor and grow his equity. Then it's just a matter of letting the 'power of compounding' do its thing. It's just a numbers game.

OUT-OF-SAMPLE TESTING

by Will Feibel

Computerized back testing has been a boon for us traders. At the click of a few buttons we can evaluate new trading strategies and ideas across different instruments and time frames and through optimization determine the strategy parameters that yield the best results.

Unfortunately with computerized back testing we also need to deal with the bane of curve fitting. Curve fitting occurs when the strategy parameters are tuned so that they produce optimized results for the specific set of historical data that was tested. With any other set of testing data the results might be radically different. For example we might run a test over a period that saw a huge price swing due to a major news event. A curve fitted strategy may be tuned to capture the maximum profit from those swings thus inflating its overall results. Take away that swing and the same parameters would yield drastically reduced or even negative results. Figure 1 shows what a curve fitted system looks like. To the left of the vertical line we see the optimized results, to the right we see the subsequent system performance using those same values. After an initial run up the system falls apart and all the initial gains are lost.

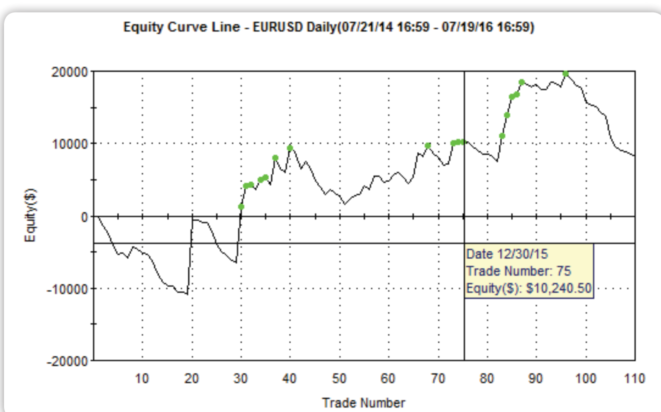

Figure 1 – Curve Fitted System

We have several ways of dealing with curve fitting:

- Optimize one variable at a time and look for ranges of variable values that all produce profitable results, then pick a value from the middle of the range. This value may not have the optimal result but ensures that small variances will still be profitable.
- Optimize over several different historical data sets and identify those strategy variables that produce profitable results across all of them. Look for overlaps and select the variable mix that has good results in each of the test periods.
- Optimize the variables on a historical set of data and then validate that they continue to perform well by applying them to a different set of data. This is called out of sample testing.

Of course you can apply all three of the above to your strategy but for this article we'll focus on the out of sample testing.

In out of sample testing we separate the available historical test data into two sets. The first set will be used for the computerized back testing and optimization. This is called the in-sample period. The optimized test results are then applied to the remaining, untested data set, referred to as the out of sample period. The out of sample data can come from the beginning of the historical data or from the end, although typically we use the most recent data for the out of sample testing.

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The ratio of in-sample to out of sample typically ranges from 2:1 to 4:1, in other words 33% to 20% of the total data will be reserved for the out of sample test. Figure 2 below shows a 2:1 split applied to six months of daily data.

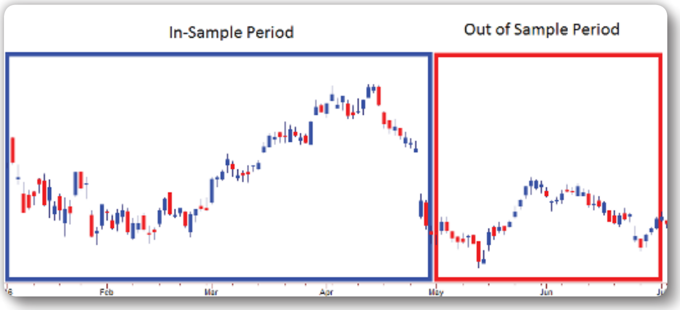

Figure 2 – In-Sample vs. Out of Sample Data

Performing an out of sample test in TradeStation is extremely easy. Begin by adding your strategies and setting the optimization parameters. For this example I used three of the strategies that come with TradeStation and you can see the optimization parameters in Figure 3 below.

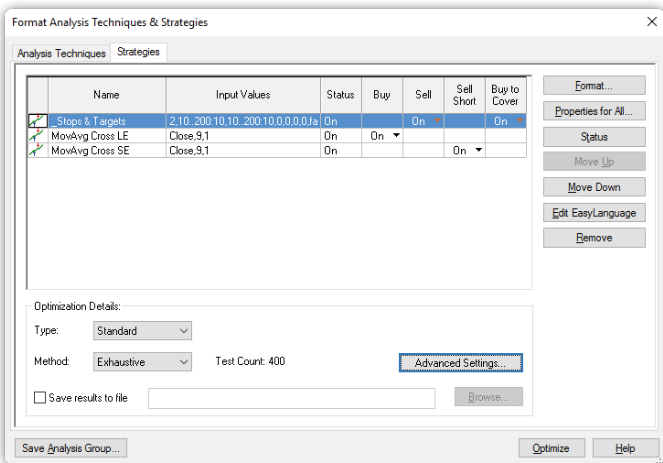

Figure 3 – Optimization Parameters

Once that's done and before we run the optimization we click on the Advanced Settings button to open the Advanced Settings window, shown in Figure 4.

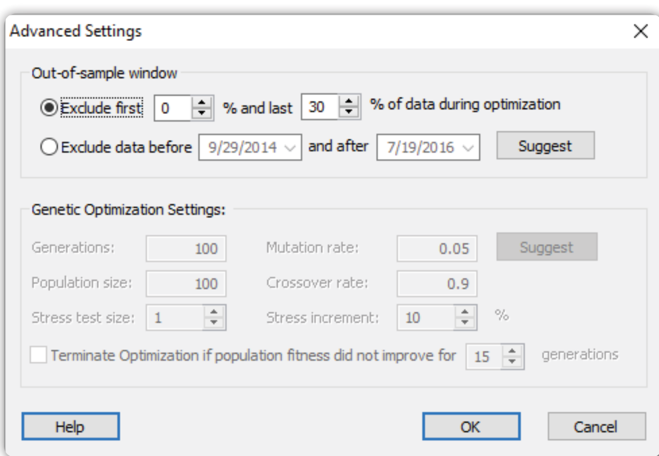

Figure 4 – Advanced Settings

The Advanced Settings window is where you define the size of the out of sample period as a percent of the total historical data set. Note that you can set separate out of sample periods: one at the beginning and one at the end of the data block. Alternatively you could specify dates for defining the out of sample periods. For simplicity I set aside the last 30% of data for out of sample testing.

After you run your optimization you can pull up the Strategy Performance Report to see how well the system performed overall and in the out of sample period. At the top of the report you can click the dropdown menu and select "All data", "In sample" or "Out of sample" to filter the results for the selected data period. You can see the dropdown menu in Figure 5 below. I placed a red vertical line to show the overall results, in sample to the left of the line and out of sample to the right.

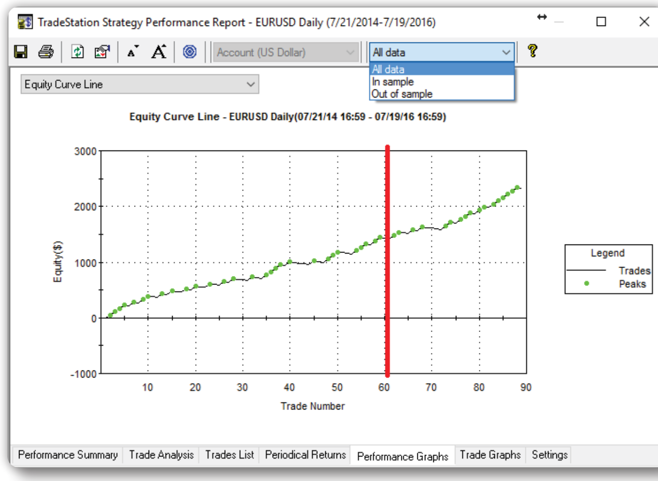

Figure 5 – All Data optimization results.

Compare this equity curve with the one from Figure 1. Here we see that the system continued to perform well even after the data optimization period and this gives us great confidence in trading it going forward.

This approach works well to test the robustness of the system. The drawback is that the testing is performed over a limited period of time. During that testing period the market may have experienced different levels of price volatility or prices may have changed significantly, and the strategy parameters don't reflect this evolution. In practice a more accurate assessment of overall performance would look at the results of consecutive or rolling out of sample tests. This is called walk forward testing and will be the subject of our next article in this series.

HOW TO GRIND OUT PROFITS IN A SLOW DULL MARKET

by Mike Rykse

"The market has to go lower from here."

"We can't continue to make new all time highs on a daily basis."

"There is no way I'm playing the market to move higher from here."

These are all comments that I have heard from traders over the last 6 weeks. The problem with these statements is that the market really doesn't care what any of us think it should do. The market will do what it wants. As a result, it's crucial for us to trade based off price action on the charts instead of our personal opinions.

Looking at current market conditions it might seem like we have 2 options. We can either continue playing the market up to new highs on a daily basis or we can blindly buy puts expecting the market will move lower. Neither one of these sound appealing to me. However, are these really our only 2 options?

So many times traders are programmed that they have to pick market direction in order to be active. This just doesn't have to be the case. When trading options, there are trade types that allow us to be active without having to make a strong directional bet. For example, in our Options Academy training room last week we took a look at TLT which is the Bond ETF. Instead of buying a long call or put option to place a directional bet, we decided to take a look at an Iron Condor. While the name can be intimidating it really is a simple trade. ***All we are doing on this trade is selling an out of the money call spread and an out of the money put spread at the same time.*** In doing so, we are betting that TLT will stay inside of a range or what we call our "***Profit Window***".

The nice part about the Iron Condor is that it is a very forgiving trade. We don't care if TLT moves higher, lower, or sideways as long as it stays inside of our Profit Window we are fine. In our TLT example, we decided to go out to the August monthly options and sell the 141/142 call spread and the 135/134 put spread at the same time. In this case we were selling the 141 call and buying the 142 call to make it a risk defined trade. On the put side we sold the 135 put and bought the 134 put to make it a risk defined trade. We collected $.52 or $52 per spread to put this trade on.

TLT Iron Condor	
ETF:	Bond ETF (TLT)
Entry:	$0.52
Call Spread:	141/141
Put Spread:	135/134
Max Profit:	$.52 or $52 per spread
Max Loss:	$.48 or $48 per spread

The $.52 that we collected to put the trade on is our maximum profit potential. Our maximum risk is $.48 (the difference between the strikes ($1) minus the credit received ($.52) when putting the trade on). To calculate our Profit Window we need to get our break even points. There will be two break even points when trading an Iron Condor. We calculate the break even point on the upside by taking the short 141 call strike and adding in the $.52 that we collected when placing the trade. This puts the break even point on the upside at $141.52. On the downside, we take the short 135 put strike and subtract the $.52 that we collected when placing the trade. This puts the break even point on the downside at $134.48. As long as TLT stays between $141.52 and $134.48 we can make money.

Even though we give up the home run profit potential when placing an Iron Condor, it can be a great trade because of all the different ways we make money. We make money if TLT moves up, down, or sideways as long as it stays inside our Profit Window. We make money as time decay adds up which means every day we hold the trade we make more money. We also make money if volatility decreases. This gives us 5 potential ways of making money on this trade. When buying a call or put option we only make money if the stock moves higher or lower and the stock has to make that move in a hurry.

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HOW TO GRIND OUT PROFITS *CONTINUED*

While the current market environment can be very frustrating due to the grind higher on very low volume, you have to make sure you are trading products that give you flexibility. The options markets allow us to do just that better than any other product out there. The Iron Condor might not be the most exciting trade type in the world, but it gives us a nice way to make money in a slow dull market. As a full time trader, this is what I'm looking for in the long run. We would love for the market to make big moves all the time but it's just not realistic. This TLT Iron Condor is great because I don't need a strong directional opinion on the movement going forward. I just need TLT to stay inside of a range. This takes a lot of the pressure off my trading.

Don't get stuck spinning your wheels during slow market conditions. Challenge yourself to find new trade types that will better reflect current conditions. If you do so, your results will improve in a big way. Having a diversified list of trade types will give you a much better equity curve in the long run. If you are looking for ways to improve your trading in a slow uncertain market environment, the Iron Condor is a great option.