SURVIVOR DAY TRADING

By Ilan Levy-Mayer

I started as a commodity broker back in 1998, when commissions of $25 per round turn for the E-minis were considered a deep discount. I had the luxury of observing many types of day traders and saw things from the sidelines that most traders could not see during the heat of battle, one of which is the importance of solid money management for the long-term survival of day trade.

Day trading is by definition a trade that is initiated and completed during the same trading day. In this wide category, you will find many types of traders. On one end of the spectrum are scalpers, who go for one or two ticks of profit several times a day in trades lasting just seconds. On the other side are speculators who stay in a position from the start of the day until the close. One of the main appeals of day trading for all types is that the trader goes home flat without having to worry about positions. When the market closes, the day is done.

Money management, as the name implies, is applying prudent principles to help conserve your trade (risk) capital. Without risk capital to trade, a speculator does not have a chance to succeed.

PRESERVE YOUR TRADING CAPITAL

The liquidity and volume of markets including the E-mini S&P 500, U.S. 30-year bonds and many others are attracting increasing numbers of day traders. The speed of execution, the growth in technology and a continued trend toward lower commissions provides an attractive environment for day trading.

Today, traders can take into account mixed markets that are open nearly 24 hours a day and offer low day-trading margins. It's easy to understand the reason some futures markets are now considered day-trading heavens for many who previously traded stocks, foreign exchange and other instruments.

The result is consistent growth in popularity and trading volume over the past few years. On Feb. 27, the E-mini S&P 500 traded 3,575,702 contracts! Yes, that is 3.575 million. You, as an individual trader, may wonder how you can participate and make it in the futures day-trading arena. The answer is complex, and there are many paths to the same destination, but in this article, I focus on the common foundation: money management.

"Survive to trade another day" is a well-known saying in our business. If you want to acquire the confidence and skills of a successful day trader, you absolutely must preserve your trading capital. Otherwise, you might end up with the education and experience that you need only to have squandered all your risk capital to acquire that education and experience!

Preserving your trading capital is easy to understand but difficult to do. You will need a tremendous amount of discipline to apply good money management during live trading. If you can implement some of the rules I outline below, you'll increase your chances of staying in the race long enough to benefit from your own experience.

MANY TRY, FEW SUCCEED

In some ways, day trading can be a great job: no boss, potentially large income, take a vacation whenever you wish—you can even work in your pajamas if you want. However, no one wants a job where he or she loses money going to work. Most day traders do lose, but the high profit potential and flexible lifestyle associated with day trading keeps many people motivated to continue trying.

New traders as well as more experienced traders often wonder and search for the perfect indicator, the "amazing method." Unfortunately, there are no perfect indicators or methods. But there is a great deal of trial and error, evolving market conditions and many obstacles against you. A successful path for one trader may not be right for another, and different traders can have very different ways of implementing the same strategy, with correspondingly varied results. Experience, risk tolerance, the person's schedule and financial situation, along with other factors can greatly influence trading decisions.

Getting back to what I consider the first step in this long journey: money management. It can and should be applied in graduated steps: first to each trade you take, then to every single trading day (as a day trader) and, finally, to your risk capital in general and account as a whole.

One common, practical solution different traders can implement when it comes to day trading is the principle: Treat your daily profit/loss as you would treat an open trade. As a broker, I sometimes see traders survive in this business, make progress and even attain consistency finding their set ups. Their main downfall is "one bad day" when they give up recent gains, lose a large percentage of their accounts or even lose their entire accounts in one session.

One way to eliminate those disastrous days and give you a better chance for survival is simple. Use daily stop limits, trailing stop losses and daily target profits on your trading capital *every single trading day*.

BE PREPARED TO LOSE

Let's assume, for example, that trader A is day trading with $10,000 of risk capital. Part of the preparation for trading should involve understanding his trading style, knowing how active a trader he is, and how much, on average, he is willing to risk per trade. Defining these factors will help calculate his daily loss limit, which is the backbone of money management for day traders.

In my view, the daily loss limit should be as important in a trader's mind as the stop loss on an individual trade, if not more so. If you are disciplined enough to set your own daily loss limit and adhere to it carefully, you will give yourself better odds of surviving in the day-trading arena and preventing catastrophic days where you may lose a large portion or all of your account.

If you have been day trading more than a few weeks, I am sure you have experienced that one, terrible day where you look back and ask yourself, "Why didn't I stop trading after I was down X amount of dollars?" or "I cannot believe I made $500 each day the last three days only to lose $2,500 today because I could not walk away."

From my experience, you will fare much better in the long run by implementing a daily loss limit. The numbers just work out that way. However, forcing yourself to adhere to your own rules and actually walking away from trading once a daily loss limit is reached is one of the most challenging steps a trader can take. In my eyes, this ability separates traders from gamblers. As a trader, you must accept risk, understand the risk you have accepted and construct your own parameters of risk, knowing that one single trading day is just a small piece of a much bigger puzzle. I have been assisting clients with day trading online for nine years. I have never witnessed a situation where one single day "made a trader," but I have witnessed many single trading days that destroyed traders.

In the example, trader A, who started the day with $10,000, should have a daily loss limit (depending on the level of aggressiveness) somewhere between $700 to $1,000. (I will provide a specific way to calculate your daily loss limit later.)

TAKE YOUR PROFITS

The next step, now that you have decided on what your daily stop limit should be is to identify which level of profit will trigger breakeven money management. By that, I refer to a level of daily profit that triggers the thought: "I am up X amount today. If, for whatever reason, the rest of my trading today does not go well and my daily profit/loss is back to zero, I should call it a day."

It is my opinion that once a trade reaches a critical level of profit, it should not turn into a losing trade. Aside from the financial implications, the psychological impact of watching a nice profit turn into a loss can spell disaster, as it opens the door to negative psychology that can spin out of control. The same applies to your trading day as a whole. Knowing that you have the mental toughness to walk away from trading if a profitable day reaches the breakeven point will reward you greatly the next trading session.

Going back to the example: Once trader A's $10,000 starting balance for the day generated a profit of $500, she should not see her profit/loss for the day turn negative.

Moving on, you should also decide on a certain profit target that is higher than your breakeven point. That level of profit, when and if achieved during the day, should trigger a corresponding trailing stop. Assume that trader A is now up $1,000 during the trading day and after implementing the new daily risk management strategy, has decided that if he is ever up a $1,000 during the trading day, his trailing stop is $500. That means trader A will continue to trade as long as he does not give up more than $500 from the intraday high mark of profits. If trader A continues to do well and is up $1,400 for the day, he should not finish the day with less than $900 in profits. If his profit/loss comes back down to $900, trader A should flatten positions and call it a day. By implementing this technique, he allows himself to continue trading as long as he does not give up too much of the profit for that day.

KEEP GREED IN CHECK

Last but not least is the profit target. There are a few schools of thought when it comes to daily profit targets. Some say that if a trader is "hot," he or she should continue trading to maximize the potential for that day. I disagree. The hot trader brings us back to the gambling rather than the trading mentality. In my opinion, setting a daily profit target based on your account size and other factors discussed previously serves you better in the long run. If trader A decided that her daily profit target is $2,000 and on any given day has reached that profit, trader A should feel satisfied and successful. At that point, she would close open positions, enjoy her good trading and call it a day.

I have seen too many instances of traders who are having successful day-trading sessions let greed take over. Instead of understanding the numbers and statistics, and saying "Thank you! That was a great trading day" and leaving work early, they continue to trade, accumulating additional trading fees and giving up too much profit.

If you can train yourself to desire the daily target profit that you set in advance, you help yourself create a positive trading psychology, which is another big key to trading survival. Although I could expand more on this, it is a subject for another article.

Only you know your financial condition, risk capital and appetite for risk. Knowing these factors is imperative before continuing.

CALCULATE A DAILY LOSS LIMIT

Now, to get back to a daily loss limit, here is one way to calculate it:

1. How much risk capital can you start with? How much more do you have available?
2. What is your risk tolerance? If you lose $1,000 in a day, can you handle it emotionally and financially? Can you go back and function as a parent, spouse or any of your other important life roles for the rest of the day? What if you lose $1,000 three days in a row, can you handle that?
3. Can your method of trading be quantified into an average number of trades per day? If yes, how many? If not, find the number by answering 1 and 2 above. Let's say the average number of trades per day is four and the maximum loss per trade is $100 per contract (two E-mini S& P 500 points). If there is no maximum loss per trade, you need to start working on one!
4. Now we know that potentially you can lose $400 per contract on average, per day. Based on the example of $10,000, I suggest trading two contracts. You are exposed to an $800 loss per day. That should determine your daily loss limit (which will prevent those really bad days when mistakes multiply and you can blow out a large portion of your account).
5. The amounts you should use for breakeven points, trailing stops and daily target are functions of your daily loss limit. Calculate a common sense risk/reward—it may have more to do with keeping a positive trading mentality than pure mathematics.

STAY TRUE TO THE RULES

I have seen the online futures trading industry grow significantly and witnessed the evolution of the markets, technology used for trading as well as many different types of traders. And in 2005 I started to implement my ideas into trading systems. During the past two years, I came to realize that I am personally better off following a certain structure. As I gained more experience in designing trading systems and backtesting data over different periods and markets, I noticed that the principles mentioned above are almost always a must for a successful trading system. I also noticed from working with different clients, that if one has the discipline to apply and follow the same rules to his or her day trading, the chances for success increase as a trader eliminates the "sudden-death syndrome."

It is my opinion that a trader will fare better in the long term by initiating these concepts I borrowed from trading system design. Getting to the point of working with these suggestions requires one to analyze him- or herself as a trader, acquire understanding of basic money management concepts and develop the self discipline to execute his or her trading plan.

Just like in a marathon, mental toughness and clarity separates the professionals from the amateurs. The same applies to trading. Using the suggestions in this article can help you remain mentally ready and positive while trading, and to understand that although you are a day trader, your progress and success are measured over time and not based on any one single trading day. To give you a fair chance, be ready for a marathon, not a sprint. Good trading! ●

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