DR. VAN K. THARP

Five Steps to Consistent Profits

Dr. Van Tharp outlines five important steps necessary to becoming a consistently profitable trader.

The goal of my Super Trader program is to help people develop a full-time trading business that produces consistent, above average profits under a variety of market conditions. This means that you can perform profitably in up markets (both quiet and volatile), in down markets (both quiet and volatile), and sideways markets (both quiet and volatile). To help traders reach this goal, I have designed a five-step approach. If you are reading this, you are probably interested in this sort of performance, even though you may not be part of the Super Trader program. My objective in this article is to familiarize you with the five steps.

1. Work on yourself and your personal issues so they do not get in the way of your trading. This step must be accomplished first. Otherwise, it will interfere with each of the other steps.

2. Develop a business plan as a working document to guide your trading. This business plan is not to raise money, which is the purpose of many business plans. Instead, it is designed to be a work-in-progress to guide you through your trading career. The business plan actually helps you with all five of the steps. The plan also includes an overview of the big picture influencing the markets you will be trading and a method for keeping on top of those factors so you will know when you are wrong. My view of the big picture is updated in the first issue each month of Tharp's Thoughts.

3. Develop several strategies that fit your view of the big picture and understand how each of these strategies will perform under various market types. The ultimate goal of this step is to develop something that will work well under every possible market condition. Actually, it is not that hard to develop a good strategy for any particular market condition (including quiet, sideways). It is very difficult to develop one strategy that works well under all market conditions – which is what most people try to do.
4. Thoroughly understand your objectives and develop a position sizing strategy to meet those objectives. Probably less than 10% of all traders and investors understand how important position sizing is to trading performance and even fewer understand that it is through position sizing that you meet your objectives. Thus, the fourth step is to develop position-sizing strategies for each system that will help meet your objectives.
5. Monitor yourself constantly and work to minimize the number of mistakes that you make. I define a mistake as not following your rules. Thus, for many people who have no written rules, every thing they do is a mistake. However, if you have followed the first four steps, you will have rules to guide your trading and you can define a mistake as not following those rules. Of course, when you repeat the same mistake over and over again, that is self-sabotage. However, by monitoring your mistakes and continuing to work on yourself, you can minimize the impact of such mistakes. In my opinion, someone who does this will tend to produce consistent, above average profits.

Part I – Working On Yourself

This part of the program is so important because everything you do is shaped by your beliefs – in fact, your reality is basically shaped by your beliefs. What is a belief? Every sentence I have written (including this one) reflects my beliefs. Every sentence that comes out of your mouth reflects your beliefs and your beliefs shape your reality. Who you think you are is shaped by your beliefs.

Let me provide an illustration of how that works. My niece from Malaysia came to live with us when she was 19 years old (my wife and I were putting her through college in the United States). One day she said to me after living with us for about a year, "Uncle, in my next lifetime, I would like to be born beautiful and talented." Let's see, she is very artistic. My wife has become a professional painter, but my niece actually completed the initial art course faster than my wife did – she was so good. She also sings like an angel and coming from a liberal arts background she earned a degree in biomedical engineering, graduating cum laude. I think she passes the talent criteria with flying colors.

As far as beauty, I would describe her as one of the most stunningly beautiful women I have ever seen. Everyone that meets her comments on how beautiful she is. Here was an incredibly beautiful and talented woman, who because of her beliefs, did not think she had those qualities at all. Your reality is shaped by your beliefs. By the way, I have been working on those beliefs of hers since she has been living here, and she is finally coming around.

Who you are is shaped by your beliefs about yourself. In addition, you do not trade the markets. Instead, you trade your beliefs about the market. One of the key aspects of working on yourself is to examine most of your beliefs to determine if they are useful. If they are not useful, then find beliefs that are more useful. This is one of the key aspects to working on yourself.

You probably will never be free of limiting beliefs and some aspects of self-sabotage during your lifetime, but I consider this step to be complete when you transform about five very limiting aspects of your life and you feel very different about each. Once you have accomplished five such transformations, then I consider you capable of generally overcoming future roadblocks that might come up in your trading.

Part II – Developing a Working Business Plan

The business plan part of trading includes step one. In fact, a good business plan includes a thorough examination of the person who is doing the trading – beliefs, issues, strengths, weaknesses, goals – everything you can possibly think of about yourself should be included in this document.

However, the plan should also include many other important things:

- Your assessment of the big picture and how you will keep up with it. For example, I wrote about the possibility of a huge secular bear market in 2001 when I first started working on Safe Strategies for Financial Freedom. I decided that the big picture should include

a) a general assessment of the stock market in the U.S. and world wide

b) a general assessment of the strongest and weakest areas of the world for investments

c) a general assessment of the strength of the dollar (or your home currency if you are not using the U.S. dollar)

d) a general assessment of inflation or deflation potential in the future. I also developed ways to measure each of these and my way of keeping up with them is to write a market update on the first Wednesday of each month.

- Other strategies, such as how you will do research, monitor your data, market yourself to your family or clients, monitor yourself, manage your cash flow, keep track of your trades and your performance. Running a trading business involves many systems other than trading systems and to have a successful trading business you will need to master the other systems.
- You will need several strategies that fit the big picture and that work when conditions change. For example, strategies that work in volatile bear markets (e.g., 2008) are quite different than those that work in quiet bull markets (e.g., 2003).
- A worst-case contingency plan so that you will be prepared for anything major that could upset your trading business. This sort of planning often takes as long as six months to complete.

Part III – Develop Trading Strategies That Work Under Various Conditions

In 1999, everyone in America seemed to be a stock market expert. For example, we were giving a stock market workshop at the Embassy Suites in Cary, North Carolina and one of the bartenders said to the other, "Perhaps we should take Dr. Tharp's Stock Market Workshop." The other one responded, "No, I don't need that. I could teach a workshop like that."

Similarly, a waiter in a high-class steak restaurant informed us that he was really a trader, but that he works at a restaurant part-time at night. He had already made over $400,000 trading and considered himself to be an expert trader. However, my guess is that those people did not survive the markets from 2000 to 2002, much less the market we have seen in 2008. Why? They are different markets, and a strategy of buying and holding high tech stocks that worked in 1999, had mixed to horrible results in the years since 1999. However, a strategy of buying inverse index funds as soon as the market signaled a clear bear market in 2007 has worked wonders in 2008. The basic idea is that you must know what kind of market we are in.

- Up volatile (11%)
- Up quiet (19%)
- Sideways volatile (20%)
- Sideways quiet (38%)
- Down volatile (10%)
- Down quiet (2%)

These are the six market types and the percentage of time we have been in them (rolling 13 week windows) since about 1950. Down quiet markets occur very seldom (about 2% of the time), but the other five market types occur often enough that you need to be able to find something that works profitably when it does happen.

Typically, people attempt to develop one strategy that works in all kinds of markets. The waiters and bartenders, and most others for that matter, usually fail. However, there is good news. It is not that hard to develop a strategy that will work well in each kind of market. What is difficult is to find one strategy that will work well under all conditions. However, you do not have to do that if you simply monitor the market conditions.

Part IV: Develop a Position Sizing Strategy to Meet Your Objectives

In our workshops, we typically play a marble game. Marbles are placed into a bag to represent a trading system. For example, a trading system might include 20% 10R winners, meaning that when one of those marbles is drawn, you make 10 times what you risk. The system might also include 70% 1R losers, meaning that when one of those marbles is drawn you lose whatever you risk. And lastly, the system might also include 10% 5R losers, meaning when those marbles are drawn, you lose five times what you risk. By the way, the marbles are always replaced after they are drawn so that your odds remain the same after each draw.

Now some of you might be thinking, "But you will lose 80% of the time. How can you possibly make money?" Let's say there are 100 marbles in the bag. If you total the R-value of all the marbles in the bag, you will find that they total to +80R. That means

that on the average, you will make 0.8R per pull over many, many marble draws. Thus, the expectancy of the system is 0.8R (after 100 trades, you will probably be up about 80R). And if your risk were about 1% on each marble pull, then after 100 pulls you would probably be up more than 80%. Perhaps now the system does not seem so bad.

However, when I play the game I usually provide the audience with different incentives. For example, I might say that if you go bankrupt, you are out of the game and have to pay a fine of $10. I might also say that if you end the game down 50%, you have to pay a fine of $5. I could also say that if you lose money by the end of the game, it will cost you $2. On the positive side, I might say that if you make money, you will win $2. If you make 50%, you will win $5. I might also say, if you make the most money, you will win whatever is left in the pot – let's say $100. Notice how my incentives set up a number of objectives for the game. For example, here are three possible objectives:

To win the game at all costs, including risking bankruptcy. The person who wins the game will usually have this objective.

To win at least $2 and to make sure that you do not lose more than $2. Notice how this is an entirely different objective.

To win the game, but to make sure that you do not go bankrupt. Again, this is an entirely different objective from the first two.

When I tell people how to strategize about the game, I suggest that they answer the following questions:

Who are you?

What are your objectives?

What is your position sizing strategy to reach your objectives?

Under what conditions might you be willing to change your position sizing strategy?

If 100 people play the game (starting with $100,000) and they all get the same trades (i.e., the same marble pulls randomly done and replaced), then chances are there will be 100 different equities at the end of the game. You will also be able to group people according to their objectives. For example, those who are trying to make money and have minimal losses will have a minimal fluctuation of equity around a 5% to 10% gain. However, those trying to win the game will have huge equity fluctuations ranging from bankruptcy to making millions.

My point here is that the game illustrates what is really important to trading success – the "how much" variable of position sizing. Thus, a key step for anyone wanting consistent profits is to develop a strategy with a positive expectancy and then develop a position sizing strategy that maximizes the probability of meeting your objectives. This is an extremely important step that is largely ignored by most traders and investors, including most professionals.

Part V: Taking Steps to Minimize Your Mistakes

What happens when you do not follow your rules? You make a trade when your system did not tell you to trade. You are supposed to get out of a trade when your stop is hit, but you do not get out. Your position sizing is too big on a particular trade. Those are all mistakes – and mistakes can be very costly.

We have done some preliminary research on the cost of mistakes and results suggest that for leveraged traders, mistakes can run as high as 4R per mistake. If a person makes ten mistakes in a year, that trader could find profits dropped by about 40R. That means that if he or she made 50% on the year – they could have made nearly 100%. If he or she lost 20%, then mistake free trading could have made that person profitable.

For long-term investors with wide stops, mistakes probably cost about 0.4R per mistake making the total cost per year about 4R. However, the average investor is lucky to make 20% per year, so 10 mistakes could easily cost them 20% of their profits.

The final step that you must concentrate on is to minimize the impact of mistakes on your trading. This amounts to developing a disciplined routine in your trading and continuing step one – working on yourself.

Dr. Tharp is the author of three acclaimed books published by McGraw Hill. The New York Times Bestseller, Safe Strategies for Financial Freedom with co-authors Steve Sjuggerud and D.R. Barton, Trade Your Way to Financial Freedom, and Financial Freedom Through Electronic Day Trading. In addition, Tharp is the only trading coach featured in Jack Schwager's best selling book, The Market Wizard's: Interviews with Great Traders.

Dr Tharp can be contacted at www.iitm.com.