ReadySetCrypto Trading Edge Masterclass

Module Six: Strategy Development

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Strategy Development

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Introduction to Strategy Development

If you're like most individual investors, the following scenario should be familiar to you:

- You learn about a trading strategy from either a friend or some online source.
- The strategy looks appealing because it will either allow you to make money faster than you were before, or it at least looks better than what you're trying to do now.
- You sign up for the program or buy the book and make a "commitment" to it.
- You study the program and learn it for a week or so.
- They make it look easy, so you surrender to the moment and jump in with your first live trade.
- It does not work out; you lose capital either through the luck of the draw or your lack of knowledge to adequately manage the position through their strategy.
- You hit the books again.
- After a couple of weeks of following their "easy" winners, you try again. You lose the trade.
- The program now becomes "shelfware" as you see ANOTHER program that catches your eye and you sign up for it....

Sound familiar? It should. I would bet that EVERY individual investor goes through this cycle. The reason that you lost money on the trades was due to some basic reasons:

1. **The Herd Effect** - this occurs when a particular strategy or signal works time after time for a while; when everyone finally notices the signal will also correspond to the time that everyone will finally "feel" comfortable making this trade, which means that the professionals will find a way to "fade" the trade.
2. **Knowledge** - you probably learned just enough to figure out how to ENTER the trade, but not enough to know how to gracefully exit the trade with a profit. This impatience on the part of Retail traders is very common, and it's akin to learning how to start a car and apply the gas, but not knowing where the brake pedal is.
3. **Earn the Right** - you had not "earned the right" to make this trade with live capital yet. It takes a lot of preliminary work to develop a true statistical edge for a trade, to make sure that the strategy does provide an edge in the current market ...and that your execution of this strategy is practiced and flawless. You must therefore "earn the right" to trade with live capital and ultimately, full-sized positions.

And to be brutally honest, this vicious cycle repeats itself over and over again while the trader gets more and more frustrated, eventually burning up their capital, all the while blaming others.

I know this problem intimately because I allowed myself to get pulled into this cycle, on the quest for the "Holy Grail" of trading, before I got a grip on things and decided to focus on getting good....*really good*...at one thing, and one thing only.

So exactly how do you get good at a strategy? Well, trading is really no different than anything else that's out there....think about any kind of athletic pursuit that you had, like learning to play golf:

- The first time that you played golf, you were atrocious and it really wasn't any fun other than the fact that it was during a corporate outing and no one else was any good. You struggled to make any kind of consistent swing to make contact with the ball.

- If you took an interest in the game, perhaps you borrowed some books from the library or rented instructional DVDs. While your game didn't improve much from sitting on the couch and watching someone else hit, you at least got the idea that you needed to break your game down into different components, like the Grip, the Full Swing, the Chip, the Pitch, the MidIron, etc.

- You took your practice out to the Driving Range. This was just as frustrating because you would occasionally hit a great shot, but the next one would be a "worm burner". You didn't know what produced a good shot and you had no consistency.

- About this time is where most people seek professional help. You take your first lesson, and while the instructions seem awkward at first, with some application you begin to notice some really positive results with your ball-striking.

- You go back to re-reading the book/video instruction and now it all makes a lot more sense and you can actually start to apply those instructions. More time at the Driving Range now means positive learning and better results. This usually leads to more coaching instruction, and even better results and consistency.

Can you see how this process involved multiple Learning Loops? Each iteration of this process got you to a higher skill level, yet there is no end to the process as many professional golfers can attest to that fact.

So what we need to do as Traders is identify 1) that we are NOT going to be perfect with any strategy out of the gate, and 2) that we need to ***earn the right*** to trade live capital by demonstrating continuously improving performance as we move through multiple iterations of Learning Loops. Only then will we be thinking with our Millionaire Mind Map!

Let's see how we can apply these Learning Loops to our trading business....

The Strategy Development Cycle

Ever watch a basketball player shoot a pair of foul shots? Their Goal is to put the ball in the basket, both times. They will follow a routine that they have worked on for years which normally gives them an 80% rate of success. They dribble the ball twice, flex their knees and loft the ball at the rim with their wrist. If the ball goes in with a “swish”, they’ll do the same thing for the second shot. If the first ball goes in, but bangs off the backboard, they’ll apply a small correction to shoot the second ball with just a little less force than the first.

Figure 1

This diagram represents the “Strategy Development Cycle” process that you’ll need to build in order to become a profitable trader. You’ll notice that the cycle starts with “Goals”, which can be represented by the distant target that you want to hit. “Rules” represents the strategies and tactics that you’ll employ to hit that distant target. Did you hit the target? The “Results” area will tell you whether or not you hit your Goals, and if not, how much you missed by. The final step in the Strategy Development Cycle is “Corrections” where you’ll use feedback, analysis, and experience to determine what corrections need to be made in your Goals and Trading Rules in order to hit that target the next time. The cycle repeats, again and again. Professional traders understand how to maintain their development by constantly seeking to improve their execution and results until their goals are met. When they meet their goals, they formulate new ones and go through a brand new iteration of the Development Cycle.

Unfortunately, this is exactly where the average Retail trader falls short. They do not formulate goals other than vague mental ones….they rarely trade via a published set of rules….they do not analyze their results (unless they take a profit in which case they're telling everyone that will listen)….and they most definitely do not make corrections to their strategy. If they do make corrections, it's to switch strategies because the new one that they tried just took a loss. Again, this is why most traders never leave Stage Four of Bo Yoder's Trader Progression.

As we go further into this program, we'll dig into how to build Rules, how to evaluate your Results, and finally how to make Corrections. You'll build your own Strategy Development Cycle. For now, though, we need to focus on developing your Goals.

Defining Trading Goals

Where do you start to define trading goals?

The obvious answer to some would be "profits" or "returns!" Yes, that's certainly one way to define a trading goal, and ultimately we'll get there in time.

One of my early trading mentors was very inspirational; he would constantly pump up his trading team with statements like, "*Come on guys, let's GO! Ten percent a month, no guts, no glory!!!*" Would it surprise you to learn that the many students that followed this mentor eventually blew up their trading accounts? The mentor's goal-setting aggressiveness was not matched by his students' trading skills. The point in relaying this story to you is that it's possible to come up with goals that are entirely unrealistic, even ones that might be dangerous to a newer trader. Setting aggressive profit goals for a new trader is like giving the keys to a Ferrari to a 16 year old boy; just because he has a license doesn't mean that he's capable of handling that machine.

Most beginning traders create goals that are far too aggressive; everyone wants to get rich quickly, don't they? But how do you know what is aggressive and what is not? Do you really know what your strategy will consistently and safely produce? How then can you start by naming a monetary goal?

Start by Following your Rules

Yes, mundane as that seems, the first goal that you need to tackle is to follow the rules that you define in the second step of the Strategy Development Cycle; this cycle starts its life in any strategy as a Learning Loop, so that you can LEARN how the strategy performs in different Markets, different seasons….and how YOU respond to those challenges. Your NUMBER ONE GOAL is simply to follow the rules that you define for that strategy, and measure the performance that you can achieve. Ideally you will start this first cycle with virtual money or a "testnet" account so that you can learn without eroding your capital.

Unfortunately, most traders do not follow this script. They are in too much of a hurry to start making money, so they shoot from the hip and learn their lessons via "market tuition." Yes, I have made this mistake more than once, so I speak from experience when I say that **your very first goal should be to follow the rules of the strategy that you design.**

<u>Kick it Up a Notch</u>

If you go through several cycles with your new strategy and you've proved to yourself that you can follow your trading rules and it's consistently profitable, you can now take the next step by trading live. Now hold on, partner….keep that weapon holstered. Your position size should be VERY small – small enough that a loss will simply generate curiosity, and not a negative emotional response. Do your results with live trades equal those executed with simulated accounts? Invariably, they will not at first. Trading with live money will introduce new emotions that you need to be able to conquer before you start trading with any size. Your goal for these cycles, therefore, is to trade live positions as well as you did with simulated ones!

<u>Earn the Right</u>

Your original goal was to build a profitable strategy by following your rules in a simulated account. You raised the ante by trading this strategy with live contracts/ shares, and your goal was to trade live accounts in exactly the same manner as your simulated accounts. If you have come this far, what's next? The obvious answer here is to shift into a higher gear by increasing your position size, but your goal now should be to "Earn the Right." This is where it's important to measure your performance, and earn the right to increase your position size through demonstrated performance. As discussed in the "Trader Mindset" chapter, your Subconscious mind will act as a "governor" to limit your performance if it feels that you have not "earned the right" to trade in increased scale. Why do you think that most Lottery winners go broke within a short time after their winnings? They subconsciously give it back, and you will, too.....if you don't convince your Subconscious that you've "earned the right" to win those trades, and seek higher returns.

By going through the first cycles of goals, you have finally achieved the ability to start laying out MONETARY goals.

<u>What Rate of Return Should You Target?</u>

Newer traders struggle with what rate of return to target as their monetary goal. In a perfect world, you would use the preceding exercises (learning to trade the strategy in simulated trading mode, small positions in live mode, etc) to determine what is a realistic "rate of return" goal for your strategy, that you can consistently achieve without driving your account too hard, and exposing yourself to too much risk. With time and with experience, you will know what that particular strategy can produce without putting too much capital at risk. The Golden Rule of Risk Management states that “no one position should put more than 2% of your trading capital at risk,” and we certainly recommend putting less than that at risk whenever possible, especially as you are in the learning mode, not “profiting” mode.

Case Studies

To give some perspective to this section, we’ll discuss a couple of examples. One of my early trading associates had discovered how to trade the Iron Condor options strategy. Initial returns with limited capital were encouraging. Trading the SPX with 10 contract positions, he was earning approximately $1200/month. He extrapolated that if he could earn this return on a $20,000 account, then he could do even better on a $100,000 account. He took out a home equity line of credit for $100,000 and transferred it to his brokerage account. He now started trading 95 contract positions, or almost 95% of the equity in his account. He was risking almost 84% of that account, but he didn’t realize it yet. He started bringing in astounding returns - $12,000 to $18,000 a month! The Options Education firm that trained him caught wind of this performance and featured him in presentations and live talks in front of prospective students - “***Hey, look at this guy! He took our class and two months later he’s bringing in $18k a month!***” Students would gather around him like a rock star; who wouldn’t enjoy the attention?

Doing the math and scaling in his profits, he figured that he’d be a millionaire and retired within a couple of years. You can guess what happened next – the market moved a little bit too much one month and most of his account was blown out. The point here is that my trading partner had GOALS, but they were not realistic. He simply did not manage his risk appropriately, and he never traded again. That Options Education firm simply took his picture off their slides

Conversely, another one of my acquaintances is a professional trader that is probably the most disciplined individual that I’ve ever encountered. He simply does not make a mistake. On a $5000 futures account with $500/margin per contract, he could easily trade 10 contract positions and produce gains equal to 200% of that account size in just a week. He wouldn’t dream of doing that, however. He has earned the right to trade whatever position size that he deems correct for his account, yet he will never exceed the 2% “Golden Rule” of risk management. His goals are much more conservative, yet that is his secret for consistent success. He understands the power of the subconscious mind and will not press his position size beyond what he has earned the right to do. He earned the right, step by step, in a slow and patient manner, never out-reaching his skills.

Two stories, two completely different outcomes. Most traders will split the difference between these two examples, yet there is no reason why someone with the drive, persistence, and patience cannot emulate the results shown by the “professional”. Keep in mind that **this will take time and effort before you can start to trade larger**

positions. In Malcolm Gladwell's book "*Outliers,*" he makes a strong case that to achieve true Mastery in any pursuit, TEN THOUSAND HOURS of dedicated effort need to be applied. When you consider that equity markets are only open about 1,632 hours a year, you can see that achieving trading mastery should be considered a marathon, not a sprint.....but there's no reason why we can't accelerate progress by using the right Mind Map.

Beyond Trading

We have kept the scope of this program to be very narrow, focused on the needs of Traders seeking consistent income. Once you master these concepts as they relate to the field of trading, then we encourage you to apply them to the rest of your life in other areas such as Personal, Health, Professional, and Discretionary. You can use the same general concepts as the Strategy Development Cycle, by first defining your Goals, then determining Rules/Approach, measuring your Results, and finally applying Corrections. This approach works well whether it's for trading, for shooting foul shots, or for improving your Marathon times. In fact, if you look up the term "Continuous Improvement" you'll find the same types of diagrams available that progressive corporations use today. Just because you're a fraction of the size of the largest corporations doesn't mean that you can't use the same techniques to drive income!

Trading Rules, the Strategy Framework

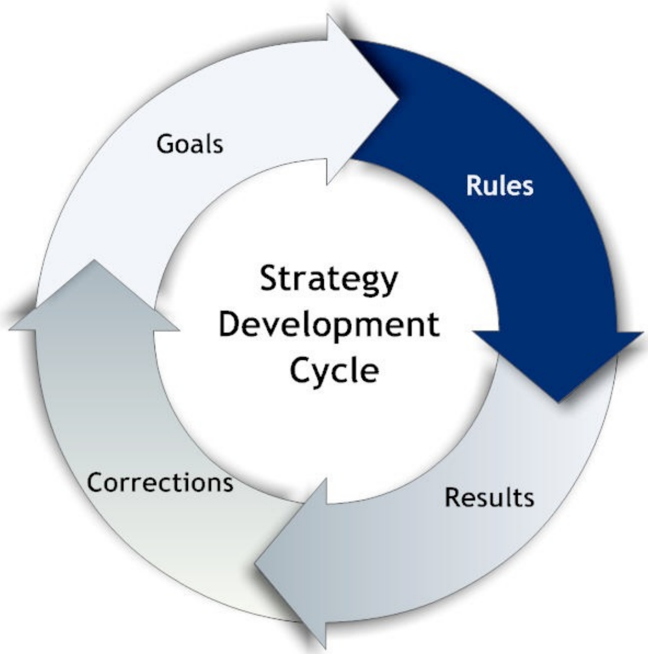
“Mind control is the result of discipline and habit. You either control your mind or it controls you.”

– Napoleon Hill

If you’ve been trading long enough, you’ll know that all the goals in the world are irrelevant if you can’t tie them into a strategy to execute against. And if you’re using a trading strategy to achieve those financial goals, then you’d better have a concrete set of RULES to trade that strategy!

The next step after writing GOALS in our Trader’s Strategy Development Cycle is developing TRADING RULES, as shown in Figure 2.

Figure 2



Rules are the meat of every trading strategy that you employ, for if you don’t trade by Rules, then you trade by FEELING. Most that trade by feel will trade “with the Herd,” meaning that sooner or later a Professional trader is going to eat their lunch.

There are some that can trade entirely by feel, however if you dig hard enough into their method, it’s more than likely that they’ve taken thousands and thousands of trades over many years, so that their trading rules are buried squarely into their subconscious minds. They've done Gladwell's ten thousand hours and have achieved Yoder's Stage Six Mastery; so don't confuse Mastery with "trading by feel." To be honest, it's how most of us start trading. We have a GOOD FEELING about a certain stock so we buy it. It goes up (as does everything in a Bull Market) so we confuse luck with talent. A few more good trades like that and everyone is coming to you for your advice. What's your secret? "A *hunch*!"

Most people would rather believe that your success is attributable to feelings and hunches than they would believe that your trading success has been built by religiously following a set of battle-hardened rules. It's an old perception that those that build wealth from the Market have "a gift" or intuition, it's what we're used to believing. After being around professional traders for a number of years, we know better that consistent profits come from tons of honest work and a drive to succeed. No intuition, no special gifts, just good old-fashioned Drive and a mindset of Success. And the Cornerstone of their success has always been based on their ability to develop sound strategies and then follow those rules no matter what.

What Rules?

We encounter all kinds of traders, from those who have elaborate rule sets that are well-tested…..to those that essentially have no rule set. You've all heard that you should "plan your trade, then trade your plan". How exactly does one go about developing these magic rules that you're supposed to trade by?

The simplest answer to get started is to "rent your rules." You should be trading a strategy that fascinates you, that gives you a "rage to master." Unless you have experience in drafting a trading strategy, you might be better off borrowing one; you can find strategies and rules in trading books, advisory services, or from other professionals.

Make it Yours

If you're starting out with someone else's strategy, your first goal should be to *make it yours*. What do we mean by this? You have to take ownership of this strategy and the associated rules, so that over time, it will be a different plan from that of the original architect. Why do we say this?

Because most traders will "ditch" someone else's strategy and/or rule set at the first sign of trouble. This is Stage Four of Bo Yoder's Trader Progression, where traders bounce from one strategy to another looking for the "Holy Grail." Only by sticking with a strategy that has becomes YOURS over time will you have the faith to stay with it, because nobody has more of a vested interest in your performance than YOU.

How do you “make it yours?” That’s the purpose of the cyclical nature of the Strategy Development Cycle, as we’ll soon see when we put this all together.

Now that you’ve got a strategy, at least in some draft skeleton form, let’s put a magnifying glass on it to make sure that it’s got all of the required components that every successful strategy has; namely Entry Rules, Defensive Rules, and Exit Rules.

Entry Rules

Think of Entry Rules as your “offense;” under what conditions will you ***enter*** a trade? These entry conditions must be precisely laid out, so that you know all of the who/what/why/when/how questions BEFORE the Markets open that day. Here are some specific “entrance” criteria that you should ensure that your strategy contains:

- **Entry triggers –** what specific conditions triggers your entry into a trade? These can be technical triggers (i.e. moving average crossover, etc), price-based triggers (enter long above a specific price level), or any number of specific time-or-condition-based triggers (i.e. enter long after 7 consecutive down days if the price closes above the 6^{th} day high).

- **Entry Filters** – these are conditions that NULL OUT the Entry Triggers and disallow an entry. These are usually technical or price-based filters that dictate when NOT to enter the trade.

- **Timing –** if you are using a time-sensitive instrument such as an Option, how much time will you sell, or how much time will you leave yourself if you’re long that Option? If you’re trading Futures, will you generate entries before the cash open? If you’re trading a Forex pair, what specific times of the day will you enter trades on that instrument?

- **Position Size –** how large a position will you trade? The generally accepted size limit is to risk no more than 2% of your trading capital on any one trade. This can be defined as the debit that you will accept on an Options spread trade, the stop loss on a long Stock or Option trade, the pre-defined static risk threshold, etc.

Defensive Rules

Defensive Rules should be considered for anyone holding a short Options position where you have an obligation, i.e. your loss is not limited to the amount that you paid for the position like a typical “long” position like buying stocks or options. These may be complex positions where you must “adjust” the position (and not necessarily exit it) as the expiration month goes on, to keep your risk parameters in check. This is a very different mentality than just setting a stop loss, because you get “paid” with a position like this one day one, and it’s your job to “defend” that credit and turn it into a profit.

The best expression that we've heard for this "defensive" mindset is: "*you don't get any smarter when you're in a trade.*" In much the same manner that salesman are taught that they need to have an 30-second "elevator pitch" prepared for any unexpected opportunity, so should a trader be prepared to answer the question: "*how and when will you defend or adjust this trade?*" Most new options traders are not prepared with an answer to this question and frequently use "hope" as their first defense.

Exit Rules

At what point would you fully close down your position? Take some profits and scale out? Decide to stay in the trade even though it's taking heat? Again, the MOST IMPORTANT part of these rules is that they MUST be defined during a non-trading cycle; they cannot be determined "on the fly" while the Market is open. Spontaneous exits during a live Market are almost always the source of later regret, as an emotional response is no doubt "trading with the Herd."

What you're trying to do here is to "program yourself" on what to do to close the position, regardless of what happens in the market on the day that you're trading. There is not a more stressful time to make a decision than when the market is moving quickly and you're trying to make a valid decision on the fly; the usual outcome of this type of decision is that it was the WRONG one! Conversely, if you tell yourself your exit decisions well ahead of time, then it's a simple decision just to follow your instructions and remove the position.

Here are some specific "exit" criteria that you should be sure that your strategy rules contain:

- **Exit Triggers** – these can be stops, max debits, price levels, technical analysis levels (i.e. touch the 50 day moving average), or any other specific level at which you have pre-determined that you no longer hold an edge by being in the position.

- **Exit Filters** – in certain instances, "exit triggers" can be filtered by time of day, such as "exit if the daily closing price is below the 50dma."

- **Profit Triggers** – exits can be predetermined by limit orders that will fire should the position hit a specific profit target.

- **Partial Exit** – you may choose to close part of your position should an exit condition be hit (i.e. close half of the position if the Delta of the portfolio reaches +/-500) or a specific profit goal be hit. Many directional traders will "scale out" of a position to lock in profits, allowing a "runner" to play the trend as long as possible while in a "free trade."

- **Money Management Exit –** some who sell options have a goal to reduce their obligation to a specific level, so that they can secure new positions to put that "margin" to work on a new position.

- **Event Risk Exit –** if you are currently profitable in a swing position, yet are staring at a potential market-moving event in the near future (i.e. earnings, FOMC release, etc) then many times it is better to close down all or part of the position to mitigate the Event Risk of the announcement.

- **Settlement Risk –** certain European-settled options carry significant risk of "settlement gaps" between where the index last traded, and the settlement price the next morning. (i.e. SPX, RUT, DJX, NDX, etc). Specifying an early exit to eliminate this risk is a wise addition to any trading plan.

<u>Example: Cash-Secured Put Trading Rules</u>

The following example is a set of Trading Rules from an options strategy; don't worry too much about the actual *content* of these rules, just try to get a feel for the *context* of the rules:

<u>Offensive Rules (establishing the position)</u>

- **You must want to own the Spot Currency!** If you're not sure if you want to accept assignment of the Spot Currency after you sell the Put, then exit the position and wait until you're ready to accept potential assignment. (Don't get cold feet unless there's a really good reason for not wanting to own the Spot Currency any more!) For this specific reason I am generally selling Puts on a major crypto asset such as Bitcoin, which should retain enough intrinsic value not go to "zero."

- You will either sell Puts OTM or ATM; if you go too far OTM then the return that you receive might not be worth enough to gain a required level of income. A suggestion would be to sell a strike that corresponds with a support level. If that is unavailable, I will choose a strike price to create a MINIMUM of a 1% return.

- The further in time that you sell the position, the more credit that you will receive, yet the more risk that you will take of the Spot Currency moving strongly towards or against your position. A suggested timeframe is 4-6 weeks to start with.

- Sell one contract of Put Options (sell to open) for every full unit/coin of Spot Currency that you intend to own. Make sure that you have enough capital in your account to be able to accept assignment of the position size that you have the potential of being put. Keep your position size very small to begin with while you learn.

- The underlying Spot Currency must be in a primary long-term uptrend, or at the very least flat, for me to consider selling Puts against it. I will judge long-term trends by the Weekly chart trend. I do not want to be fighting the trend with this strategy and typically do not sell Puts if we are in a primary Bear Market.

- You can sell more than one monthly cycle at a time however keep in mind that you could be put the Spot Currency on all of the open contracts. I must ensure that I have enough cash to accept assignment on all of the positions.

- I will look for the underlying Spot Currency to make a pullback in the midst of an uptrend before I enter my short Put order.

Defensive Rules (maintaining the position)

- I generally do not "defend" these positions. I wanted to purchase the Spot Currency at this price so I'm OK with being exercised. The only time that I will change my mind is when the character and trend have changed on the underlying Spot Currency, and it no longer has a "tailwind" behind it.

- If I have more than one month of Cash-Secured Puts in play at the same time, I may not necessarily want to be assigned on BOTH monthly positions. If so, I will close the front month position by buying back the short Puts for a few pennies to close my obligation.

- When possible, I will allow my short put position to expire vs. closing it early at a specific target. This is more aggressive than pre-determining a specific price at which to buy back the short option and terminate your obligation. Find a method that works best for you and stick with it on every trade.

Rules, Rules, and More Rules!

As you can see there are plenty of alternatives for specifying your entry, defensive, and exit rules, and all of them will change depending on your strategy and instrument that you trade. Think of yourself as a C++ programmer (many of you are already!) who is trying to cover how you will program "yourself" to act consistently regardless of what the Market can throw at you. Remember, the most difficult thing to do in trading is to make a critical decision in a live market with money on the line.

Now that you've come up with a strategy and a set of rules to go with that, let's discuss how you can evaluate the Results of your trades.

Evaluating Trading Results

"It's not what you make, it's what you keep."

– Unknown

The next step after determining Trading RULES in our Strategy Development Cycle is determining our trading RESULTS; how well is the strategy working, and are we executing it correctly? Figure 3 below shows the next step in the Trader's Strategy Development Cycle cycle:

Figure 3

<u>Numbers Don't Lie</u>

The first time that many traders start to measure the results of their trading strategy is when they're trying out a strategy for the first time, with live money. That's like buying a $50,000 automobile without test driving it first. Many traders need to just SLOW DOWN and not be in a rush to get rich. Profits will only come after you have mastered the strategy and your ability to follow its rules in a live market. As the caption suggests, regardless of how you feel about this strategy, the numbers do not lie about performance

R&D First

In most manufacturing companies, the team that starts developing new products is Research and Development. Think of yourself as the head of R&D for your trading company; you wouldn't have scientists bring a new idea immediately to market without developing, refining, and testing it first, would you?

Test and Backtest

Your Strategy Development Cycle begins with Goals, and those can be realized via the profitable execution of your Rules. In this "Results" phase, you'll take a good, hard look to see whether or not the strategy WORKS. One valuable tool to use is Backtesting; this is the process of testing your strategy to see how it worked in the past. You may test your strategy against differing types of Markets, such as calm, flat markets or more volatile markets and even runaway Bulls and resulting crashes. As the well-worn phrase states, "*past performance is not an indicator of future results*" but you can at least see how well your strategy accommodates these different types of markets.

Backtesting: Automation vs. Hard Right Edge

How can you backtest your strategies? Some tools are available to turn your strategy rules into code, and you can tell the program what past dates to test your strategy with. It will compile a full report complete with P/L graph, profit ratio, expectancy, performance graphs, drawdowns, and dozens of other statistical performance information. You can make small changes to your trading rules and re-test your performance over that time period in seconds. This is great for simple directional strategies, and not so much for complex Options strategies.

Another simple tool is the "Bar Replay" feature in TradingView. Choose your timeframe, select the sample set, determine how fast the candles should be printed, and you can chew through months of price data in minutes.

The "Hard Right Edge" is more of an old school form of backtesting using a price chart. Based on your technical charting strategy, you'll pick some random date in the past where the "unseen future" is hidden beyond the "hard right edge" of the chart. This allows you to simulate the difficult skill of making trading decisions without knowing what will occur in the future, allowing you an almost infinite supply of backtesting data with different charts and different points of time in the past. The keys to using the "hard right edge" method are: 1) don't look at the actual dates that you're trading, because you may know the chart well enough to anticipate "future" movement, and 2) don't peek at the "future" price action when you select the testing period. This is all about testing your strategy and not cheating the point of the exercise.

In Figure 4 below, you can see how the “hard right edge” represents the future, as you don’t know what’s beyond that boundary. It will test your ability to judge your reactions against your rule set.

Figure 4

Yet another form of testing strategies comes in the form of “Replays;” some vendors such as NinjaTrader and SierraCharts have the ability to capture all of the price action from a trading period, and record that on your computer’s hard drive. You may then pull up any specific day from your catalog, and actually “replay” that day just like watching a DVD. These tools will let you simulate trading as well, with an order entry interface that is a complete replica of the interface that you use for live trading. This allows you to further “live test” your strategy without risking live capital.

<u>Strategy Performance vs. Your Performance</u>

We’ve done a lot of talking here about your “Strategy” and how well it performs over different Market types and time periods. We’re still missing an important component – YOU. Your ability to actually EXECUTE the strategy flawlessly without adding emotions such as Fear or Greed to the equation is easily 80% of the bottom line performance of your strategy. A common quote that we hear is, “*I have backtested this strategy and* *tested this strategy in live markets with simulated trades, all with a winning record. When I started using live money, I started losing trades*." YOU are the most important component of the execution of any strategy, and is why we've dedicated the entire program to this point about YOU and your ability to manage yourself. If we were to really dig through any trader's record that had a losing performance with live money vs. a winning record with simulated trades, in each case we could probably find instances where the trader slightly modified their entry/defensive/exit rules due to feeling a completely different emotion while using live capital.

The Development Cycle

This is why we advocate several "development cycles" in the process of bringing a new strategy to market. Not only do you need to learn about, develop, and "tune" your trading rules to make this a profitable strategy, you also need to teach ***yourself*** to trust this strategy and learn to execute it without prejudice.

The Development Cycle will be different for every trader, every strategy, and every instrument traded….but it should roughly be conducted with this progression:

- **Strategy Development** - understanding the basic rules of the strategy, developing entry/defensive/exit rules.

- **Backtesting** - utilizing past data, understand the performance of this strategy depending on market type. Tune trading rules as required.

- **Replays** – utilizing past data, test your ability to follow the trading rules in a real-time environment.

- **Simulated Testing** – test the strategy in a live environment using simulated accounts, or in a replay environment. Tune trading rules as required.

- **Live Testing** – using the minimum possible position size, test the strategy with a live account using 1 contract. Tune trading rules as required, and look carefully for any evidence of "execution gap" where the trader is introducing errors. If trading in this phase is unprofitable, go back one stage (simulated testing) until profitable in simulated mode again.

- **Live Trading –** progressively scale in to larger position size as performance allows you to "earn the right". If you are unprofitable in this stage, go back to the "live testing" phase with minimum position size until you are profitable again.

Note how each phase of the Development Cycle gives you progressively greater responsibility based on a merit system; you must "earn the right" to get to the next stage. Again, most traders simply skip all of these steps because they are in too much of a rush to earn their keep and get rich. Instead, they usually just end up spending more “market tuition” fees.

Results Depend on Where You’re at in the Cycle

Where are you at with your strategy on the Development Cycle? As you can see, where you are in this cycle will really dictate what your results mean, and whether or not you’re at the right stage of the cycle to earn the right to be there. If you haven’t paid your dues in the earlier stages, you won’t be profitable with live contracts.

If this sounds like a lot of work, it is. Surgeons don’t operate on a live patient until after spending years with cadavers and pigs, before graduating to looking over someone’s shoulder while they operate…to assisting…and then finally to running the operation after many, many iterations. Think of your trading capital as being as important as someone’s life; in some instances, it can be.

Results – the Bottom Line

What should you strive for in your Results? The answer is simple – results that match your Goals! Regardless what cycle that you’re in….Development, Backtesting, Sim Trading, or Live Trading…your Goals should drive your Results for this cycle. In other words, if your goals for *this specific cycle* stated that you wanted to make sure that you followed every single one of your rules on at least 80% of your trades, what results did you achieve against your goals? By not trying to “eat the elephant” and go from strategy development to live trading in the space of a couple of days, we allow ourselves to learn how we respond and execute each step of the strategy, in different markets. Be patient, it will take time to build and correctly execute a new strategy that you build from scratch.

Now that you have set up Goals, developed a Strategy to execute those trades via your Rules, and now have some Results to show for your work, what do you do with this information? We make *Corrections*, which we’ll discuss in the next section.

Adjustments and Course Corrections

Did you know that a plane flying from Los Angeles to Honolulu is off-course more than 99% of the time? Upper-air currents, weather fronts, and traffic patterns conspire to keep the plane constantly changing its course during the several-hour journey, yet the plane always arrives at the gate within inches of its goal. How is this done? By determining its Goal (destination Honolulu, gate 43), developing the Rules that it will use to achieve this (flight plan), comparing intermediate Results on a periodic basis (GPS/Navigation), and finally by making small but definitive CORRECTIONS necessary to keep the goal on target. Figure 5 shows how this principle completes the cycle of the Strategy Development Cycle.

Figure 5

This “servo mechanism” that becomes the final step in our Strategy Development Cycle is really about taking a good, objective look at our results….and then applying corrective feedback to bring the results closer in line with our goals on the next iteration.

Corrections are Everywhere

Beyond a sophisticated airplane, this step of observing results and then applying corrective feedback is literally EVERYWHERE throughout our lives:

- It's why you still need a steering wheel to navigate a long, straight stretch of highway.
- It's why football teams meet at halftime, away from the heat of battle, so that they can figure out what didn't work in their game plan and make corrective changes to their personnel and play calls.
- It's why professional marksmen will correct for distance and windage after a failure to hit the bullseye on the first shot.

The list of examples goes on indefinitely – it's how humans adapt and excel if they are willing to be persistent and patient enough to keep their eye on the Target (Goals) and make enough iterations and course corrections to achieve those goals.

And frankly, ***this is where most Traders fail***. You're already one step ahead of them.

Persistence Pays

Most traders are not willing to go through dozens if not hundreds of cycles through the Strategy Development Cycle to be able to adjust their strategy (and themselves) to be able to successfully trade live in the Markets. We all want results, as do our spouses, and the number one mistake that we see Traders make in this regard is to abandon their strategy after one failed cycle, and substitute it for another as a "Correction". This is where Traders get stuck in Bo Yoder's "phase four" as they eternally hunt for the Holy Grail by bouncing from strategy to strategy.

The Holy Grail of trading strategies does not exist…one strategy that works in any market, simply by following lines or arrows that signify trading signals. It doesn't work because we won't let it work; as we mentioned before most directional system strategies only have a 40% win/loss percentage, and most Retail traders cannot endure the normal drawdowns before the profits come.

Quite simply, we've learned that the Holy Grail of trading is this: find a core set of simple strategies, diversify them to handle different types of markets, and then relentlessly apply the Strategy Development Cycle to them on a daily/weekly/monthly basis to achieve Mastery in their performance, and in your execution of the Rules.

How to Correct?

You should be asking at this time, “OK, how do I apply these Corrections?” Good, we knew you’d ask that one! To answer this, let’s look at a couple of these “servo-mechanism” examples that we use in daily life:

- **Driving in Snow** – if you’ve ever driven in snow before, you know how daunting that can be for the newer driver. It was especially bad a while back, when newer drivers had to learn this skill on the family station wagon/land yacht with rear wheel drive. A common mistake was for the new driver to make a turn from a standing stop with a little too much acceleration. The rear end of the car would swing out wide, causing what we would call a “Negative Result”. The newer driver would frantically correct by steering in the other direction, causing the tail of the car to “waggle” back and forth in what engineers call an “underdamped oscillation”, and could eventually cause a complete spin. The more experienced driver would cut power on the first hint of wheelspin, yet even if the tail did swing wide, they would provide instant, accurate corrective action through the steering wheel to immediately get the car pointed straight without further wild gyrations.
- **Your Home’s Thermostat** – Most people don’t notice how their home thermostat works in conjunction with your furnace. Its job is similar to that of an active Trader’s, however; it has to manage the “Climate Engine” in your home. If you had your thermostat set to keep your home warmed to 68°F in the wintertime, when does the heater actually turn on, and for how long? Most thermostats run the heater until it actually exceeds the desired temperature by a degree or so, and then lets it sit idle until the room temperature is below your target by a degree or so, at which point it kicks on the heater again and the cycle repeats. The point here is that it does not kick the heat on at a fraction below 68° and turn it off again just above 68°; the racket from the heater continually turning on and off would be distracting and it would cause a lot of wear and tear on the furnace itself.

What can we learn about corrections that we see in everyday life?

- Most Corrections are relatively minor; big Corrections usually lead to wildly oscillating results.
- Seek to change only one thing at a time per cycle; if you change too many things on every cycle, you’ll never know which changes had the desired effect of moving you closer to achieving your goals.
- Make changes slowly and deliberately; have a specific reason for wanting to make a change.

How Do We Apply This to Trading?

Now that we've given you some background on how appropriate system changes and corrections are made, let's apply that to how we can make Corrections to our strategy running inside our Strategy Development Cycle. Remember what we talked about in terms of Results; the two biggest factors are: 1) the Trading Rules under your strategy, and 2) how YOU execute those rules. Let's see how we can evaluate our results and apply Corrections to each of these areas…

Corrections to Trading Strategies

Does your Trading Strategy give you an **edge** in the market that you're trading? This question usually stuns traders at first – "What's your Edge?" Usually a deer-in-the-headlights look is the first response. When you first start to develop your strategy, you might not know the answer to this question, but over time and after MULTIPLE developmental cycles, you should have a very good idea if your strategy holds an edge in the current Market that you're trading.

Here are some examples of "edges" in the Marketplace:

- **Flat, Neutral Markets:** you're trading a Neutral strategy like short options, especially with a relatively high level of implied volatility, you will have a significant edge in this Market for as long as the market condition remains.
- **Strongly Trending Bull Markets:** traders employing bullish strategies such as long spot crypto, short put writing, or put vertical credit spreads will hold a significant edge in this type of Market.
- **Strongly Trending Bear Markets:** tougher to trade than most other types of Markets for the strongly trending, whippy price action….traders taking advantage of intraday volatility with futures hold the strongest edge in this type of Market.

Ask yourself some questions during every Trading Strategy review: Does my strategy hold an edge in this current Market? Are my trading rules effective with this strategy and this type of Market? Do I need to make any adjustments in my trading rules or capital utilization due to these changes?

Pareto's Law Again

Ever hear of Dr. Pareto and the 80/20 rule? It states that roughly 80% of the events come from 20% of the causes. Chances are pretty good that after some analysis on your own, you'll find that 80% of your losses are coming from breaking 20% of your Trading Rules. Let's see how we do this:

Classifying Results

One of the tools that I use is a spreadsheet-based journal that breaks down all of my Trading Rules into separate categories. In the figure below, you can see that there are five trading rules, in this case for Entries….and five additional rules for Position Management. With these you can classify your performance by determining if you entered the position with the correct signals….and once you were in the position, did the trader manage it correctly? (This example is a simple intraday scalping strategy so there are few rules.)

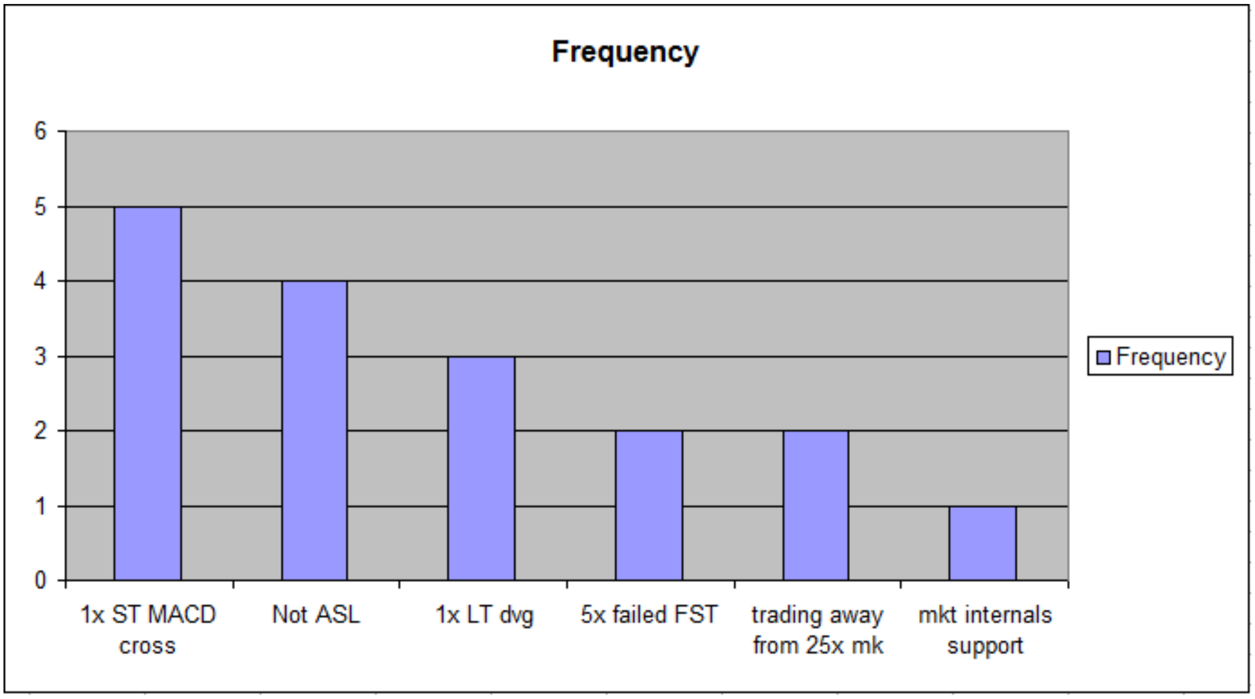
Figure 6

				Trading Rules					Management Rules						Good	
Trade #	Date	Time	l/s	1	2	3	4	5	1	2	3	4	5	Win?	Wave?	Score
1	8/3/2009	842	l			1	1		1					1	0	7
2	8/4/2009	935	l		1	1		1					1	1	1	6
3		949	l		1	1								1	1	8
4	8/5/2009	1035	l		1								1	1	0	8
5		1054	l											1	1	10
6	8/6/2009	934	l											0	0	10
7		1052	s	1				1						1	0	8
8		1138	l		1	1								0	0	8
9		1308	l										1	1	1	9
10		1533	l			1	1							1	1	8
				1	4	5	2	2	1	0	0	0	3	80.00%	50.00%	8.2

In this spreadsheet, we have entered a "1" where the rule was broken, and colored that cell red to help make it stand out. We have totaled up the frequency of each error on the bottom row, as well as calculating summary statistics for this batch of 10 trades. There were winners on 8 out of 10 trades with an average "score" of 8.2. Even though we won 80% of these trades, we were only in a valid "wave" 50% of the time – definite room for improvement.

If we go a step further, using Pareto's Law, what elements of our Trading execution should we focus on? Looking at the summary row on the bottom of Figure 6, trading rule 3 was violated five times, rule 2 was violated four times, and so on down the line. Putting this into a "Pareto Chart" helps us to visualize what to work on next:

Figure 7



The horizontal scale can be customized so that the rules can be identified, such as "1x Timeframe Short Term MACD Cross," "Not Average Swing Length," "1x Timeframe Long Term Divergence," and so on. Personalize the Pareto chart so that your triggers and rules stand out, and you know which ones need further work.

This chart tells us that we need to work on Trading Rule 3 (1x ST MACD cross) first; we need to find out WHY we are breaking this rule, and incorporate practice replays, hard right edge exercises, or some other form of iterative training (stepping into the batting cage!) until we can drill this error out of our trading results.

How will you know when this error has been corrected? Your results and subsequent analysis will tell you! After the next cycle of ten trades, or whatever interval makes sense for your trading strategy, you'll be able to develop a new Pareto chart and you can: 1) see if you've fixed your previous issue, and 2) see what your next #1 issue is!

Corrections to Trader Performance

Now that you've evaluated your Strategy's performance, how well did YOU do? Did you follow all of your rules? Why or why not? Were they the correct decisions, performed according to your Strategy Rules? Or were they the "discretionary" decisions that "felt" like the correct ones to do over time? It is so critical to evaluate your ability to follow your rule set at the end of every "cycle," whether that is daily, weekly, or monthly…because it's a CERTAINTY that the greatest impact on your Strategy's performance will be YOUR ability – or inability – to follow your rules in a live market.

Corrections through Storytelling

All of this detailed corrective analysis rarely tells the whole picture, because trading decisions are made by human beings that have emotions. How well are you dealing with your emotions during a trade? Classifying trading errors through Pareto analysis will tell you WHAT errors that you're making in your trades that you need to correct, but not necessarily WHY you're making them.

The majority of cases that we hear about from traders deal not necessarily with the execution of a particular trading strategy, but all of the reasons and excuses why the trader made the wrong decision when it came time to pull the trigger. This is why we need "storytelling" journaling in the Correction cycle of the Strategy Development Cycle.

Here is an example of a trade journal entry that details the "story" of how the trader felt…and the "story" that he told as he managed a live trade:

Figure 8

I entered this trade at 11379 as the price broke below the ascending trendline and tested it from underneath. I did not realize it at the time, but this was also a 175t short signal from my Watts strategy.

The entry was very choppy and I did not think that I would survive it. It looked as though the price would climb back inside the wedge. The 20 point YM stop did its job, though.

I think that I could have done better with the exit. I was up about 100 points on the position and gave back a large chunk of it on the final retracement. I need to look into employing an ATR stop once a minimum profit target has been achieved.

It was very difficult not to just hit the "close" button as the trade got more in the green and I find that I really have to fight that impulse. This is how mediocre trades turn into big ones, though....by riding out the pullbacks.

What did this trader LEARN from this trade that is told with his story?

- He is watching more than one intraday strategy at a time, however he failed to see the confluence between entries on two different strategies. This might have given him more confidence on the entry point.
- He has learned once again to trust in his stop once a system signal has fired.
- He sees an opportunity to improve his trade's profit efficiency by getting a bigger percentage of the swing…by experimenting with different exit management tools.
- He acknowledges the normal human reaction to cutting profits short, which is something that every trader needs to work through.

Can you see how these lessons could NOT be learned from rule classification and Pareto analysis? You must take the effort to learn from each and every trade, particularly the losing trades. Storytelling journaling is the key to this.

Something else that's important to capture through storytelling journaling are any external influences that could be affecting your game; writing these in a journal can help you understand the cause and effect the next time you go through a similar situation.

Some examples of this would be:

- If you're ill or sleep deprived, it can lead to poor trading performance on that particular day. Understanding this might lead you to step away from trading the next time that you feel the same way.

- Extreme market moves can be unsettling to everyone and create emotional responses. A particularly poignant entry in my storytelling journal was captured on Nov 20, 2008 as the Bear Market crash unfolded on another leg down…."*this Market has no hope, perhaps it's time to buy.*" Understanding how you *think* and *feel* during extreme moves can help you think clearly through the next similar "event."

- Conflicts with loved ones always seem to get final resolution in the Markets at the expense of your capital. Journaling these events (in addition to the cathartic nature of writing it down!) can help you understand that you may have a connection between being emotionally upset, and poor performance in your trading. Perhaps guilt in how you're handling a relationship is manifesting trading losses as a way of penitence. (Not kidding here...learn as much as you can about how the Subconscious mind operates!)

Archive and Review!

There are many different ways to create and archive storytelling journals. Some annotate directly onto their charts, some use software tools such as Microsoft OneNote, Evernote, or Google Keep, others write everything out longhand and create a whole loose-leaf binder per year. However you do it, the important part is that you not only take the time to enter your thoughts and reasoning behind your entry & management of the trade, but that you also take the time on a regular basis to review your actions and MAKE CORRECTIONS going forward!

A One-Time Fix?

This “continuous improvement” process of journaling – whether classification/Pareto or storytelling - NEVER ENDS if you are a serious, professional trader. You will always be working to perfect your current strategies, and using your Development cycle inside the Strategy Development Cycle to develop and incorporate new strategies into your trading. In this manner, trading can really be an interesting, invigorating pursuit that will give you a lifetime of challenge and opportunity.

Summary - Strategy Development

This module looks like a lot of work, doesn't it? That's true. Yet you simply will stall out in your quest to advance to the next level of the Trader Progression if you don't take every single opportunity to learn from your performance and make adjustments. This is a very important part of developing your professional trading mindset.

I'm at a loss to remember who said this, but a quote that I've remembered from a pro trader was "*I can tell how well a trader is performing by how detailed their trading journal is*."

Professional sports has gotten so "over the top" lately where every broadcaster has access to the the statistics to every at-bat in recent history...and can comment on the statistical probabilities with every pitch. Yet most traders don't know what their most frequent errors are. Can you imagine the following dialog?:

"*Next up....here comes Trader Jim. Jim has a winning percentage this month of .545, and a profit factor of .90. Jim generally wins more often in the morning than the afternoon session, and is due for a string of losses that will test his faith in his system.....*"

Homework and Next Steps

Please complete the following tasks before moving to the next module:

- [ ] Watch the associated video for this module.
- [ ] Develop a tracking mechanism for tracking your trades, and cataloging your trading rules.
- [ ] Develop a form of storytelling-based trade journaling.
- [ ] Add time for Journaling after every trading day to your Calendar.
- [ ] Add time to your Calendar for reviewing your trading results/journals after every month
- [ ] Practice the Hard Right Edge exercise on a price chart; how well can you forecast the highest-probability move that the price is likely to take next?
- [ ] Experiment with TradingView Bar Replay.
- [ ] Are there other pursuits in your life that could benefit from a continuous improvement process like the Strategy Development Cycle?