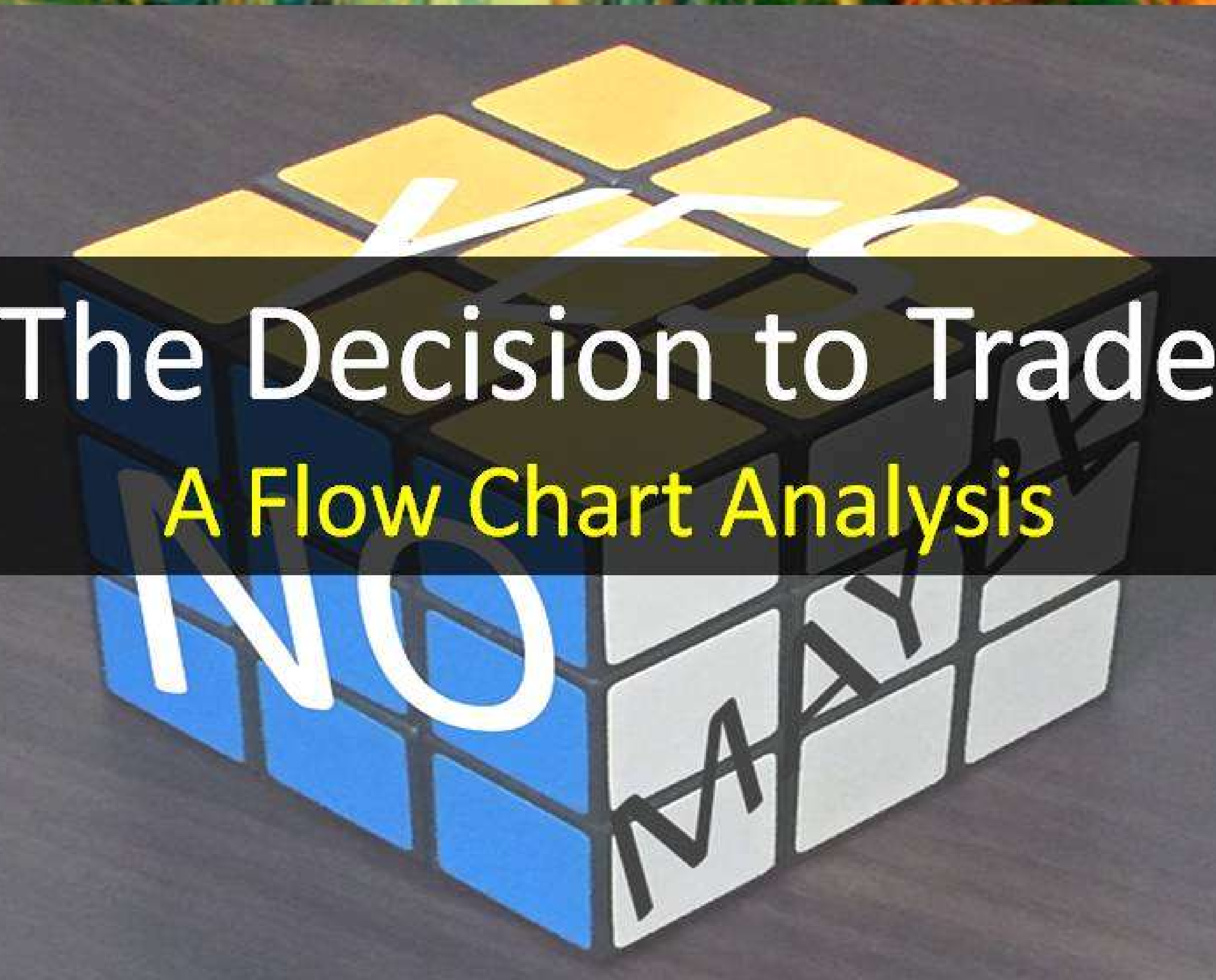
The Decision to Trade

A Flow Chart Analysis



The Decision to Trade

Anyone who has downloaded and gone through the eBook that accompanies the free 15 day course on Mindfulness for Traders will be aware that practicing mindfulness is not a substitute for having a good proven trading plan and the discipline to follow the plan.

Rather, mindfulness will help you to focus on your plan and to develop the discipline to follow it.

A typical trading plan will have a number of sections. For example, it will

- Outline the overall strategy to be followed such as the main markets and instruments, the general form of the analysis you will undertake and the size of your trading fund.
- Detail the observations and results that will alert you to a particular opportunity to enter a trade. I refer to these as set-ups.
- Outline how a trade, once opened, will be managed.
- Contain detailed rules for risk management.

Let's say you have this plan in place and you have identified a possible opportunity.

Notice that this is largely a result of following the rules set out in your trading plan. There's not a lot where you need to make a decision.

But this now changes and you have a crucial decision to make.

Your analysis just means that you have identified an opportunity. You have to decide whether or not to take the trade.

You are putting your money at risk.

You must have clear, consistent means to enable you to decide if you should put your money at risk.

And the basis on which you make this decision must be consistent with the way in which you identified the opportunity.

Clarity, Simplicity and Complexity

I am a great believer in the need to undertake very involved analysis to find opportunities. This does not have to be particularly difficult once you have the rules in place but it does require effort.

But, it is also important that you have a way to call a halt to the analysis and force a decision.

Otherwise you can either make impulsive decisions to go ahead with the trade – without really knowing why you are doing so – or you can experience a sort of paralysis because you are not sure how to make the decision.

This is where it is important that you have clear simple rules to guide your decision making and that you follow them.

Decision Flow Analysis

The final decision whether or not to trade is not a trivial exercise.

In fact, it's very easy to go wrong, to lost sight of the conclusions of your analysis given the amount of information you have generated.

My approach is that if I cannot find a good reason not to enter a trade once I have identified an opportunity then I go ahead and trade.

It may seem strange to say that I am looking for a decision not to trade.

But notice that all the analysis so far has been to find an opportunity.

If you look for a reason to trade then you will always find one as a result of confirmation bias.

You will always find confirmation for what you have done. That's just human nature.

But can you find a reason to reject what you have done so far?

Among the reasons for not taking a trade might be:

- An important news announcement or release of economic data that is imminent and is likely to disrupt the market. Trying to trade news is not a good plan.
- Unusual market action such as a sharp spike, sudden volatility or unusual volume. Wait for the market to provide a better, clearer signal.
- The market is trending strongly but is approaching an important support or resistance line that it is unlikely to break through at the first attempt.
- There is a divergence between an important indicator and the price on a short term chart.
- It's late on Friday, unless you are trading very short term, or you are prohibited from holding the trade overnight by the rules of the setup you are considering.
- Your mind is distracted by something else in your life.

There may be other reasons also.

Trade: Yes or No?

It sounds fairly simple to say you are looking for a reason not to trade. But just posing the question in that form is still not enough.

It's important that you find definite answers. It's also important that you don't undermine your analysis.

To achieve this I break done the question 'Should I trade?' into a series of eight questions that are all closely related to my trading plan and each of which has a 'YES' or 'NO' answer.

As a result, there is no ambiguity at any stage or in the outcome of this process.

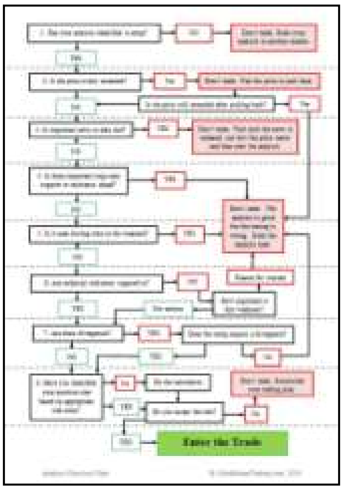
Depending on the answer to each, I either move on to the next of the eight questions or abandon the opportunity.

And if I get to the end without seeing the need to decline the trade then the decision is made.

Decision Flow Chart

I have created a decision flow chart to guide me through this process. You can download it by clicking here or on the image below.

A flow chart helps to ensure I undertake the process of reaching a decision in a complete and consistent manner in line with the rules of my trading plan.



Starting at the top of the flowchart, if your answer leads you to a green bordered box then you move on to the next question (black border).

If your answer leads you to a red bordered box then you immediately have your answer: you do not enter the trade.

Eventually, if you avoid the red boxes you will land in the Green box at the bottom. The instruction in that box is clear: **Enter the Trade**.

Your decision is made. It is consistent in terms of the rules of your system and the conclusions of your analysis.

The Flow Chart in Detail

The flow chart works for the particular approach, or overall strategy, that I use. In summary, I use:

- Technical rather than fundamental analysis;

- Primarily a trend following approach;
- Time periods of a few days up to a few weeks for trades; and
- A rules based system that allows me a fair bit of discretion.

You may have a different strategy. That's fine as long as you know what it is and you stick to it.

If you have a different approach the you will need to alter the emphasis you place on the various questions in this flow chart but the general principles will remain valid.

Let's work through each of the 8 questions in turn. Remember, your aim is to see if you can find a reason not to trade the opportunity you have identified.

This final answer is indeed final - there is no need for second-guessing.

If you can't find a reason to not trade then you commit to the trade and put your money at risk.

Question 1: Has your analysis identified a setup?

This seems like a simple question but it assumes that you have put together a set of rules that define a trading opportunity. That's what is meant by a setup.

It also assumes that you have undertaken the required analysis.

If you have done this then answering this question is a trivial step.

If you have not then you need to step back and develop your trading plan.

If you have identified a setup, that is an opportunity to trade in line with your rules, than go on to question 2. If not then start again.

See how clear this is?

Question 2: Is the price overly extended?

Markets don't move in straight lines no matter how strong a trend may be.

Being correct about the general trend of the market, but persistently entering just as a pullback is starting, is one of the most common problems faced by traders.

This is a particular difficulty for a trend following system.

The best way to avoid this is to assume that while the market may have a bias to move in a particular direction, at times it will need to reset to some more sustainable level and then push on again.

There are various ways to do this, but my favourite is to see if the market has closed outside the Bollinger bands, using the default settings, on **either** of the past 2 days. If so then it is extended.

In the standard rules for using Bollinger bands a move outside is a signal that the market is likely to continue to move in this direction.

That's fine as it confirms a trend. But, by construction, a market only trades outside its Bollinger bands for 5% of the time.

So, while it is likely to move in this direction, it is not likely to do so right now.

When the market closes outside the bands, I deem it to be extended and not suitable for entry at this time.

It's still a trending market and a good opportunity – but not right now.

Instead, I first wait for it to pull back into the band and touch the central line of the band. I then look for a close in the direction of the trend.

So, on the flow chart, if it is not extended just move on to the next question.

If it is extended then wait for it to pullback. However, be aware that this can take some time and it may be necessary to redo your analysis to see if the opportunity is still there.

Question 3: Is important news or data due?

I never try to trade the news. I just don't see how I could possibly have an edge in the market.

Large traders have the news before I do, they can understand it faster and better, and they can execute trades faster than I can. So, why would I be able to beat them to an opportunity?

Notice that my analysis has been based on what has happened.

I am assuming that what has happened indicates what is going to happen in some way.

But news can undermine the validity of this assumption.

So I purposely try to avoid trading the news as it can be disruptive.

In terms of the decision flow, if there is important news due, such as an earnings announcement or an interest rate decision, wait until it is released and then see how the market has reacted.

If it is disruptive then you may need to redo the analysis.

No matter when my analysis has told me I don’t trade if news is due.

If you think there is no important news due, then just move on to the next question.

Question 4: Is there important long term support or resistance ahead?

Remember that I am trading using a trend following approach.

Trends are most likely to reverse when they hit important support or resistance lines.

So the fundamental assumption of trend following – which is that the trend is likely to continue – is most likely to be proven false close to these levels.

Look at the charts and see if this is the case.

If so you need to wait to see what happens when the market hits this level.

If no such important level is close by then there is no issue and you should just move on to the next question.

Question 5: Is it near closing time or the weekend?

I don’t like entering trades as the market close approaches or on a Friday afternoon near the weekend.

You can see volatile moves at these times and the risk of gap openings the next day cannot be ignored.

I also like to reduce my open risk a bit overnight and at weekends.

So this question has a simple Yes or No answer.

If it is close to one of these times then I simply leave the trade until the market has reopened.

There's seldom any need to redo the analysis, but sometimes there is and I don't want to be in the market if it gaps against me.

Question 6: Are technical indicators supportive?

So far, the questions have been simple to answer as there is no real discretion.

The next two are a little different but if you are familiar with the logic of your trading plan and analysis then they are straightforward enough.

Technical indicators are part of the setups to identify opportunities.

But I also have a look at a few others just to see if there is additional support for what I have found.

If there is additional support then that's great. Move on to the next question.

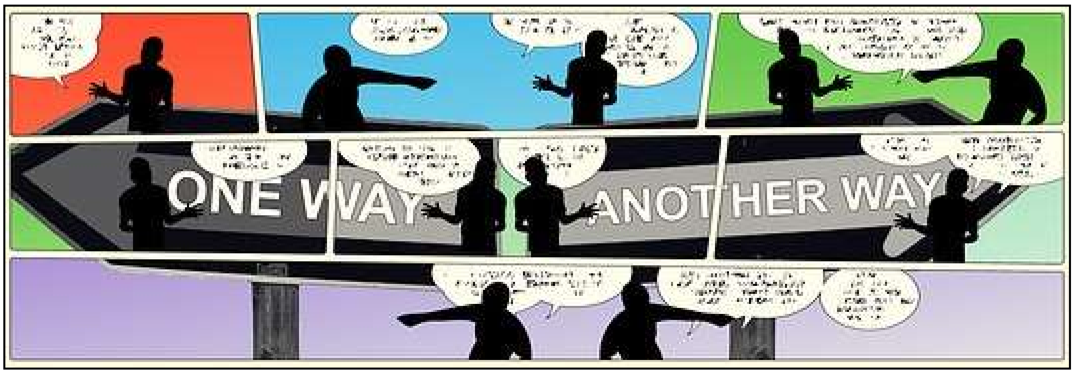
If there is no support, or if other indicators tell a different story, then just stop to consider this for a moment.

Do you think this is important? You need some discretion here but don't allow this to become paralysis.

Remember you are looking at information here that is not a central part of the analysis that is specified by your trading plan.

Is the lack of support enough to stop you trading at this time? Perhaps you would rather come back later?

Or maybe this is unimportant. It's your call on this one, but reach a quick decision.



Question 7: Are there divergences?

Again, there is a bit of discretion required. Your setup may actually require a divergence, in which case there is added confidence if you see additional support.

But, when I am following a trend and I find a divergence between recent price moves and an indicator such as MACD I will be a bit concerned.

I will likely not abandon the opportunity, but I may leave it a day and come back to it to see if I have cause for concern.

Or I may enter a small trading perhaps using half my usual risk allowance.

If there is no such divergence then move on the final question.

Question 8: Have you identified your position size based on appropriate risk rules?

This is a hugely important question and must not be ignored.

This is where you implement your risk management. You must already have rules for risk control in your plan.

I have a simple over-riding rule that I do not break: I do not risk more than 2% of my fund on any trade.

I also limit me total exposure to 20% of my fund and I look to have a reward to risk ratio of 2.5 at entry.

In order to implement these rules you must identify a stop loss level and stick to it.

Then enter a trade size such that the most you can lose on that trade, assuming no gaps, is not greater than 2% of your fund.

Having done these simple calculation you then need to decide if you are ready to accept the risk.

This should be a trivial step, and if I saw a reason not to accept this risk then I would go back to reconsider my plan.

I take it that seriously and for good reason.

After all, I use the plan to guide my trading and it has taken me to point of entering a trade.

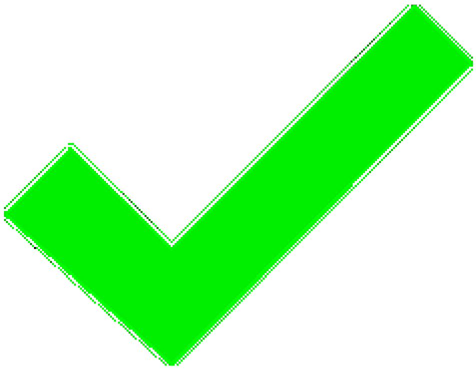
Something must be seriously wrong if I have followed the plan this far and then decided I’m unwilling to enter the trade because I don’t want to put any money at risk.

Enter the Trade

And now look: you decision is made. Once you accept the risk you enter the trade.

Do not second guess yourself at this stage. You have followed the rules of your plan.

Trust your plan. Let the market do as it will. You have no control over the market.



There is just one final point: be sure to wait for the trade to trigger.

The precise requirement here will depend on the set-up involved but timing entry usually involves having a look at a chart in a shorter time frame than the one you have used for your analysis.

On this shorter timescale chart you will need to identify situations such as:

- A touch of support or resistance, or a trendline, with a trade in the direction of the trend. This often coincides with a resumption of a trend following a pullback.
- A move of an oscillator across some pre-defined level as the price moves in the direction of the trend.
- A cross of a slower moving average by a faster one in the direction of the trend.
- A recovery from a divergence by an indicator such as MACD so that it is aligned with the trend.

What trigger you use to time entry as well as you can will be determined by the set-ups you are following.

The point here is that you are simply timing your entry to improve your chances of success.

You are not deciding whether or not to trade, this decision has already been made.

Occasionally you may find a reason to delay taking the trade and then find later that the opportunity has passed.

If this happens, don't worry. There are always plenty more opportunities.

But learn from what you did.

Print Out the Flow Chart

Be sure to print out a copy of the decision flow chart.

I keep a laminated copy on my desk (even though I know it by heart at this stage).

Use it as it is if it suits your plan, or use is as a template to develop your own copy.

If you want to follow this outline but think you need to modify the flow chart and you would like an editable copy, just get in touch and I'll send you one.