

How to Trade Like a Business

Lesson #10

The edge - who has it - how to get it

"You have to get rich in the dark... you have to live with percentages. Forget about luck. That's a very treacherous magic!"

From "Fools Die" by Mario Puzo

In previous lessons, we learned how to create a Profit Center structure designed to organize our trading results similar to the techniques used by a successful business. We also took a look at the Drawdown, Return on Investment, PTR / UTR, and Breakeven reports which can be created from the trading results we entered into our Profit Centers.

The two screenshots below display various Report Criteria created by ManusRisco, which can be selected to create custom-designed Analysis Reports. The first screenshot displays the Report Criteria for the trade elements, and the second screenshot displays the Report Criteria for the type of report and the time period.

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BREAKOUT

Trade Type
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Symbol **Month** **Year**
ES Jun 05

Position
Buy

Traded

Comparison	Number
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Leave field blank to search for ALL values.
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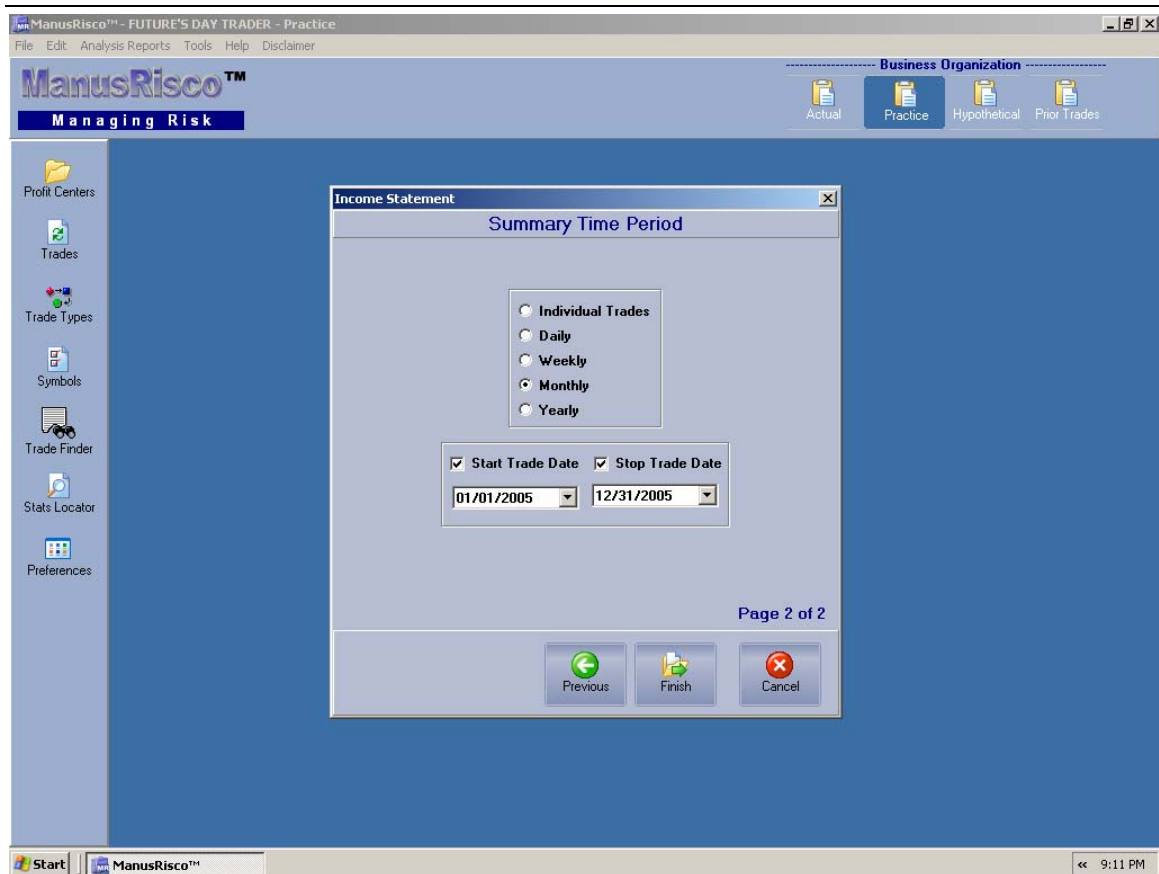
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The information displayed in the Analysis Reports enables the trader to confidently and professionally manage his trading business.

The money management methodology described in previous lessons provides the structure which organizes your trading results so that the Analysis Reports can be quickly and efficiently created.

We will now take a look at what every trader is seeking - the edge.

"The race is not always to the swift, nor the battle to the strong - but that's the way to bet it!"

Damon Runyon

The edge, also called the advantage, comes in three forms:

- The perceived edge
- The actual edge
- The variable edge

The perceived edge

The perceived edge is perceived because it is not certain. The perceived edge is the advantage the trader thinks he has because he has developed and tested a trading methodology which has shown a profit, either in hypothetical back testing or in actual trading.

For example, a trader develops a trading system and back tests it over 10 years of historical price data, and rejoices in the fact that the system has produced a \$500,000 profit over the 10-year period. He then commences to trade the method since he perceives he has the advantage based on extensive back testing of the system.

Another example is where a trader does not back test a trading system, but instead can discern visual or intuitive signals on a price chart which he instinctively recognizes as a Buy or Sell trading opportunity.

For example, if the TICK does not make a new high, but the E Mini price does make a new high, and the premium rises to a certain level, the trader may instinctively sell short the E Mini based on this divergence and the high premium, since he has perceived over many years of trading that this trade has a high probability of success.

The perceived edge is so named because the market, which is going to do what it is going to do, couldn't care less about how many years you have back tested a trading system or what your intuition or instincts tell you about a trade. You perceive you have the edge, but that's all it is - a perception.

The perceived edge always occurs before the trade is taken. If the perceived edge did not exist, there would be no trading and no markets, since no one would take a position because no one would think he has an advantage. If there is no perceived advantage, then there is no reason to trade.

A clothing retailer buys \$20,000 worth of pants at wholesale because he thinks he has a perceived edge of selling the pants at retail for \$30,000 and making a \$10,000 profit. **If** he sells the pants at a profit,

this will become a profitable trade resulting from a perceived edge which, through hindsight he now realizes after the fact, actually existed.

The edge is perceived because the pants might go out of style, or the economy could go into a recession, or the pants might be stolen or destroyed in a fire or he might be forced to sell the pants at a price lower than his \$20,000 cost and take a loss.

If he sells the pants at a loss, then this was an unprofitable trade resulting from a perceived edge which, he sees through hindsight, did not really exist.

The perceived edge exists only in our imaginations, but it is the foundation of modern civilization and is absolutely required for any type of economy to exist. If the perceived edge did not exist, there would be no business, no commerce, no markets, no trading, and no economy.

The actual edge

On the other hand, the actual edge is a statistical certainty, given a sufficiently large sample size.

Casinos enjoy a built-in actual edge in games like roulette, keno, baccarat, and dice. This advantage arises by paying out lower than fair odds if you win a bet (like roulette) or the advantage is built into the way the rules of the game are set (like baccarat).

The statistical advantage of these games is pre-determined statistically down to the third decimal place. In the short run, anything can happen in a casino. Players can win thousands or millions of dollars.

But in the long run, the house will win very close to its predicted advantage.

Casinos enjoy the actual edge because the game is "fixed" in favor of the house, and the edge is statistically "guaranteed" if they can get into the long run.

They get into the long run by taking many small bets, none of which will jeopardize the casino's bankroll. A casino will never take a single

bet which will cause the loss of a significant percentage of the house's bankroll.

When you are playing a game in which you enjoy an actual edge, you should make many small bets; never jeopardize your bankroll and get into the long run so the inevitable statistical advantage can grind out its handiwork.

Since markets are not "fixed" in the trader's favor, and traders do not possess the holy grail trading system which produces statistically guaranteed profits, the only locations where you will find the elusive actual edge are Las Vegas, Reno or Atlantic City casinos - or any other locality where there are gambling establishments, legal or otherwise.

Which bring us to the most important edge of all, the variable edge.

The variable edge

The trading game is a completely unique situation. A trader can become a better, more educated and disciplined trader, and can actually change a losing (negative expectation) situation into a profitable (positive expectation) game.

You can not become a "better" roulette player or a "better" keno or dice player, since you can not change the negative expectation which is hardwired into the game itself. You will always suffer the negative financial effects of trying to overcome a negative statistical disadvantage.

However, a negative expectation is not "hardwired" into trading. Traders who evolve and develop psychologically and emotionally through education and experience are able to turn an unprofitable situation into a profitable, positive expectation enterprise.

The book Market Wizards, by Jack Schwager, is filled with tales of numerous traders who lost significant amounts of capital when they started trading, but overcame their difficulties and eventually became very successful and profitable speculators and traders. In other words, a negative expectation was turned into a positive expectation.

Thus, we now encounter the variable edge, the most important factor

which determines every trader's success or failure from the million dollar high-volume professional trader to the small account, part time novice.

The variable edge is so named because it - varies (surprise!) It may be positive and becoming more positive; it may be positive and becoming less positive; it may be negative and becoming less negative; or it may be negative and becoming more negative. In other words, the type of game you are playing is constantly changing.

The only certainty about the variable edge is that it is uncertain. And that is what makes the adrenalin pump and the heart beat faster when a trader initiates a new position.

The trader knows, either consciously or subconsciously, that his equity curve will rise and his equity curve will fall. One day you're up and happy, and the next day you're down and depressed. Traders enjoy profits and traders suffer losses.

One month you have the edge and the next month you don't, and worst of all, it is impossible to predict with absolute certainty if your next trade or next week or next month will be a winner, loser, or a breakeven.

The variable edge is like smoke from a cigarette. You reach out to grab it and you think you've got a hold of it, only to open up your hand and discover that it has disappeared.

Traders start out unprofitable, rise up the learning curve to become profitable, only to become complacent, arrogant, greedy, over-confident, and become unprofitable once again, another victim of the variable edge.

All traders are imprisoned in a twilight zone of uncertainty caused by the variable edge, and this is the main factor causing the high failure rate of individuals who choose to participate in the trading game.

In case you are a little confused about the variable edge, or don't believe it exists, then answer the following questions. It doesn't make a difference if you are a 20-year professional trader who has made millions or if you have never traded before - the answers will be the same.

The questions are:

Will you show a profit or loss after your next 100 trades? (Requires a definite, guaranteed answer. "It depends," "could be," "maybe," etc. are not allowed.)

What will be your exact dollar profit or loss after the next 100 trades?

For your next 100 trades, exactly how many trades will be profitable and how many trades will be unprofitable? (No estimates allowed - we need exact numbers.)

What will be your worst drawdown in your next 100 trades?

As you can see, it doesn't matter if you are a profitable trader, an unprofitable trader, experienced or novice. The answers are uncertain and the edge will vary.

The profitable trader may be more profitable in the next 100 trades, less profitable, breakeven - or he may be unprofitable.

Likewise, the unprofitable trader may become more unprofitable, less unprofitable, breakeven - **or** become profitable.

Every trader, regardless of experience or Account size, has the front seat on the volatile ride of the variable edge roller coaster.

The variable edge can be managed only by having properly organized results of trading performance. The fruit of this information is to **a**) inform the trader where he is located on the variable edge, and **b**) the current direction and trend of the edge.

A trader possessing this information is able to answer questions such as:

What type of game am I playing, positive or negative? Am I getting better or worse at the game? If I am playing a negative expectation game, should I stop playing it or should I continue to play and hope I can turn it around? Am I better playing some games versus other games?

Why am I better playing some games and worse playing others? Should I become more aggressive in games where I have the advantage and the edge is increasing? Why am I playing a negative expectation game which is becoming more negative?

The Profit Centers are the games and the Analysis Reports provide the information necessary to answer these questions. The end result of this process is a slowly evolving, disciplined, confident, professional and, hopefully, profitable trader.

There may be an easier way to approach the trading game. But the question is how long can you remain profitable before you get blindsided by the variable edge and fall victim to the uncertainty and confusion resulting from an amateurish and inadequate money management methodology?

We have all learned that the trend is our friend when analyzing a price chart. But the same principle applies to money management.

It is imperative that you monitor the trend of your expectation by graphing the Profit Factor as discussed in Lesson #5.

A graph of the trend of the Profit Factor as described in Lesson 5 reveals not only if you are profitable or unprofitable, but also if you are becoming more or less profitable or becoming more or less unprofitable.

The trend of the Profit Factor reveals your growth and maturity as a trader.

Mastery of money management, psychological development, and trading methodology disciplines is required for long term success. Competence in one or two of the disciplines is not sufficient for long term profitability. All three need to be mastered and incorporated into your trading personality to afford you the best possible chance of achieving long term profitability.

Money management, psychological development, and trading methodology are three paths all traders must walk to safely arrive at the destination of long term profitable speculation.

Hopefully these ten short lessons have provided concepts which will

enhance your money management skills and enable you to adopt a more professional and disciplined approach towards speculation and investment - and may the variable edge always be going your way!

"It's business. That's all, just business"

Michael Corleone, from "The Godfather," by Mario Puzo

And so is trading - just business.

Tom D'Angelo
CEO ManusRisco Inc
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