

Bringing Commodities and Futures Research, Data,
and Analysis to Traders for over Seventy-Five Years

50 RULES OF FUTURES TRADING

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| +1.2 | -.04 | +23 | -.02 | +25 | +1.12 | -.25 | +12 | -1.54 | +78 | +1.5 | +3.08 | -03 |



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Introduction

Fewer than 25% of all people who trade futures are successful. Yet, even among the 25% who are successful, some traders consistently make hundreds of thousands—even millions of dollars—each year. What is it these millionaire traders are doing so differently? That's exactly what we asked some of the industry's top traders.

Their answers resulted in the following 50 “Principles of Trading.” A few of these principles already may be familiar to you, while others may go against everything you've ever heard. In any case, the most important thing to remember is not what set of rules you use, but to always maintain your trading discipline.

Once you have developed discipline, you then can begin learning and applying these principles to make your trading experience more rewarding.

1

Use only money you can afford to lose.

If you are speculating in futures with funds you need for other things, you are ultimately doomed to failure. Why? Because it is virtually impossible to make sound decisions if you are trading with “scared money.” One of the keys to successful trading is mental independence. You must be able to trade with a minimum of “static” from outside influences. That means it is absolutely imperative your trading freedom is not influenced by the fear of losing money you have earmarked for something else.

With that in mind, it is best to view speculation funds as money you can afford to lose. Your position should be carefully analyzed so you never jeopardize other funds or assets.



2

Know yourself.

To be successful, you must possess an objective temperament and an ability to control your emotions. Losing your cool almost always will lead to disaster. Although trading discipline can be developed, the most successful traders usually have a personality that allows them to remain unemotional about their positions. It is suggested that people who are not able to control their emotions are better off looking elsewhere for profits.



There are many exciting things happening in the market every day. It takes a hard-nosed attitude and an ability to look beyond short-term circumstances to avoid the temptation of changing your mind (and your position) every few minutes.

3

Start small.

Test your ability first by making some trades on paper. From there, begin trading in small lots (1,000 to 3,000 bu. of grain, for example). If your broker doesn't offer smaller lot contracts, start with a commodity like oats (which is less volatile than pork bellies, currencies or index futures). No matter which markets you choose, it's wise to become thoroughly familiar with the mechanics of trading before graduating to larger contracts and/or more volatile markets.

4

Don't over commit.

Another rule many successful traders suggest is to keep three times the money in your margin account than is needed for a particular position - even if that means reducing your position. Viewed another way, this means you shouldn't commit more than one-third of your account balance on any single position. This rule helps you avoid making trading decisions based on the amount of money in your margin account. If you find yourself under margined, you may be forced to liquidate a position early, most times at a costly loss that might have otherwise been avoided.

5

Isolate your trading from your desire for profit.

Don't hope for a move so much that it clouds your vision. Although hope is a wonderful virtue in other areas of life, it is often the enemy to a futures trader.

Successful futures speculators are able to separate their trading from their emotions. When hoping that the market will turn in their favor, beginning speculators often violate even the most basic rules of trading.

6

Don't form new opinions during trading hours.

Decide on a basic course of action, then don't let the up and downs that always occur during the Trading day affect your game plan.

Decisions based on price moves or news items are usually poor ones. You are always better off formulating an opinion before the market opens, then looking for the proper time to execute a decision based on that opinion. When speculators completely change their direction during the trading day, it often generates large commissions for the broker, but very little profit for the traders.

7

Take a trading break.

Trade every day and you're almost certain to dull your judgment. One successful trader commented, "When I fall to 90% of mental efficiency, I begin to break even. Anything below that and I start to lose."

A trading break allows you to step back and take a fresh look at yourself and the way you want to trade for the next several weeks. Sometimes you get so close to the forest that you can't see the trees. A break in the action will help you view market factors from a new perspective, and often in a much better light.



8

Don't follow the crowd.

Successful traders need breathing room. When everyone seems to be going long, they look for a reason to go short. Historically, the public is usually wrong. Most good traders feel uncomfortable when their position is popular with the buying public (and especially when it's popular with the small traders).

Viewing government reports on the position of traders can provide helpful clues on overcrowding. Another clue is "contrary opinion"—when most advisory services are long, move to the sideline or take a short position; likewise, when most advisors are bearish, go long.

Some services give a reading on market sentiment determined by compiling opinions from many advisory services. If 85% of the analysts are bullish, this indicates an overbought situation. If less than 25% are bullish, an oversold condition would be indicated.



9

Stick to your guns.

Don't be influenced by what others say or you'll be changing your mind all the time. Once you have formed an opinion on market direction, don't allow yourself to be easily influenced. You can always find a so-called expert who has logical reasons for reversing your position. If you start listening to these outside views, you may be tempted to change your mind. More often than not, holding your position will be more profitable.



10

When in doubt, sit out.

Don't feel you have to trade (or even hold a position) every day. Beginning traders are often tempted to trade or hold a position every day—a tendency that can be very costly. Successful traders develop the patience and discipline to watch and wait for an opportunity. After they have taken a position and begin to feel uncomfortable, experienced traders usually reduce the size of their position or liquidate. Then they wait on the sidelines until the next opportunity comes along.



11

Try to avoid market orders.

Placing an order to buy or sell “at the market” may show nothing more than a lack of discipline. To avoid violating this rule, consider placing specific price orders instead. For example, “Buy 5,000 bushels of December corn at \$2.20.”

If you feel you must liquidate your position immediately, market orders can be helpful. However, it's usually a good strategy to minimize their use whenever possible.



12

Trade the most active option month.

In soybeans, for example, November, March and July are usually the options with the highest volume and open interest. Trading these active options should enable you to get in and out of a position easily.

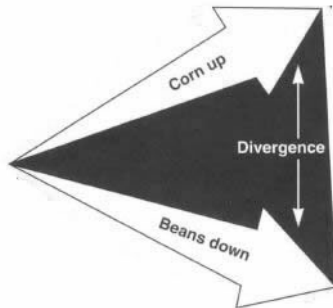
A similar caution should be noted for inactive futures. Low volume commodities are not the market for speculators because it may become difficult to liquidate a position when you want to get out. Your broker will be able to offer assistance in this area.



13

Trade divergence between related commodities.

Watch the commodity “families” (i.e. the grains, the meats, the metals, and so on). Whenever you identify a wide divergence in a group, that could signal a trading opportunity. For example, if all grains except soybeans are moving higher, it’s a good idea to look for an opportunity to sell soybeans when grains in general appear to be weakening. The reverse of this is true also. Knowledgeable traders usually buy the strongest commodity in the group during periods of weakness.



14

Don't trade too many different things at once.

What happens if you do this? Most times you'll fail if you try to have the necessary information and "feel" of several different markets. Few traders, for example, are able to successfully trade both metals and grains at the same time, simply because both markets are moved by factors independent of each other. Learn to know your limitations and always trade within those limits.



15

Trade the opening range breakout.

This is usually a good price direction clue, particularly after a major report. A breakout of the opening range may tell you the direction of trading for the next several days. If the market breaks through the opening range on the high side, go long, say the experts. If it breaks out on the bottom side of the opening range, go short.



16

Trade the breakout of the previous day's range.

This rule is used by many successful traders to decide when to establish or lift a position. It means never buy until the price trades above the previous day's close. Followers of a "market momentum philosophy" use this rule, believing that the weight in the market is in their favor when they wait for trading to break out of the previous day's trading range before adding to their position.



17

Trade the breakout of the weekly range.

This rule is similar to the daily rule, except it is based on weekly highs. When the market breaks through a weekly high, recognize that as a buy signal. When it breaks through the previous week's low, it is a sell signal.

18

Trade the breakout of the monthly range.

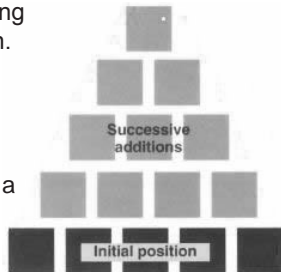
The longer the period you're watching, the more market momentum behind your decision. So, monthly price breakout are an even stronger clue to price trends and are vital signals for the position trader or hedger. When prices break out on the top side of the previous monthly high, it's a buy signal. When the breakout is on the bottom side of a previous monthly low, it's a sell signal.

19

Build a trading “pyramid.”

When you add a position, don't add more contracts at anyone time than the number of contracts in your base commitment. Let's assume your initial position was 20,000 bushels of soybeans. An ideal situation would be to pyramid by adding 15,000 bushels, then 10,000 bushels, then 5,000 bushels, providing the market is moving in a favorable direction.

Always avoid the “inverted pyramid” where on each addition you add more than your original position. This is an extremely dangerous trading technique because even a minor market reversal can wipe out profits for the entire position. Your average cost is closer to market price in the “inverted pyramid” situation which makes your position more vulnerable.



Another danger in pyramiding is that of over committing yourself to the point where you lack sufficient margin money.

20

Never put your entire position on at one price.

If you want to be long 50,000 bushels of corn, you may want to do it in five installments of 10,000 bushels. That way you'll see if the market is moving in your direction before you become totally committed.



Most traders use the fundamentals and various technical signals to guide their trading, but the most important key is market action.

Intelligent traders wait for the market to verify that the initial position was a good one before putting on their entire position.

21

Never add to a losing position.

Regardless of how confident you feel, you should NEVER add to a position that is already showing a loss. It may mean you are already out of step with the market.

Some traders disagree with this rule, believing in a “price averaging” technique.

But many traders believe this can be a risky technique and a way to mentally justify adding to a position that only magnifies a mistake. (See rule #5.)



22

Cut your losses short.

One of the most dangerous mistakes many new traders make is not admitting it when they're wrong. It takes a great deal of discipline to swallow your pride and resist the temptation to hang on to a loss.



When the market moves against you, admit your mistake and liquidate your position. You can still make money, even if you're correct on less than half of your trade, as long as you keep your losses short and let your profits run. Some successful traders may have only three or four profitable trades out of ten because, through discipline or stop loss orders, they are able to exit a market early when they are wrong.

23

Let profits run.

Cutting your profits short can be another cause of unsuccessful speculating. The old saying “you never go broke taking a profit” doesn’t apply to futures trading. The reason: Your losses will outweigh your profits unless you let your profits run.



How do you know when to take a profit? Here’s where some of the technical rules on reversals and other chart formations can help. Experienced traders say you should never take a profit just for the sake of taking a profit—always have a reason for closing out a profitable position.

24

Avoid holding losing positions.

Never carry a losing position more than two or three days or over a weekend. This rule is used as a way to force discipline. Although it sounds simple to say “cut your losses short,” it can be a difficult rule to follow, even for seasoned traders. That’s why it’s a good idea to make a flat rule on carrying losses. Sticking to this rule is sure to save you from making substantial losses.

25

Learn to like losses.

No trader likes losing. But, like it or not, losses are part of the business. So, when you’ve learned to accept a loss without it affecting your pride, you’re well on your way to becoming a successful trader. The fear of taking a loss must be eliminated before you can reach your full potential as a trader.



26

Use stop orders cautiously.

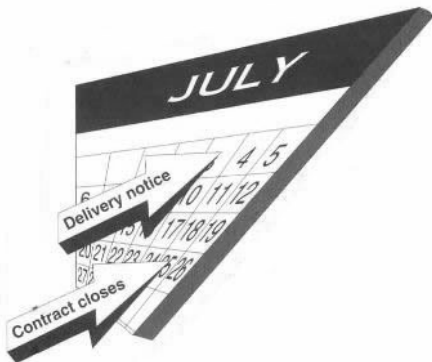
“Stop loss” orders are easy discipline. They may help you cut losses automatically. But remember to place your stop when you place your order. If you don’t, you may be tempted to give the market a “few more cents,” adding to your potential loss. Be sure to use stop loss orders with great discretion, because stops that are placed too tight can put you out of the market with a loss very quickly. You can become “whipsawed” by poor placement of stops.



27

Get out before contract maturity.

The price of a commodity during the delivery month is usually more volatile.

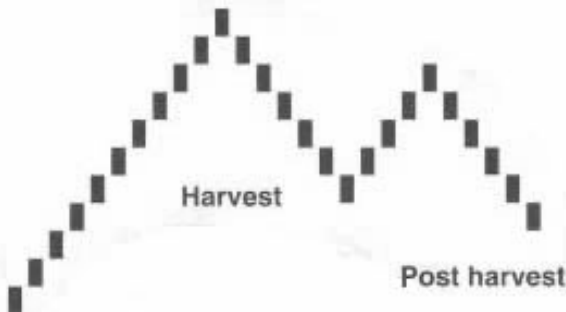


For that reason, it is recommended novice traders move into other contract positions to avoid any unnecessary added risk. The profit potential in making and taking delivery is one that should be handled only by experienced cash market traders.

28

Ignore normal seasonal trends.

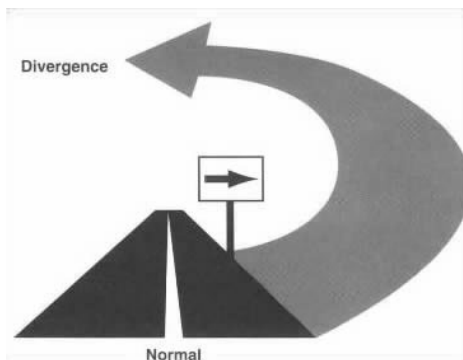
Although the price of corn historically goes down at harvest, most experts don't let seasonal trends influence trading decisions. Too many people try to trade seasonal trends, so it's usually best to do the exact opposite. (See rule #8)



29

Trade the divergence from normal.

This is one of the rules money-making traders rely on regularly. They simply trade the divergence from that which is normally

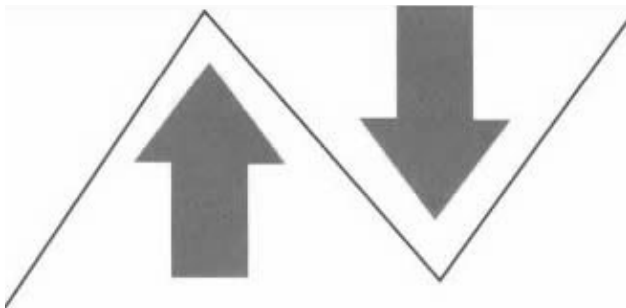


expected. So, if traders in general believe the market is bullish but the rally fails, it's usually a good signal to sell—especially if the activity follows a government report. It's sometimes smart to wait for the general trading population to lean one way, and then time a trade in the opposite direction.

30

Avoid picking tops and bottoms.

Many a beginner has learned this costly lesson the hard way. If you believe a market has topped or bottomed and decide to go against the trend, you are making yourself very vulnerable. Expert traders suggest you let the market price action prove a top or bottom has been formed before taking an active position.



31

Buy the rumor, sell the fact.

If market rumors are bullish, then you should buy when that news hits the streets. But when the new reports turn into reality, it is time to “sell the fact.”

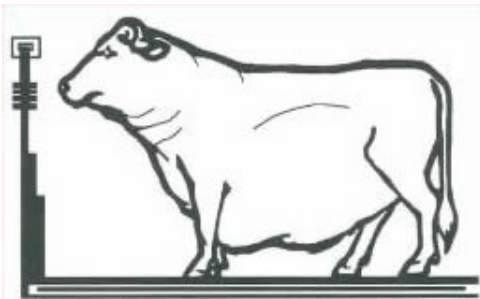
An example would be news of a potential grain sale. Because the market tends to “build the news into the market price,” this rule would tell you to buy on the first piece of news; then when the grain sale was actually made, sell.



32

Bull markets die of being overweight.

There's an old stock market trading rule that says, "when prices get top-heavy, bull markets can fall flat from their own weight. So, be especially sensitive to bearish news if you're long.

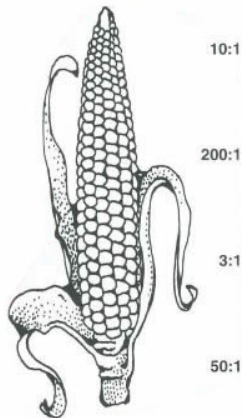


33

Look for good odds.

Look for opportunities in which loss potential is small in relation to the profit potential. For example, if a market is trading near its recent historic lows, it could mean a long position has great upside potential in relation to possible loss. Or if it is trading just above government price support levels, there may be an opportunity for a low-risk trade.

Watching the trading range of a market over a year or several years helps you gain the perspective you need to help determine the odds. Market fundamentals are also helpful in finding situation with good odds for success.



34

Always take windfall profits.



Sometimes within 48 hours of taking a position, you have more of a profit than you ever expected. Resist the urge to watch the market a few more days to figure out why the profit came so fast. Just take your quick profits and don't ask questions.

35

Learn to sell short.

Most beginning speculators tend to be bulls, which means they like to buy markets they think will go higher. Because markets often fall faster than they rise, you can frequently earn quicker profits by selling short. For that very reason, it's important for you to learn to trade from the short side of the market.

36

Act promptly.

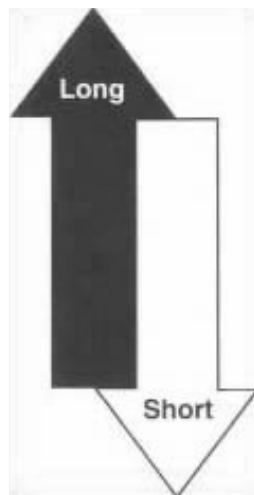
The futures market is rarely friendly to those who procrastinate. For that reason, a good rule of thumb is to always act promptly. This does not mean you should act impulsively. However, if your judgment tells you to liquidate a position, do it immediately.



37

Don't reverse your position.

When your position is a loser and you decide to get out, don't make an 180-degree turn. For example, if you have been long and decide the market is working against you, get out and stand aside for awhile before going short. Ignore this advice and you could be whipsawed—losing as the market heads downward, then losing more as the market goes up.



38

Don't be a nickel and dimer.

If you want to be long, don't put a price order in 2 cents below the market, hoping to find a bargain. Traders who try to squeeze an extra penny out of the market frequently find the market moves almost to their target, then slips in the opposite direction. So, although they were hoping for an extra penny, they may in act end up losing a nickel. When you think it is time to do something, make your move without hesitation.



39

Know the price trend.

Major price trends can be identified with line charts, one of the fundamental tools used by successful traders. The mistake speculators sometimes make is trying to buy or be long while markets are still in a basic downtrend, or selling short when they are in an uptrend.

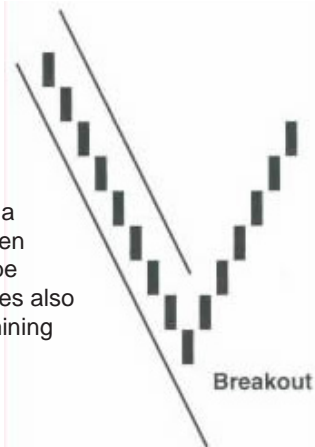
Charting futures yourself or subscribing to a chart service can help avoid costly errors of selling into obvious uptrends or buying into downtrends.



40

Watch for key breakouts through trend lines.

Some successful traders base their trades almost exclusively on this rule. It works like this: Make bar charts and watch them closely. When prices break through a trendline for two or three days, it's usually a good trading signal. A violation of a downtrend line is a buy signal. The reverse is also true: When an uptrend line is penetrated, it should be considered a sell signal. These trend lines also offer you excellent guidelines for determining stops.



41

Watch for 50% retracements of a major move.

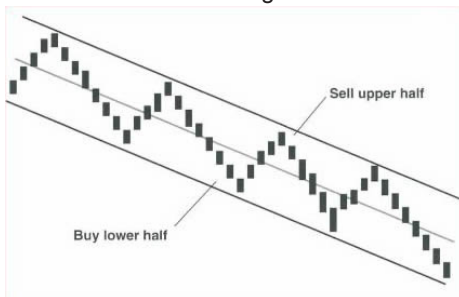
Frequently you'll hear the market is in a "technical reaction." That means following a major move in either direction, the market has a tendency to retrace the move up to 50%. For example, if corn went from \$2 to \$3 in a major move up and then started to slide, look for another chance to buy when the price drops to \$2.50.



42

Use the "half-way rule" when picking buy/sell spots.

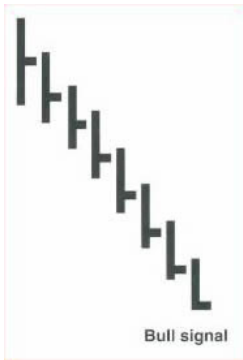
This means finding out over what range the market has been trading, then buying in the lower half of that range or selling in the upper half. This rule is particularly useful in a trading market or in a situation where the market is trading within a chart channel.



43

Watch the magnitude of market change.

By watching the size of price movements, you can sometimes predict the direction the market is headed. When a market moves lower, but by a smaller amount each day, it may be a signal for an uptrend. When the market moves up each day, but in smaller amount, it's an early signal that a downtrend may be just around the corner.



44

Congestion areas can mean support or resistance.

Congestion areas act as barriers that slow down price action. When a market commentator says there is good technical support at a certain price level, chances are good he is looking at a line chart that shows an old congestion area where trading took place for several weeks over a narrow range. Major price moves may develop when the market breaks out of a trading area. Usually, the longer the market has remained in the trading area, the further the price moves once it breaks out.



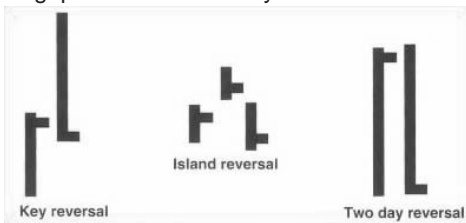
45

Major moves frequently climax with a key reversal.

A key reversal of an uptrend is usually indicated when prices make new highs on high volume, then price erosion during the same day causes a lower close than the previous day's close.

A key reversal of a downtrend is a move into lows, then a strong recovery during the day with a close higher than the previous day's close. A key reversal may come in the form of a two-day reversal when on the first day the move establishes a new high, then closes strong. On the second day the market may open near the high close of the previous day, then close sharply lower.

An island reversal is formed when prices gap into new highs on one day, then gap lower the next day.



46

Watch for “head-and shoulder” formations.

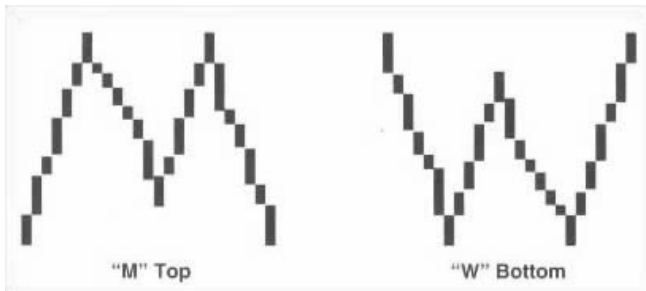
When you observe a chart pattern resembling a head and shoulders, it can usually be read as a sign that the market is topping out. Remember to be aware that head and shoulder patterns should not be trusted until the second “shoulder” is formed by a rally or sideways pattern.



47

Watch for “M” tops and “W” bottoms.

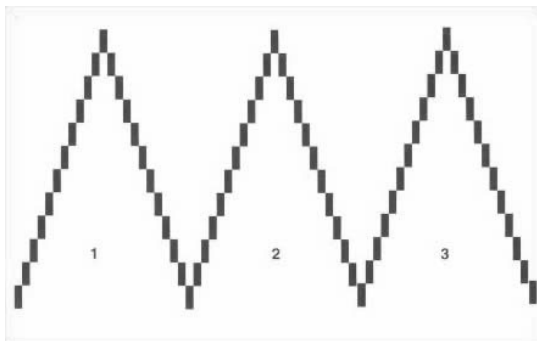
When the market action on a price chart indicates a large “M,” the price signal is telling you to sell. When a “W” is formed, it is signaling a move higher.



48

Trade triple tops and bottoms.

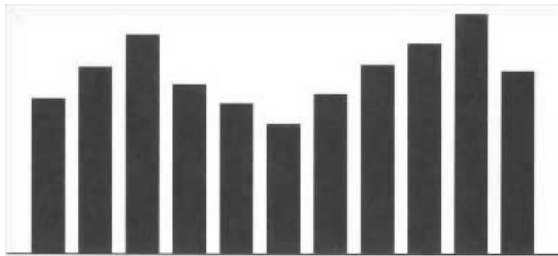
Once a market has hit a peak the second or third time, that can be read as a bearish signal. The reverse is also true at the bottom. Money-making traders are always aware of these signals and use them as a part of their overall strategy.



49

Watch volume for price clues.

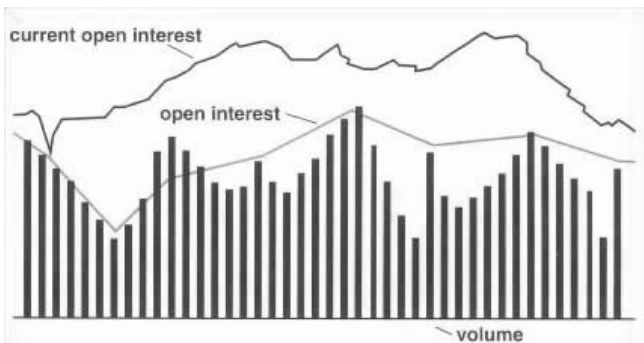
When volume and price go up together, this should be considered a buy signal. When volume increases and prices go down, it's a signal telling you to sell. However, when trade volume goes down, regardless of price direction, it's usually best to stand aside, or prepare your position for a market reversal.



50

Open interest may be a tip-off.

If open interest continues to increase as prices rise, it's a buy signal—especially if volume increases at the same time. The reverse is also true. If open interest increases with lower prices and on good volume, it is a sell signal.



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