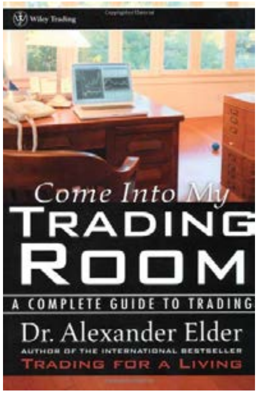
Come Into My Trading Room



A Complete Guide to Trading

By Dr Alexander Elder

In 1992, Dr Alexander Elder wrote a book that was destined to be the best selling book on trading ever written. He named it *Trading for a Living.* This was an inspired title, which captured the aspirations of a generation. These were people who were increasingly disillusioned by the corporate rat race and yearning for a better life style. Earning their living from trading the financial markets seemed one of the most attractive ways to achieve that desire.

If Dr Elder's book was only an apt title, it would have joined countless thousands of unsuccessful books in the great library in the sky. Instead, *Trading for a Living* remained on the financial best seller lists for a decade. This was because it was written by someone who is both a good writer and a successful trader, a rare combination.

I read *Trading for a Living* in 1992 and it changed forever the way I look at the stock market. It opened my eyes to the importance of combining analysis with money management and psychology for a total approach to trading and investing – what Dr Elder calls the there Ms of trading – Mind, Method and Money.

Dr Elder became my friend and I had the privilege of teaching my own methods alongside him at several of his famous trading camps. This gave me a deeper understanding of his ideas, many of which had been refined and expanded since he wrote *Trading for a Living.* It seemed obvious to me that another book was needed to bring Dr Elder's latest ideas to the world.

When I discussed this with him, he told me that the reason it was taking so long to write another book was that he did not want to repeat the experience of so many people, who wrote a great book, but failed to reach the same standard in subsequent books. Dr Elder told me that the new book would not be published until he was sure it was even better than the first book.

I am writing here to tell you that Dr Elder has now published his second book and it is brilliant. He called it *Come Into my Trading Room*, another superb title that encapsulates the wish of every beginning trader to sit beside a master and learn what they do.

However, *come Into my Trading Room* is not only for beginners. Dr Elder begins with a primer, aimed at people just starting out, but which is also valuable revision for more experienced traders. From then on, Dr Elder takes both beginners and experienced traders on a journey through his methods.

Most people who start out trading soon lose most or all of their capital. Even people who have been trading for some time seem to suddenly flame out when hit by one catastrophic loss. Staying in the game is the central core of *Come Into my Trading Room.*

Most books on trading focus on how to pick stocks and tell you how you can make big profits. Dr Elder is about so much more. He shows how you must study trends in several timeframes to find the safest trades – short term trades in the direction of a longer term trend. What makes his book different is what else he does.

Having found a potentially good trade, you must know how many shares you can safely buy. You will learn the simple but effective way to do this. Then you must know where and how to place your order. Dr Elder shows his method for placing buy orders where the market is saying is a consensus of value. Using Dr Elder's method you are unlikely ever to buy the top of a trending move again. This insight alone justifies the price of the book.

The next, and perhaps the most important thing, a trader has to know is when to sell. Dr Elder will show you how to exit losing trades with only small losses and how to capture most of a trending move.

Finally, *Come Into my Trading Room* takes you through the other disciplines that separate the amateurs from the professionals. Your eyes will be opened as to how organised traders build on their successes and learn from their mistakes. I only wish this book had been available when I started out in trading.

I wrote two reviews of this book. The second, more detailed, one follows:

The Most Important Book Ever Written on Trading

This is what I believe is the most important book ever written about trading. This is a big call and my readers will be aware that I am not prone to making such statements lightly. (This was written twelve years ago and recently Dr Elder has published *The New Trading for a Living*, a book I would now make this claim about. There is a review of it on this page).

The book I refer to is Dr Alexander Elder's book *Come Into My Trading Room*. Many readers will also be aware that Dr Elder has been an inspiration for me in learning the craft of investing and trading. More than that, he has been a mentor and I have had the privilege of working with him at traders' camps in Fiji, Dominican Republic and Vanuatu. You might therefore feel that I am a biased reviewer. I hope that I will be able to justify all of comments I make about the book and that you will see it as being a fair assessment.

Dr Elder had been teaching traders for many years before he wrote his first book. I had been a client of his *Research Reports* back in the 1980s. These opened my eyes to many aspects of analysis and trading that I had not previously perceived. These early publications became the first drafts of Dr Elder's now famous book *Trading for a Living*, published in 1992.

Trading for a Living was an inspired title for the book and may account in part for its success, because this single idea captured what so many dreamed of doing in the great 1990s bull market. However, to dismiss it so superficially would be a mistake. I have recommended *Trading for a Living* to countless Australians who have consulted me about learning the craft of trading. Never has even one come back and complained about this recommendation. To the contrary, I have been thanked many times for making them aware of this book.

In the mid-1990s, Dr Elder was first thinking of writing a new book to capture some of his developing ideas. He told me that his great fear was that, like so many authors, he might write a second book that was not as good as the first. He told me then that he would not publish another book on trading unless it was an improvement on *Trading for a Living.* This was a very tall order and it is not a surprise to me that it took him until 2002 to achieve this feat.

And achieve it he has. The new book *Come Into My Trading Room* is nothing short of sensational for would-be traders. While *Trading for a Living* introduced new ideas and particularly the three Ms of trading – Mind, Method and Money, *Come Into My Trading Room* builds these ideas into a far more coherent and complete analysis of the trading process.

Come Into My Trading Room is far more complete and practical than the earlier book and the one word that I cannot get out of my mind is "authenticity". So many books I have read on trading lack authenticity. I feel that the authors have mastered the subject matter to a satisfactory level, but somehow it is all intellectual. I feel that they have not really been there and sweated through the trades, good and bad, win or lose. As I read *Come Into My Trading Room,* I kept muttering to myself: "I have done that, I have been there".

One clue to why Dr Elder's book is so good is given in the dedication. It is dedicated to his campers. I have been privileged to work with Dr Elder at three of his camps and I know what goes on there. He is totally open with his campers. Anything they want to know, he is willing to share from his experience. The campers are always highly successful and confident people. They ask the right questions and the tough questions. From answering them, Dr Elder has been able to weave his book through the really critical issues, the practical issues that are missing from so many other books.

Come Into My Trading Room is structured in three parts:

Part 1: Financial Trading for Babes in the Woods
Part 2: The Three Ms of Successful Trading
Part 3: Come Into My Trading Room

Part 1: Financial Trading for Babe's in the Woods

Thus, it starts at the very beginning of a reader's journey to trading mastery. *Come Into My Trading Room* stands by itself. There is no necessity to have read *Trading for a Living* first.

Chapter One: Explores what is trading, as apart from investing and as apart from gambling, with excursions into the efficient market theory and a preliminary discussion of what is meant by price.

Chapter Two: Discusses which markets to trade. It covers stocks, futures and options. This chapter is unique in being not just a simple explanation of the features of each instrument, but examines who uses them, why and who wins (professionals) and who loses (amateurs). The clear conclusion is that it is best to start with stocks, then futures. After a year of successful trading, you might be ready to tackle options. This is entirely in accord with my experience and is the opposite of what many do – they start with options because they have limited capital and want to restrict risk, but end up losing more than if they learned the game trading stocks. It would not be as exciting, but there is a chance of learning the game before losing their capital.

Chapter Three: Is one of the most significant chapters in the book. It explores the three external barriers to success – brokerage, slippage and expenses. Unless these are understood and dealt with appropriately, the trader has little chance of success. In addition there are helpful discussions on how much capital you need to start, what hardware and software you need and what data you will require. There is also a brief tour of fundamental versus technical analysis.

All in all, Part 1 deals with most of the key questions that beginners ask, or should be asking if they know what they don't know. It provides an excellent introduction to the rest of the book and is one of the best introductions to trading that I have read. Very little of it is specific to the US and can be readily translated to Australia or New Zealand.

Part 2: The Three Ms of Successful Trading

This part of the book is the engine room of Dr Elder's trading methods. Here, he shows us everything that he does. It covers everything that Dr Elder believes is essential for his approach. There is no suggestion that this is the only way to trade. Indeed, Dr Elder encourages the reader to understand what he does and why, as a basis for developing their own approach. He points out that many of his campers have become successful traders even though they have varied the tools and methods.

Chapter Four: This deals with the first M of trading – Mind, or psychology. Here, we cut straight to the part of trading that most bedevils beginners before they realise that the game of trading is played in our minds.

Dr Elder introduces us to the ways all of us will recognise that we behaved when we started out. The key message from this insightful discussion is that to succeed, we have to stop blaming brokers, gurus, unexpected events and stop wishful thinking. In short, we have to take responsibility for our decisions. This leads into a unique way to deal with self-destructive behaviour that will be unforgettable for most readers.

It leads into a description of where we need to finish the journey of psychological self-discovery, emerging as a mature trader. The path to maturity as a trader is in three stages: The gradual assumption of responsibility, through constant evaluations, continuing our training until our actions become automatic.

It is my opinion that this is one the strongest chapters in the book and capitalises on Dr Elder's background in psychology. I will personally be reading this chapter more than once a year to familiarise myself with this all-important part of the trading and investing task.

Chapter Five: This deals with the second M of trading – Method, or technical analysis.

The chapter begins with a thorough explanation of the meaning of prices – the high, the low, the open and the all-important close. A brief discussion of candlesticks and point and figure charting gives way to an introduction to trends and trendlines.

This is followed by a discussion of the Kangaroo Tail pattern, which is well-known in candlestick charting, but is not generally identified and used by bar chartists.

This leads into an outline of support and resistance and their psychological rationale. From there Dr Elder takes us into an excursion into false breakouts and their importance as representing some of the best trading opportunities. Included is some invaluable advice to protect yourself against false breakouts by reducing your trading size and placing wide stops – exactly the opposite to what most beginners do. Moreover, Dr Elders suggests that after being stopped out on a false breakout, beginners do the exact opposite to professionals – they are reluctant to get back in again - and miss a great many opportunities as a result.

There is then a discussion of some chart patterns and volume is visited briefly.

Under the general heading: Indicators – Five Bullets to a Clip, Dr Elder then introduces us to a very important concept. This is the factor of five as a way of dealing with analysis in multiple time frames. This is a really useful discussion because, of all the ideas that beginners struggle with in analysis, the issue of time frame is one of the most difficult.

Dr Elder then devotes a large section of the book to moving averages, which ones to use and how to use them, including moving average channels, a major element in his latest trading ideas. Channels are then used as a means to show you how to rate yourself as an A, B or C trader. They also help you decide which stock to trade. This is expanded into a discussion of the rewards of day trading.

The next section deals with an indicator invented by Dr Elder many years ago called the MACD Histogram. He shows how to identify its strongest signal and the stop-and-reverse method he calls The Hound of the Baskervilles.

Next, is a discussion of another of Dr Elder's own indicators, the Force Index. He shows you how to use it to identify that a reversal is coming.

The last of the five bullets is the Elder Ray indicator, also invented by Dr Elder. He shows clearly when it signals us to go long or go short. There is also a useful discussion of the Stochastic indicator and how it can be used very simply to keep us out of bad trades.

Chapter Six: Deals with a series of issues to do with trading. This is the longest single chapter in the book and breaks up the three Ms to discuss some issues that are absolutely critical to the subject of trading.

The chapter begins with a discussion of system testing and its close cousin paper trading. Some readers will be unhappy that Dr Elder takes the view that computerised system testing will only take us so far and that manual testing – the time consuming task of stepping through historical charts bar by bar cannot be avoided if we are to properly test our trading ideas.

Paper trading is similarly limited in that many people soon discover that they can make money on paper, but lose money with real trades. The only solution ultimately is to trade small positions with real money if we are to learn the big lessons – especially to deal with the first M – mind, or psychology.

There is then a substantial update on the triple screen trading method. The ideas here are applicable to anyone who is struggling with the idea of timeframe, one of the more difficult aspects of trading and investing.

Next there is an extensive discussion of day trading. There is a clear outline of how the triple screen approach is applied to day trading, which will clear up many of the common questions that I am constantly asked, such as the need for intra-day data, and what sort of orders to use getting in and out. At the top of the list however, is another opinion from Dr Elder that will be confronting to many beginners, which is that we should have a year of successful position trading with end of day data before attempting day trading. Most people will ignore this advice. The few who listen will be generally the ones who succeed at this most difficult of trading methods.

The 1990s bull market was an exciting time, which has passed into history. However, these periods of wild speculation will return, and when they do, it will again be important to understand Dr Elder's Impulse System, which is outlined at length with clear rules for entries and exits.

After that Dr Elder introduces a deceptively simple new indicator to measure market temperature.

Most beginners focus on entries, what to buy and when to buy it. It often seems to me as though they think that entries are all there is to trading. However, the professionals spend less time on entries than they do on exits, managing the trade, taking losses and taking profits. Not surprisingly, the long section headed Exiting Trades is one of the most valuable parts of the whole book.

Under Exiting Trades, Dr Elder describes channel targets and protective stops. He debunks many common ideas about stops and introduces a relentlessly logical approach to this aspect of trading. He tells you that beginners must use stops, like the professionals do, only with far more discipline, to cover their lack of experience. His advice is difficult to follow in Australia, where most brokers will not take stops on the stock market. Nevertheless, it is essential that the key ideas are understood – it is just that their application is more difficult in our market.

The discussion of stops in two dimensions is excellent and leads into the SafeZone Stop, which has not previously been discussed other than in Dr Elder's traders' camps. Dr Elder describes very clearly how to calculate these stops and provides rules for their application in both uptrends and downtrends.

There is also a clear explanation of Chuck Le Beau's Chandelier Exit strategy which is the best application of the idea of Average True Range that I have come across. It makes sense and is easy to understand and apply. Anyone who wants to trade explosive trends needs to know this strategy.

The chapter finishes with a long discussion of what to trade, stocks, options or futures. Anyone who is inclined to jump straight into options trading should read this chapter before they do so – it will save them losing a large multiple of the cost of the book.

The discussion of trend trading versus swing trading of stocks is something everyone should understand. It lies at the heart of the timeframe problem that most beginners spend years struggling with. Dr Elder's idea that we should look to use both with a part of our funds accords entirely with my experience, as does his proposition that swing trading is easier and should be mastered before attempting trend trading.

Chapter Seven: Deals with the third M of trading – money management formulas.

This is a short chapter, but one of enormous importance. Most beginners fail because they over-trade. Overtrading means taking on positions that are too large in relation to our trading capital. Trading is essentially about risk – taking it on to make profits, but limiting it to avoid going broke in the process. Money management is the means by which we keep risk to a reasonable level.

Money management means we have to make some calculations before we put on a trade and as we go along. Most people have a fear of making calculations, so they just avoid doing them. These people have no right to be trading markets. Dr Elder makes the point as strongly as he can – the markets are measured in numbers. If, like most people you are afraid of numbers, either learn the skills or stay out of the trading game.

Money management has two aspects – limiting the risk on each trade, which Dr Elder calls protecting yourself against a shark eating your account, and limiting the risk in any month, which Dr Elder calls protecting yourself against piranhas stripping the flesh off your trading account bite by bite.

Every trader needs to have these two safety nets in place, to stop both sharks and piranhas. This chapter tells us succinctly how to do this.

Part Three: Come Into My Trading Room

In this part of the book, Dr Elder moves into ground that few trading books bother to deal with - what is needed to move beyond the three Ms of successful trading into the realm of the professional trader. Many beginners are not going to like what they read here, because it is going to sound like work. They have come to trading because it seems the opposite to work – freedom from discipline and the drudgery of controls, reports and budgets. However, professional traders all have one common trait – they approach trading as a business and not an entertainment.

Chapter Eight: is headed The Organised Trader and is about discipline, the key thing that separates professionals from beginners.

Show me a business that is in trouble and I will bet you that their records are in a mess. I have been trading for many years. On any one day, I can tell you exactly where I am. I know every position I have and how much profit or loss I have on it. I also know my net overall position on open positions and my result year to date. Likewise in my business, I keep my records constantly up to date and know exactly where I am. I learned this the hard way. I understood its importance when I worked for a company that built its size up by taking over businesses that had good products and customers, but had got into trouble. Always, their records were non existent or totally disorganised. They could not make good decisions, because they had no basis for even knowing where they were at any time. In contrast, the company I worked for knew its exact cash position at the close of business every day and had excellent budgeting and costing systems. Dr Elder sets out the sort of records a trader needs to keep in order to emulate this successful business that I worked for.

Dr Elder proposes that every good trader maintains four types of record: A trading spreadsheet, and equity curve, a trading diary and a trading plan for the period ahead.

Starting with the trading spreadsheet, Dr Elder lists the 19 columns that should be in it. There are some additional things you can do if you like, which he also lists. An important element in it is a grading system based on the channel size definition he provided earlier. This enables you to grade yourself on entry, exit and trade result for each trade as you go. This is a very powerful tool for giving you feedback to improve your trading. Most beginners never think of it. All the successful professionals I have ever heard of rate their performance constantly by some means.

The equity curve is a relentless measure of how well you are going and whether you might contemplate giving up that day job and becoming a full time trader. Dr Elder also gives it an interesting twist by using it to decide when to add money to your trading account – using the same principles he used to enter a trade in a stock.

The trading diary is, Dr Elder asserts, probably the most effective single learning tool for a trader. This is a highly practical discussion of how to keep and use such a diary. Yet I dare say that less than 10% of traders would ever keep such a diary. However, among that number will be most of the successful traders.

The action plan is like the list every organised and effective manager makes before they start each day. They do not arrive at the office and then think what they will do today. They make a list of priorities and tasks before they leave the day before, at night, or first thing in the morning. They hit the ground running. Show me a manager with a list of things to do today and I know they are effective at what they do. Show me someone without a list and I will expect to find chaos in their area of operations.

Of particular resonance for me is Dr Elder’s exhortation to write down your orders before you phone the broker. I always do this and it has stood me in good stead. Show me someone who has a dispute with their broker and I will find someone without a written order they were working from. They were trying to keep so much in their head there was no room to see they were making a mistake.

Chapter Nine: Having established the discipline needed to become a professional trader, Dr Elder now takes us into the realm of actually trading for our living – the goal sought, but rarely achieved by so many beginners.

This is a fascinating chapter that spells out in practical terms what you need to do to progress from beginner to experienced amateur through to professional trader. In particular I liked the ten points that Dr Elder lists to test whether you are becoming a more disciplined trader.

Time is very important and all business people know how important it is to manage their time. It is especially important in trading because most beginners learn it as a hobby or part-time job in addition to their full-time day job. The ABC Rating System presented in this chapter is an interesting approach to time management in the stock market, although quite different to mine, which utilises software to alert me to stocks hitting key levels.

Some time is devoted to the all-important task of developing a trading plan. A trading plan is presented for both a stock trader and a futures trader to get the reader started. However, it is left for the reader to complete the task, because every trading plan must be made to fit the trader concerned.

There is a fascinating section on the expected returns that might be expected from a successful amateur trader, a serious amateur and an expert. I think Dr Elder’s very realistic conclusions will be a big surprise for many beginners. It is not the size of the individual annual profits that are important, so much as their consistency and the avoidance of losing years.

Finally, there is a good discussion on how to become a professional trader.

Chapter 10: This is a case study chapter with excerpts from Dr Elder’s trading diary. It nicely rounds out and embeds much of what he has discussed in part three of the book.