

THE EDGE: WHO HAS IT AND HOW TO GET IT – PART 2

By Tom D'Angelo

SUBJECT SUMMARY

THE BUSINESS OF TRADING

Trading is a business. The trader deals in buy and sell contracts and has an inventory of shares that are the same as the 'stock' in a retail shop. His customers do not walk in the door. They are found throughout the country and are connected by a broker and an exchange which facilitates the sale of 'shares'. Every business has its profitable and less profitable sections. Trading is no different and our profits come from particular techniques and processes. Successful traders create a professional trading environment to manage their trading activities similar to a successful business.

Good software assists in this process. These articles explain how ManusRisco money management software is used to improve the business control and management of trading.

Failure to adopt a professional, disciplined businesslike approach towards speculation and investment will significantly decrease your chances of achieving long term profitability in today's volatile trading arena. These articles are designed to teach you how to create a professional trading environment so you can manage your trading activities similar to a successful business and make confident, disciplined trading decisions.

Over the next few weeks we will cover these topics:

- Introduction - How successful businesses are organised
- The Profit Centre business model applied to trading
- A professional, disciplined money management methodology
- Positive and negative expectation games
- Drawdown
- Return on Investment
- PTR / UTR
- Breakeven Analysis
- **The edge: Who has it and how to get it.**

In previous articles, we learned how to create a Profit Centre structure designed to organise our trading results similar to 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 Centres.

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

Last week we discussed both the perceived edge and the actual edge. This week we will discuss 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 cannot become a “better” roulette player or a “better” keno or dice player since you cannot change the negative expectation which is hard wired 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 “hard wired” 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 littered 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 and 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”, “maybes” 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 only be managed by having properly organised 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 Centres 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 analysing 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 our previous article **Positive And Negative Expectation Games**. A graph of the trend of the Profit Factor as described in **Positive And Negative Expectation Games** 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 the 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 articles 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!

Tom D'Angelo is the CEO of ManusRisco Inc. The money management methodology described in these articles is used by ManusRisco money management software which can be found at www.manusrisco.com This software adds an important business dimension to the business of share trading.
