

## THE EDGE: WHO HAS IT AND HOW TO GET IT – PART 1

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.

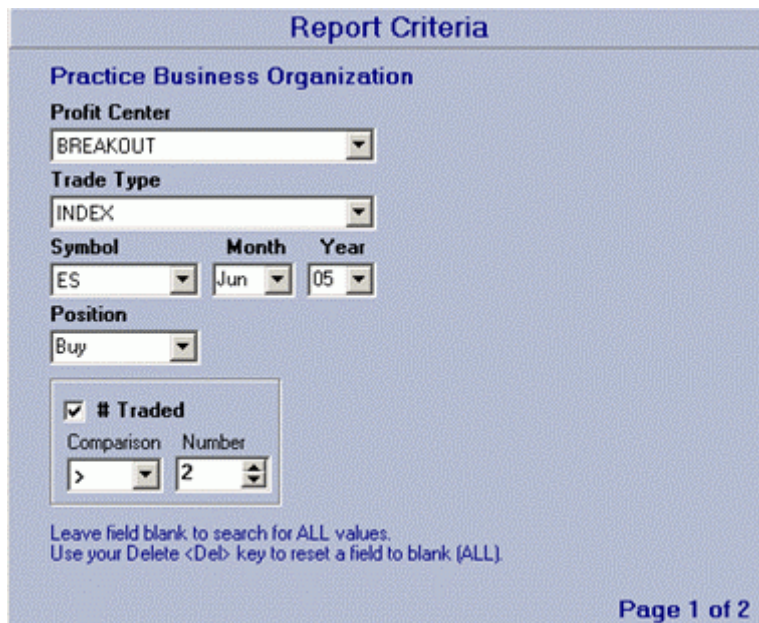
Failure to adopt a professional, disciplined businesslike approach towards speculation and investment will significantly decrease your chances of achieving long term profitability in today's volatile trading arena. These articles are designed to teach you how to create a professional trading environment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

The two images below display various Report Criteria which can be selected to create custom designed Analysis Reports. The first image displays the Report Criteria for the trade elements, and the second image displays the Report Criteria for the type or report and the time period.



The information displayed on the Analysis Reports enables the trader to confidently and professionally manage his trading business.

The money management methodology described in previous articles provides the structure which organises 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 screenshot shows a web form titled "Summary Time Period". It features a group of radio buttons for selecting a time period: "Individual Trades", "Daily", "Weekly", "Monthly" (which is selected), and "Yearly". Below this is a section for trade dates with two checked checkboxes: "Start Trade Date" and "Stop Trade Date". The start date is set to "01/01/2005" and the stop date is set to "12/31/2005". The text "Page 2 of 2" is visible in the bottom right corner of the form area.

### 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 recognises 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 could not care less about how many years you have back tested a trading system or what your intuition or instincts tell you about a trade. The market is going to do what it is going to do and could not care less about all your back testing and intuition. 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 they have 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 realises, after the fact, actually existed.

The edge is perceived because the pants may go out of style, or the economy can go into a recession, or the pants may be stolen or destroyed in a fire and he is 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 is an unprofitable trade resulting from a perceived edge which, through hindsight, did not really exist.

The perceived edge only exists in our imagination, but it is the foundation of modern civilisation 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 forth (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 favour 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 jeopardise 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 where you enjoy an actual edge, you should only make many small bets, never jeopardise 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 favour, 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. We will discuss the variable edge and how it is based on a constantly changing game next week in part 2 of this article.

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](http://www.manusrisco.com) This software adds an important business dimension to the business of share trading.

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